EUROPEAN CENTRAL BANK

CONVERGENCE REPORT
MAY 2006

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Address
Kaiserstrasse 29
60311 Frankfurt am Main
Germany

Postal address
Postfach 16 03 19
60066 Frankfurt am Main
Germany

Telephone
+49 69 1344 0

Website
http://www.ecb.int

Fax
+49 69 1344 6000

Telex
411 144 ecb d

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ABBREVIATIONS

COUNTRIES

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

OTHERS

BIS	Bank for International Settlements
b.o.p.	balance of payments
BPM5	IMF Balance of Payments Manual (5th edition)
CD	certificate of deposit
c.i.f.	cost, insurance and freight at the importer's border
CPI	Consumer Price Index
ECB	European Central Bank
EDP	excessive deficit procedure
EER	effective exchange rate
EMI	European Monetary Institute
EMU	Economic and Monetary Union
ERM	exchange rate mechanism
ESA 95	European System of Accounts 1995
ESCB	European System of Central Banks
EU	European Union
EUR	euro
f.o.b.	free on board at the exporter's border
GDP	gross domestic product
HICP	Harmonised Index of Consumer Prices
HWWA	Hamburg Institute of International Economics
ILO	International Labour Organization
IMF	International Monetary Fund
MFI	monetary financial institution
NACE Rev. 1	statistical classification of economic activities in the European Community
NCB	national central bank
OECD	Organisation for Economic Co-operation and Development
PPI	Producer Price Index
SITC Rev. 3	Standard International Trade Classification (revision 3)
ULCM	unit labour costs in manufacturing
ULCT	unit labour costs in the total economy

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

INTRODUCTION AND COUNTRY SUMMARIES

INTRODUCTION

The euro was introduced on 1 January 1999 in 11 Member States and on 1 January 2001 in Greece. Following the enlargement of the European Union (EU) with ten new Member States on 1 May 2004, 13 Member States are not yet full participants in Economic and Monetary Union (EMU). This Convergence Report has been prepared following requests for a country examination from Slovenia on 2 March 2006 and Lithuania on 16 March 2006. In producing this report, the ECB fulfils the requirements of Article 122(2) in conjunction with Article 121(1) of the Treaty establishing the European Community (the Treaty) to report to the Council of the European Union (EU Council) at least once every two years or at the request of a Member State with a derogation "on the progress made in the fulfilment by the Member States of their obligations regarding the achievement of economic and monetary union". The same mandate has been given to the European Commission, and the two reports have been submitted to the EU Council in parallel.

The European Central Bank (ECB) uses the framework applied in the previous Convergence Reports produced by the ECB and the European Monetary Institute (EMI) to examine, for the two countries concerned, whether a high degree of sustainable economic convergence has been achieved, to ensure the compatibility of national legislation with the Treaty, as well as to gauge compliance with the statutory requirements to be fulfilled for national central banks (NCBs) to become an integral part of the Eurosystem.

The examination of the economic convergence process is highly dependent on the quality and integrity of the underlying statistics. The compilation and reporting of statistics, particularly government finance statistics, must not be vulnerable to political considerations. Member States are invited to consider the quality and integrity of their statistics as a matter of priority, to ensure that a proper system of checks and balances is in place when compiling these statistics, and to apply minimum standards in the domain of statistics. These standards should reinforce the independence, integrity and accountability of the national statistical institutes and help to support confidence in the quality of fiscal statistics (see the statistical annex to Chapter 1).

This Convergence Report contains two chapters. Chapter 1 describes the key aspects and results of the examination of economic convergence. Chapter 2 examines the compatibility of Lithuania's and Slovenia's national legislation, including the statutes of their NCBs, with Articles 108 and 109 of the Treaty and with the Statute of the European System of Central Banks and of the European Central Bank.

COUNTRY SUMMARIES

LITHUANIA

Over the reference period, Lithuania achieved a 12-month average rate of HICP inflation of 2.7%, which is just above the reference value stipulated by the Treaty. However, on the basis of the most recent information, the 12-month average rate of HICP inflation is expected to rise gradually in the coming months.

Looking back over a longer period, consumer price inflation in Lithuania has been relatively low for most of the last five years. This was supported by the orientation of monetary policy towards the achievement of price stability, notably through the pursuit of a currency board arrangement which provided an anchor to inflation expectations. The low inflation was achieved despite relatively strong real GDP growth. The low level of inflation in Lithuania was, however, also to a considerable extent a reflection of Lithuania's exchange rate strategy and the associated developments in the nominal effective exchange rate. Initially, when the Lithuanian litas was pegged to the US dollar in the currency board arrangement, import prices were dampened by the strong appreciation of the US dollar. In 2002 the litas was re-pegged to the euro. Thereafter import prices were dampened by the strong appreciation of the euro against other currencies until 2004. The deflationary period from 2002 to the first half of 2004 was largely due to external factors and increased competition in some domestic markets. Since 2001 real GDP growth has been relatively high, driven mainly by domestic demand, which contributed to reducing unemployment. Growth in compensation per employee has increased considerably in recent years. While unit labour cost growth was contained by strong labour productivity growth until 2004, it rose to 3.8% in 2005. Looking at recent trends, the annual average rate of HICP inflation reached 2.7% in 2005. The annual rate of HICP inflation rose to 3.5% in January 2006, before falling back to 3.1% in March.

There are several upward risks to inflation in Lithuania in the years ahead. First, the level of gas prices paid by households in 2005 was still only around 50% of the average euro area level and the harmonisation of excise taxes on fuel, tobacco and alcohol with EU levels is not yet complete. The harmonisation of the excise tax for tobacco products will have a cumulative upward impact of 2 percentage points on inflation in the period up to 2010. Second, very buoyant output growth, fuelled by strong credit growth and low interest rates, and emerging bottlenecks in the labour market imply a risk of increases in unit labour costs and, more generally, in domestic prices. Although the expected increases in energy prices, indirect taxes and administered prices are, as such, only expected to result in isolated one-off price shocks, the combination of such price shocks in an environment of very buoyant growth and tightening labour market conditions implies risks of second-round effects, and thus of a more significant, and possibly also protracted, increase in inflation. Moreover, the catching-up process is likely to have a bearing on inflation in the coming years, although it is difficult to assess the exact size of the impact.

In 2005 Lithuania achieved a fiscal deficit of 0.5% of GDP, i.e. well below the reference value. Lithuania is not in an excessive deficit situation. A slight increase to 0.6% of GDP is forecast by the European Commission for 2006. The general government debt ratio declined to 18.7% of GDP in 2005 and is forecast to rise to 18.9% in 2006, thus remaining far below the 60% reference value. The medium-term objective is quantified in the convergence programme as a deficit of 1% of GDP. With regard to other fiscal factors, in 2004 and 2005, the deficit ratio did not exceed the ratio of public investment to GDP.

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

The Lithuanian litas has been participating in ERM II for around 22 months, i.e. for less than two years prior to the examination by the ECB. In the part of the reference period prior to its participation in ERM II, the litas was stable at its later ERM II central rate against the euro. Lithuania joined ERM II with its existing currency board arrangement in place, as a unilateral commitment, thus placing no additional obligation on the ECB. Since joining ERM II, the litas has remained at its central parity. Lithuania has not devalued its currency's central rate against the euro on its own initiative. While the currency board regime implied that Lietuvos bankas was regularly active in the foreign exchange markets, the volumes of foreign exchange transactions it conducted with Lithuanian commercial banks were small on a net basis. Real exchange rate levels – both bilaterally against the euro and in effective terms – are somewhat above historical averages. These measures should be interpreted with caution, however, as Lithuania was subject to a process of transition to a market economy in the reference period, which complicates any historical assessment of real exchange rate developments. This notwithstanding, the deficit in the combined current and capital account balance is relatively large, at 5.6% of GDP in 2005. Net inflows of foreign direct investment have covered slightly less than half of this deficit.

Long-term interest rates averaged 3.7% over the reference period and thus were well below the reference value for the interest rate criterion. They continued to move towards average bond yields in the euro area, reflecting the credibility of the currency board arrangement and market confidence in general economic and fiscal developments in Lithuania.

Overall, in order to secure a high degree of sustainable convergence, it will be important for Lithuania to implement adequately tightened fiscal policies in order to help reduce the risk of demand-induced inflationary pressures building up. Tight fiscal policies will also support fiscal consolidation. In addition, the currently strong credit growth and large current account deficit need to be monitored closely, as they may indicate the emergence of imbalances. Furthermore, it will be important to further enhance competition in product markets, proceed with the liberalisation of regulated sectors, implement appropriate wage policies reflecting labour productivity growth and developments in competitor countries, and further improve the functioning of labour markets. Such measures will help to maintain an environment conducive to price stability and support competitiveness and employment.

The Lithuanian Constitution and the Law on Lietuvos bankas were last amended and other laws were repealed (the Law on the issue of money, the Law changing the name and amounts of monetary units, the Law on money and the Law on the credibility of the litas) on 25 April 2006. Following these recent amendments, the Lithuanian Constitution and the Law on Lietuvos bankas are compatible with the Treaty and Statute requirements for Stage Three of Economic and Monetary Union.

SLOVENIA

Over the reference period, the 12-month average rate of HICP inflation in Slovenia was 2.3%, i.e. below the reference value for the criterion on price stability stipulated by the Treaty. On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to remain stable in the coming months.

Looking back over a longer period, Slovenia has been recording low inflation rates only for a relatively short period of time. Consumer price inflation in Slovenia fell significantly between 1995 and 2005. This inflation pattern reflects a number of important policy choices, most notably the introduction in 2001 of a new monetary policy framework with the primary objective of price stability, and entry into the ERM II in June 2004. During the period since ERM II entry, Banka Slovenije has used its foreign exchange swap facility to maintain the stability of the euro-tolar exchange rate while keeping domestic interest rates above those in the euro area. This policy, which translated into a high short-term interest rate differential with the euro area, facilitated the disinflationary process. For most of the period under review, inflation developments should be viewed against a background of fairly robust real GDP growth and rather stable labour market conditions. Compensation per employee has been growing at relatively high rates, although decelerating since 2000, while growth in unit labour costs has gradually declined since 2001. Looking at recent trends, the annual average rate of HICP inflation reached 2.5% in 2005. In 2006 the annual rate of HICP inflation was 2.6% in January, before falling to 2.0% in March.

Looking ahead, as regards foreseeable factors that will exert upward pressure on inflation in Slovenia, the harmonisation of excise taxes on tobacco is expected to be introduced in three steps by 2008, contributing in total up to 0.5 percentage point to HICP inflation. Furthermore, the possible VAT rate increase envisaged in the budget for 1 January 2007 may have a direct upward impact on inflation of around 0.7 percentage point in 2007. A number of upside risks to inflation can be identified. First, risks are associated with relatively strong domestic demand, particularly in the light of accelerating credit growth and further interest rate convergence. Second, risks relate to hikes in administered prices and the fading downward effects of increased competition on inflation. In addition, there are risks relating to wage growth and potential second-round effects stemming from recent energy price increases. Moreover, the catching-up process is likely to have a bearing on inflation in the coming years, although it is difficult to assess the exact size of the impact.

In 2005 Slovenia achieved a fiscal deficit of 1.8% of GDP, i.e. well below the reference value. Slovenia is not in an excessive deficit situation. A slight deficit increase to 1.9% of GDP is forecast by the European Commission for 2006. The general government debt-to-GDP ratio declined to 29.1% in 2005 and is forecast to rise to 29.9% in 2006, thus remaining far below the 60% reference value. On the basis of the fiscal balances projected in the convergence programme, further consolidation is required for Slovenia to comply with the medium-term objective, which is quantified in the convergence programme as a deficit of 1% of GDP. With regard to other fiscal factors, in 2004 and 2005, the deficit ratio did not exceed the ratio of public investment to GDP.

According to the latest projections by the EU's Economic Policy Committee and the European Commission, Slovenia is expected to experience a substantial increase in age-related expenditures amounting to 9.7 percentage points of GDP in the years to 2050. Coping with the burden is necessary at an early point in time. This would be facilitated if sufficient room for manoeuvre were created in public finances before the period in which the demographic situation is projected to worsen.

The Slovenian tolar has been participating in ERM II for around 22 months, i.e. for less than two years prior to the examination by the ECB. In the part of the reference period prior to its participation in ERM II, the tolar depreciated gradually against the euro. Slovenia joined ERM II at a rate of 239.64 tolars per euro, which was the market rate at the time of entry. Upon ERM II entry, this policy of depreciating the tolar vis-à-vis the euro was phased out. Within ERM II, Slovenia has not devalued its currency's central rate against the euro on its own initiative and has managed to maintain the tolar close to its central parity, while keeping domestic short-term interest rates above those in the euro area. Banka Slovenije contained the volatility of its currency at very low levels by using its foreign exchange swap facility. In order to reduce the amount of accumulated swaps outstanding, outright purchases of foreign exchange were occasionally made, implying overall significant net purchases of foreign exchange to absorb potential upward pressure on the currency. The real exchange rate of the tolar – both bilaterally against the euro and in effective terms – stood in April 2006 close to historical averages as calculated from January 1996 and since the launch of the euro. As regards other external developments, Slovenia has recorded a broadly balanced position in the combined current and capital account balance over the past ten years.

The average level of long-term interest rates was 3.8% over the reference period and thus stood well below the reference value for the interest rate criterion. Long-term interest rates in Slovenia moved steadily towards average bond yields in the euro area, reflecting in particular confidence in the monetary and exchange rate policy pursued by Banka Slovenije and general economic and fiscal developments in Slovenia.

Overall, in order to secure a high degree of sustainable convergence, it will be important for Slovenia to implement a sound fiscal consolidation path – which would also reduce potential demand pressures in the economy – and moderate wage policies reflecting labour productivity growth and developments in competitor countries. It is also essential to proceed with structural reforms. In particular, increased labour market flexibility, through de-indexation, and the continuation of economic liberalisation resulting in enhanced competition in product markets will help to create an environment conducive to price stability.

Following the recent amendments to the Law on Banka Slovenije, Banka Slovenije's statutes are compatible with Treaty and Statute requirements for Stage Three of Economic and Monetary Union.

CHAPTER I

EXAMINATION OF ECONOMIC CONVERGENCE

1 FRAMEWORK FOR ANALYSIS

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

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

In this respect, economic developments in the countries concerned are reviewed from a backward-looking perspective, covering, in principle, the past ten years. This helps to better determine the extent to which current achievements are the result of genuine structural adjustments, which in turn should lead to a better assessment of the sustainability of economic convergence. At the same time, due account must be taken of the fact that backdata for most new Member States may be heavily influenced by the transition these countries have been passing through. In addition, and to the extent appropriate, a forward-looking perspective is adopted. In this context, particular attention is drawn to the fact that the sustainability of favourable economic developments hinges critically on appropriate and lasting policy responses to existing and future challenges. Overall, it is emphasised that ensuring the sustainability of economic convergence depends both on the achievement of a sound starting position and on the policies pursued after the adoption of the euro.

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

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

Box 1

PRICE DEVELOPMENTS

1 Treaty provisions

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

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

Article 1 of the Protocol on the convergence criteria referred to in Article 121(1) of the Treaty stipulates that:

"the criterion on price stability referred to in the first indent of Article 121(1) of this Treaty shall mean that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1½ percentage points that of, at most, the three best performing Member States in terms of price stability. Inflation shall be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions."

2 Application of Treaty provisions

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

– First, with regard to "an average rate of inflation, observed over a period of one year before the examination", the inflation rate has been calculated using the change in the latest available 12-month average of the HICP over the previous 12-month average. Hence, with regard to the rate of inflation, the reference period considered in this report is April 2005 to March 2006.

– Second, the notion of "at most, the three best performing Member States in terms of price stability", which is used for the definition of the reference value, has been applied by taking the unweighted arithmetic average of the rate of inflation of the following three EU countries with the lowest inflation rates: Sweden (0.9%), Finland (1.0%) and Poland (1.5%). As a result, the average rate is 1.1% and, adding 1½ percentage points, the reference value is 2.6%.

Inflation has been measured on the basis of the HICP, which was developed for the purpose of assessing convergence in terms of price stability on a comparable basis (see the statistical annex to Chapter 1). For information, the average euro area inflation rate is shown in the statistical part of this report.

To allow a more detailed examination of the sustainability of price developments, the average rate of HICP inflation over the 12-month reference period from April 2005 to March 2006 is reviewed in the light of the Member States' economic performance over the last ten years in terms of price stability. In this connection, attention is drawn to the orientation of monetary policy, in particular to whether the focus of the monetary authorities has been primarily on achieving and maintaining price stability, as well as to the contribution of other areas of economic policy to this objective. Moreover, the implications of the macroeconomic environment for the achievement of price stability are taken into account. Price developments are examined in the light of demand and supply conditions, focusing on, inter alia, factors influencing unit labour costs and import prices. Finally, trends in other relevant price indices (such as the HICP excluding unprocessed food and energy, the national CPI, the CPI excluding changes in net indirect taxation, the private consumption deflator, the GDP deflator and producer prices) are considered. From a forward-looking perspective, a view is provided of prospective inflationary developments in the immediate future, including forecasts by major international organisations and market participants. Moreover, structural aspects which are relevant for maintaining an environment conducive to price stability after adoption of the euro are discussed.

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

Box 2

FISCAL DEVELOPMENTS

1 Treaty provisions

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

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

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

"shall mean that at the time of the examination the Member State is not the subject of a Council decision under Article 104(6) of this Treaty that an excessive deficit exists".

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

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

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

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

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

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

2 Application of Treaty provisions

For the purpose of examining convergence, the ECB expresses its view on fiscal developments. With regard to sustainability, the ECB examines key indicators of fiscal developments from 1996 to 2005, considers the outlook and challenges for general government finances and focuses on the links between deficit and debt developments.

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

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

The examination of fiscal developments is based on data compiled on a national accounts basis, in compliance with the European System of Accounts 1995 (see the statistical annex to Chapter 1). Most of the figures presented in this report were provided by the Commission in April 2006 and include government financial positions from 1996 to 2005, as well as Commission forecasts for 2006.

With regard to the sustainability of public finances, the outcome in the reference year, 2005, is reviewed in the light of the Member States' performance over the last ten years. As a starting-point, the development of the government debt ratio in this period is considered, as well as the factors underlying it, i.e. the difference between nominal GDP growth and interest rates, the primary balance, and the deficit-debt adjustment. Such a perspective can offer further information on the extent to which the macroeconomic environment, in particular the combination of growth and interest rates, has affected the dynamics of debt. It can also provide more information on the contribution of fiscal consolidation efforts, as reflected in the primary balance, and on the role played by special factors as included in the deficit-debt adjustment. In addition, the structure of government debt is considered, focusing in particular on the shares of debt with a short-term maturity and foreign currency debt, as well as their development. By comparing these shares with the current level of the debt ratio, the sensitivity of fiscal balances to changes in exchange rates and interest rates is highlighted.

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

Turning to a forward-looking perspective, national budget plans and recent forecasts by the European Commission for 2006 are recalled and account is taken of the medium-term fiscal strategy, as reflected in the convergence programme. This includes an assessment of the projected attainment of its medium-term objective, as foreseen in the Stability and Growth Pact. Furthermore, long-term challenges to the sustainability of budgetary positions are emphasised, particularly those related to the issue of unfunded government pension systems in connection with demographic change and to guarantees given by the government.

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

Box 3

EXCHANGE RATE DEVELOPMENTS

1 Treaty provisions

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

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

Article 3 of the Protocol on the convergence criteria referred to in Article 121(1) of the Treaty stipulates that:

"the criterion on participation in the exchange-rate mechanism of the European Monetary System referred to in the third indent of Article 121(1) of this Treaty shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against any other Member State's currency on its own initiative for the same period."

2 Application of Treaty provisions

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

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

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

All bilateral exchange rates for the reference period from May 2004 to April 2006 are official ECB reference rates (see the statistical annex to Chapter 1).

Both Lithuania and Slovenia have participated in ERM II with effect from 28 June 2004, i.e. for less than two years prior to the examination by the ECB. The performance of their currencies is shown against the euro during the period from 29 April 2004 to 28 April 2006.

In addition to the performance of the nominal exchange rate against the euro, evidence relevant to the sustainability of the current exchange rate is briefly reviewed. This is derived from the development of the real bilateral and effective exchange rates, the current, capital and financial accounts of the balance of payments and the country's net international investment position over longer periods. With respect to the integration of markets, the euro area's share in the country's total external trade is also examined.

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

Box 4

LONG-TERM INTEREST RATE DEVELOPMENTS

1 Treaty provisions

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

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

Article 4 of the Protocol on the convergence criteria referred to in Article 121(1) of the Treaty stipulates that:

"the criterion on the convergence of interest rates referred to in the fourth indent of Article 121(1) of this Treaty shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions."

2 Application of Treaty provisions

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

– First, with regard to "an average nominal long-term interest rate" observed over "a period of one year before the examination", the long-term interest rate has been calculated as an arithmetic average over the latest 12 months for which HICP data were available. The reference period considered in this report is April 2005 to March 2006.

– Second, the notion of "at most, the three best performing Member States in terms of price stability" which is used for the definition of the reference value has been applied by using the unweighted arithmetic average of the long-term interest rates of the same three EU countries entering the calculation of the reference value for the criterion on price stability (see Box 1). Over the reference period considered in this report, the long-term interest rates of these three countries were 3.3% (Sweden), 3.3% (Finland) and 5.0% (Poland); as a result, the average rate is 3.9% and, adding 2 percentage points, the reference value is 5.9%.

Interest rates have been measured on the basis of available harmonised long-term interest rates, which were developed for the purpose of examining convergence (see the statistical annex to Chapter 1).

As mentioned above, the Treaty makes explicit reference to the "durability of convergence" being reflected in the level of long-term interest rates. Therefore, developments over the reference period from April 2005 to March 2006 are reviewed against the background of the path of long-term interest rates over the last ten years (or the period for which data are available) and the main factors underlying differentials vis-à-vis the average long-term interest rate prevailing in the euro area.

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

The statistical data used in the application of the convergence criteria have been provided by the European Commission (see also the statistical annex to Chapter 1 and the tables and charts), in cooperation with the ECB in the case of the long-term interest rates. Convergence data on price and long-term interest rate developments are presented up to March 2006, the latest month for which data on HICPs were available. For exchange rates, the period considered in this report ends on 28 April 2006. Data for fiscal positions cover the period up to 2005. Account is also taken of forecasts from various sources, together with the most recent convergence programmes of the two Member States and other information considered to be relevant to a forward-looking consideration of the sustainability of convergence.

The cut-off date for the statistics included in this Convergence Report was 28 April 2006.

2 COUNTRY EXAMINATIONS

2.1 LITHUANIA

2.1.1 PRICE DEVELOPMENTS

Over the reference period from April 2005 to March 2006, the 12-month average rate of HICP inflation in Lithuania was 2.7%, i.e. just above the reference value of 2.6 % for the criterion on price stability (see Table 1). However, on the basis of the most recent information, the 12-month average rate of HICP inflation is expected to rise gradually in the coming months.

Looking back over a longer period, HICP inflation fell sharply in the second half of the 1990s, from roughly 25% in 1996 to around 1.5% in 1999. On average, inflation remained at this low level until mid-2002, when it turned negative due to a combination of specific factors. These included lower prices in the telecommunications sector owing to substantial reforms and a considerable decline in unit labour costs and in import prices. Inflation rates turned positive again in mid-2004, rising further to 2.7% in 2005 (see Chart 1). The process of disinflation after 1996 reflects a number of important policy choices, most notably the orientation of monetary policy towards the achievement of price stability, which is the primary objective enshrined in the central bank law. In 1994 Lithuania adopted a currency board arrangement, with the litas being first pegged to the US dollar and then re-pegged to the euro in 2002, which provided an anchor to inflation expectations. The low level of inflation in Lithuania during the early 2000s was, to a considerable extent, a reflection of Lithuania's exchange rate strategy and the associated development of the nominal effective exchange rate. The strong appreciation of the US dollar against several other currencies in 1999 and 2000 had a marked dampening impact on import prices in Lithuania. In 2002 the litas was re-pegged to the euro. Thereafter import prices were dampened by the strong appreciation of the euro against other currencies until 2004. The disinflation process has also been supported by fiscal policy, reforms designed to enhance product market competition, progressive financial market liberalisation and labour market reforms. The deflationary period from 2002 to the first half of 2004 was largely due to external factors and increased competition in some domestic markets.

The reduction in inflation during the late 1990s was achieved despite relatively strong real GDP growth. Following the impact of the Russian crisis on Lithuania's export sector, real GDP growth turned negative in 1999, which had a downward impact on inflation (see Table 2). The Lithuanian economy recovered quickly after the Russian crisis, and since 2001 it has returned to relatively high levels of growth, driven mainly by domestic demand. The strong economic growth, in conjunction with emigration flows, helped to reduce unemployment considerably, from 16.5% in 2001 to 8.2% in 2005. Against this background, growth in compensation per employee increased from 3.8% in 2001 to 8.7% in 2005. Reflecting wage and labour productivity developments, unit labour cost growth was negative from 2000 to 2001. It has turned positive again in the past few years and rose to 3.8% in 2005 from 1.0% in 2004. Import prices were rather volatile during the period under review, mostly reflecting exchange rate and oil price developments, but their rate of change remained negative throughout the period 2001 to 2004. The import deflator rose to 8.2% in 2005, mainly as a result of energy price increases, which added to inflationary pressures. In contrast to overall HICP inflation, HICP inflation excluding unprocessed food and energy has shown a lower and more stable development in recent years (see Table 2).

Looking at recent trends, the annual average rate of HICP inflation reached 2.7% in 2005. The annual rate of HICP inflation rose to 3.5% in January 2006, before falling back to 3.1% in March (see Table 3a). In 2005 the main contributions to inflation came from energy, food and services. Compared with the year before, the services sector's contribution to overall inflation increased most significantly, by almost 1 percentage point in 2005. Lietuvos bankas estimates that, on balance, changes in indirect taxes and administered prices added around 0.8 percentage point to inflation in 2005. The rise in inflation in early 2006 reflected, to a large extent, rising services and non-energy industrial goods prices. The current inflation picture needs to be viewed against a background of very dynamic economic conditions. In the fourth quarter of 2005, real GDP growth accelerated to a year-on-year rate of 8.7%, resulting in an average growth rate of 7.5% for 2005. Output growth is being driven by domestic demand, partly reflecting low interest rates and buoyant credit growth, and the negative contribution of net exports to growth has started to neutralise gradually, reflecting a significant rise in exports. The buoyancy of aggregate demand and migration outflows have also affected the labour market, with many domestic producers reporting labour shortages, in particular of skilled labour, leading to declining unemployment.

Looking ahead, the gradual pass-through of the hike in the price of imported gas at the beginning of 2006 will, in total, have a direct upward impact of around 0.4 percentage point on inflation in the course of the year. There are several upside risks to inflation. First, the level of gas prices paid by households in Lithuania in 2005 was still only around 50% of the average euro area level.[1] Consequently, further energy price adjustments can be expected. Second, the harmonisation of excise taxes on fuel, tobacco and alcohol with EU levels is not yet complete. Particularly the harmonisation of the excise tax on tobacco products, which has to be completed by 1 January 2010, will have a significant cumulative upward impact on inflation of around 2 percentage points over the next few years, starting in 2007. In addition, at the current juncture, very buoyant output growth, fuelled by very strong credit growth and low interest rates, and emerging bottlenecks in the labour market imply a risk of further increases in unit labour costs and, more generally, in domestic prices. Although the expected increases in energy prices, indirect taxes and administered prices are, as such, only expected to result in one-off price shocks, the combination of such price shocks in an environment of very buoyant growth and tightening labour market conditions implies risks of second-round effects and thus a more significant and protracted increase in inflation. Looking further ahead, the catching-up process is also likely to have a bearing on inflation in the coming years, given the still relatively low GDP per capita and price level in Lithuania compared with the euro area (see Table 2). However, it is difficult to assess the exact size of the inflation effect resulting from this catching-up process.

An environment conducive to sustainable price stability in Lithuania requires, inter alia, the implementation of adequately tightened fiscal policies, which would help to offset demand-induced inflationary pressures. It will be equally important to strengthen national policies aimed at further enhancing competition in product markets and to proceed with the liberalisation of regulated sectors. Improvements in the functioning of labour markets will also be needed, given the fact that the continuing high rate of unemployment in Lithuania is coinciding with regional and sector-specific bottlenecks in the labour market. Wage increases should reflect labour productivity growth and should take developments in competitor countries into account.

2.1.2 FISCAL DEVELOPMENTS

In the reference year 2005, the general government budget balance showed a deficit of 0.5% of GDP, i.e. well below the 3% reference value ratio. The general government debt-to-GDP ratio was 18.7%, i.e. far below the 60% reference value (see Table 4). Compared with the previous year, the fiscal deficit ratio decreased by 1.0 percentage point and the general government debt ratio declined by 0.8 percentage point. In 2006 the deficit ratio is

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

forecast by the European Commission to increase slightly to 0.6% and the government debt ratio is projected at 18.9%. In 2004 and 2005 the deficit ratio did not exceed the ratio of public investment expenditure to GDP. Lithuania is not in an excessive deficit situation.

Looking back over the years 1996 to 2005, the general government debt ratio increased cumulatively by 4.2 percentage points (see Chart 2a and Table 5). It initially rose gradually, from 14.5% in 1996 to 16.8% in 1998, but then increased steeply in 1999 to 23.0%. In 2000 the ratio climbed to 23.6%, before declining gradually to reach 18.7% in 2005. As shown in greater detail in Chart 2b, until 2000 primary deficits contributed to government debt growth, in particular in 1997. Deficit-debt adjustments reflecting privatisation receipts and valuation gains on foreign currency-denominated government debt were the major factors behind the reduction in the debt ratio from 2000 until 2004 (see Table 6). The patterns observed during the mid-1990s and early 2000s may be seen as indicative of the close link between primary deficits and adverse debt dynamics, irrespective of the starting level of debt – which in the case of Lithuania was comparatively low. In this context, it may be noted that the share of government debt with a short-term maturity decreased continuously from 1997 until 2003. In 2004 and 2005 the share increased by a cumulative 5.7 percentage points. The proportion of debt with a short-term maturity is noticeable, but, taking into account the level of the debt ratio, fiscal balances are relatively insensitive to changes in interest rates. Though the proportion of foreign currency-denominated government debt is high, more than 95% of this is denominated in euro, the anchor currency of Lithuania's currency board arrangement. Fiscal balances are therefore insensitive to changes in exchange rates other than the euro-litas exchange rate.

Since 1996 a pattern of initially volatile and subsequently improving outturns has been observed in the deficit-to-GDP ratio (see Chart 3a and Table 7). Starting from a level of 3.6% in 1996, the deficit ratio peaked at 11.4% in 1997. This rise is mainly explained by a change in the recording of restitutions of confiscated property and compensation for losses incurred during the changeover from the rouble to the litas. The deficit ratio then declined to 3.0% in 1998 and 2.9% in 1999, before rising again to 3.6% in 2000. In the years thereafter, it gradually improved to 1.2% in 2003, deteriorated to 1.5% in 2004 and improved to 0.5% in 2005. As is shown in greater detail in Chart 3b, European Commission estimates indicate that cyclical factors have had only a relatively small impact on the change in the fiscal balance in recent years. Non-cyclical changes in the government budget balance have, on average, had a broadly neutral impact on the balance. Available evidence suggests that temporary measures had no significant impact on the deficit in 2004 and 2005.

Moving on to examine trends in other fiscal indicators, it can be seen from Chart 4 and Table 7 that the general government total expenditure ratio rose to over 50% in 1997, but stabilised at about 40% in the years from 1998 to 2000. After 2000 the ratio declined due to expenditure reductions in all major categories relative to GDP, reaching 33.2% in 2003. It was broadly stable at 33.4% in 2004 and 33.7% in 2005. On balance, the expenditure ratio was 4.2 percentage points lower in 2005 than in 1996. Government revenue in relation to GDP increased strongly in 1997 and decreased thereafter, rising again in 2005. Overall it declined by 1.2 percentage points between 1996 and 2005.

The Lithuanian medium-term fiscal policy strategy as stated in the convergence programme for 2006-08, dated December 2005, differs from the Commission forecasts shown in Table 4 and foresees a budget deficit of 1.4% of GDP in 2006, compared with an estimated 1.5% of GDP for 2005, and general government debt of 19.9% of GDP. The total revenue and expenditure ratios are projected to stay roughly unchanged compared with the 2005 data presented in the programme. There is currently no evidence of measures with a significant temporary effect in the 2006 budget. In 2007 the deficit ratio is forecast to decline to 1.3% and the government debt ratio to remain at roughly its 2006 level. The medium-term objective specified in the Stability and Growth Pact is quantified in the convergence programme as a deficit of 1% of GDP.

With regard to the potential future course of the government debt ratio, current trends suggest that government debt will increase, but will be maintained at below 60% of GDP for the foreseeable future.

As highlighted in Table 8, a marked ageing of the population is expected. According to the latest projections by the EU's Economic Policy Committee and the European Commission,[2] Lithuania is expected to experience a moderate net increase in age-related public expenditures amounting to 1.4 percentage points of GDP in the years to 2050. This reflects in part the implementation of pension reforms in the past. However, vigilance is needed, as demographic, economic and financial developments may turn out to be less favourable than assumed in the projections.

Turning to further fiscal challenges, adequately tightened fiscal policies to contain aggregate demand are warranted in the light of Lithuania's large current account deficit and accelerating credit growth, and with a view to containing inflationary pressures. On the structural side, the recourse to budgetary amendments to finance additional expenditure raises concerns about the strictness of budget implementation.

2.1.3 EXCHANGE RATE DEVELOPMENTS

The Lithuanian litas has been participating in ERM II with effect from 28 June 2004, i.e. for around 22 months of the two-year reference period between May 2004 and April 2006 (see Table 9a). Following a careful assessment of the appropriateness and sustainability of Lithuania's currency board at the time of ERM II entry, Lithuania joined the exchange rate mechanism with its currency board arrangement in place, as a unilateral commitment, thus placing no additional obligation on the ECB. A standard fluctuation band of ±15% was adopted around the central rate of 3.45280 litas per euro.

In the part of the reference period prior to its participation in ERM II, the litas was stable at its later ERM II central rate against the euro. Since joining ERM II, the litas has continued to be stable and has not exhibited any deviation from its central rate against the euro, reflecting the unchanged Lithuanian exchange rate policy under the currency board regime (see Table 9a and Chart 5). Within ERM II, Lithuania has not devalued its currency's central rate against the euro on its own initiative. While the currency board regime implied by definition that Lietuvos bankas was regularly active in the foreign exchange markets, the volumes of foreign exchange transactions it conducted with Lithuanian commercial banks were small on a net basis. Short-term interest rate differentials with the three-month EURIBOR declined during the reference period, from 0.6 percentage point in the three months ending in July 2004 to negligible levels in the three months ending in April 2006 (see Table 9b).

In a longer-term context, the real exchange rate of the litas in April 2006 – particularly in effective terms – was somewhat above the historical average as calculated from January 1996, yet close to its average since the launch of the euro (see Table 10). These measures should nevertheless be interpreted with caution, as Lithuania was subject to a process of transition to a market economy in the reference period, which complicates any historical assessment of real exchange rate developments. As regards other external developments, Lithuania has consistently run large deficits on the combined current and capital account of the balance of payments, which rose to 11.7% of

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

GDP in 1998, before declining to 4.7% in 2002 and edging up again to reach 5.6% in 2005 (see Table 11). On the one hand, deficits of this magnitude could signal problems in terms of price competitiveness. On the other hand, they may reflect the catching-up process of an economy such as Lithuania. Over the past ten years, net inflows of foreign direct investment (FDI) have covered slightly less than half of these deficits. In 2005 the portfolio investment balance showed a net outflow following an extended period of net inflows. As additional financing needs have been met by inflows into "other investments" in recent years, primarily in the form of bank loans, Lithuania's gross external indebtedness has increased. Its net international investment position has been negative, rising between 1996 and 1999 and stabilising at around 35% of GDP in subsequent years.

Lithuania is a small, open economy with, according to the most recent data available, a ratio of foreign trade in goods and services to GDP of 58.3% for exports and 65.3% for imports. In 2005 exports of goods to the euro area and to the EU as a share of total exports amounted to 28.5% and 65.3% respectively. The corresponding figures for imports as a percentage of total imports in 2005 were 32.3% and 59.0%.

2.1.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from April 2005 to March 2006, long-term interest rates in Lithuania were 3.7% on average, and thus stood well below the reference value of 5.9% for the interest rate criterion (see Table 12).

Long-term interest rates have been on a downward trend since 2001 (see Chart 6a).[3] The decline was particularly pronounced until early 2002, after which it slowed somewhat. Similarly, the long-term interest rate differential between Lithuania and the euro area average declined relatively rapidly and remained low after the conversion of the currency board to the euro in 2002 (see Chart 6b). In March 2006 the two rates stood at the same level. The main factors underlying the narrowing of the long-term interest rate differential were the positive development of the Lithuanian economy and its progress in the transition to a market economy. This process of the narrowing in the long-term interest rate differential also benefited from market expectations of an early participation of Lithuania in ERM II, and, since June 2004, its smooth actual participation in the mechanism, with the existing currency board arrangement remaining in place. The process of interest rate convergence was additionally supported by the expectation of the adoption of the euro. All in all, the fact that the spread between Lithuanian and euro area long-term interest rates has declined to a low level is indicative of the credibility of the currency board arrangement and market confidence in general economic and fiscal developments in Lithuania.

3 2001 is the first year for which data are available on the reference long-term interest rate for Lithuania.

2.1.5 LIST OF TABLES AND CHARTS

1 PRICE DEVELOPMENTS

Table 1 HICP inflation

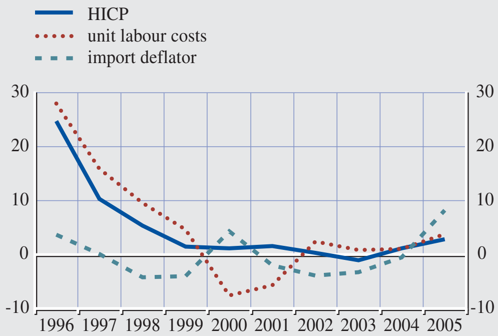
(annual percentage changes)

	2005 Dec.	2006 Jan.	Feb.	Mar.	Apr. 2005 to Mar. 2006
HICP inflation	3.0	3.5	3.4	3.1	2.7
Reference value [1]	-	-	-	-	2.6
Euro area [2]	2.2	2.4	2.3	2.2	2.3

Source: European Commission (Eurostat).
1) Calculation for the April 2005 to March 2006 period is based on the unweighted arithmetic average of the annual percentage changes of the HICP for Poland, Finland and Sweden, plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(annual average percentage changes)



Sources: European Commission (Eurostat) and national data.

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Measures of inflation										
HICP	24.7	10.3	5.4	1.5	1.1	1.6	0.3	-1.1	1.2	2.7
HICP excluding unprocessed food and energy	-	10.3	4.5	1.7	-1.1	0.1	0.6	0.7	0.7	1.3
CPI	24.6	8.9	5.1	0.8	1.0	1.3	0.3	-1.2	1.2	2.7
CPI excluding changes in indirect taxes	-	-	-	-	-	-	-	-	-	-
Private consumption deflator	18.2	9.5	5.4	-0.4	-1.5	2.4	-0.1	-2.7	1.1	3.3
GDP deflator	20.6	14.0	5.0	-0.6	1.8	-0.5	0.2	-1.1	2.8	5.9
Producer prices [1]	-	-	-0.5	1.0	10.2	-0.6	-0.7	-0.7	2.4	5.9
Related indicators										
Real GDP growth	4.7	7.0	7.3	-1.7	3.9	6.4	6.8	10.5	7.0	7.5
GDP per capita in PPS [2] (euro area = 100)	31.8	33.5	35.3	34.1	35.1	36.9	38.9	42.2	44.8	.
Comparative price levels (euro area = 100)	33.7	41.4	43.9	45.4	51.7	52.8	54.0	53.4	53.2	.
Output gap [3]	-6.3	-3.0	0.0	-5.2	-4.9	-2.5	-1.6	2.1	2.1	2.2
Unemployment rate (%) [4]	-	14.1	13.2	13.7	16.4	16.5	13.5	12.4	11.4	8.2
Unit labour costs, whole economy	28.0	15.9	6.8	1.9	-6.5	-5.7	2.4	0.8	1.0	3.8
Compensation per employee, whole economy	32.7	23.3	15.5	2.5	1.3	3.8	5.1	8.9	8.2	8.7
Labour productivity, whole economy	3.7	6.4	8.1	0.5	8.3	10.1	2.7	8.0	7.1	4.7
Imports of goods and services deflator	3.7	0.1	-4.2	-4.0	4.3	-2.0	-3.9	-3.3	-0.5	8.2
Nominal effective exchange rate [5]	3.2	11.3	3.3	2.9	10.8	3.2	4.6	4.9	1.5	-0.8
Money supply (M3) [6]	-3.6	35.7	13.6	7.2	16.1	21.9	17.0	20.1	27.5	30.6
Lending from banks [6]	-10.1	9.5	21.4	9.7	-3.2	24.8	29.4	56.2	40.6	63.5
Stock prices (OMX Vilnius Index) [6]	-	-	-	-	-	-18.5	12.2	105.8	68.2	52.9
Residential property prices	-	-	-	-	-9.6	23.6	9.8	17.8	9.6	50.2

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

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2005		2006		
	Nov.	Dec.	Jan.	Feb.	Mar.
HICP					
Annual percentage change	2.9	3.0	3.5	3.4	3.1
Change in the average of the latest 3 months from the previous 3 months, annualised rate, seasonally adjusted	5.5	4.5	3.4	3.2	3.1
Change in the average of the latest 6 months from the previous 6 months, annualised rate, seasonally adjusted	3.1	3.5	3.9	4.1	3.9

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2006	2007
HICP, European Commission (spring 2006)	3.5	3.3
CPI, OECD (December 2005) [1]	-	-
CPI, IMF (April 2006)	3.2	2.7
CPI, Consensus Economics (March 2006)	2.6	2.3

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

2 FISCAL DEVELOPMENTS

Table 4 General government fiscal position

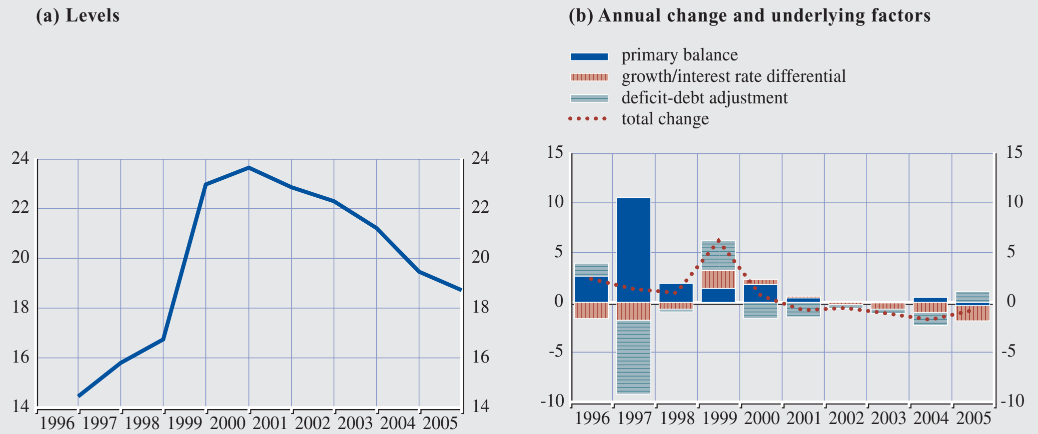
(as a percentage of GDP)

	2004	2005	2006 [1]
General government surplus (+)/deficit (-)	-1.5	-0.5	-0.6
Reference value	-3.0	-3.0	-3.0
Surplus/deficit, net of government investment expenditure [2]	2.0	3.0	2.9
General government gross debt	19.5	18.7	18.9
Reference value	60.0	60.0	60.0

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

Chart 2 General government gross debt

(as a percentage of GDP)



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

Table 5 General government gross debt – structural features

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Total debt (as a percentage of GDP)	14.5	15.8	16.8	23.0	23.6	22.9	22.3	21.2	19.5	18.7
Composition by currency (% of total)										
In domestic currency	30.5	37.3	36.4	23.4	25.9	26.1	33.4	35.2	29.4	29.5
In foreign currencies	69.5	62.7	63.6	76.6	74.1	73.9	66.6	64.8	70.6	70.5
Euro [1]	9.0	9.0	19.6	33.5	40.6	44.5	53.8	54.6	62.5	68.6
Other foreign currencies	60.4	53.8	44.0	43.1	33.5	29.4	12.8	10.2	8.1	1.9
Domestic ownership (% of total)	23.2	39.6	38.9	27.4	32.1	35.3	40.0	39.8	39.5	40.0
Average residual maturity (in years)	5.2	6.0	5.5	5.2	5.0	4.8	5.2	4.1	4.3	4.8
Composition by maturity [2] (% of total)										
Short-term (up to and including one year)	24.0	29.1	24.2	15.4	11.3	6.8	5.3	5.0	5.6	10.7
Medium and long-term (over one year)	76.0	70.9	75.8	84.6	88.7	93.2	94.7	95.0	94.4	89.3

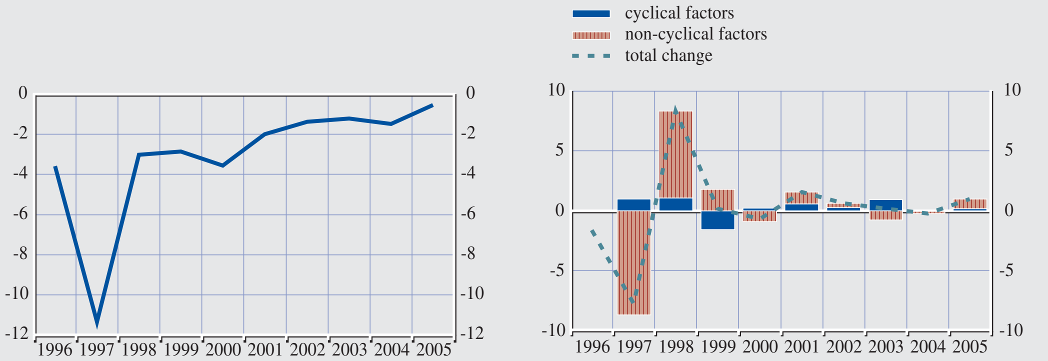
Sources: ESCB and European Commission.
Note: Year-end data. Differences between totals and the sum of their components are due to rounding.
1) Comprises debt denominated in euro and, before 1999, in ECU or in one of the currencies of the Member States which have adopted the euro.
2) Original maturity.

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

(as a percentage of GDP)

(a) Levels

(b) Annual change and underlying factors



Sources: European Commission and ECB calculations.
Note: In Chart 3(b) negative values indicate a contribution to an increase in deficits, while positive values indicate a contribution to their reduction.

Table 6 General government deficit-debt adjustment

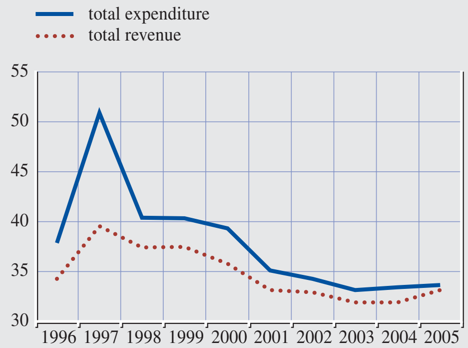
(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Change in general government debt	4.9	4.0	2.7	5.8	1.9	0.5	0.9	0.8	0.2	1.6
General government surplus (+)/deficit (-)	-3.6	-11.4	-3.0	-2.9	-3.6	-2.0	-1.4	-1.2	-1.5	-0.5
Deficit-debt adjustment	1.3	-7.4	-0.3	3.0	-1.6	-1.4	-0.4	-0.4	-1.3	1.1
Net acquisitions (+)/net sales (-) of financial assets	1.4	2.3	-1.8	-0.1	0.0	-0.8	0.8	-0.8	-0.7	0.4
Currency and deposits	0.1	1.6	1.4	-2.2	0.5	0.2	1.2	0.9	-0.1	0.3
Loans and securities other than shares	1.0	1.0	1.7	2.8	1.0	0.1	0.0	-0.1	-0.3	-0.2
Shares and other equity	0.0	-0.1	-5.0	-1.0	-1.7	-1.0	-0.6	-1.6	-0.6	-0.3
Privatisations	0.0	-0.1	-5.0	-1.0	-1.7	-1.0	-0.6	-1.6	-0.6	-0.3
Equity injections	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other financial assets	0.3	-0.2	0.0	0.3	0.3	0.0	0.2	0.1	0.4	0.6
Valuation changes of general government debt	0.0	-0.3	0.2	-0.4	-0.6	-0.7	-1.0	-0.5	0.0	0.0
Foreign exchange holding gains (-)/losses (+)	0.5	0.0	0.2	-0.4	-0.6	-0.7	-1.0	-0.4	-0.1	0.1
Other valuation effects [1]	-0.6	-0.3	0.0	0.0	0.0	-0.1	0.0	-0.1	0.0	-0.1
Other changes in general government debt [2]	0.0	-9.5	1.4	3.4	-0.9	0.0	-0.2	0.9	-0.6	0.7

Sources: ESCB and European Commission.
Note: Differences between totals and the sum of their components are due to rounding.
1) Includes the difference between the nominal and market valuation of general government debt in issue.
2) Transactions in other accounts payable (government liabilities), sector reclassifications and statistical discrepancies. This item may also cover certain cases of debt assumption.

Chart 4 General government expenditure and revenue

(as a percentage of GDP)



Source: ESCB.

Table 7 General government budgetary position

(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Total revenue	34.3	39.6	37.4	37.5	35.8	33.1	32.9	31.9	31.9	33.1
Current revenue	34.3	39.5	37.4	37.4	35.7	33.1	32.4	31.5	31.5	32.4
Direct taxes	8.3	9.0	9.1	9.2	8.4	7.8	7.5	8.0	8.7	9.1
Indirect taxes	11.9	14.6	14.0	13.8	12.6	12.2	12.4	11.8	11.1	11.2
Social security contributions	8.0	8.6	9.1	9.3	9.4	9.0	8.7	8.6	8.7	8.6
Other current revenue	6.2	7.3	5.1	5.0	5.4	4.1	3.8	3.2	2.9	3.5
Capital revenue	0.0	0.0	0.0	0.1	0.1	0.1	0.5	0.4	0.5	0.8
Total expenditure	37.9	50.9	40.4	40.3	39.3	35.1	34.3	33.2	33.4	33.7
Current expenditure	32.7	35.4	36.7	36.8	34.7	32.2	30.8	29.7	29.6	30.0
Compensation of employees	10.9	11.4	12.8	13.5	12.7	11.7	11.4	10.8	10.8	10.4
Social benefits other than in kind	8.9	9.3	10.0	11.4	10.7	10.6	9.3	9.1	9.1	9.0
Interest payable	0.9	0.8	1.1	1.4	1.7	1.5	1.3	1.2	0.9	0.8
of which: impact of swaps and FRAs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other current expenditure	12.0	13.9	12.8	10.4	9.6	8.5	8.8	8.5	8.8	9.7
Capital expenditure	5.1	15.5	3.8	3.6	4.6	2.9	3.5	3.4	3.8	3.7
Surplus (+)/deficit (-)	-3.6	-11.4	-3.0	-2.9	-3.6	-2.0	-1.4	-1.2	-1.5	-0.5
Primary balance	-2.7	-10.5	-1.9	-1.5	-1.8	-0.5	-0.1	0.0	-0.5	0.3
Surplus/deficit, net of government investment expenditure	-1.1	-9.0	-0.5	-0.3	-1.2	0.2	1.5	1.8	2.0	3.0

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

Table 8 Projections of ageing-induced fiscal burden

(percentages)

	2004	2010	2020	2030	2040	2050
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	22.3	23.4	26.0	33.4	39.3	44.9
Change in age-related government expenditure (as a percentage of GDP) compared with 2004	-	-0.7	-0.9	0.3	0.8	1.4

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

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

Membership of the exchange rate mechanism (ERM II)		Yes
Membership since		28 June 2004
Devaluation of bilateral central rate on country's own initiative		No
Maximum upward and downward deviations [1]	Maximum upward deviation	Maximum downward deviation
28 June 2004 to 28 April 2006		
Euro	0.0	0.0

Source: ECB.
1) Maximum percentage deviations from ERM II central rate. Ten-day moving average of daily data at business frequency.

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

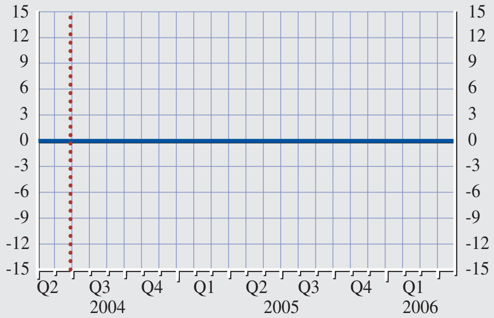
(average of three-month period ending in specified month)

	2004		2005				2006	
	July	Oct.	Jan.	Apr.	July	Oct.	Jan.	Apr.
Exchange rate volatility [1]	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Short-term interest rate differential [2]	0.6	0.6	0.5	0.4	0.2	0.2	0.1	0.0

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

Chart 5 Lithuanian litas: deviation from ERM II central rate

(daily data; percentage deviation; 1 May 2004 to 28 April 2006)



Source: ECB.
Note: The vertical line indicates the date of entry into ERM II (28 June 2004). A positive/negative deviation from the central parity implies that the currency is at the strong/weak side of the band. For the Lithuanian litas, the fluctuation band is ±15%. Deviations prior to 28 June 2004 refer to the Lithuanian litas's central rate as established upon ERM II entry.

Table 10 Lithuanian litas: real exchange rate developments

(monthly data; percentage deviations; April 2006 compared with different benchmark periods)

	Average Jan. 1996 to Apr. 2006	Average Jan. 1999 to Apr. 2006
Real bilateral exchange rate against the euro [1]	9.5	1.8
Memo items:		
Nominal effective exchange rate [2]	13.8	6.5
Real effective exchange rate [1, 2]	11.3	4.4

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

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Current account plus capital account balance	-8.9	-9.9	-11.7	-11.0	-5.9	-4.7	-4.7	-6.4	-6.4	-5.6
Combined direct and portfolio investment balance [1]	4.2	5.3	8.1	9.1	5.6	5.8	5.1	2.3	3.2	1.1
Direct investment balance	1.9	3.3	8.3	4.4	3.3	3.6	5.0	0.8	2.3	2.6
Portfolio investment balance	2.3	2.0	-0.2	4.7	2.3	2.2	0.1	1.5	0.9	-1.5
Net international investment position	-13.9	-18.5	-22.5	-34.3	-35.0	-34.6	-32.9	-33.4	-34.7	-35.4
Exports of goods and services [2]	52.2	53.1	45.7	39.1	44.6	49.8	52.8	51.3	52.2	58.3
Imports of goods and services [2]	61.8	63.4	57.2	49.2	50.9	55.2	58.3	57.0	59.2	65.3
Exports of goods to the euro area [3, 4]	29.7	27.4	30.4	36.4	32.0	26.7	25.7	27.5	30.4	28.5
Imports of goods from the euro area [3, 4]	31.8	34.7	36.8	35.3	32.3	34.7	35.4	34.7	35.6	32.3
Memo items:										
Intra-EU25 exports of goods [3, 4]	54.5	50.8	58.8	73.5	74.6	73.4	69.2	62.5	66.9	65.3
Intra-EU25 imports of goods [3, 4]	53.6	57.7	60.7	60.0	54.5	54.8	56.5	55.8	63.3	59.0

Sources: ESCB and European Commission (Eurostat).
1) Differences between the total and the sum of the components are due to rounding.
2) Balance of payments statistics.
3) External trade statistics.
4) As a percentage of total exports/imports.

4 LONG-TERM INTEREST RATE DEVELOPMENTS

Table 12 Long-term interest rates

(percentages; average of observations through period)

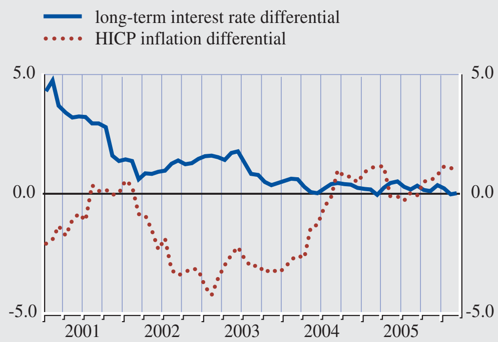
	2005 Dec.	2006 Jan.	Feb.	Mar.	Apr. 2005 to Mar. 2006
Long-term interest rate [1)]	3.8	3.6	3.5	3.7	**3.7**
Reference value [2)]					***5.9***
Euro area [3)]	*3.4*	*3.4*	*3.6*	*3.7*	***3.4***

Sources: ECB and European Commission.
1) The long-term interest rate is based on primary market yields.
2) Calculation for the April 2005 to March 2006 period is based on the unweighted arithmetic average of the interest rate levels of Poland, Finland and Sweden, plus 2 percentage points.
3) The euro area average is included for information only.

Chart 6

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

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



Sources: ECB and European Commission.

2.2 SLOVENIA

2.2.1 PRICE DEVELOPMENTS

Over the reference period from April 2005 to March 2006, the average rate of HICP inflation in Slovenia was 2.3%, i.e. below the reference value of 2.6% for the criterion on price stability (see Table 1). On the basis of the most recent information, the 12-month average of annual HICP inflation rates is expected to remain stable in the coming months.

Looking back over a longer period, Slovenia has been recording low inflation rates only for a relatively short period of time. Consumer price inflation in Slovenia decreased gradually until 1999, when the downward trend was interrupted, and then started to fall again after 2000 (see Chart 1). HICP inflation gradually declined from 9.9% in 1996 to 6.1% in 1999, and then rose again to 8.9% in 2000. This renewed increase was due to several factors, most notably the introduction of a value added tax, a surge in domestic demand, strong wage increases and a jump in import prices. The disinflation process gained momentum again after 2000, with inflation gradually coming down to 2.5% in 2005. This inflation pattern reflects a number of important policy choices. In 2001 a new monetary policy framework was adopted, with the primary objective of price stability being enshrined in the new Banka Slovenije Law. The pursuit of an intermediate target for monetary growth was abandoned and a two-pillar monetary policy framework introduced, covering both monetary and real economic developments. At the same time, monetary policy was complemented by an exchange rate policy guided by the uncovered interest parity, which enabled monetary policy to maintain sufficiently high interest rates to support disinflation. Since 28 June 2004, when Slovenia joined ERM II, monetary policy has been geared towards maintaining exchange rate stability vis-à-vis the euro. During the period under review, Banka Slovenije used its foreign exchange swap facility to maintain the stability of the euro-tolar exchange rate, while keeping domestic interest rates relatively high and thereby maintaining a positive spread versus comparable euro area interest rates.[1] This in turn facilitated the move towards price stability. The disinflation process has also been broadly supported by fiscal policy and structural reforms, including the progressive de-indexation of financial contracts and wages, and the gradual liberalisation of financial markets.

For most of the period from 1996 to 2005, inflation developments should be viewed against a background of fairly robust output growth. After real GDP growth was somewhat more subdued between 2001 and 2003, it has picked up again since 2004 (see Table 2). Labour market conditions have remained fairly stable over time, with the unemployment rate fluctuating mostly within a range of 6-7%. Compensation per employee growth rose to double-digit figures in 2000 and 2001, before declining to 7.7% in 2004[2]. In conjunction with a temporary slowdown in labour productivity growth, this resulted in a substantial increase in unit labour cost growth in 2000 and 2001, followed by a gradual decline to 3.8% in 2004. Import prices have been rather volatile during the period under review, mainly reflecting exchange rate and oil price developments. Relatively small increases in import prices in 2002 and 2003 facilitated the process of disinflation during these two years. The general pattern of decelerating inflation developments is also apparent from other relevant indices, such as HICP inflation excluding unprocessed food and energy and CPI inflation excluding changes in net indirect taxes (see Table 2).

Looking at recent trends, the annual average rate of HICP inflation reached 2.5% in 2005. The annual rate of HICP inflation was 2.6% in January 2006, before falling to 2.0% in March (see Table 3a). A decline in non-energy industrial goods prices and lower food price

1 For more details, see Section 2.2.3 entitled "Exchange rate developments".

2 Data for compensation per employee for 2005 are not yet available. Average monthly gross earnings growth was 4.9% in 2005, up from 4.6% in 2004.

inflation due to increased international and domestic competition counteracted the upward impact of oil price increases. The impact of recent oil price hikes has also been mitigated by frequent adjustments in the excise duties, which, according to Banka Slovenije, reduced inflation over the reference period by 0.06 percentage point. Banka Slovenije estimates that, on balance, changes in indirect taxes and administered prices added around 1.9 percentage points to inflation in 2005, of which about 1.3 percentage points were due to higher energy prices. The current inflation picture should be viewed against a background of relatively dynamic economic conditions. In the fourth quarter of 2005, real GDP grew by 3.7% year on year, resulting in an average growth rate of 3.9% for the year as a whole.

Looking ahead, as regards foreseeable factors that will exert upward pressure on inflation in Slovenia, the harmonisation of excise taxes on tobacco is expected to be implemented in three steps by 2008, contributing in total up to 0.5 percentage point to HICP inflation. Furthermore, the possible VAT rate increase envisaged in the budget for 1 January 2007 to compensate for the gradual abolition of payroll tax may have a direct upward impact on inflation of around 0.7 percentage point in 2007. Moreover, a number of upside risks to the inflation outlook can be identified. First, the current relatively strong growth of domestic demand, fuelled by accelerating credit expansion, could gain additional momentum, with further interest rate convergence towards the level of the euro area. Second, risks relate to the fading downward effects of increased competition on inflation, which have been present since mid-2004 and were partially associated with Slovenia's accession to the EU. Finally, potential additional second-round effects stemming from recent energy price increases, in conjunction with a strengthening of domestic demand and possible adjustments in administered prices may exert significant upward pressure on wages and inflation. A particular uncertainty associated with wage developments is that the new wage agreement for 2006 and beyond has not yet been concluded. Looking further ahead, the catching-up process is likely to have a bearing on inflation in the coming years, given that the GDP per capita and price level are still lower in Slovenia than in the euro area (see Table 2). However, it is difficult to assess the exact size of the inflation effect resulting from this catching-up process.

An environment conducive to sustainable price stability in Slovenia will be dependent on, inter alia, the implementation of a sound fiscal consolidation path, which would also reduce potential demand pressures in the economy. Moreover, the acceleration of additional structural reforms, such as further de-indexation (in particular of wages and certain social transfers, for which indexation to inflation still largely applies), will be crucial for maintaining price stability. In this context, it will be important to increase labour market flexibility by increasing regional labour mobility and addressing skill mismatches. At the same time, social partners should ensure that wage increases reflect labour productivity growth, while taking developments in competitor countries into account. Equally important will be to continue with the liberalisation process across the economy and to strengthen national policies aimed at further enhancing competition in product markets.

2.2.2 FISCAL DEVELOPMENTS

In the reference year 2005, the general government budget balance showed a deficit of 1.8% of GDP, i.e. well below the 3% reference value. The general government debt-to-GDP ratio was 29.1%, i.e. far below the 60% reference value (see Table 4). Compared with the previous year, the fiscal deficit decreased by 0.5 percentage point and the government debt ratio declined by 0.4 percentage point. In 2006 the deficit ratio is forecast by the European Commission to increase to 1.9% and the government debt ratio is projected to rise to 29.9%. In 2004 and 2005 the deficit ratio did not exceed the ratio of public investment expenditure to GDP. Slovenia is not in an excessive deficit situation.

Looking back over the years from 1999 (the first year for which comparable government debt data are available) to 2005, the general government debt ratio increased cumulatively by 4.5 percentage points (see Chart 2a and Table 5). It increased steeply from 24.6% in 1999 to 29.7% in 2002 and remained above 29% in the years up to 2005. As shown in greater detail in Chart 2b, primary deficits contributed to government debt growth from 2000 onwards (the first year for which comparable data are available). Deficit-debt adjustments increased the government debt ratio particularly in 2002, mainly on account of changes in the budgeting system (see Table 6). The output growth/interest rate differential had, overall, a decreasing effect on the debt ratio in the period under review. The patterns observed since 2000 may be seen as indicative of the close link between primary deficits and adverse debt dynamics, irrespective of the starting level of debt – which in the case of Slovenia was comparatively low. In this context, it may be noted that the share of government debt with a short-term maturity increased between 1999 and 2002 to 7.7%, before decreasing by 2.8 percentage points in the period to 2005. The proportion of debt with a short-term maturity is low, and, taking into account the level of the debt ratio, fiscal balances are relatively insensitive to changes in interest rates. The proportion of foreign currency-denominated government debt is high, but over 95% of this is denominated in euro. Fiscal balances are therefore relatively insensitive to changes in exchange rates other than the euro-tolar exchange rate.

Since 2000 (the first year for which comparable government deficit data are available) a pattern of broadly improving outturns has been observed in the deficit-to-GDP ratio (see Chart 3a and Table 7). Starting from a level of 3.9% in 2000, the deficit ratio deteriorated to 4.3% in 2001, improving to 2.3% in 2004 and 1.8% in 2005. As is shown in greater detail in Chart 3b, European Commission estimates indicate that cyclical factors contributed negatively to the change in the fiscal balance, in particular in 2001 and 2003. Non-cyclical changes in the government budget balance had a positive impact on the balance, in particular in 2002. Such changes could reflect either a lasting structural change or the effect of temporary measures. Available evidence suggests that temporary measures had no impact in 2004 and 2005.

Moving on to examine trends in other fiscal indicators, it can be seen from Chart 4 and Table 7 that the general government total expenditure ratio rose from 48.1% of GDP in 2000 (the first year for which comparable data are available) to 49.0% in 2001. It then stabilised at around 48% until 2003 and declined moderately thereafter. After 2001 the decline in interest expenditure contributed about half to the decrease. On balance, the expenditure ratio was 0.8 percentage point lower in 2005 than in 2000. Government revenue in relation to GDP increased by 1.1% between 2000 and 2002 and broadly stabilised thereafter. In 2005 the revenue ratio was 45.5%.

The Slovenian medium-term fiscal policy strategy as stated in the convergence programme for 2006-08, dated December 2005, differs slightly from the Commission forecasts shown in Table 4 and foresees a slight decline in the budget deficit to 1.7% of GDP in 2006 and an increase in general government debt to 29.6% of GDP. It is planned that total expenditure and revenue will both decrease by about 0.5% of GDP compared with the programme data for 2005, the latter in part reflecting a gradual abolition of the payroll tax. This shortfall is, however, expected to be partially compensated for by an increase in other taxes. The 2007 budget currently envisages an increase in the VAT rates (from 8.5% to 9% and from 20% to 21%), pending parliamentary approval. There is currently no evidence of measures with a significant temporary effect in the 2006 budget. In 2007 the deficit ratio is forecast to decline to 1.4% and the government debt ratio to remain broadly stable at its 2006 level. On the basis of the fiscal balances projected in the convergence programme, further consolidation is required for Slovenia to comply with the medium-term objective specified in the Stability and Growth Pact, which is quantified as a deficit of 1% of GDP in the convergence programme.

With regard to the potential future course of the government debt ratio, current trends suggest that government debt will increase but can be maintained at below 60% of GDP for the foreseeable future.

As highlighted in Table 8, a marked ageing of the population is expected. According to the latest projections by the EU's Economic Policy Committee and the European Commission,[3] Slovenia is expected to experience a substantial increase in age-related public expenditures amounting to 9.7 percentage points of GDP in the years to 2050. Coping with the burden is necessary and would be facilitated if sufficient room for manoeuvre were created in public finances before the period in which the demographic situation is projected to worsen.

Turning to further fiscal challenges, it will be important for Slovenia to implement a sound fiscal consolidation path which would also reduce potential demand pressures in the economy, in particular in the light of accelerating credit growth and short-term interest rate convergence. Slovenia's expenditure structure appears to be characterised by a relatively high degree of rigidity, which may inhibit an expenditure-based fiscal adjustment. According to information from the European Commission, dated end-2003, explicit contingent liabilities, mainly in the form of state guarantees to public sector entities for the financing of infrastructure and export guarantees, amounted to about 8% of GDP. This level appears to have increased somewhat in 2004 and 2005. However, there is no agreed method for estimating the full scale of contingent liabilities and estimates may vary widely.

2.2.3 EXCHANGE RATE DEVELOPMENTS

The Slovenian tolar has been participating in ERM II with effect from 28 June 2004, i.e. for around 22 months of the two-year reference period between May 2004 and April 2006 (see Table 9a). The central rate for the Slovenian currency was set at 239.64 tolars per euro, which was the market rate at the time of entry. A standard fluctuation band of ±15% was adopted around the central rate.

At the beginning of the reference period, before the tolar joined ERM II, the Slovenian authorities pursued an exchange rate policy vis-à-vis the euro which translated into a gradual depreciation of the tolar-euro exchange rate at a declining pace. This policy, which had also been followed in previous years, was guided by uncovered interest rate parity considerations and aimed at fostering the nominal convergence process. It was phased out upon ERM II entry. Since joining ERM II the tolar has traded in a very narrow range, close to its euro central rate (see Chart 5). Within ERM II, Slovenia has not devalued its currency's central rate against the euro on its own initiative. Banka Slovenije temporarily intervened in the foreign exchange markets shortly after ERM II entry to signal its intention to maintain the nominal tolar exchange rate close to the central rate. During the period under review, the central bank was able to maintain the stability in the euro-tolar exchange rate while keeping domestic short-term interest rates above those in the euro area. It contained volatility of its currency by using its foreign exchange swap facility. This facility allows commercial banks to obtain liquidity in domestic currency by swapping, on a seven-day basis, foreign exchange holdings at the central bank. The premium charged on these operations, carried out in combination with sterilisation operations based on tolar bills, allowed a sizeable wedge to be maintained between short-term interest rates in Slovenia and in the euro

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

area. To a small extent, this wedge may also be explained by risk premia. In order to reduce the amount of accumulated swaps outstanding, outright purchases of foreign exchange were occasionally carried out, implying overall significant net purchases of foreign exchange to absorb potential upward pressure on the currency. Over the reference period, volatility in the tolar's exchange rate against the euro was very low (see Table 9b). Since ERM II entry, the short-term interest rate differential with the three-month EURIBOR has been declining gradually, but amounted to 1.7 percentage points in the last quarter of 2005. After Banka Slovenije lowered the policy interest rates by a cumulative 50 basis points in February and March 2006, it fell to 0.7 percentage point in April 2006.

Prior to ERM II entry, the exchange rate policies of the Slovenian authorities vis-à-vis the euro implied a continuous decline in the tolar in nominal effective terms too. This decline reflected the sizeable inflation differentials between Slovenia and the euro area in the past. As a consequence, the real exchange rate of the tolar – both bilaterally against the euro and in effective terms – stood in April 2006 close to historical averages as calculated from January 1996 and since the launch of the euro (see Table 10). However, these measures should be interpreted with caution, as Slovenia was undergoing a process of transition to a market economy, which complicates any historical assessment of real exchange rate developments.

As regards other external developments, Slovenia, on average, has reported a broadly balanced position in the combined current and capital account over the past ten years. Exceptions were 1999 and 2000, when deficits of around 3% of GDP were recorded. Subsequently, in 2001 and 2002, the combined current and capital account of the balance of payments moved into a small surplus position. From 2003 onwards, however, deficits in the range of 1% to 2.5% of GDP were observed again in the combined current and capital account balance (see Table 11). Slovenia has recorded only modest net FDI inflows over the past ten years. Its net international investment position has been negative, peaking at 19.3% of GDP in 2005.

Slovenia is a small, open economy with, according to the most recent data available, a ratio of foreign trade in goods and services to GDP of 64.8% for exports and 65.3% for imports. In 2005 exports of goods to the euro area and to the EU as a share of total exports amounted to 52.9% and 66.4% respectively. The corresponding figures for imports as a percentage of total imports in 2005 were 66.7% and 78.2%.

2.2.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from April 2005 to March 2006, long-term interest rates in Slovenia were 3.8% on average, and thus stood well below the reference value of 5.9% for the interest rate criterion (see Table 12).

In recent years, long-term interest rates have been on a broadly declining trend (see Chart 6a).[4] As a consequence, Slovenia's long-term interest rate differential with the euro area average declined steadily from 2002 onwards (see Chart 6b), resulting in a spread of around 0.1 percentage point in March 2006. The main factors underlying this trend were a reduction in economic and financial uncertainty due to prudent fiscal and monetary policies, and a declining inflation differential between Slovenia and the euro area. In addition, the narrowing of the long-term interest rate differential benefited from market expectations of an early participation of Slovenia in ERM II, which it entered in June 2004, and from the tolar's relatively stable exchange rate against the euro since then. The process of interest rate convergence was also supported by the

4 March 2002 is the first month for which data are available on the reference long-term interest rate for Slovenia.

expectation of adoption of the euro. Overall, long-term interest rates in Slovenia have moved steadily towards rates in the euro area, reflecting market confidence in general economic and fiscal developments in Slovenia and a credible monetary and exchange rate policy.

2.2.5 LIST OF TABLES AND CHARTS

SLOVENIA

I PRICE DEVELOPMENTS

Table 1 HICP inflation

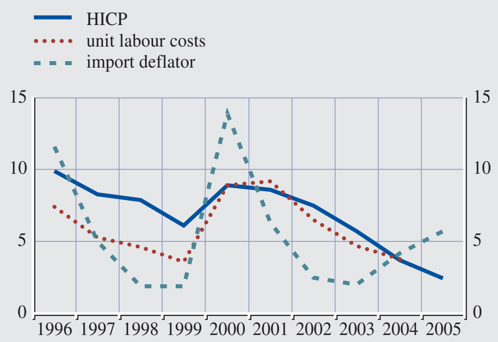
(annual percentage changes)

	2005 Dec.	2006 Jan.	Feb.	Mar.	Apr. 2005 to Mar. 2006
HICP inflation	2.4	2.6	2.3	2.0	2.3
Reference value [1]					2.6
Euro area [2]	2.2	2.4	2.3	2.2	2.3

Source: European Commission (Eurostat).
1) Calculation for the April 2005 to March 2006 period is based on the unweighted arithmetic average of the annual percentage changes of the HICP for Poland, Finland and Sweden, plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(annual average percentage changes)



Sources: European Commission (Eurostat) and national data.

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Measures of inflation										
HICP	9.9	8.3	7.9	6.1	8.9	8.6	7.5	5.7	3.7	2.5
HICP excluding unprocessed food and energy	-	-	-	-	-	7.4	8.4	6.3	3.7	1.3
CPI	9.8	8.4	7.9	6.2	8.9	8.4	7.5	5.6	3.6	2.5
CPI excluding changes in indirect taxes	-	-	-	-	7.9	8.3	6.5	5.3	3.4	2.3
Private consumption deflator	10.7	8.6	6.8	6.4	7.9	7.7	7.9	5.4	3.5	1.6
GDP deflator	11.1	8.4	6.8	6.4	5.4	8.7	7.9	5.8	3.2	1.0
Producer prices [1]	6.1	6.0	6.1	2.2	7.7	8.9	5.1	2.6	4.3	2.7
Related indicators										
Real GDP growth	3.7	4.8	3.9	5.4	4.1	2.7	3.5	2.7	4.2	3.9
GDP per capita in PPS [2] (euro area = 100)	63.2	65.0	65.8	67.6	67.0	68.0	69.2	70.8	74.1	.
Comparative price levels (euro area = 100)	68.8	70.9	73.3	73.6	73.2	73.0	74.7	75.7	73.8	.
Output gap [3]	-	0.1	0.2	1.2	1.0	-0.3	-0.5	-1.6	-1.2	-0.9
Unemployment rate (%) [4]	6.9	6.9	7.4	7.3	6.7	6.2	6.3	6.7	6.3	6.3
Unit labour costs, whole economy	7.3	5.3	4.6	3.6	8.9	9.2	6.5	4.7	3.8	.
Compensation per employee, whole economy	13.6	12.6	8.9	7.7	12.4	11.6	8.5	7.8	7.7	.
Labour productivity, whole economy	5.9	6.9	4.1	3.9	3.3	2.2	1.9	2.9	3.7	3.1
Imports of goods and services deflator	11.6	5.0	1.9	1.9	13.9	6.3	2.5	2.0	4.2	5.7
Nominal effective exchange rate [5]	-9.8	-5.5	-1.2	-6.4	-9.3	-5.1	-2.8	0.5	-0.9	-0.8
Money supply (M3) [6]	19.7	20.0	19.1	10.2	17.2	29.4	10.6	6.5	8.6	-3.0
Lending from banks [6]	20.2	14.2	26.9	29.9	18.8	18.7	10.2	16.4	17.0	23.7
Stock prices (SBI Index) [6]	-18.3	18.7	21.4	5.9	0.1	19.0	55.2	17.7	24.7	-5.6
Residential property prices	-	-	-	-	-	-	-	-	-	-

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

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2005		2006		
	Nov.	Dec.	Jan.	Feb.	Mar.
HICP					
Annual percentage change	2.1	2.4	2.6	2.3	2.0
Change in the average of the latest 3 months from the previous 3 months, annualised rate, seasonally adjusted	4.8	2.8	0.8	0.3	0.7
Change in the average of the latest 6 months from the previous 6 months, annualised rate, seasonally adjusted	2.8	3.0	2.8	2.9	2.4

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2006	2007
HICP, European Commission (spring 2006)	2.4	2.5
CPI, OECD (December 2005) [1]	-	-
CPI, IMF (April 2006)	2.4	2.4
CPI, Consensus Economics (March 2006)	2.3	2.1

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

2 FISCAL DEVELOPMENTS

Table 4 General government fiscal position

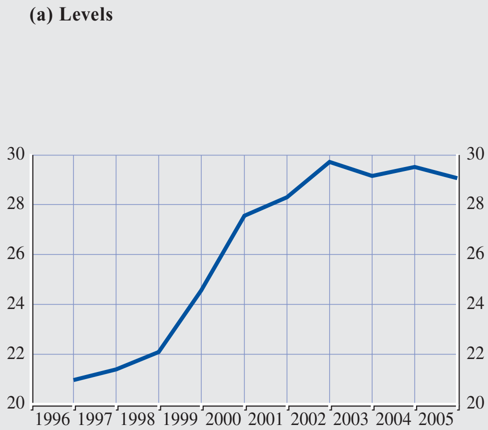
(as a percentage of GDP)

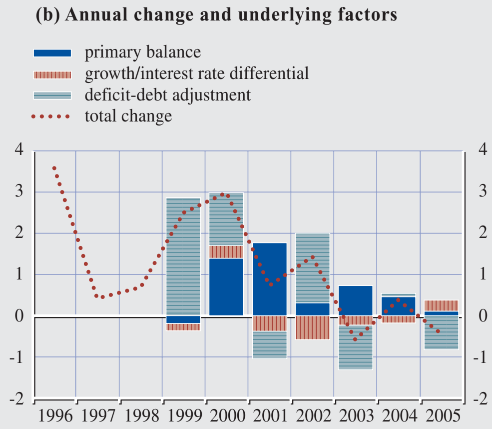
	2004	2005	2006 [1]
General government surplus (+)/deficit (-)	-2.3	-1.8	-1.9
Reference value	-3.0	-3.0	-3.0
Surplus/deficit, net of government investment expenditure [2]	1.1	1.5	1.5
General government gross debt	29.5	29.1	29.9
Reference value	60.0	60.0	60.0

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

Chart 2 General government gross debt

(as a percentage of GDP)





Sources: European Commission and ECB.
Notes: In Chart 2(b) negative values indicate a contribution of the respective factor to a decrease in the debt ratio, while positive values indicate a contribution to its increase. The debt before 1999 is not comparable with the debt from 1999 onwards and the deficit before 2000 is not comparable with the deficit from 2000 onwards due to changes in the methodology and sources.

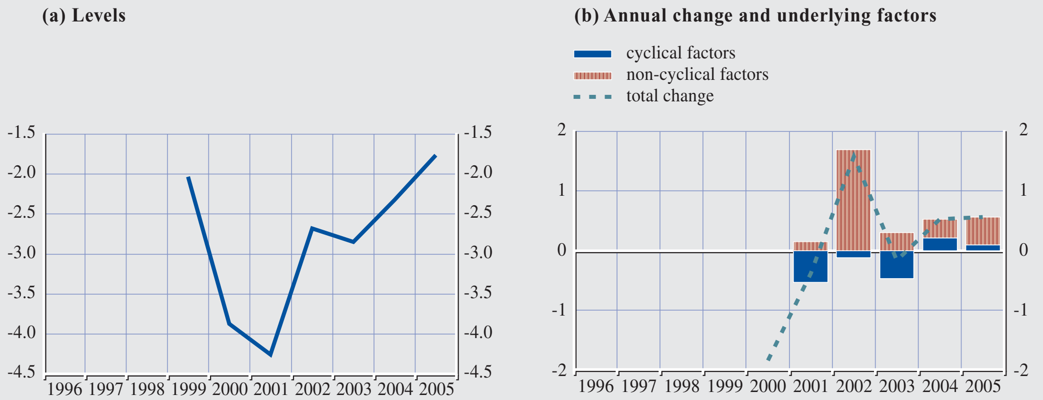
Table 5 General government gross debt – structural features

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Total debt (as a percentage of GDP)	21.0	21.4	22.1	24.6	27.6	28.3	29.7	29.1	29.5	29.1
Composition by currency (% of total)										
In domestic currency	38.2	47.9	50.8	46.5	42.9	42.2	45.5	46.6	53.0	60.0
In foreign currencies	61.8	52.1	49.2	53.5	57.1	57.8	54.5	53.4	47.0	40.0
Euro [1]	29.9	22.4	32.0	37.9	43.5	53.7	52.4	51.9	45.8	39.0
Other foreign currencies	31.9	29.7	17.2	15.7	13.6	4.1	2.1	1.5	1.1	1.0
Domestic ownership (% of total)	-	-	-	53.3	50.4	51.3	59.2	62.4	68.6	72.6
Average residual maturity (in years)	.	.	.	6.7	6.7	7.2	6.5	5.9	5.6	5.6
Composition by maturity [2] (% of total)										
Short-term (up to and including one year)	0.1	0.1	2.3	3.0	5.0	5.9	7.7	7.2	5.5	4.9
Medium and long-term (over one year)	99.9	99.9	97.7	97.0	95.0	94.1	92.3	92.8	94.5	95.1

Sources: ESCB and European Commission.
Notes: Year-end data. Differences between totals and the sum of their components are due to rounding. The debt before 1999 is not comparable with the debt from 1999 onwards due to changes in the methodology and sources.
1) Comprises debt denominated in euro and, before 1999, in ECU or in one of the currencies of the Member States which have adopted the euro.
2) Original maturity.

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

(as a percentage of GDP)



Sources: European Commission and ECB calculations.
Notes: In Chart 3(b) negative values indicate a contribution to an increase in deficits, while positive values indicate a contribution to their reduction. The deficit before 2000 is not comparable with the deficit from 2000 onwards due to changes in the methodology and sources.

Table 6 General government deficit-debt adjustment

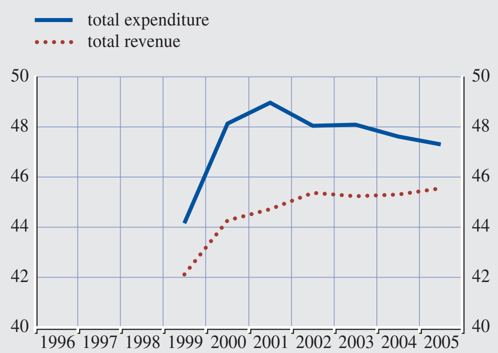
(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Change in general government debt	5.9	2.9	2.8	4.9	5.2	3.6	4.4	1.8	2.4	0.9
General government surplus (+)/deficit (-)	-	-	-	-2.0	-3.9	-4.3	-2.7	-2.8	-2.3	-1.8
Deficit-debt adjustment	-	-	-	2.9	1.3	-0.7	1.7	-1.1	0.1	-0.8
Net acquisitions (+)/net sales (-) of financial assets	-	-	-	0.9	0.6	-0.4	0.1	-2.2	2.0	-0.9
Currency and deposits	-	-	-	0.7	0.8	0.7	3.0	-1.1	0.3	-0.9
Loans and securities other than shares	-	-	-	0.3	0.1	-0.2	0.7	-0.1	-0.1	0.2
Shares and other equity	-	-	-	-0.1	-0.2	-0.2	-3.9	-0.7	-0.1	-0.6
Privatisations	-	-	-	-	-0.9	-0.7	-3.6	-0.7	-0.6	-1.1
Equity injections	-	-	-	-	0.0	0.0	0.0	0.0	0.0	0.0
Other	-	-	-	-	0.7	0.5	-0.4	-0.1	0.5	0.5
Other financial assets	-	-	-	-0.1	0.0	-0.8	0.3	-0.3	1.9	0.4
Valuation changes of general government debt	-	-	-	0.8	1.1	0.7	1.1	0.3	-0.8	0.0
Foreign exchange holding gains (-)/losses (+)	-	-	-	0.9	1.3	0.9	0.5	0.3	0.2	0.0
Other valuation effects [1]	-	-	-	-0.1	-0.2	-0.1	0.6	0.0	-1.0	0.0
Other changes in general government debt [2]	-	-	-	1.2	-0.4	-1.0	0.5	0.9	-1.1	0.1

Sources: ESCB and European Commission.
Notes: Differences between totals and the sum of their components are due to rounding. The change in debt and the deficit before 2000 are not comparable with the change in debt and the deficit from 2000 onwards due to changes in the methodology and sources.
1) Includes the difference between the nominal and market valuation of general government debt in issue.
2) Transactions in other accounts payable (government liabilities), sector reclassifications and statistical discrepancies. This item may also cover certain cases of debt assumption.

Chart 4 General government expenditure and revenue

(as a percentage of GDP)



Source: ESCB.
Note: Revenue and expenditure before 2000 are not comparable with revenue and expenditure from 2000 onwards due to changes in the methodology and sources.

Table 7 General government budgetary position

(as a percentage of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Total revenue	-	-	-	42.1	44.3	44.7	45.4	45.2	45.3	45.5
Current revenue	-	-	-	41.9	44.1	44.5	45.2	45.1	45.1	45.3
Direct taxes	-	-	-	9.1	7.5	7.6	7.9	8.2	8.4	8.6
Indirect taxes	-	-	-	16.2	16.3	16.1	16.4	16.6	16.2	16.2
Social security contributions	-	-	-	14.3	15.0	15.2	15.1	15.0	15.0	15.2
Other current revenue	-	-	-	2.3	5.3	5.5	5.8	5.4	5.5	5.3
Capital revenue	-	-	-	0.2	0.2	0.2	0.2	0.1	0.2	0.2
Total expenditure	-	-	-	44.1	48.1	49.0	48.0	48.1	47.6	47.3
Current expenditure	-	-	-	39.4	43.2	44.3	43.8	43.3	43.0	43.1
Compensation of employees	-	-	-	10.5	11.6	12.2	12.0	12.1	12.0	12.1
Social benefits other than in kind	-	-	-	.	17.0	17.0	17.1	17.0	16.9	16.9
Interest payable	-	-	-	2.2	2.5	2.5	2.4	2.1	1.9	1.6
of which: impact of swaps and FRAs	-	-	-	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other current expenditure	-	-	-	.	12.1	12.6	12.4	12.1	12.3	12.4
Capital expenditure	-	-	-	4.8	4.9	4.7	4.2	4.7	4.6	4.2
Surplus (+)/deficit (-)	-	-	-	-2.0	-3.9	-4.3	-2.7	-2.8	-2.3	-1.8
Primary balance	-	-	-	0.2	-1.4	-1.8	-0.3	-0.7	-0.5	-0.1
Surplus/deficit, net of government investment expenditure	-	-	-	0.7	-0.7	-1.1	0.3	0.5	1.1	1.5

Sources: ESCB and European Commission.
Notes: Differences between totals and the sum of their components are due to rounding. Interest payable as reported under the excessive deficit procedure. The item "impact of swaps and FRAs" is equal to the difference between the interest (or deficit/surplus) as defined in the excessive deficit procedure and in the ESA 95. See Regulation (EC) No 2558/2001 of the European Parliament and Council on the reclassification of settlements under swaps arrangements and under forward rate agreements. Revenue, expenditure and surplus/deficit before 2000 are not comparable with revenue, expenditure and surplus/deficit from 2000 onwards due to changes in the sources and methodology.

Table 8 Projections of ageing-induced fiscal burden

(percentages)

	2004	2010	2020	2030	2040	2050
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	21.4	23.6	30.8	40.4	47.7	55.6
Change in age-related government expenditure (as a percentage of GDP) compared with 2004	-	-0.2	1.3	4.4	7.5	9.7

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

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

Membership of the exchange rate mechanism (ERM II)		Yes
Membership since		28 June 2004
Devaluation of bilateral central rate on country's own initiative		No
Maximum upward and downward deviations [1]	Maximum upward deviation	Maximum downward deviation
28 June 2004 to 28 April 2006		
Euro	0.1	-0.2

Source: ECB.
1) Maximum percentage deviations from ERM II central rate. Ten-day moving average of daily data at business frequency.

(b) Key indicators of exchange rate pressure for the Slovenian tolar

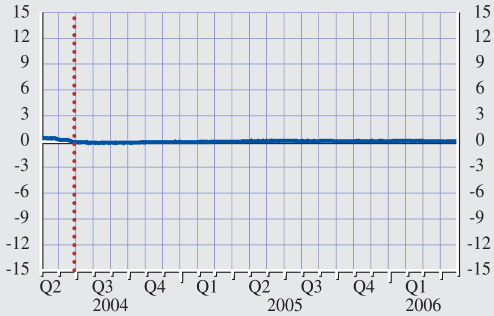
(average of three-month period ending in specified month)

	2004		2005				2006	
	July	Oct.	Jan.	Apr.	July	Oct.	Jan.	Apr.
Exchange rate volatility [1]	0.4	0.2	0.2	0.1	0.2	0.1	0.1	0.1
Short-term interest rate differential [2]	2.3	1.9	1.9	1.9	1.9	1.9	1.6	0.9

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

Chart 5 Slovenian tolar: deviation from ERM II central rate

(daily data; percentage deviation: 1 May 2004 to 28 April 2006)



Source: ECB.
Note: The vertical line indicates the date of entry into ERM II (28 June 2004). A positive/negative deviation from the central parity implies that the currency is at the strong/weak side of the band. For the Slovenian tolar, the fluctuation band is ±15%. Deviations prior to 28 June 2004 refer to the Slovenian tolar's central rate as established upon ERM II entry.

Table 10 Slovenian tolar: real exchange rate developments

(monthly data; percentage deviations; April 2006 compared with different benchmark periods)

	Average Jan. 1996 to Apr. 2006	Average Jan. 1999 to Apr. 2006
Real bilateral exchange rate against the euro [1]	1.7	0.4
Memo items:		
Nominal effective exchange rate [2]	-12.2	-5.5
Real effective exchange rate [1), 2)]	3.2	2.6

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

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Current account plus capital account balance	0.2	0.3	-0.6	-3.3	-2.7	0.2	0.8	-1.0	-2.5	-1.5
Combined direct and portfolio investment balance [1]	3.9	2.7	1.5	1.8	1.2	1.5	6.2	-1.4	-1.3	-4.6
Direct investment balance	0.8	1.5	1.1	0.3	0.4	1.1	6.5	-0.5	0.8	-0.1
Portfolio investment balance	3.1	1.2	0.4	1.6	0.8	0.3	-0.3	-0.9	-2.2	-4.5
Net international investment position	-2.7	-2.1	-4.6	-9.9	-12.5	-6.7	-2.6	-11.2	-16.2	-19.3
Exports of goods and services [2]	51.3	53.0	52.7	48.8	55.5	57.2	57.1	55.8	60.1	64.8
Imports of goods and services [2]	52.2	53.7	54.1	52.9	59.0	57.8	55.6	55.8	61.3	65.3
Exports of goods to the euro area [3), 4)]	61.4	60.4	62.1	62.3	60.0	57.6	55.1	54.4	53.0	52.9
Imports of goods from the euro area [3), 4)]	63.7	63.2	65.1	63.4	62.5	63.5	64.0	63.5	69.1	66.7
Memo items:										
Intra-EU25 exports of goods [3), 4)]	70.3	69.5	71.8	72.9	71.2	69.6	67.5	66.9	66.0	66.4
Intra-EU25 imports of goods [3), 4)]	74.2	74.9	76.1	76.4	75.9	76.1	76.4	75.6	81.3	78.2

Sources: ESCB and European Commission (Eurostat).
1) Differences between the total and the sum of the components are due to rounding.
2) Balance of payments statistics.
3) External trade statistics.
4) As a percentage of total exports/imports.

4 LONG-TERM INTEREST RATE DEVELOPMENTS

Table 12 Long-term interest rates

(percentages; average of observations through period)

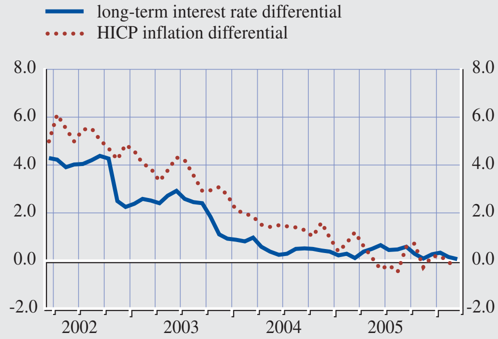
	2005 Dec.	2006 Jan.	Feb.	Mar.	Apr. 2005 to Mar. 2006
Long-term interest rate	3.7	3.7	3.7	3.8	**3.8**
Reference value [1]					***5.9***
Euro area [2]	*3.4*	*3.4*	*3.6*	*3.7*	***3.4***

Sources: ECB and European Commission.
1) Calculation for the April 2005 to March 2006 period is based on the unweighted arithmetic average of the interest rate levels of Poland, Finland and Sweden, plus 2 percentage points.
2) The euro area average is included for information only.

Chart 6

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

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



Sources: ECB and European Commission.
Note: Harmonised long-term interest rates are only available as of March 2002.

ANNEX

STATISTICAL METHODOLOGY OF CONVERGENCE INDICATORS

The examination of the convergence process is highly dependent on the quality and integrity of the underlying statistics. The compilation and reporting of statistics, particularly government finance statistics, must not be vulnerable to political considerations. Member States are invited to consider the quality and integrity of their statistics as a matter of priority, to ensure that a proper system of checks and balances is in place when compiling these statistics, and to apply certain standards with respect to governance and quality in the domain of statistics.

The Code of Practice for the national and Community statistical institutes (hereinafter referred to as "the Code") is expected to reinforce the independence, integrity and accountability of the national statistical institutes (NSIs) and help inspire confidence in the quality of fiscal statistics.[1] The Code, which goes beyond the application of minimum standards, recommends certain institutional and organisational arrangements for the production of statistics by NSIs and is also intended to enhance the quality of these statistics by promoting the application of best international statistical principles, methods and practices.

The quality and integrity of the primary convergence indicators in terms of the underlying statistics are reviewed in this annex. It refers to some institutional features relating to the quality and integrity of the statistics, and generally provides information on the statistical methodology of the convergence indicators and about the compliance of the underlying statistics with the standards necessary for an appropriate assessment of the convergence process.

1 INSTITUTIONAL FEATURES RELATING TO THE QUALITY OF THE STATISTICS FOR THE ASSESSMENT OF THE CONVERGENCE PROCESS

The Code refers to a variety of principles to be implemented, covering institutional features, such as professional independence, the mandate for data collection, the adequacy of resources, quality commitment, statistical confidentiality, and impartiality and objectivity, as well as statistical processes and outputs.[2]

During 2005, Eurostat and the NSIs carried out an initial self-assessment of their adherence to the Code on the basis of a questionnaire. An overview of a few institutional features relating to the quality of the statistics, namely the specification of the legal independence of the NSI, its administrative supervision and budget autonomy, legal mandate for data collection, and legal provisions regarding statistical confidentiality, is presented in Table 1.[3]

2 HICP INFLATION

This section considers the methodology and quality of the statistics underlying the measurement of price developments, specifically the Harmonised Index of Consumer Prices (HICP). The HICP was developed for the purpose of assessing convergence in terms of price stability on a comparable basis. It is published for all Member States by the European Commission (Eurostat).[4] The HICP covering the euro area as a whole has been the main measure of price developments for the single monetary policy of the ECB since January 1999.

1 See "Recommendation of the Commission on the independence, integrity and accountability of the national and Community statistical authorities", COM (2005) 217 final, European Commission, Brussels, 25 May 2005.

2 The principles referring to statistical processes include sound methodology, appropriate statistical procedures, non-excessive burden on respondents and cost-effectiveness. Principles linked to the statistical output correspond to the data quality dimensions as indicated by Eurostat. They are relevance, accuracy and reliability, timeliness and punctuality, coherence and comparability, and accessibility and clarity. See http://epp.eurostat.cec.eu.int (April 2006).

3 Some information on the institutional set-up of the NSIs has been taken from the websites http://epp.eurostat.cec.eu, http://www.std.lt and http://www.stat.si (April 2006).

4 For further details on methodological aspects of the HICP, see "Harmonized Indices of Consumer Prices (HICPs) – A Short Guide for Users", Office for Official Publications of the European Communities, Luxembourg, 2004.

Table 1 Quality and integrity of primary convergence indicators

	Lithuania	Slovenia
Institutional features relating to the quality and integrity of the statistics assessing the convergence process		
Legal independence of the national statistical institute	According to Article 4 of the Law on Statistics, statistics are based on the principles of objectivity, professional independence, transparency of methods and methodologies, compliance with international classifications and standards, and confidentiality. Head of NSI appointed by the Prime Minister on the basis of an official selection procedure regulated by the Civil Servants Law; term of office is not fixed.	According to Article 2 of the National Statistics Act, national statistics shall be implemented according to the principles of neutrality, objectivity, professional independence, rationality, statistical confidentiality and transparency. Head of NSI appointed by the Prime Minister on the basis of a recommendation by the Ministry of Finance; term of office is fixed (five years, reappointment is possible).
Administrative supervision and budget autonomy	The NSI is a department of the Government of the Republic of Lithuania. It has budget autonomy on the basis of an annual amount assigned from the state budget.	The NSI is a government office directly accountable to the Prime Minister. It has budget autonomy on the basis of an annual amount assigned from the state budget.
Legal mandate for data collection	The Law on Statistics determines the main principles of data collection.	The National Statistics Act determines the main principles of data collection.
Legal provisions regarding statistical confidentiality	According to Article 13 of the Law on Statistics, the confidentiality of statistical data is secured. See also "Rules and Regulations for Data Acknowledgement as Confidential One and its Usage" (Statistics Lithuania).	According to Article 34 of the National Statistics Act, the confidentiality of the statistical data is secured.
HICP inflation		
Compliance with legal minimum standards	Confirmed by Eurostat in 2004 (28th CMFB meeting, June 2004, HICP compliance monitoring – progress report) and in 2006.	Confirmed by Eurostat in 2004 (28th CMFB meeting, June 2004, HICP compliance monitoring – progress report) and in 2006.
Other issues	In 2006 Lithuania provided revised HICP data for the period 1996 to 2000. The coverage and weights of the data correspond to the standards applied from 2001 onwards.	Slovenia provided backdata for the period 1995 to 1999 for the overall index and the 12 COICOP sub-indices based on the definition and the coverage of the CPI.
Government finance statistics		
Data coverage	Revenue, expenditure, deficit and debt data are provided for the period 1996 to 2005.	Revenue, expenditure and deficit data are not provided for the years before 1999.
Outstanding statistical issues	According to the information currently available, there seem to be no outstanding statistical issues for Lithuania.	The impact of a change in the recording of value added taxes in the budget on the deficit-debt adjustment in 2002 is still under discussion.
Consistency of government finance statistics	No inconsistencies observed.	From 1999 to 2001 the figures provided for net transactions in financial assets/liabilities do not match the figures provided for transactions in assets and transactions in liabilities.
Deficit-debt adjustment	No major issues observed.	The transactions in Maastricht debt for the period 1999 to 2001 are recorded at nominal value rather than at market value. Accordingly, no consistent reconciliation between the borrowing requirement and the change in debt is possible for these years.
Responsible institution for the compilation of EDP data	The NSI, in cooperation with the Ministry of Finance, compiles the actual EDP data, and the Ministry of Finance provides the forecasts. The NCB is not directly involved in the compilation of these statistics, but closely monitors the compilation process via methodological discussions.	The NSI, in cooperation with the Ministry of Finance, compiles the actual EDP data, and the Ministry of Finance provides the forecasts. The NCB is not directly involved in the compilation of these statistics, but closely monitors the compilation process via methodological discussions.

Article 1 of Protocol No 21 on the convergence criteria referred to in Article 121 of the Treaty requires price convergence to be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions. In October 1995 the EU Council adopted Regulation No 2494/95 concerning harmonised indices of consumer prices. Furthermore, the harmonisation measures introduced for HICPs have been based on several EU Council and Commission Regulations. HICPs use a common coverage in terms of the items, the territory and the population included (all three issues are major reasons for differences between national consumer price indices). Common standards have also been established in several other areas (for example, the treatment of new goods and services).

The HICPs use annually updated expenditure weights (or less frequent updates if this is not going to have a significant effect on the index). They cover all goods and services included in household final monetary consumption expenditure (HFMCE). HFMCE is derived from the national accounts concept of household final consumption expenditure but excludes owner-occupied housing costs. The prices observed are the prices households actually pay for goods and services in monetary transactions and thus include all taxes (less subsidies) on products, e.g. VAT and excise duties. Expenditure on health, education and social services is covered to the extent it is financed "out of the pocket" by households and not reimbursed.

2.1 COMPLIANCE OF THE COUNTRIES WITH LEGAL MINIMUM STANDARDS

In March 2004 Eurostat confirmed the compliance of Lithuania and Slovenia with the legal minimum standards for the HICP. It was confirmed again in 2006, when the treatment of administered prices and energy prices, in particular, was validated. The two national HICPs cover HFMCE as required by EU standards. Expenditure weights and product baskets are revised on an annual basis. Other HICP standards relating to the level of detail of published price indices and publication timetables, for example, are also met. However, as the HICPs have been harmonised in stages, HICP data before 2001 are not fully comparable with the most recent data.

3 GOVERNMENT FINANCE STATISTICS

This section assesses the methodology and quality of the statistics used to measure fiscal developments. Government finance statistics are based on national accounts concepts and should comply with the European system of national and regional accounts in the Community (ESA 95)[5] and Council Regulation (EC) No 3605/93 of 22 November 1993, amended by Council Regulation (EC) No 2103/2005 of 12 December 2005 for debt. Protocol No 20 on the excessive deficit procedure (EDP), together with Council Regulation (EC) No 3605/93 on the application of the Protocol on the excessive deficit procedure as amended[6], define concepts such as "government", "surplus/deficit", "interest expenditure", "investment", "debt" and "gross domestic product (GDP)" with reference to the ESA 95. The ESA 95 is consistent with other international statistical standards, such as the System of National Accounts 1993 (SNA 93). EDP statistics refer to the ESA 95 sector "general government". This comprises central government, state government (in Member States with a federal structure), regional or local government and

5 Council Regulation (EC) No 2223/96 of 25 June 1996 on the European system of national and regional accounts in the Community, OJ L 310, 30.11.1996, pp. 1-469.

6 Relevant legal texts include Article 104 of the Treaty; the Protocol on the excessive deficit procedure (EDP) annexed to the Treaty; Council Regulation (EC) No 3605/93 on the application of the Protocol on the EDP; the Stability and Growth Pact (SGP), which includes: (i) Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the EDP; and (ii) Council Regulation (EC) No 1056/2005 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the EDP.

social security funds. It does not typically include public corporations.

The EDP general government deficit (-)/surplus (+) is equal to the ESA 95 "net lending (+)/net borrowing (-)" plus "net settlements under swaps and forward rate agreements". ESA 95 net lending (+)/net borrowing (-) is equal to "total revenue" minus "total expenditure". While most transactions within the general government sub-sectors are not consolidated, the distributive transactions "interest", "other current transfers", "investment grants" and "other capital transfers" are consolidated. The primary government deficit/surplus is the government deficit/surplus excluding interest expenditure.

EDP general government debt is the sum of the outstanding gross liabilities at nominal value (face value) as classified in the ESA 95 categories "currency and deposits", "securities other than shares excluding financial derivatives" (e.g. government bills, notes and bonds) and "loans". It excludes financial derivatives, such as swaps, as well as trade credits and other liabilities not represented by a financial document, such as overpaid tax advances. It also excludes contingent liabilities, such as government guarantees and pension commitments. So far, there is no agreed method for collecting and estimating the full scale of fiscal contingent liabilities. Estimates of such items have to be based on far-reaching assumptions and may vary widely. While government debt is a gross concept in the sense that neither financial nor non-financial assets are deducted from liabilities, it is consolidated within the general government sector and therefore does not include government debt held by other government units.

The measure of GDP used for compiling government deficit and debt ratios is the ESA 95 GDP at current market prices.

In April 2006 the European Commission transmitted data on government financial positions (general government deficit/surplus and debt) to the ECB from 1996 to 2005 and forecasts for 2006. The NCBs of the Eurosystem provide the ECB with detailed government finance statistics under the ECB's GFS Guideline (ECB/2005/5).[7] Although this Guideline is legally binding only on the euro area NCBs, the non-euro area NCBs transmit these GFS data to the ECB by the same deadlines and using the same procedures as the euro area NCBs. The GFS Guideline not only asks for detailed information on the breakdowns of revenue and expenditure, but also on the components of the deficit-debt adjustment. Moreover, various breakdowns of the debt by instrument, by initial and residual maturity and by holder are requested.

3.1 DATA COVERAGE OF THE COUNTRIES

As regards compliance with the legal requirement to transmit government finance statistics to the European Commission, annual revenue, expenditure, deficit and debt data have been transmitted by Lithuania for the period 1996 to 2005. Revenue, expenditure and deficit data before 1999 have not yet been provided by Slovenia. Due to changes in the methodology and the sources, its deficit data prior to 2000 are not comparable with the deficit data from 2000 onwards. Similarly, the debt data prior to 1999 are not comparable with the debt data from 1999 onwards. The main factor affecting the comparability of these statistics is a different delineation of the government sector.

3.2 OUTSTANDING STATISTICAL ISSUES

The statistics for the EDP must reflect decisions taken by Eurostat in line with the ESA 95 for specific cases involving the general government sector. A detailed explanation of the application of the decisions taken by Eurostat is provided in Eurostat's ESA 95 manual on government deficit and debt. Recent decisions refer to the

7 Guideline of the ECB of 17 February 2005 on the statistical reporting requirements of the ECB and the procedures for exchanging statistical information within the European System of Central Banks in the field of government finance statistics (ECB/2005/5); amended by Guideline ECB/2006/2.

classification of funded pension schemes in case of government responsibility or guarantee and to the recording of military expenditure.

On 2 March 2004 Eurostat took a decision on the classification of funded pension schemes where government is involved either as a manager of the flows of contributions and pension benefits or as a guarantor for the risk of defaulting payments of pensions. Eurostat has decided that if a government unit is responsible for the management of a defined-contribution funded scheme, for which there is no government guarantee for the risk of defaulting payments covering the majority of the participants, the scheme cannot be treated in national accounts as a social security scheme. The unit managing the scheme must be classified as a public financial corporation. Therefore, the flows of contributions and benefits under the scheme are not recorded as government revenue and expenditure and do not have an impact on the government deficit/surplus. The existence of a government guarantee for a scheme not classified as a social security scheme is not as such a condition for reclassifying the beneficiary scheme as a social security scheme.

As far as the implementation of this decision is concerned, Eurostat granted some Member States a transitional period that will expire with the notification of spring 2007. Since the notification will cover the years 2003 to 2007, the Member States benefiting from the transitional period will have to compile backwards their statistical series at the end of that period.

The impact of pension reforms on the government deficit within the ESA 95 framework needs careful consideration in the context of the convergence process. Consequently, the recording of pension reforms must be sufficiently detailed to strengthen the reliability of the data on which the convergence assessment is generally based. The cost of pension reforms should be measured on the basis of the pension scheme accounts. Data have to be provided on the revenue, expenditure and deficit/surplus of the newly created pension scheme. The cost of pension reforms is determined by the difference between the government data including the scheme and the government data excluding the scheme.

In 2004 a defined-contribution funded scheme was set up in Lithuania and has been classified outside general government. Slovenia's pension schemes have also been classified outside general government.

As regards military expenditure, Eurostat took a decision on 9 March 2006 specifying the time of recording and thus the impact on the government deficit/surplus. Leases of military equipment organised by the private sector are to be considered as financial leases, and not as operating leases. In the case of long-term contracts involving complex systems, government expenditure has to be recorded at the time of delivery of individual and operational pieces of equipment that compose the system, and generally not at the time of completion of the contract. So far, Lithuania's and Slovenia's military expenditures on equipment are rather small.

In the case of Slovenia, the impact of a change in the recording of VAT in 2002 is still under discussion between Eurostat and the Slovenian authorities. The issue centres on the question of which component of the deficit-debt adjustment will be impacted, while the government deficit/surplus will remain unchanged. In this context, the financial accounts as compiled by the NCB are not yet used for the compilation of the breakdown of the deficit-debt adjustment in the EDP notification.

3.3 CONSISTENCY OF GOVERNMENT FINANCE STATISTICS

One of the principles of the Code linked to statistical output focuses on the data quality dimension of coherence and comparability, stating that European statistics should be consistent internally, consistent over time and comparable between countries and that it should be possible to combine and make joint use of related data from different sources. In other words, arithmetic and accounting identities should be observed, and statistics should be coherent or reconcilable over a reasonable period of time, as well as compiled on the basis of common standards with respect to scope, definitions, units and classifications in the different surveys and sources. Lithuania has provided a full set of government finance statistics. However, further efforts should be made to reconcile its non-financial and financial transactions, as well as its financial flow data with the respective balance sheet data. For Slovenia, work has to be done to reconcile its non-financial accounts with the recently published integrated system of financial accounts for the period 2001 to 2004. For the period 1999 to 2001, the figures for the net transactions in financial assets/liabilities do not match the figures provided for transactions in assets and transactions in liabilities.

3.4 DEFICIT-DEBT ADJUSTMENT

The change in government debt outstanding at the end of a year compared with that of the previous year may differ substantially from the government deficit for the year under consideration. For example, government debt may be reduced by using the receipts from privatising public corporations or by selling other financial assets without any (immediate) impact on the government deficit. The explanation of the difference between the deficit and the change in government debt, the "deficit-debt adjustment", is seen as an important indicator for the assessment of the quality and consistency of government finance statistics.[8] The components of this difference are the net acquisition of financial assets, valuation changes of general government debt, and other changes in debt. To compile these components a fully-fledged system of ESA 95 financial accounts for the government sector has to be compiled (transactions, other flows and stocks) and reconciled with nominal debt.

As regards the data reported for 1997, Lithuania's government deficit peaked at 11.4% of GDP, due mainly to a change in the recording of restitutions of confiscated property and compensation for lost savings of rouble deposit holders, whose deposits where frozen at the time of switchover to the litas.[9] This recording follows a recommendation of Eurostat to record a capital transfer in the year in which the government recognised this liability and not when the actual cash payments to households were made, with a counterpart entry as other accounts payable. The bulk of these liabilities referred to 1997.

Slovenia's integrated system of "from-whom-to-whom" financial accounts and balance sheets for 2001 to 2004 facilitates a full assessment of the relationship between the government deficit and debt. From 1999 to 2001 the transactions in Maastricht debt are recorded at nominal value rather than at market value.

4 EXCHANGE RATES

Article 3 of Protocol No 21 on the convergence criteria referred to in Article 121 of the Treaty specifies what is meant by the criterion on participation in the exchange rate mechanism of the European Monetary System. In a policy position dated 18 December 2003, the Governing Council of the ECB clarified that the criterion refers to participation in the exchange rate

8 See "Stock-flow adjustment for the euro-zone and the EU 25 2001 to 2004 reported in the second 2005 EDP notification", Eurostat, 26 September 2005, http://epp.eurostat.cec.eu.int (April 2006).

9 See "First notification of deficit and debt data for 2004", Eurostat's press release STAT/05/39 of 18 March 2005. This press release indicated that there were ongoing discussions between Eurostat and Lithuania on the recording of restitutions, which could lead to a downward revision in the government deficit for 2004 and earlier years. While Eurostat's autumn 2005 press release (120/2005) of 26 September 2005 on the provision of deficit and debt data indicated that the decrease in the government deficit in 2003 and 2004 was mainly due to a change in the recording of restitutions by government of lost savings and real estate, the spring 2006 press release (48/2006) of 24 April 2006 did not mention this issue.

mechanism (ERM II) for a period of at least two years prior to the convergence assessment without severe tensions, in particular without devaluing against the euro.

Bilateral exchange rates of the Member States' currencies vis-à-vis the euro are daily reference rates recorded by the ECB at 2.15 p.m. (following the daily concertation procedure between central banks). They are published on the ECB's website. Real bilateral exchange rates are constructed by deflating the nominal exchange rate index using the HICP or the CPI. Nominal and real effective exchange rates are constructed by applying overall trade weights (based on a geometric weighting) to the bilateral nominal and real exchange rates of the Member States' currencies against the currencies of selected trading partners. Both nominal and real effective exchange rate statistics are calculated by the ECB. An increase in these indices corresponds to an appreciation of the Member State's currency. Overall trade weights refer to trade in manufactured goods and are calculated to account for third-market effects. The effective exchange rate indices are based on moving weights for the periods from 1995 to 1997 and 1999 to 2001, which are linked in January 1999. The group of trading partners comprises the euro area, non-euro area EU Member States, Australia, Canada, China, Hong Kong, Japan, Norway, Singapore, South Korea, Switzerland and the United States.

5 LONG-TERM INTEREST RATES

Article 4 of Protocol No 21 on the convergence criteria referred to in Article 121 of the Treaty requires interest rates to be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions. While Article 5 assigns the responsibility for providing the statistical data for the application of the Protocol to the European Commission, the ECB, given its expertise in the area, assists by defining representative long-term interest rates and collects the data from the NCBs for transmission to the Commission. This is a continuation of the work carried out by the EMI as part of the preparations for Stage Three of EMU in close liaison with the Commission.

The conceptual work resulted in the definition of seven key features to be considered in the calculation of long-term interest rates, as presented in Table 2. Long-term interest rates refer to bonds denominated in national currency.

6 OTHER FACTORS

The last paragraph of Article 121(1) of the Treaty states that the reports of the European Commission and the ECB shall, in addition to the four main criteria, also take account of the

Table 2 Statistical framework for defining long-term interest rates for the purpose of assessing convergence

Concept	Recommendation
Bond issuer	The bonds should be issued by the central government.
Maturity	As close as possible to ten years' residual maturity. Any replacement of bonds should minimise maturity drift; the structural liquidity of the market must be considered.
Coupon effects	No direct adjustment.
Taxation	Gross of tax.
Choice of bonds	The selected bonds should be sufficiently liquid. This requirement should determine the choice between benchmark or sample approaches, depending on national market conditions.
Yield formula	"Yield to maturity" ISMA formula "Redemption yields"
Aggregation	Where there is more than one bond in the sample, a simple average of the yields should be used to produce the representative rate.

development of the ECU, the results of the integration of markets, the situation and development of the national balance of payments on current account and an examination of the development of unit labour costs and other price indices. Whereas for the four main criteria Protocol No 21 stipulates that the Commission will provide the data to be used for the assessment of compliance and describes those statistics in more detail, it makes no reference to the provision of statistics for these "other factors".

With regard to the national balance of payments (b.o.p.) and the international investment position (i.i.p.), the statistics are compiled by the NCBs in accordance with the concepts and definitions laid down in the fifth edition of the IMF Balance of Payments Manual (BPM5) and following methodological standards set out by the ECB and Eurostat. Similar to the ECB's Convergence Report 2004, this report examines the sum of the current account balance and the balance on the capital account, which corresponds to the net lending/net borrowing of the total economy. In addition, it is worth noting that the distinction between current transfers (sub-component of the current account) and capital transfers (sub-component of the capital account) is not always straightforward to identify in practice, as it depends on the recipient's use of the transfer. In particular, the difficulty occurs in the classification of the current and capital components of transfers between EU institutions and Member States.[10]

In the b.o.p. current and capital accounts, both credit and debit transactions are presented with a positive sign. The presentation of net transactions in the b.o.p. financial account (e.g. direct and portfolio investment) follows the conventions of the BPM5, with a negative sign corresponding to either an increase in net assets or a decrease in net liabilities, and the converse for a positive sign. Finally, a positive sign for the net i.i.p. indicates net external assets (i.e. assets exceed liabilities), while a negative sign corresponds to net external liabilities (i.e. liabilities exceed assets).

With regard to producer price indices, these refer to domestic sales of total industry excluding construction. The statistics are collected on a harmonised basis under the EU Short-Term Statistics (STS) Regulation.[11]

Statistics on unit labour costs (calculated as the ratio of compensation per employee to GDP at constant prices per person employed) are derived from data provided under the ESA 95 transmission programme.

7 CUT-OFF DATE

The cut-off date for the statistics included in this Convergence Report was 28 April 2006.

10 For more details, see "European Union balance of payments/ international investment position statistical methods", ECB, November 2005.

11 Council Regulation (EC) No 1165/98 of 19 May 1998 concerning short-term statistics, OJ L 162, 5.6.1998, p. 1. Regulation as amended by Regulation (EC) No 1158/2005 of the European Parliament and of the Council of 6 July 2005 , OJ L 191, 22.7.2005, p. 1.

CHAPTER 2

COMPATIBILITY OF NATIONAL LEGISLATION WITH THE TREATY

1 INTRODUCTION

1.1 GENERAL REMARKS

Article 122(2) of the Treaty requires the ECB (and the Commission) to report, at least once every two years or at the request of a Member State with a derogation, to the EU Council in accordance with the procedure laid down in Article 121(1). Each such report must include an examination of the compatibility between, on the one hand, the national legislation of each Member State with a derogation, including the statutes of its NCB, and, on the other hand, Articles 108 and 109 of the Treaty and the Statute of the European System of Central Banks and of the European Central Bank (hereinafter the "Statute"). This Treaty obligation applying to Member States with a derogation is also referred to as "legal convergence".

1.2 MEMBER STATES WITH A DEROGATION AND LEGAL CONVERGENCE

Slovenia and Lithuania, whose national legislation is examined in this report, have the status of Member States with a derogation. Article 4 of the Act concerning the conditions of accession[1] provides that: "Each of the new Member States shall participate in Economic and Monetary Union from the date of accession as a Member State with a derogation within the meaning of Article 122 of the EC Treaty".

The ECB has examined the level of legal convergence in Slovenia and Lithuania, as well as the legislative measures that have been taken or need to be taken by them to achieve this goal.

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

1.3 STRUCTURE OF THE LEGAL ASSESSMENT

The legal assessment broadly follows the framework of the ECB's and the EMI's previous reports on legal convergence, in particular the ECB's Convergence Reports of 2004 (on the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia, Slovakia and Sweden), of 2002 (on Sweden) and of 2000 (on Greece and Sweden) and the EMI's Convergence Report of 1998. The compatibility of national legislation is also considered in the light of any legislative amendments enacted before 27 April 2006.

2 SCOPE OF ADAPTATION

2.1 AREAS OF ADAPTATION

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

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

– compatibility with the prohibitions on monetary financing (Article 101 of the Treaty) and privileged access (Article 102 of the Treaty) and compatibility with the

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

single spelling of the euro required by Community law; and

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

2.2 "COMPATIBILITY" VERSUS "HARMONISATION"

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

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

The obligation in Article 109 of the Treaty only covers incompatibility with the Treaty and Statute. However, national legislation that is incompatible with secondary Community legislation should be brought into line with such secondary legislation. The primacy of Community law does not affect the obligation to adapt national legislation. This general requirement derives not only from Article 109 of the Treaty but also from the case law of the Court of Justice of the European Communities.[2]

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

Furthermore, inter alia as a tool to achieve and maintain the compatibility of national legislation with the Treaty and Statute, the ECB must be consulted by the Community institutions and the Member States on draft legislative provisions in its fields of competence, pursuant to Article 105(4) of the Treaty and Article 4 of the Statute. Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions[3] expressly requires that the Member States take the measures necessary to ensure compliance with this obligation.

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

3 INDEPENDENCE OF NCBs

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

3.1 CENTRAL BANK INDEPENDENCE

In 1997 the EMI established a list of features of central bank independence (later described in detail in its 1998 Convergence Report) which were the basis for the assessment of the national legislation of the Member States at that time, in particular the NCB statutes. The concept of central bank independence includes various types of independence that must be assessed separately, namely functional, institutional, personal and financial independence. Over the past few years, there has been further refinement of the analysis of these aspects of central bank independence in the opinions adopted by the ECB. These aspects are the basis for assessing the level of convergence between the national legislation of the Member States with a derogation, on the one hand, and the Treaty and Statute, on the other hand.

3.1.1 FUNCTIONAL INDEPENDENCE

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

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

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

3.1.2 INSTITUTIONAL INDEPENDENCE

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

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

PROHIBITION ON GIVING INSTRUCTIONS

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

PROHIBITION ON APPROVING, SUSPENDING, ANNULLING OR DEFERRING DECISIONS

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

PROHIBITION ON CENSORING DECISIONS ON LEGAL GROUNDS

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

PROHIBITION ON PARTICIPATING IN DECISION-MAKING BODIES OF AN NCB WITH A RIGHT TO VOTE

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

PROHIBITION ON EX ANTE CONSULTATION RELATING TO AN NCB's DECISION

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

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

– this does not result in interference with the independence of the members of the NCB's decision-making bodies;

– the special status of Governors in their capacity as members of the ECB's General Council is fully respected; and

– confidentiality requirements resulting from the Statute are observed.

DISCHARGE OF DUTIES OF MEMBERS OF THE NCB's DECISION-MAKING BODIES

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

3.1.3 PERSONAL INDEPENDENCE

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

MINIMUM TERM OF OFFICE FOR GOVERNORS

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

GROUNDS FOR DISMISSAL OF GOVERNORS

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

SECURITY OF TENURE OF MEMBERS OF NCBs' DECISION-MAKING BODIES, OTHER THAN GOVERNORS, WHO ARE INVOLVED IN THE PERFORMANCE OF ESCB-RELATED TASKS

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

RIGHT OF JUDICIAL REVIEW

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

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

National legislation should also provide for a right of review by the national courts of a decision to dismiss any other member of the decision-making bodies of the NCB involved in the performance of ESCB-related tasks. This right can either be a matter of general law or can take the form of a specific provision in the NCB's statutes.

SAFEGUARDS AGAINST CONFLICT OF INTEREST

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

3.1.4 FINANCIAL INDEPENDENCE

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

Member States may not put their NCBs in a position where they do not have sufficient financial resources to carry out their ESCB- or Eurosystem-related tasks, as applicable. It should be noted that Article 28.1 and Article 30.4 of the Statute provide for the possibility of further calls on the NCBs to make contributions to the ECB's capital and make further transfers of foreign reserves.[4] Moreover, Article 33.2 of the Statute provides[5] that in the event of a loss incurred by the ECB which cannot be fully offset against the general reserve fund, the ECB's Governing Council may decide to offset the remaining loss against the monetary income of the relevant financial year in proportion and up to the amounts allocated to the NCBs. The principle of financial independence requires that compliance with these provisions leaves an NCB's ability to perform its functions unimpaired.

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

The concept of financial independence should therefore be assessed from the perspective of whether any third party is able to exercise either direct or indirect influence not only over an NCB's tasks but also over its ability (understood both operationally in terms of manpower, and financially in terms of appropriate financial resources) to fulfil its mandate. The four aspects of financial independence set out below are particularly relevant in this respect, and some of them have only been refined quite recently.[6] These are the features of financial independence

4 Article 30.4 of the Statute only applies within the Eurosystem.
5 Article 33.2 of the Statute only applies within the Eurosystem.

where NCBs are most vulnerable to outside influence.

DETERMINATION OF BUDGET

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

THE ACCOUNTING RULES

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

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

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

DISTRIBUTION OF PROFITS, NCBs' CAPITAL AND FINANCIAL PROVISIONS

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

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

FINANCIAL LIABILITY FOR SUPERVISORY AUTHORITIES

Some Member States place their financial supervisory authorities within their NCB. When such authorities are subject to the NCB's independent decision-making this is unproblematic. On the other hand, when the law provides for separate decision-making by such supervisory authorities, it is important to ensure that decisions adopted by them do not endanger the finances of the NCB as a whole. In those cases, the national legislation should enable the NCBs to have ultimate control over any decision by the supervisory authorities that could affect the NCB's independence, in particular its financial independence.

6 The main formative ECB opinions in this area are the following:
– CON/2002/16 of 5 June 2002 at the request of the Irish Department of Finance on a draft Central Bank and Financial Services Authority of Ireland Bill, 2002;
– CON/2003/22 of 15 October 2003 at the request of the Finnish Ministry of Finance on a draft government proposal to amend the Suomen Pankki Act and other related acts;
– CON/2003/27 of 2 December 2003 at the request of the Austrian Federal Ministry of Finance on a draft Federal law on the National Foundation for Research, Technology and Development; and
– CON/2004/1 of 20 January 2004 at the request of the Economic Committee of the Finnish Parliament on a draft government proposal to amend the Suomen Pankki Act and other related acts.

3.2 CONFIDENTIALITY

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

4 PROHIBITION ON MONETARY FINANCING AND PRIVILEGED ACCESS

4.1 PROHIBITION ON MONETARY FINANCING

The monetary financing prohibition is laid down in Article 101(1) of the Treaty, which prohibits overdraft facilities or any other type of credit facility with the ECB or the NCBs of Member States in favour of Community institutions or bodies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States; and the purchase directly from these public sector entities by the ECB or NCBs of debt instruments. The Treaty contains two exemptions from the prohibition: it does not apply to publicly-owned credit institutions which, in the context of the supply of reserves by central banks, must be given the same treatment as private credit institutions (Article 101(2) of the Treaty); and the ECB and the NCBs may act as fiscal agents for the public sector bodies referred to above (Article 21.2 of the Statute). The precise scope of application of the monetary financing prohibition is further clarified by Council Regulation (EC) No 3603/93 of 13 December 1993 specifying definitions for the application of the prohibitions referred to in Articles 104 and 104b(1) of the Treaty[7] (now Articles 101 and 103(1)), which makes clear that the prohibition includes any financing of the public sector's obligations vis-à-vis third parties.

The monetary financing prohibition is of essential importance to ensure that the primary objective of monetary policy (namely to maintain price stability) is not impeded. Furthermore, central bank financing of the public sector lessens the pressure for fiscal discipline. Therefore the prohibition must be interpreted extensively in order to ensure its strict application, subject only to certain limited exemptions contained in Article 101(2) of the Treaty and Regulation (EC) No 3603/93. The ECB's general stance regarding the compatibility of national legislation with the prohibition has been primarily developed within the framework of consultations of the ECB by Member States on draft national legislation under Article 105(4) of the Treaty.[8]

7 OJ L 332, 31.12.1993, p. 1.

8 Some formative EMI/ECB opinions in this area are the following:
– CON/95/8 of 10 May 1995 on a consultation from the Swedish Ministry of Finance under Article 109(f) of the Treaty establishing the European Community ("the Treaty") and Article 5.3 of the Statute of the EMI ("the Statute"); on a draft government bill introducing a ban on monetary financing ("the Bill");
– CON/97/16 of 27 August 1997 on a consultation from the Austrian Federal Ministry of Finance under Article 109(f) of the Treaty establishing the European Community (the "Treaty") and Article 5.3 of the Statute of the EMI as elaborated in the Council Decision of 22 November 1993 (93/717/EC) (the "Decision"); concerning a draft Federal Act on the participation of Austria in the New Arrangement to Borrow with the International Monetary Fund;
– CON/2001/32 of 11 October 2001 at the request of the Portuguese Ministry of Finance a draft decree law amending the legal framework of credit institutions and financial companies;
– CON/2003/27 of 2 December 2003 at the request of the Austrian Federal Ministry of Finance on a draft Federal law on the National Foundation for Research, Technology and Development;
– CON/2005/1 of 3 February 2005 at the request of the Italian Ministry of Economic Affairs and Finance on a draft law amending Law Decree No 7 of 25 January 1999, as converted by Law No 74 of 25 March 1999, concerning urgent provisions on Italian participation in the International Monetary Fund's interventions to confront severe financial crises of its member countries;
– CON/2005/24 of 15 July 2005 at the request of the Ministry of Finance of the Czech Republic on a draft law on the integration of financial market supervisors;
– CON/2005/29 of 11 August 2005 at the request of the Austrian Federal Ministry of Finance concerning a draft Federal law on the payment of a contribution by Austria to the trust fund administered by the International Monetary Fund for low income developing countries affected by natural disasters; and
– CON/2005/60 of 30 December 2005 at the request of Lietuvos bankas on a draft law amending the Lietuvos bankas Act.

NATIONAL LEGISLATION TRANSPOSING THE MONETARY FINANCING PROHIBITION

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

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

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

ASSUMPTION OF PUBLIC SECTOR LIABILITIES

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

FINANCIAL SUPPORT FOR CREDIT AND/OR FINANCIAL INSTITUTIONS

National legislation foreseeing the financing by NCBs of credit institutions other than in connection with central banking tasks (such as monetary policy, payment system or temporary liquidity support operations), in particular to support insolvent credit and/or other financial institutions, is not compatible with the monetary financing prohibition.

FINANCIAL SUPPORT FOR DEPOSIT INSURANCE AND INVESTOR COMPENSATION SCHEMES

The Deposit Guarantee Schemes Directive[9] and the Investor Compensation Schemes Directive[10] provide that the costs of financing deposit guarantee schemes and investor compensation schemes must be borne, respectively, by credit institutions and investment firms themselves. National legislation foreseeing the financing by NCBs of a public sector national deposit insurance scheme for credit institutions or a national investor compensation scheme for investment firms would not be compatible with the monetary financing prohibition, if it is not short term, it does not address urgent situations, systemic stability aspects are not at stake, and decisions do not remain at the NCB's discretion.

4.2 PROHIBITION ON PRIVILEGED ACCESS

NCBs may not, as public authorities, take measures granting privileged access by the public sector to financial institutions if such measures are not based on prudential considerations. Furthermore, the rules on mobilisation or pledging of debt instruments enacted by the NCBs must not be used as a means of circumventing the prohibition on

9 Recital 23 to Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes (OJ L 135, 31.5.1994, p. 5).

10 Recital 23 to Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor-compensation schemes (OJ L 84, 26.3.1997, p. 22).

privileged access.[11] Member States' legislation in this area may not establish such privileged access.

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

5 SINGLE SPELLING OF THE EURO

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

At its meeting in Madrid on 15 and 16 December 1995, the European Council decided that "the name given to the European currency shall be Euro", that "the name … must be the same in all the official languages of the European Union, taking into account the existence of different alphabets" and that "the specific name Euro will be used instead of the generic term 'ECU' used by the Treaty to refer to the European currency unit". Finally, the European Council concluded that: "The Governments of the fifteen Member States have achieved the common agreement that this decision is the agreed and definitive interpretation of the relevant Treaty provisions." This unambiguous and definitive agreement by the heads of state and government of the Member States has been confirmed in all Community legal acts that refer to the euro, which always use a single spelling in all official Community languages. Of particular importance is the fact that the single spelling of the euro agreed by the Member States has been retained in Community monetary law.[12] The recent Council Regulation (EC) No 2169/2005 of 21 December 2005 amending Regulation (EC) No 974/98 on the introduction of the euro[13] confirms the correct spelling of the single currency. First, Regulation (EC) No 974/98 states in all language versions that "the name given to the European currency shall be the 'euro'". Second, all language versions of Regulation (EC) No 2169/2005 refer to the "euro".

In 2003 all the Member States ratified the Decision of the Council, meeting in the composition of the Heads of State or Government of 21 March 2003 amending Article 10.2 of the Statute of the European System of Central Banks and of the European Central Bank[14], where, once more, this time in a legal act pertaining to primary law, the name of the single currency is spelled identically in all language versions.

This unambiguous and definitive position of the Member States is also binding on the Member States with a derogation. Article 5(3) of the Act concerning the conditions of accession stipulates that "the new Member States are in the same situation as the present Member States in respect of declarations or resolutions of, or other positions taken up by, the European Council or the Council and in respect of those

11 See Article 3(2) of and recital 10 to Council Regulation (EC) No 3604/93 of 13 December 1993 specifying definitions for the application of the prohibition of privileged access referred to in Article 104a [now Article 102] of the Treaty (OJ L 332, 31.12.1993, p. 4).
12 See Council Regulation (EC) No 1103/97 of 17 June 1997 on certain provisions relating to the introduction of the euro (OJ L 162, 19.6.1997, p. 1), Council Regulation (EC) No 974/98 of 3 May 1998 on the introduction of the euro (OJ L 139, 11.5.1998, p. 1) and Council Regulation (EC) No 2866/98 of 31 December 1998 on the conversion rates between the euro and the currencies of the Member States adopting the euro (OJ L 359, 31.12.1998, p. 1), all three of which were amended in 2000 for the introduction of the euro in Greece; see also the legal acts adopted by the Community regarding euro coins in 1998 and 1999.
13 OJ L 346, 29.12.2005, p. 1.
14 OJ L 83, 1.4.2003, p. 66.

concerning the Community or the Union adopted by common agreement of the Member States; they will accordingly observe the principles and guidelines deriving from those declarations, resolutions or other positions and will take such measures as may be necessary to ensure their implementation".

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

6 LEGAL INTEGRATION OF NCBs INTO THE EUROSYSTEM

Provisions in national legislation (in particular the NCB statutes, but also other legislation) which would prevent the performance of Eurosystem-related tasks or compliance with ECB decisions are incompatible with the effective operation of the Eurosystem once the Member State concerned has adopted the euro. National legislation therefore has to be adapted to ensure compatibility with the Treaty and the Statute in respect of Eurosystem-related tasks. To comply with Article 109 of the Treaty, national legislation had to be adjusted to ensure its compatibility by the date of establishment of the ESCB (as regards Sweden) and by 1 May 2004 (as regards the Member States which joined the EU on that date). Nevertheless, statutory requirements relating to the full legal integration of an NCB into the Eurosystem need only enter into force at the moment that full integration becomes effective, i.e. the date on which the Member State with a derogation adopts the euro.

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

6.1 ECONOMIC POLICY OBJECTIVES

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

6.2 TASKS

The tasks of an NCB of a Member State that has adopted the euro are predominantly determined by the Treaty and the Statute, given that NCB's status as an integral part of the Eurosystem. In order to comply with Article 109 of the Treaty, provisions on tasks in NCB statutes therefore need to be compared with the relevant provisions of the Treaty and the Statute, and any incompatibility must be removed.[15] This applies to any provision that, after adoption of the euro and integration into the Eurosystem, constitute an impediment to the execution of ESCB-related tasks and in particular to provisions which do

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

not respect the ESCB's powers under Chapter IV of the Statute.

Any national legislative provisions relating to monetary policy must recognise that the Community's monetary policy is a task to be carried out through the Eurosystem[16]. The NCB statutes may contain provisions on monetary policy instruments. Such provisions should be compared with those in the Treaty and Statute and any incompatibility must be removed, in order to comply with Article 109 of the Treaty.

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

With regard to foreign reserve management[17], any Member States that have adopted the euro which do not transfer their official foreign reserves[18] to their NCB are in breach of the Treaty. In addition, the right of a third party – for example, the government or parliament – to influence an NCB's decisions with regard to management of the official foreign reserves is inconsistent with the third indent of Article 105(2) of the Treaty. Furthermore, NCBs have to provide the ECB with foreign reserve assets in proportion to their shares in the ECB's subscribed capital. This means that there must be no legal obstacles to NCBs transferring foreign reserve assets to the ECB.

6.3 FINANCIAL PROVISIONS

The financial provisions in the Statute comprise rules on financial accounts[19], auditing[20], capital subscription[21], the transfer of foreign reserve assets[22] and the allocation of monetary income[23]. NCBs must be able to comply with their obligations under these provisions and therefore any incompatible national provisions must be repealed.

6.4 EXCHANGE RATE POLICY

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

6.5 INTERNATIONAL COOPERATION

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

16 First indent of Article 105(2) of the Treaty.
17 Third indent of Article 105(2) of the Treaty.
18 With the exception of foreign-exchange working balances, which Member State governments may retain pursuant to Article 105(3) of the Treaty.
19 Article 26 of the Statute.
20 Article 27 of the Statute.
21 Article 28 of the Statute.
22 Article 30 of the Statute.
23 Article 32 of the Statute.

6.6 MISCELLANEOUS

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

7 COUNTRY ASSESSMENTS

7.1 LITHUANIA

7.1.1 COMPATIBILITY OF NATIONAL LEGISLATION (ARTICLE 109 OF THE TREATY)

The legal basis for Lietuvos bankas and its operations is contained in the following legislation:

– the Lithuanian Constitution[24]; and

– the Law on Lietuvos bankas (hereinafter the "Law").[25]

In the light of the ECB's Convergence Report of 2004 and the ECB's Opinions[26], on 25 April 2006 the Lithuanian Parliament adopted three laws (hereinafter collectively referred to as the "Amending Legislation"). These were: a law amending Article 125 of the Constitution[27]; a law amending the Law on Lietuvos bankas[28] (hereinafter the "Amending Law"); and a law repealing the Law on the issue of money, the Law changing the name and amounts of monetary units, the Law on money and the Law on the credibility of the litas[29] (hereinafter the "Repealing Law"). The Amending Legislation will enter into force by the day the euro is introduced in Lithuania.[30]

7.1.2 INDEPENDENCE OF THE NCB

With regard to Lietuvos bankas's independence, the Amending Legislation provides for the following adaptations.

PERSONAL INDEPENDENCE

The ECB's Convergence Report of 2004 noted that Articles 75 and 84(13) of the Constitution were incompatible with the Treaty and the Statute. According to these articles the Lithuanian Parliament could remove officials appointed or chosen by the Lithuanian Parliament[31], including the Chairperson of Lietuvos bankas's Board, by a majority vote by all members of no confidence in the officials in question. The ground for dismissal, a vote of no confidence, was previously incompatible with Article 14.2 of the Statute, and therefore had to be adapted accordingly. The law amending Article 125 of the Constitution addresses this issue by providing that that the grounds for dismissal of the Chairperson of Lietuvos bankas's Board are established by the Law.

Lithuanian law also did not prescribe with sufficient certainty which courts were competent to hear cases concerning the dismissal of the Deputy Chairpersons and Members of Lietuvos bankas's Board. The Amending Law addresses this issue by providing that the abovementioned

24 *Lietuvos Respublikos Konstitucija*, as approved in a referendum on 25 October 1992 (published in the Official Gazette on 10.11.1992, No 31-953 and on 30.11.1992, No 33-1014) and as last amended by Law No X-572 of 25 April 2006.

25 *Lietuvos banko įstatymas* Law No I-678 of 1 December 1994, as last amended by Law No X-569 of 25 April 2006.

26 ECB Opinion CON/2005/38 of 26 October 2005 at the request of Lietuvos bankas on a draft law amending Article 125 of the Constitution of the Republic of Lithuania and ECB Opinion CON/2005/60 of 30 December 2005 at the request of Lietuvos bankas on a draft law amending the Lietuvos bankas Act.

27 *Lietuvos Respublikos Konstitucijos 125 straipsnio pakeitimo įstatymas* Law No X-572 of 25 April 2006 (published in the Official Gazette on 29.4.2006, No 48-1701).

28 *Lietuvos Respublikos Lietuvos banko įstatymo 1, 6, 7, 8, 11, 12, 14, 19, 20, 25, 31, 33, 35, 36, 38, 47, 49, 50, 53, 54, 54(1), 55 straipsnių, ketvirtojo ir penktojo skirsnių pavadinimų pakeitimo, 26, 27, 28, 29, 30, 32, 37 straipsnių pripažinimo netekusiais galios ir įstatymo priedo papildymo įstatymas* Law No X-569 of 25 April 2006 (published in the Official Gazette on 29.4.2006, No 48-1699).

29 *Lietuvos Respublikos kai kurių įstatymų pripažinimo netekusiais galios įstatymas* Law No X-570 of 25 April 2006 (published in the Official Gazette on 29.4.2006, No 48-1700).

30 The constitutional amendment will enter into force on 25 May 2006; with the exception of two articles, the Amending Law will enter into force on the day Lithuania's derogation is abrogated; and the Repealing Law will enter into force on the day Lithuania adopts the euro.

31 Except for officers specified in Article 74 of the Lithuanian Constitution.

officials may refer to Vilnius District Court regarding their dismissal.

7.1.3 SINGLE SPELLING OF THE EURO

In the draft law on the adoption of the euro[32], the name of the single currency was spelled in a way which is currently inconsistent with Community law. In addition, on 28 October 2004 the Lithuanian State Language Commission decided that the name of the single currency should be used in its adapted form in the Lithuanian version of all official documents. In the ECB's opinion, the name of the single currency is legally required to be consistently rendered in all national legal acts, in the nominative singular case, as the "euro".

The Amending Legislation contains the correct spelling of the word "euro" and is therefore compatible with the Treaty.

The ECB expects that the correct spelling of the word "euro" will also be applied in all other national legal acts, in particular the law on the adoption of the euro.

7.1.4 LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

With regard to the legal integration of Lietuvos bankas into the Eurosystem, the Amending Law contains the following adaptation to address the previous incompatibility of Article 7(2) of the Law with the Treaty and the Statute.

ECONOMIC POLICY OBJECTIVES

Article 7(2) of the Law, which stated that Lietuvos bankas "shall, within the range of its competence, support the economic policy carried out by the Government of the Republic of Lithuania, without prejudice to the primary objective of Lietuvos bankas", was previously incompatible with the provisions of the Treaty and the Statute. The Amending Law provides for revised wording of Article 7(2) of the Law in relation to economic policy objectives and this revised wording is compatible with the Treaty and Statute requirements.

7.1.5 TASKS

MONETARY POLICY

The application of Lietuvos bankas's monetary policy instruments depended on a fixed exchange-rate regime for the litas and Lietuvos bankas's obligation to exchange the litas into the euro as the anchor currency, and the anchor currency into the litas, without restriction. The Law's provisions on monetary policy, including Articles 8 and 11 and Chapter 4, did not previously recognise the ECB's powers in this field.

The Amending Law recognises the ECB's powers in this field.

ISSUING BANKNOTES

Article 125(2) of the Lithuanian Constitution, which provided that Lietuvos bankas has the exclusive right to issue currency, was previously incompatible with the Treaty and the Statute. The law amending Article 125 of the Constitution eliminates this incompatibility by repealing Lietuvos bankas's exclusive right to issue currency.

Article 6 of the Law, which also provided that Lietuvos bankas had the exclusive right to issue currency in Lithuania, was previously incompatible with the Treaty and the Statute. The Amending Law recognises the ECB's powers in this field.

The Law on money, which entrusted Lietuvos bankas with the exclusive right to issue banknotes and coins, was previously incompatible with the Treaty and the Statute as it did not recognise the ECB's powers in this field. The Repealing Law repeals the Law on money.

The Law on the issue of money, which also did not recognise the ECB's powers in the field of banknote and coin issue, was previously incompatible with the Treaty and the Statute.

32 See ECB Opinion CON/2005/21 of 14 June 2005 at the request of Lietuvos bankas on a draft law on the adoption of the euro.

The Repealing Law repeals the Law on the issue of money.

FOREIGN RESERVE MANAGEMENT

The Law, which did not recognise the Eurosystem's right to hold and manage the official foreign reserves, was previously incompatible with the Treaty and the Statute. The Amending Law addresses this issue by providing that "Lietuvos bankas shall manage, use and dispose of foreign reserves following the principles and procedure meeting the requirements of European Union law".

7.1.6 INSTRUMENTS

Articles 8 and 11, as well as Chapter 4, of the Law, which referred to the monetary policy instruments available to Lietuvos bankas but did not recognise the ECB's powers in this field, were previously incompatible with the Treaty and the Statute. The Amending Law recognises the ECB's powers in this field.

Article 11(1)(2) and Article 30 of the Law, both on minimum reserves, did not recognise the ECB's powers in this field and were therefore previously incompatible with the Treaty and the Statute. The Amending Law does not prejudice the ECB's powers in this field and is therefore compatible with the Treaty and the Statute.

7.1.7 FINANCIAL PROVISIONS

FINANCIAL REPORTING

The financial provisions of the Law, in particular the rules on financial reporting, auditing (appointment of independent external auditors), capital subscriptions, the transfer of foreign reserve assets and monetary income did not comply with the Community's and the ECB's powers in this field and were therefore previously incompatible with the Treaty and the Statute. The Amending Law recognises the Community's and the ECB's powers in this field.

APPOINTMENT OF INDEPENDENT EXTERNAL AUDITORS

The provisions of the Law on auditing (appointment of independent external auditors) did not comply with the Community's and the ECB's powers in this field and were therefore previously incompatible with the Treaty and the Statute. The Amending Law recognises the Community's and the ECB's powers in this field.

The ECB notes that, under the Law on the State Audit Office, this Office is empowered to check whether the State's property is being effectively managed. The ECB understands that: (i) the State Audit Office is also bound by Article 3(2) of the Law, which concerns the general prohibition on giving instructions to the NCB; (ii) the audit of the State Audit Office is limited to the management, usage and disposal of real estate, equipment and capital of Lietuvos bankas; and (iii) the State Audit Office has no power to interfere with either the opinion of the external auditors or with Lietuvos bankas's ESCB-related tasks.

In view of the safeguards stated above, the powers of the State Audit Office are not incompatible with central bank independence.

7.1.8 EXCHANGE RATE POLICY

The Law on the credibility of the litas and the Law on foreign currency in the Republic of Lithuania did not acknowledge the Community's and the ECB's exchange-rate policy powers and were therefore previously incompatible with the Treaty and the Statute. In particular, the Law on the credibility of the litas provided that all litas in circulation had to be backed by Lietuvos bankas's foreign reserves and that an official exchange rate had to be set between the litas and the anchor currency (euro). The Repealing Law repeals the Law on the credibility of the litas.

7.1.9 INTERNATIONAL COOPERATION

The Law, which provided that Lietuvos bankas could participate in international monetary institutions without the approval of any other party, was previously incompatible with the Treaty and the Statute as any such participation needs to be subject to the ECB's approval, pursuant to Article 6.2 of the Statute. The Amending Law recognises the ECB's powers in this field.

7.1.10 ADAPTATION OF OTHER LEGISLATION

As far as other legislation is concerned, the ECB is not aware of any other statutory provisions which require adaptation under Article 109 of the Treaty.

7.1.11 CONCLUSION

Following the recent amendments, the Lithuanian Constitution and the Law on Lietuvos bankas are compatible with the Treaty and Statute requirements for Stage Three of Economic and Monetary Union.

7.2 SLOVENIA

7.2.1 COMPATIBILITY OF NATIONAL LEGISLATION (ARTICLE 109 OF THE TREATY)

The following legislation forms the legal basis for Banka Slovenije and its operations:

– the Slovenian Constitution; and

– the Law on Banka Slovenije (hereinafter the "Law").[33]

On 30 March 2006, Slovenia's Parliament adopted a law amending the Law on Banka Slovenije (the "Amending Law")[34] to meet Treaty and Statute requirements in respect of Banka Slovenije's independence and its integration into the ESCB. The ECB has been consulted on the Amending Law, which was finalised, inter alia, in the light of the ECB's Convergence Report of 2004 and the ECB's Opinion[35]. The Amending Law entered into force on 14 April 2006.

7.2.2 INDEPENDENCE OF THE NCB

With regard to Banka Slovenije's independence, the Amending Law provides for the following adaptations.

INSTITUTIONAL INDEPENDENCE

Article 27(2) of the Law, which provided that "Banka Slovenije and the ministry in charge of finance shall determine in an underlying agreement the type, range, conditions and manner of carrying out the operations for the Republic of Slovenia pursuant to Article 12 of this Law", was previously incompatible with the Treaty and the Statute.

Article 27(2) of the Law could have called into question Banka Slovenije's independence in foreign reserve management, as it implied that Banka Slovenije required the agreement of the Ministry of Finance in determining matters concerning the management of foreign reserves. This article is amended by Article 9 of the Amending Law, which excludes the management of foreign reserves from the scope of Article 27(2).

PERSONAL INDEPENDENCE

The Law did not previously entirely reflect the provisions of the Treaty and the Statute on personal independence.

Article 39(1) of the Law (concerning the grounds on which Banka Slovenije's Governor could be dismissed), which provided that the Governor could be dismissed if found guilty of a criminal offence and unconditionally

33 *Zakon o Banki Slovenije*, adopted on 19 June 2002, published in the Official Gazette of the Republic of Slovenia Nos 58/2002 and 85/2002 (corrigendum).

34 *Zakon o spremembah in dopolnitvah Zakona o Banki Slovenije*, adopted on 30 March 2006, published in the Official Gazette of the Republic of Slovenia No 39/2006.

35 ECB Opinion CON/2006/17 of 13 March 2006 at the request of the Slovenian Ministry of Finance on a draft law amending the Law on Banka Slovenije.

sentenced to imprisonment, was incompatible with the Treaty and the Statute. Article 16 of the Amending Law deletes this ground and aligns the wording of the ground under point 4 (new point 3), concerning serious misconduct, with the wording of Article 14.2 of the Statute.

The ECB understands that the reference to a conflict of interest in Article 39.1(2) addresses only the situations defined in Article 38 of the Law and is of the view that a cross-reference for legal certainty reasons in a further revision of the Law would be welcome.

The Law on prevention of corruption[36], and its potential impact on the Governor's personal independence, was incompatible with the Treaty and the Statute. According to the Law on prevention of corruption, Banka Slovenije's Governor could also be dismissed if they failed to provide or update their declaration of wealth and/or information on ancillary activities. In circumstances in which the Governor willingly cooperated with the competent authorities, this ground for dismissal would have been incompatible with Article 14.2 of the Statute. The Amending Law satisfactorily addresses this concern since Article 17 thereof provides that the provisions of the Law on prevention of corruption or the Law on the incompatibility of holding public office with profitable activity which relate to the sanction of early termination of office "shall not apply to members of the Governing Board of Banka Slovenije".

7.2.3 SINGLE SPELLING OF THE EURO

The Law did not use the correct spelling of the name of the single currency and wrongly referred to the "evro". The Amending Law addresses this problem and eliminates the incompatibility. Its Article 1 provides that in the Law on Banka Slovenije, the word "evro" in all grammatical cases must be replaced with the word "euro" in the appropriate case.

The ECB expects that the correct spelling of the word "euro" will also be applied in all other national legal acts, in particular the euro changeover law. Only when all national legal acts use the correct spelling of the word "euro" will Slovenia comply with the Treaty requirements.

7.2.4 LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

With regard to the legal integration of Banka Slovenije into the Eurosystem, the following adaptations are provided for in the Amending Law, to deal with certain incompatibilities between the Law, on the one hand, and the Treaty and the Statute, on the other hand.

ECONOMIC POLICY OBJECTIVES

Article 4 of the Law, which provided that, without prejudice to the primary objective of price stability, Banka Slovenije "shall support the general economic policy and shall strive for financial stability", was previously incompatible with the Treaty and the Statute. The wording of this secondary objective needed to be more closely aligned to Article 105(1) of the Treaty. Moreover, the third objective needed to be more clearly subordinated to the secondary one. This article is satisfactorily amended by Article 2 of the Amending Law, which provides that "without prejudice to the objective of ensuring price stability, Banka Slovenije shall support general economic policy in accordance with the objectives set in the Treaty establishing the European Community".

7.2.5 TASKS

ISSUING BANKNOTES

Article 58(2) of the Law, which provided that Banka Slovenije had to act independently and not be bound by the provisions of the Statute when performing the tasks pursuant to Articles 5, 6, 9, points 2 to 7 of Article 12, and Articles 23 and 27 of the Law, was previously incompatible with the Treaty and the Statute.

36 *Zakon o preprečevanju korupcije*, adopted on 19 December 2003, published in the Official Gazette of the Republic of Slovenia No 2/2004.

The wording of Article 58(2) of the Law required further adaptation to specify clearly that the performance of the tasks pursuant to these articles should not interfere with the objectives and tasks of the Eurosystem. Article 29 of the Amending Law provides for amendments to Article 58(2) of the Law which recognise the Eurosystem's objectives and tasks. According to this provision, from the day the euro is introduced in Slovenia, Banka Slovenije must act in accordance with the provisions of the Treaty and the Statute regarding the implementation of monetary policy, the conduct of foreign exchange operations, the holding and managing of official foreign reserves and the promotion of the smooth operation of payment systems.

The Amending Law also modifies the Law with respect to banknotes and coins. Article 32 of the Amending Law inserts a new Article 60a, which provides that from the day the euro is introduced in Slovenia, Banka Slovenije "shall begin to place banknotes into circulation in accordance with the first paragraph of Article 106 of the Treaty establishing the European Community". Moreover, the Amending Law repeals the articles of the Law that will become obsolete when the euro is introduced.

7.2.6 INSTRUMENTS

Articles 15, 16, 17, 18, 19, 20 and 45 of the Law (concerning Banka Slovenije's powers to implement monetary policy), in conjunction with Chapter 11 of the Law on the introduction of the euro in Slovenia, which did not sufficiently recognise the ECB's powers in this field, were incompatible with the Treaty and the Statute. The Amending Law addresses this issue by amending Article 61 of the Law. Article 3 of the Amending Law provides that from the day the euro is introduced in Slovenia, in implementing monetary policy Banka Slovenije must implement the Statute and the decisions of the ESCB's decision-making bodies. Moreover, Banka Slovenije's tasks concerning the design and implementation of monetary policy (pursuant to Article 11, points 1 and 3) and decision-making (specified in Articles 15, 16, 17, 18, 19 and 20 of the Law) are stated to be ESCB competences. In addition, Article 35 of the Amending Law specifies that Article 45 will cease to apply with effect from the day the euro is introduced in Slovenia.

7.2.7 INTERNATIONAL COOPERATION

Article 48 of the Law, which provided that Banka Slovenije could cooperate with international financial institutions, did not clearly recognise the ECB's powers in this field under Article 6.1 of the Statute and was therefore previously incompatible with the Treaty and the Statute. Articles 3 and 36 of the Amending Law provide for an amendment of Article 12 of the Law and for a new Article 67a respectively. According to the new Article 67a inserted by the Amending Law, from the day the euro is introduced Banka Slovenije "shall participate in international monetary organisations subject to approval of the European Central Bank".

7.2.8 ADAPTATION OF OTHER LEGISLATION

As far as other legislation is concerned, the ECB is not aware of any other statutory provisions which require adaptation under Article 109 of the Treaty.

7.2.9 CONCLUSION

Following the recent amendment, the Law on Banka Slovenije is compatible with Treaty and Statute requirements for Stage Three of Economic and Monetary Union. Legal certainty reasons, as described above, would favour a technical adjustment of Article 39.1(2) of the Law on Banka Slovenije in a further revision of the Law.

GLOSSARY

Acquis communautaire: the body of Community legislation, including its interpretation by the European Court of Justice, by which all EU Member States are bound.

Central government: the government as defined in the **European System of Accounts 1995** but excluding regional and local governments (see also **general government**). It includes all administrative departments of the (central) state and other central agencies whose competence extends over the entire economic territory, except for the administration of social security funds.

Central rate: the exchange rate of each **ERM II** member currency vis-à-vis the euro around which the **ERM II fluctuation margins** are defined.

Combined direct and portfolio investment balance: the sum of the direct investment balance and the portfolio investment balance in the financial account of the balance of payments. Direct investment is cross-border investment for the purpose of acquiring a lasting interest in/from an enterprise resident in another country (assumed for ownership equivalent to at least 10% of ordinary shares or voting rights). This includes equity capital, reinvested earnings and "other capital" associated with inter-company operations. Portfolio investment includes equity securities (when not a direct investment), debt securities in the form of bonds and notes, and money market instruments.

Contingent liabilities: government obligations that arise only upon the realisation of particular events, e.g. state guarantees.

Convergence criteria: the criteria set out in Article 121(1) of the **Treaty** (and developed further in the Protocol on the convergence criteria referred to in Article 121) that must be fulfilled by each EU Member State before it can adopt the euro. They relate to performance in respect of price stability, government financial positions, exchange rates and long-term interest rates. The reports produced under Article 121(1) by the **European Commission** and the **ECB** examine whether a high degree of sustainable convergence has been achieved by each Member State on the basis of its fulfilment of these criteria.

Convergence programme: a programme containing medium-term government plans and assumptions regarding the development of key economic variables towards the achievement of **reference values** indicated in the **Treaty**. Measures to consolidate fiscal balances are also highlighted, together with underlying economic scenarios. Convergence programmes normally cover the following three to four years but are regularly updated during that time. They are examined by the **European Commission** and the Economic and Financial Committee, whose reports serve as the basis for an assessment by the **ECOFIN Council**. Following the start of Stage Three of **Economic and Monetary Union**, EU Member States with a derogation continue to submit convergence programmes, while countries which are members of the **euro area** present annual stability programmes, in accordance with the **Stability and Growth Pact**.

Current transfers: government transfers to enterprises, households and the rest of the world, net of transfers received from the rest of the world, which are not related to capital expenditure; they include production and import subsidies, social benefits and transfers to EU institutions.

Cyclical component of the budget balance: shows the effect on the budget balance of the **output gap**, as estimated by the **European Commission**.

Debt ratio (general government): general government debt is defined as total gross debt at nominal value outstanding at the end of the year and consolidated between and within the sectors of general government. The government debt-to-GDP ratio is defined as the ratio of general government debt to GDP at current market prices. It is the subject of one of the fiscal criteria used to define the existence of an excessive deficit, as laid down in Article 104(2) of the **Treaty**.

Deficit-debt adjustment: the difference between the **general government** budget balance (government deficit or surplus) and the change in general government debt. Such adjustments may stem from, inter alia, changes in the amount of financial assets held by the government, revaluations or statistical adjustments.

Deficit ratio (general government): the **general government** deficit is defined as net borrowing and corresponds to the difference between general government revenue and general government expenditure. The deficit ratio is defined as the ratio of the general government deficit to GDP at current market prices. It is the subject of one of the fiscal criteria used to define the existence of an excessive deficit, as laid down in Article 104(2) of the **Treaty**. It is also referred to as the budget or fiscal balance (deficit or surplus).

ECOFIN Council: see **EU Council**.

Economic and Monetary Union (EMU): the **Treaty** describes the process of achieving EMU in the EU in three stages. Stage One of EMU started in July 1990 and ended on 31 December 1993; it was mainly characterised by the dismantling of all internal barriers to the free movement of capital within the EU. Stage Two began on 1 January 1994. It provided for, inter alia, the establishment of the **European Monetary Institute (EMI)**, the prohibition of financing of the public sector by the central banks, the prohibition of privileged access to financial institutions by the public sector and the avoidance of excessive government deficits. Stage Three started on 1 January 1999 with the transfer of monetary competence to the **ECB** and the introduction of the euro. The cash changeover on 1 January 2002 completed the process of setting up EMU.

Effective exchange rate (nominal/real): the nominal effective exchange rate is the weighted average of the bilateral exchange rates of a country's currency against the currencies of its trading partners. The weights used reflect the share of each partner country in the trade of the country under consideration and account for competition in third markets. The real effective exchange rate is the nominal effective exchange rate deflated by a weighted average of foreign prices relative to domestic prices.

Elderly dependency ratio: the proportion of the population of a country aged 65 and over in relation to the population aged 15-64.

ERM II (exchange rate mechanism II): the exchange rate mechanism which provides the framework for exchange rate policy cooperation between the **euro area** countries and the EU Member States not participating in Stage Three of **EMU**. ERM II is a multilateral arrangement with fixed, but adjustable, **central rates** and a standard fluctuation band of ±15%. Decisions concerning central rates and, possibly, narrower fluctuation bands are taken by mutual agreement between the EU Member State concerned, the euro area countries, the **ECB** and the other EU

Member States participating in the mechanism. All participants in ERM II, including the ECB, have the right to initiate a confidential procedure aimed at changing the central rates (see also **realignment**).

ERM II fluctuation margins: the floor and ceiling within which **ERM II** member currencies are allowed to fluctuate against the euro.

EU Council: an institution of the European Union made up of representatives of the governments of the Member States, normally the ministers responsible for the matters under consideration. The EU Council meeting in the composition of the ministers of economics and finance is often referred to as the **ECOFIN Council**. In addition, for decisions of particular importance, the EU Council meets in the composition of the Heads of State or Government. This should not be confused with the **European Council**.

Euro area: the area encompassing those EU Member States in which the euro has been adopted as the single currency in accordance with the **Treaty** and in which a single monetary policy is conducted under the responsibility of the **Governing Council** of the **ECB**. The euro area currently comprises Belgium, Germany, Greece, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland.

Eurogroup: informal group bringing together those members of the **ECOFIN Council** who represent the **euro area** countries. It meets on a regular basis (usually prior to meetings of the ECOFIN Council) to discuss issues connected with the euro area countries' shared responsibilities for the single currency. The **European Commission** and the **ECB** are regularly invited to take part in these meetings.

European Central Bank (ECB): the ECB lies at the centre of the **Eurosystem** and the **European System of Central Banks (ESCB)** and has its own legal personality in accordance with the **Treaty** (Article 107(2)). It ensures that the tasks conferred upon the Eurosystem and the ESCB are implemented either through its own activities or through those of the NCBs, pursuant to the **Statute** of the ESCB. The ECB is governed by the **Governing Council** and the **Executive Board**, and, as a third decision-making body, by the **General Council**.

European Commission: the institution of the European Union which ensures the application of the provisions of the **Treaty**. The Commission develops Community policies, proposes Community legislation and exercises powers in specific areas. In the area of economic policy, the Commission produces Integrated Guidelines for Growth and Jobs, containing the Broad Economic Policy Guidelines and the Employment Guidelines, and reports to the **EU Council** on economic developments and policies. It monitors public finances within the framework of multilateral surveillance and submits reports to the EU Council.

European Council: provides the EU with the necessary impetus for its development and defines the general political guidelines thereof. It brings together the Heads of State or Government of the Member States and the President of the **European Commission** (see also **EU Council**). It does not have legislative capacity.

European Monetary Institute (EMI): a temporary institution established at the start of Stage Two of **Economic and Monetary Union** on 1 January 1994. The two main tasks of the EMI were to strengthen central bank cooperation and monetary policy coordination and to make the preparations required for the establishment of the **European System of Central Banks**, for the conduct of the single monetary policy and for the creation of a single currency in Stage Three. It went into liquidation following the establishment of the **ECB** on 1 June 1998.

European Parliament: an institution of the European Union. It comprises 732 representatives of the citizens of the Member States (as of July 2004). The Parliament plays a role in the EU's legislative process, although with differing prerogatives that depend on the procedures through which the respective EU legislation is to be enacted. Where monetary policy and the **ESCB** are concerned, the Parliament has mainly consultative powers. However, the **Treaty** establishes certain procedures with respect to the democratic accountability of the **ECB** to the Parliament (presentation of the ECB's Annual Report, including a general debate on monetary policy, and testimonies before the competent parliamentary committees).

European System of Accounts 1995 (ESA 95): a comprehensive and integrated system of macroeconomic accounts based on a set of internationally agreed statistical concepts, definitions, classifications and accounting rules aimed at achieving a harmonised quantitative description of the economies of the EU Member States. The ESA 95 is the Community's version of the world System of National Accounts 1993 (SNA 93).

European System of Central Banks (ESCB): the central banking system of the European Union. Composed of the **ECB** and the NCBs of all 25 EU Member States, i.e. it includes, in addition to the members of the **Eurosystem**, the NCBs of those Member States that have not yet adopted the euro. The ESCB is governed by the **Governing Council** and the **Executive Board** of the ECB, and, as a third decision-making body of the ECB, by the **General Council**.

Eurostat: the Statistical Office of the European Communities. Eurostat is part of the **European Commission** and is responsible for the production of Community statistics.

Eurosystem: the central banking system of the euro area. Comprises the **ECB** and the NCBs of those EU Member States that have adopted the euro in Stage Three of **Economic and Monetary Union** (see also **euro area**). The Eurosystem is governed by the **Governing Council** and the **Executive Board** of the ECB.

Excessive deficit procedure: the provision set out in Article 104 of the **Treaty** and specified in the Protocol on the excessive deficit procedure requires EU Member States to maintain budgetary discipline, defines criteria for a budgetary position to be considered an excessive deficit and regulates steps to be taken following the observation that the requirements for the budget balance or government debt have not been fulfilled. This is supplemented by Council Regulation (EC) No 1467/97 of 7 July 1997, amended by Council Regulation (EC) No 1056/2005 of 27 June 2005, on speeding up and clarifying the implementation of the excessive deficit procedure, which is an element of the **Stability and Growth Pact**.

Executive Board: one of the decision-making bodies of the **ECB**. It comprises the President and the Vice-President of the ECB and four other members, all of whom are appointed by common accord by the Heads of State or Government of the EU Member States that have adopted the euro.

Exchange rate volatility: a measure of the variability of exchange rates, usually calculated on the basis of the annualised standard deviation of daily percentage changes.

Funded and unfunded pension schemes: funded pension schemes are arrangements in which the pension commitments are covered by the accumulation of assets from contributions. By contrast, unfunded pension schemes – frequently referred to as "pay-as-you-go" systems – are schemes in which current pension contributions are used immediately to pay out the pension benefits to the current pensioners. Thus, no capital is accumulated.

General Council: one of the decision-making bodies of the **ECB**. It comprises the President and the Vice-President of the ECB and the governors of all of the NCBs of the **European System of Central Banks**.

General government: a sector defined in the **European System of Accounts 1995** as comprising resident entities that are engaged primarily in the production of non-market goods and services intended for individual and collective consumption and/or in the redistribution of national income and wealth. Included are central, regional and local government authorities, as well as social security funds. Excluded are government-owned entities that conduct commercial operations, such as public enterprises.

Governing Council: the supreme decision-making body of the **ECB**. It comprises all the members of the **Executive Board** of the ECB and the governors of the NCBs of the EU Member States that have adopted the euro.

Growth-interest rate differential: the difference between the annual change in nominal GDP and the nominal average interest rate paid on outstanding government debt (the "effective" interest rate). The growth-interest rate differential is one of the determinants of changes in the government **debt ratio**.

Harmonised Index of Consumer Prices (HICP): a measure of consumer prices which is compiled by **Eurostat** and harmonised for all EU Member States.

Harmonised long-term interest rates: Article 4 of the Protocol on the convergence criteria referred to in Article 121 of the **Treaty** requires interest rate convergence to be measured by means of interest rates on long-term government bonds or comparable securities, taking into account differences in national definitions. In order to fulfil the Treaty requirement, the **ECB** has carried out conceptual work on the harmonisation of long-term interest rate statistics and regularly collects data from the NCBs, in cooperation with and on behalf of the **European Commission** (**Eurostat**). Fully harmonised data are used for the convergence examination in this report.

International investment position (i.i.p.): the value and composition of an economy's outstanding net financial claims on (or financial liabilities to) the rest of the world. The net i.i.p. is also referred to as the net external asset position.

Intervention at the limits: compulsory intervention by central banks if their currencies reach the floor or the ceiling of their **ERM II fluctuation margins**.

Intra-marginal intervention: intervention by a central bank to influence the exchange rate of its currency within its **ERM II fluctuation margins**.

Investment: gross fixed capital formation as defined in the **European System of Accounts 1995**.

Legal convergence: the process of adaptation by EU Member States of their legislation, in order to make it compatible with the **Treaty** and the **Statute** for the purposes of (i) integrating their NCBs into the **European System of Central Banks** and (ii) adopting the euro and making their NCBs an integral part of the **Eurosystem**.

Measures with a temporary effect: comprise all non-cyclical effects on fiscal variables which (i) reduce (or increase) the **general government** deficit or gross debt (see also **debt ratio** and **deficit ratio**) in a specified period only ("one-off" effects) or (ii) improve (or worsen) the budgetary situation in a specified period at the expense (or to the benefit) of future budgetary situations ("self-reversing" effects).

Net capital expenditure: comprises a government's final capital expenditure (i.e. gross fixed capital formation, plus net purchases of land and intangible assets, plus changes in stocks) and net capital transfers paid (i.e. investment grants, plus unrequited transfers paid by the **general government** sector to finance specific items of gross fixed capital formation by other sectors, minus capital taxes and other capital transfers received by the general government sector).

Non-cyclical factors: influences on a government budget balance that are not due to cyclical fluctuations (see the **cyclical component of the budget balance**). They can therefore result from either structural, i.e. permanent, changes in budgetary policies or from **measures with a temporary effect**.

Output gap: the difference between the actual and potential levels of output of an economy as a percentage of potential output. Potential output is calculated on the basis of the trend rate of growth of the economy. A positive output gap means that actual output is above the trend or potential level of output, and suggests the possible emergence of inflationary pressures. A negative output gap signifies that actual output is below the trend or potential level of output, and indicates the possible absence of inflationary pressures.

Primary balance: the **general government**'s net borrowing or net lending excluding interest payments on consolidated government debt.

Realignment: a change in the **central rate** of a currency participating in **ERM II**.

Reference period: a time interval specified in Article 121 of the **Treaty** and in the Protocol on the convergence criteria for examining progress towards convergence.

Reference value: the Protocol on the excessive deficit procedure sets explicit reference values for the **deficit ratio** (3% of GDP) and the **debt ratio** (60% of GDP), while the Protocol on the convergence criteria referred to in Article 121 of the **Treaty** specifies the methodology for calculating the reference values for the examination of price and long-term interest rate convergence.

Stability and Growth Pact: intended to serve as a means of safeguarding sound government finances in Stage Three of **Economic and Monetary Union** in order to strengthen the conditions for price stability and for strong, sustainable growth conducive to employment creation. To this end, the Pact prescribes that Member States specify medium-term budgetary objectives. It also contains concrete specifications on the **excessive deficit procedure**. The Pact consists of the Resolution of the Amsterdam European Council of 17 June 1997 on the Stability and Growth Pact and two Council Regulations, namely (i) Regulation (EC) No 1466/97 of 7 July 1997, as amended by Regulation (EC) No 1055/2005 of 27 June 2005, on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies and (ii) Regulation (EC) No 1467/97 of 7 July 1997, as amended by Regulation (EC) No 1056/2005 of 27 June 2005, on speeding up and clarifying the implementation of the excessive deficit procedure.

Statute: refers to the Protocol on the Statute of the **European System of Central Banks** and of the **European Central Bank**, annexed to the **Treaty** establishing the European Community, as amended by the Treaty of Amsterdam, the Treaty of Nice, Council Decision 2003/223/EC and the Act concerning the conditions of accession of the Czech Republic, the Republic of Estonia, the Republic of Cyprus, the Republic of Latvia, the Republic of Lithuania, the Republic of Hungary, the Republic of Malta, the Republic of Poland, the Republic of Slovenia and the Slovak Republic and the adjustments to the Treaties on which the European Union is founded.

Treaty: refers to the Treaty establishing the European Community ("Treaty of Rome"). The Treaty has been amended on several occasions, in particular by the Treaty on European Union ("Maastricht Treaty") which laid the foundations for **Economic and Monetary Union** and contained the **Statute** of the **ESCB**.

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