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2006 Convergence Report on Lithuania

2006 Convergence Report on Slovenia

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

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Directorate-General for Economic and Financial Affairs

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2006 Convergence Report on Lithuania

2006 Convergence Report on Slovenia

(May 2006)

Abbreviations and symbols used

Member States

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

EU-10	European Union Member States that joined the EU on 1 May 2004 (CZ, EE, CY, LT, LV, HU, MT, PL, SI, SK)
EUR-12	European Union Member States having adopted the single currency (BE, DE, EL, ES, FR, IE, IT, LU, NL, AT, PT, FI)
EU-15	European Union, 15 Member States before 1 May 2004 (EUR-12 plus DK, SE and UK)
EU-25	European Union, 25 Member States

Currencies

EUR	euro
ECU	European currency unit
LTL	Lithuanian litas
SIT	Slovenian tolar
USD	US dollar

Other abbreviations

CPI	consumer price index
ECB	European Central Bank
EMI	European Monetary Institute
EMU	economic and monetary union
ERM II	exchange rate mechanism II
ESCB	European System of Central Banks
Eurostat	Statistical Office of the European Communities
FDI	foreign direct investment
GDP	gross domestic product
GFCF	gross fixed capital formation
HICP	harmonised index of consumer prices
MTO	medium-term objective
VAT	value added tax

Contents

I. 2006 Convergence Report on Lithuania*

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

* This report was formally adopted by the College of Commissioners on 16 May 2006 (COM(2006) 223 final).

1. Purpose of the report

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

This report has been prepared at the request of Lithuania, submitted on 16 March 2006. A more detailed assessment of the state of convergence in Lithuania is provided in a technical annex to this report (SEC(2006) 614).

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

2. Legal compatibility

In its 2004 Convergence Report (COM(2004) 690), the Commission concluded that, as regards central bank integration into the ESCB at the time of euro adoption, legislation in Lithuania, in particular the Law on the Bank of Lithuania and the Constitution of Lithuania, as well as the Law on Currency and the Law on the Credibility of the litas, was not fully compatible with Article 109 of the EC Treaty and the ESCB/ECB Statute. In addition, the correction of some residual imperfections was recommended, in particular with respect to the Bank's objectives.

These incompatibilities have been addressed in three laws that were adopted by the Seimas on 25 April 2006 and shall enter into force on the day of the abrogation of the derogation of the Republic of Lithuania by the Council of the European Union, pursuant to the procedure laid down in Article 122(2) of the Treaty. The first Law governs amendments to the Law on the Bank of Lithuania. The second Law repeals the Law on Currency and the Law on the Credibility of the litas, which also contained several incompatibilities. The third Law introduces amendments to Article 125 of the Constitution of the Republic of Lithuania.

With respect to the Law on the Bank of Lithuania, the incompatibilities raised in the 2004 Convergence Report have been removed. The amendments strengthen "personal" independence and take account of EC Treaty requirements, in particular as regards the respective roles and competences of the ECB, the ESCB and the Council in the area of monetary policy, the conduct of foreign exchange operations and the definition of foreign exchange policy, the holding and managing of foreign reserves and the issuance of banknotes and coins. The need for the ECB's prior approval for the participation of the Bank of Lithuania in international monetary organisations is fully taken into account, while the possibility for the Parliament to wind up the Bank of Lithuania has been removed. In addition, a reference to the ESCB's secondary objective has been inserted, which takes precedence over the Bank of Lithuania's additional objective of supporting the economic policy carried out by the national authorities.

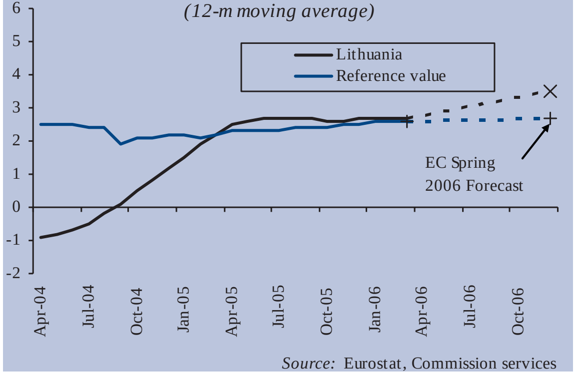
Legislation in Lithuania, in particular the Law on the Bank of Lithuania and Lithuania's Constitution, are compatible with the requirements of the EC Treaty and the ESCB/ECB Statute.

3. Price stability

Evolution of the reference value

In the 2004 convergence report Lithuania was found to have fulfilled the criterion on price stability. The average inflation rate in Lithuania during the 12 months to August 2004 was -0.2 percent, below the reference value of 2.4 percent.

Chart 1. **HICP Inflation**
(12-m moving average)



Source: Eurostat, Commission services

The 12-month average inflation, which is used for the convergence assessment, declined in the course of 2002 and was negative in 2003 and most of 2004. From the middle of 2004 onwards it started to increase gradually and has been above the reference value since April 2005. In March 2006, the reference value was 2.6 percent, calculated as the average of the 12-month average inflation rates in the three best-performing Member States (Sweden, Finland and Poland) plus 1.5 percentage points. The corresponding inflation rate in Lithuania was 2.7 percent, just above the reference value.

Underlying factors and sustainability

After independence Lithuania experienced triple-digit inflation in the first years of transition. With the introduction of the litas in 1993, inflation was curbed and the exchange rate stabilised. Inflation dropped to single-digit levels in 1997 and decreased further in the next few years. By then, transition-related rapid increases in administered prices had subsided and in the following years rapid productivity growth and the steady appreciation of the nominal effective exchange rate in response to the appreciating trends in the respective anchor currencies (first the US dollar, then the euro) also helped to bring inflation down.

From April 1999 to July 2004, Lithuania experienced a prolonged period of more than 5 years where harmonised inflation rates were below 2 percent. From June 2002 until April 2004 consumer prices were even decreasing year-on-year, helped by the change of the peg of the litas to the euro in early 2002, which extended the period of effective nominal appreciation of the litas. Positive inflation rates re-emerged subsequently and year-on-year HICP inflation rates increased to around 3 percent in the second half of 2004. The return of positive inflation rates reflected a combination of factors including a pick-up in wage costs; substantial increases in unprocessed food prices which were partly linked to price arbitrage as EU accession enabled the convergence of food prices; increases in indirect taxes and in administered prices; and the impact of higher energy prices. While a significant part of the pick-up in HICP inflation from the summer of 2005 onwards was accounted for by external factors, such as increases in energy prices, inflation excluding administered and energy prices also edged up, from around 1 percent in the summer of 2005 to 2.7 percent in the first quarter of 2006, notably for food, transport and some services components, such as restaurant services.

Import prices for natural gas rose markedly as of 1 January 2006, by around 40 percent, after a multi-year agreement with a major gas exporter had expired. This led to price hikes in gas used for cooking and direct heating, adding around 0.1 percentage point to inflation in January 2006. The main impact of higher import prices for gas is likely to occur with a delay, however, due to the adjustment of regulated prices for distributed heat.

Inflation in the remainder of 2006 is expected to rise gradually reflecting upward pressures stemming from higher labour costs (unit labour costs growth picked up in 2005 to 3.8 percent) and import prices, in particular for energy products, which will partly be reflected in consumer prices only with a lag. Average inflation in 2006 is expected to increase to 3.5 percent, from 2.7 percent in 2005.

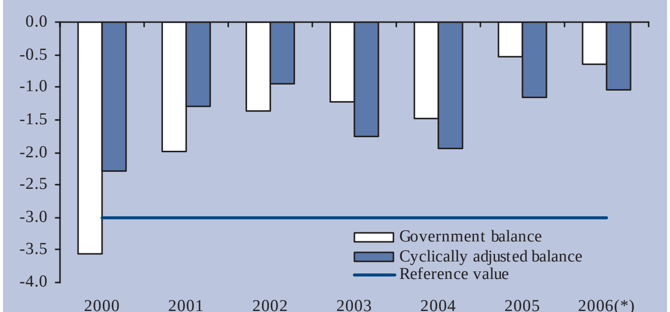
In a longer-term perspective, buoyant domestic demand and increases in certain excise duties represent risk factors to inflation. The achievement and maintenance of a low level of inflation in the medium-term will depend on keeping wage growth in line with productivity developments.

The 12-month average inflation in Lithuania has been above the reference value since April 2005 and is likely to stay above it in the months ahead. Lithuania does not fulfil the criterion on price stability.

4. Government budgetary position

In the 2004 Convergence Report, the Commission stated that Lithuania was not subject to a Council decision on the existence of an excessive deficit and that it fulfilled the criterion on the government budgetary position.

Chart 2. **Lithuania: Government balance**
(in percent of GDP)



(*) Spring Forecast

Source : Commission services

The general government deficit declined from 3.6 percent of GDP in 2000 to 1.2 percent of GDP in 2003. In 2004 the deficit increased slightly to 1.5 percent of GDP, to which also the introduction of a funded pension scheme contributed. The deficit decreased to 0.5 percent of GDP in 2005. Unlike in previous years, the budgetary adjustment in 2005 was revenue-driven. Strong revenue growth reflected buoyant economic activity and improvements in tax collection and enforcement. Expenditure targets were broadly met, as additional expenditures through supplementary budgets in the second half of the year, which had been the case before, were avoided. Cyclical conditions have become supportive of fiscal consolidation since 2003 but the structural deficit deteriorated in 2003 and 2004 on the back of a significant worsening of the primary deficit. In 2005, the primary deficit improved, as did the structural deficit. Lithuania thus continues recording budgetary deficit outcomes below the 3 percent of GDP threshold. The deficit is expected to remain broadly stable in 2006, although there are uncertainties related to the absorption of EU funds and the impact of the tax reform that will decrease the personal income tax rate while raising the corporate tax.

The ratio of general government debt to GDP declined steadily from 23.6 percent at the end of 2000 to below 19 percent in 2005. The main factor contributing to the decrease was the impact of financial transactions of the government, reflecting mainly privatisation receipts and positive valuation effects on foreign debt related to the nominal appreciation of the litas. The debt ratio has remained well below the 60 percent of GDP threshold, and is expected to remain stable also in the medium term.

According to the December 2005 convergence programme, the headline general government deficit was expected to gradually decrease from 1.5 percent of GDP in 2005 (the actual outcome in 2005 was a lower deficit of 0.5 percentage point of GDP) to 1 percent of GDP in 2008, against the background of robust GDP growth. The foreseen consolidation is expenditure-driven, mostly due to cuts in collective consumption and social transfers in percent of GDP, while a significant increase in government investment is planned. The update of the convergence programme estimates Lithuania's debt ratio to remain at about 19-20 percent of GDP throughout the remainder of the programme horizon.

The Council examined the updated convergence programme on 14 March 2006. It regarded the programme's budgetary strategy as plausible and saw the risks to the budgetary projections in the programme to be broadly balanced. However, as the medium-term objective of a cyclically adjusted deficit at or below 1 percent of GDP might not be reached during the programme's period, the Council invited Lithuania to strengthen the effort in the structural budgetary adjustment. As regards the sustainability of public finances, Lithuania appears to be at low risk in view of the projected budgetary costs of ageing.

Lithuania is not subject to a Council decision on the existence of an excessive deficit and fulfils the criterion on the government budgetary position.

5. Exchange rate stability

In the 2004 Convergence Report Lithuania was assessed not to fulfil the exchange rate criterion. By the time of the examination, the country had been participating in ERM II for two months.

The two-year period relevant for the assessment of exchange rate stability extends from May 2004 to April 2006. Lithuania entered ERM II on 28 June 2004, maintaining its longstanding currency board as a unilateral commitment within the mechanism, and has so far spent 22 months in ERM II. The litas-euro exchange rate in the two months prior to ERM II entry was stable with only minor deviations from the central rate. There has been no deviation from the central rate since the litas started participating in ERM II.

Public and market confidence in ERM II participation and the currency board remains strong, and the development of additional indicators does not reveal any major exchange rate pressures on the litas. The ratio of official reserve assets to the monetary base has well exceeded 100 percent and reached 127.5 percent in 2005. Discretionary facilities to influence liquidity have not been used actively to a significant extent.

Short-term interest rates have become very closely aligned to the euro area, suggesting that no appreciable currency risk is priced in by financial markets. The spread of the 3-month VILIBOR to the EURIBOR has decreased markedly, from around 65 basis point on average in April 2004 to around 3 basis points on average in the period January-March 2006.

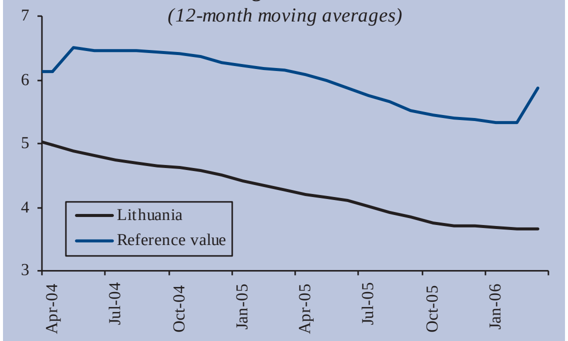
The litas has been at the ERM II central rate for the period of two years covered by this assessment. There has been no devaluation of the central parity of the litas inside ERM II on the initiative of Lithuania. By the time of a possible Council decision in July 2006, the litas will have participated in ERM II for more than 24 months. Lithuania fulfils the exchange rate criterion.

6. Long-term interest rates

In the 2004 Convergence Report Lithuania fulfilled the criterion on the convergence of interest rates. The average long-term interest rate in Lithuania in the year to August 2004 was 4.7 percent, below the reference value of 6.4 percent.

The spread vis-à-vis euro area average long-term interest rates had been declining markedly in the run-up to ERM II entry in June 2004. Subsequently, the spreads have fallen further from around 55 basis points around the time of ERM II entry to around 25 basis points in March 2006, indicative of – among other factors – the credibility of Lithuanian macro-economic policies. Since long-term interest rates for Lithuania reflect primary market rates, the short-term fluctuations in the spread mostly mirrored the volatility of euro area long-term interest rates.

Chart 3. **Long-term interest rates**
(12-month moving averages)



Source: ECB, Eurostat, Commission services

The twelve-month moving average long-term interest rate relevant for the assessment of the Treaty criterion has continued to decline over the whole assessment period. In March 2006, the latest date for which data are available, the reference value, given by the average of long-term interest rates in Sweden, Finland and Poland plus 2 percentage points stood at 5.9 percent. The twelve-month moving average of the yield on ten-year Lithuanian benchmark bond stood at 3.7 percent, below the reference value. Lithuania fulfils the criterion on long-term interest rate convergence.

7. Additional factors

Lithuania has made encouraging progress with respect to the integration of financial and product markets in several areas. Lithuania's financial system has substantially integrated into the broader EU financial system. The main channels of integration have been a high degree of foreign ownership of financial intermediaries associated with substantial foreign currency borrowing. The size of the financial system remains relatively small compared to GDP, but financial deepening is progressing rapidly in line with economic development. High concentration and foreign ownership highlights the importance of cross-border cooperation to ensure adequate supervisory structure and safeguard financial stability.

Similar to other new EU Member States, Lithuania experienced important changes in the structure of its economy in the past 15 years. Data on trade and foreign direct investment show that Lithuania has become increasingly integrated in the EU economy. The presence of foreign firms has been instrumental in promoting technology transfer, boosting organisational and managerial skills, and fostering competition. Differences in the sectoral composition of production and exports in comparison with the euro area remain considerable, while consumer price levels in Lithuania are still considerably lower than the EU average (54.6 percent in 2004). Important progress has been made with respect to the adoption and application of the Internal Market acquis and improvement of the business environment.

Lithuania has had rather high current account deficits for many years, reflecting substantial deficits in goods trade partly compensated by a positive balance on services and current transfers. The current account deficit in Lithuania widened from 4.7 percent of GDP in 2003 to 7.7 percent of GDP in 2004, mainly on account of strong domestic demand. This trend was halted in 2005 as the current account deficit slightly decreased to 7.0 percent of GDP. The slight reduction in the current account deficit was due to improvements in the services and transfers balances (with the rise in the latter in the last two years mainly due to inflows of EU funds), while the deficit in goods trade widened and reached 11.2 percent of GDP as imports were buoyed by rapid real GDP growth. The balance on current income was negative at 2.4 percent of GDP, a similar figure as in the previous two years, mainly due to a sizeable repatriation of profits by foreign companies (underlining the healthy profitability of past foreign direct investment).

The pattern of high real GDP growth rates with relatively high current account deficits is consistent with the rapid catch-up path of the economy, whereby foreign savings are mobilised via external financing to finance investment. So far, the financing of the current account deficit has been unproblematic, but the external position reflects substantial financing needs in the medium term. A key challenge for Lithuania will be to ensure that there is no substantial widening of the external deficit and that growth rates can be sustained in the future without negatively impacting on competitiveness. Looking forward, a substantial contribution to domestic investment is expected to come from EU funds, which will help external financing without increasing external indebtedness.

* * *

Lithuania has made significant progress towards reaching a high degree of sustainable convergence by meeting the criteria on public finances, exchange rate stability and long-term interest rates. Lithuania does not, as yet, meet the criterion on price stability.

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

2006 Convergence Report on Lithuania – Technical Annex

Acknowledgements

The technical annex to the '2006 Convergence Report on Lithuania', which is a Commission services' working paper, was prepared in the Directorate-General for Economic and Financial Affairs by Ronald Albers, Jiri Plecity and Pavlina Zakova.

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The paper was coordinated by Johan Baras, Economic Adviser, and approved by Servaas Deroose, Director, and Klaus Regling, Director-General.

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1. Introduction

1.1. Role of the report

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

Those Member States which are assessed as not fulfilling the necessary conditions for the adoption of the single currency are referred to as "Member States with a derogation". Article 122(2) of the Treaty lays down provisions and procedures for examining the situation of Member States with a derogation *(Box 1.1)*. At least once every two years, or at the request of a Member State with a derogation, the Commission and the European Central Bank (ECB) are required to prepare convergence reports on such Member States.

Box 1.1: **Article 122(2) of the Treaty**

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

Denmark and the United Kingdom negotiated opt-out arrangements before the adoption of the Maastricht Treaty[4] and do not participate in the third stage of EMU. Until these Member States indicate that they wish to participate in the third stage and join the single currency, they are not the subject of an assessment by the Council as to whether they fulfil the necessary conditions.

Greece submitted a request on 9 March 2000 for its convergence situation to be re-examined. The Ecofin Council adopted the decision[5] that Greece fulfilled the necessary conditions for adoption of the single currency on 19 June 2000. The decision was taken on the basis of a proposal from the Commission and having regard to the discussion of the Council, meeting in the composition of the Heads of State or Government. The decision was based on two convergence reports made by the Commission[6] and the ECB[7], which covered both Greece and Sweden.

1 OJ L 139, 11.5.1998, pp. 30-35.

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

3 European Monetary Institute, Convergence Report, March 1998.

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

5 OJ L 167, 7.7.2000, pp. 19-21.

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

7 European Central Bank, Convergence Report 2000, May 2000.

Greece adopted the single currency with effect from 1 January 2001. Sweden was assessed in 2000 as not fulfilling the necessary conditions for the adoption of the single currency.
In 2002, the convergence assessment covered only Sweden and concluded that Sweden was not fulfilling the necessary conditions for the adoption of the single currency and continued to be referred to as a "Member State with a derogation".[8]

In 2004, Sweden was examined together with the ten countries that joined the EU on 1 May 2004. In accordance with Article 4 of the Act of Accession, the ten countries became upon entry “Member States with a derogation”. Although the maximum period referred to in Article 122(2) of the Treaty had not elapsed for these countries in 2004, the re-assessment of Sweden was seized as an opportunity to analyse also the state of convergence in the new Member States. None of the assessed countries was considered to have fulfilled the necessary conditions for the adoption of the single currency.[9]

In 2006, two years will have elapsed since the last reports were made. The Commission and the ECB envisage to prepare a comprehensive report in autumn 2006, assessing progress with convergence for all Member States with a derogation. On 16 March, Lithuania submitted a request for an earlier convergence assessment. As a response to this request, the Commission and the ECB prepared convergence reports for Lithuania.

This Commission services working paper is a technical annex to the convergence report on Lithuania and includes a detailed assessment of the progress with convergence. The remainder of the first chapter presents the methodology used for application of the assessment criteria and an overview of the main findings. Chapters 2 to 7 examine fulfilment of each of the convergence criteria and other requirements in the order as they appear in Article 121(1). The cut-off date for the statistical data included in this convergence report was 28 April 2006.

1.2. Application of the criteria

In accordance with Article 121(1), the convergence reports shall examine the compatibility of national legislation with the Treaty and the Statute of the European System of Central Banks (ESCB) and of the European Central Bank. The reports shall also examine the achievement of a high degree of sustainable convergence by reference to the fulfilment of the four convergence criteria dealing with price stability, the government budgetary position, exchange rate stability and long-term interest rates as well as some additional factors *(Box 1.2)*. The four convergence criteria have been developed further in a Protocol annexed to the Treaty (Protocol No 21 on the convergence criteria). A more detailed explanation of how to interpret and apply the criteria was provided in the convergence reports issued up to present.

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

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

Box 1.2 : **Article 121(1) of the Treaty**

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

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

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

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

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

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

Compatibility of legislation

In accordance with Article 121(1) of the Treaty, the legal examination includes an assessment of compatibility between a Member State's legislation, including the statute of its national central bank, and Articles 108 and 109 of the Treaty and the Statute of the ESCB/ECB. This assessment mainly covers three areas. First, the objectives of the national central bank must be examined, in order to verify their compatibility with the objectives of the ESCB as formulated in Article 105(1) and Article 2 of the Statute of the ESCB/ECB. The ESCB's primary objective is to maintain price stability. Without prejudice to this objective, it shall support the general economic policies in the Community. Second, the independence of the national central bank and of the members of its decision-making bodies (Article 108) must be assessed. This assessment covers all issues linked to a National central bank's institutional and financial independence and to the personal independence of the members of its decision-making bodies. Third, the integration of the national central bank into the ESCB has to be examined, in order to ensure that the national central bank acts in accordance with the ECB's guidelines and instructions once the country concerned has adopted the single currency.

Price stability

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

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

Since national consumer price indices (CPIs) diverge substantially in terms of concepts, methods and practices, they do not constitute the appropriate means to meet the Treaty requirement that inflation must be measured on a comparable basis. To this end, the Council adopted on 23 October 1995 a framework regulation[10] setting the legal basis for the establishment of a harmonised methodology for compiling consumer price indices in the Member States. This process resulted in the production of the *Harmonised Indices of Consumer Prices (HICPs)*, which have been used for assessing the fulfilment of the price stability criterion. Until December 2005, HICP series had been based on 1996 as the reference period. A Commission Regulation (EC) No 1708/2005[11] provided the basis for a change of the HICP index base reference period from 1996=100 to 2005=100.

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

Over the 12 month period covering April 2005-March 2006, the three best-performing Member States in terms of price stability were Sweden (0.9 percent), Finland (1.0 percent) and Poland (1.5 percent) yielding a reference value of 2.6 percent.[12] Over the period January 1999 to March 2006, the reference value – based on the EU-15 until April 2004 and the EU-25 afterwards – fell to a low of 1.8 percent in July 1999 and peaked between February and April 2002 at 3.3 percent. In September 2004, the reference value fell for the first time below the euro area average when Lithuania entered the basket of three best performers.

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

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

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

[12] The reference values used in the 1998, 2000, 2002 and 2004 Convergence Reports were 2.7, 2.4, 3.3 and 2.4 percent, respectively. The ordering of best performers is based on unrounded data.

Table 1.1.

Evolution of the inflation reference value [1)]

	Three best performers [2)]	Reference value [3)]	Euro area average inflation rate [2)]
January 04	DE, FI, AT	2.7	2.1
February 04	DE, FI, AT	2.6	2.0
March 04	FI, DE, AT	2.5	1.9
April 04	FI, DE, AT	2.5	1.9
May 04	FI, CZ, DE	2.5	2.0
June 04	FI, DK, CZ	2.5	2.0
July 04	FI, DK, UK	2.4	2.1
August 04	FI, DK, SE	2.4	2.1
September 04	LT, FI, DK	1.9	2.1
October 04	FI, LT, DK	2.1	2.1
November 04	FI, LT, DK	2.1	2.1
December 04	FI, DK, SE	2.2	2.1
January 05	FI, DK, SE	2.2	2.1
February 05	FI, DK, SE	2.1	2.2
March 05	FI, DK, SE	2.2	2.2
April 05	FI, SE, DK	2.3	2.2
May 05	FI, SE, DK	2.3	2.2
June 05	FI, SE, DK	2.3	2.2
July 05	FI, SE, DK	2.3	2.1
August 05	FI, SE, DK	2.4	2.1
September 05	FI, SE, NL	2.4	2.2
October 05	FI, SE, NL	2.4	2.2
November 05	FI, SE, NL	2.5	2.2
December 05	FI, SE, NL	2.5	2.2
January 06	SE, FI, NL	2.6	2.2
February 06	SE, FI, NL	2.6	2.2
March 06	SE, FI, PL	2.6	2.3

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

Source: Commission services

Government budgetary position

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

The convergence assessment in the budgetary area is thus directly linked to the excessive deficit procedure which is specified in Article 104 of the Treaty and further clarified in the Stability and Growth Pact.[13] The existence of an excessive deficit is determined in relation to the two criteria for budgetary discipline set in Article 104(2), namely on the government deficit and the government debt. Failure by a Member State to fulfil the requirements under either of these criteria can lead to a decision by the Council on the existence of an excessive deficit, in which case the Member State concerned does not comply with the budgetary convergence criterion.[14]

Exchange rates

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

Article 3 of the Protocol on the convergence criteria stipulates: *"The criterion on participation in the Exchange Rate Mechanism of the European Monetary System (…) shall mean that a Member State has respected the normal fluctuation margins provided for by the Exchange Rate Mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against any other Member State's currency on its own initiative for the same period"*. Based on the Council Resolution on the establishment of the ERM II[15], the European Monetary System has been replaced by the exchange-rate mechanism II upon the introduction of the euro, and the euro has become the centre of the mechanism.

As in previous reports, the assessment of this criterion verifies the participation in ERM II and examines exchange rate behaviour within the mechanism. The relevant period for assessing exchange rate stability in this Working Paper is May 2004 to April 2006.

Long-term interest rates

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

For the assessment of the criterion on the convergence of interest rates, yields on benchmark 10-year bonds have been taken, using an average rate over the latest 12 months. The reference value is calculated as the simple average of the average long-term interest rates of the three best-performing Member States in terms of price stability plus 2 percentage points. In March 2006, the reference value, derived from the average interest rate in Sweden (3.3 percent), Finland (3.3 percent), and Poland (5.0 percent), was 5.9 percent.

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13 Information regarding the excessive deficit procedure and its application to different Member States since 2002 can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/edp_en.htm.

14 The definition of the general government deficit used in this report is in accordance with the excessive deficit procedure, as was the case in previous convergence reports. In particular, interest expenditure, total expenditure and the overall balance include net streams of interest expenditure resulting from swaps arrangements and forward rate agreements. Government debt is general government consolidated gross debt at nominal value.

15 97/C 236/03 of 16 June 1997, OJ C 236, 2.8.1997, p.5.

Additional factors

The Treaty in Article 121(1) also requires an examination of other factors relevant to economic integration and convergence. These additional factors include the results of financial and product market integration and the development of the balance of payments. The examination of the development of unit labour costs and other price indices, which is also prescribed by Article 121 of the Treaty, is covered in the chapter on price stability.

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

2. Legal compatibility

2.1. Situation in the 2004 Convergence Report

In its 2004 Convergence Report, the Commission concluded that, as regards central bank integration into the ESCB at the time of euro adoption, legislation in Lithuania, in particular the Law on the Bank of Lithuania and the Constitution of Lithuania, as well as the Law on Currency and the Law on the Credibility of the litas, was not fully compatible with Article 109 of the EC Treaty and the ESCB/ECB Statute. In addition, the correction of some residual imperfections was recommended, in particular as regards the Bank's objectives.

With respect to the Law on the Bank of Lithuania, the incompatibilities in the area of integration into the ESCB were linked to the definition of monetary policy; the conduct of foreign exchange operations and the definition of foreign exchange policy; the holding and managing of foreign reserves; the right to authorise the issue of banknotes and the volume of coins; and the monetary functions, operations and instruments of the ESCB. In addition, the need for the ECB's prior approval for the participation of the Bank of Lithuania in international monetary organisations was not recognised, and the possibility for Lithuania's Parliament to dissolve the Bank of Lithuania was also considered incompatible.

Further incompatibilities were raised with respect to the Constitution of Lithuania, as Article 125(2) attributed to the Bank of Lithuania the exclusive right to issue banknotes. The Law on Currency contained incompatibilities as regards the definition of the monetary unit, the right to authorise the issue of banknotes and coins, as well as in respect of the definition of the foreign exchange policy. The Law on the Credibility of the Litas contained similar incompatibilities as regards the right to issue currency and the definition of the foreign exchange policy.

An imperfection subsisted as regards the Bank of Lithuania's objectives, since its secondary objective referred to the general economic policy of the State, without any reference to the general economic policies in the Community and without the latter taking precedence over the former.

2.2. Current legal situation

A first draft Law amending the Law on the Bank of Lithuania was prepared in summer 2005. Pursuant to Article 105(4) EC, it was submitted to the ECB for an opinion in autumn 2005. The ECB issued its Opinion (CON/2005/60) on 30 December 2005. Further amendments and improvements were incorporated in a revised draft Law, which was adopted by the Seimas on 25 April 2006.

The Law on Currency and the Law on the Credibility of the litas have been repealed by a special Law, which was adopted by the Seimas together with the Law on the amendments to the Law on the Bank of Lithuania.

A draft Law amending Article 125 of the Constitution of the Republic of Lithuania was submitted to the ECB for Opinion in autumn 2005. The ECB issued its Opinion (CON/2005/38) on 26 October 2005. The Seimas adopted a revised draft Law on 25 April 2006.

Integration into the ESCB

With respect to the Law on the Bank of Lithuania (LBoL), the incompatibilities raised in the 2004 Convergence Report have been removed. The Law on the amendments to the Law on the Bank of Lithuania repeals Articles 8(1)3, 11(1)1-3 and 5, 25-27, 29, 30 and 32 of the Law on the Bank of Lithuania. A series of articles have been amended so as to take account of the EC Treaty requirements and the respective roles and competences of the ECB, the ESCB and the EC Council. This concerns in particular articles 8(1)2 and 25 LBoL (on monetary policy); Article 31 LBoL (on the conduct of foreign exchange operations and the definition of foreign exchange policy); Articles 11(1)4, 11(1)17 and 33 LBoL (on the holding and managing of foreign reserves); and Articles 6, 8(1)1 and 11(1)9 (on the issue of banknotes and coins). Article 11(1)8 LBoL now fully takes into account the need for the ECB's prior approval for the participation of the Bank of Lithuania in international monetary organisations. The possibility for the Parliament of dissolving the Bank of Lithuania is also removed.

The Law amending Article 125 of the Constitution of the Republic of Lithuania repeals paragraph 2 of Article 125. The special Law repealing certain other laws not only repeals the Law on Currency and the Law on the Credibility of the litas, but also other legal acts and laws related to the litas, which also contained several incompatibilities.

Objectives

With respect to the Law on the Bank of Lithuania, a reference to the ESCB's secondary objective has been inserted. The latter takes precedence over the Bank of Lithuania's additional objective to support the economic policy carried out by the national authorities.

Independence

Article 125 of the Constitution has been amended in order to strengthen the Bank of Lithuania's "personal" independence.

Other issues

In Article 8(2)5 of the Law on the Bank of Lithuania, a safeguard clause has been inserted as regards the role of the Bank as a lender of last resort, so as to strengthen compliance with Art 101 EC and to avoid that the Bank of Lithuania might eventually end up bearing financial costs which are in principle to be borne by the state.

Timing

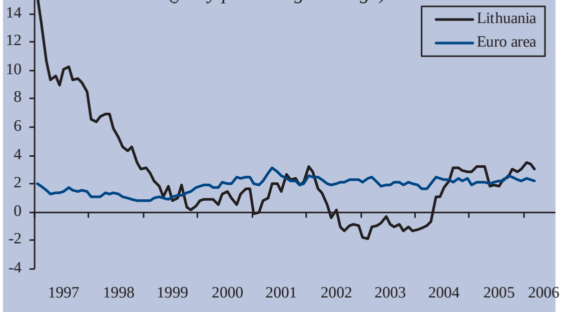
The Law on the amendments to the Law on the Bank of Lithuania, the Law amending Article 125 of the Constitution of the Republic of Lithuania and the special Law repealing certain other Laws, are planned to enter into force on the day of the abrogation of the derogation of the Republic of Lithuania by the Council of the European Union pursuant to the procedure laid down in Article 122(2) of the Treaty. Articles 6 and 7 of the Law on the amendments to the Law on the Bank of Lithuania entered into force on 29 April 2006.

3. Price stability

3.1. Recent inflation developments

HICP inflation, which had been low or even negative since 1999, picked up in early 2004 and rose to slightly above 3 percent until early 2005; it decreased temporarily in the period from May to July 2005 when it fell to just below 2 percent. In the following months HICP inflation increased again, partly in response to higher oil prices on the world markets, and reached 3.1 percent in March 2006. As a result, 12-month average inflation gradually increased from a low of around -1 percent in the second half of 2003 and the first half of 2004 to around 2.7 percent by June 2005 and it has been hovering around this level between July 2005 and March 2006.

Chart 3.1. **HICP inflation**
(y-o-y percentage change)

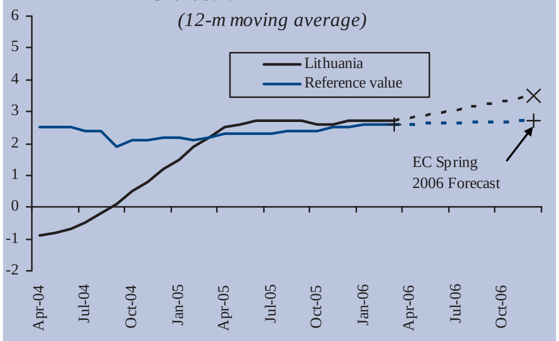


Source: Eurostat

3.2. Respect of the reference value

The 12-month average inflation rate, which is used for the convergence assessment, has been above the reference value since April 2005. The difference between Lithuanian 12-month average inflation and the reference value narrowed from July 2005 onwards to 0.1 percentage point in the first months of 2006. In March 2006 the reference value was 2.6 percent, calculated as the average of the 12-month average inflation rates in the three best-performing Member States (Sweden, Finland and Poland) plus 1.5 percentage points. The corresponding inflation rate in Lithuania was 2.7 percent, 0.1 percentage points above the reference value.

Chart 3.2. **Inflation criterion**
(12-m moving average)



Source: Eurostat, Commission services

Table 3.1.
Lithuania: Average inflation rate (HICP) and the reference value[1)]
(percentage change)

	December 2002	December 2003	December 2004	December 2005	March 2006
LT	0.3	-1.1	1.2	2.7	2.7
Reference value [2)]	2.9	2.7	2.2	2.5	2.6

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

2) Unweighted arithmetic average of the three best performers in terms of inflation plus 1.5 percentage points; only EU-15 Member States are used in the period prior to May 2004.

Source: Eurostat, Commission services

3.3. Underlying factors and sustainability of inflation

The profound economic, institutional and regulatory changes that marked the transition process in Lithuania had an important bearing on inflation. After independence Lithuania experienced triple-digit inflation in the first years of transition when the country was still in the ruble zone. With the introduction of the litas in 1993, inflation was curbed and the exchange rate stabilised. Since April 1994, Lithuania has been operating a currency board regime. The litas was initially pegged to the US dollar, but re-pegged to the euro at the prevailing market rate in February 2002.

As a result of successful stabilisation policies Lithuania achieved remarkable progress in disinflation. Stability-oriented macro-economic policies, progress with structural reforms and the transformation towards a market economy inducing more competition helped anchor inflation and inflation expectations. Inflation dropped to single-digit levels in 1997 and decreased further in the next few years. By then transition-related rapid increases in administered prices had subsided and in the following years rapid productivity growth and the steady appreciation of the nominal effective exchange rate vis-à-vis trading partners in response to the appreciating trends in the respective anchor currencies (first the US dollar, then the euro) also helped to bring inflation down. From April 1999 to July 2004 Lithuania experienced a prolonged period of more than 5 years where harmonised inflation rates were below 2 percent. From June 2002 until April 2004, consumer prices even decreased year-on-year.

Positive inflation rates re-emerged subsequently, however, and year-on-year HICP inflation rates increased to around 3 percent in the course of the second half of 2004. After some easing in the summer of 2005, inflation picked up again and reached 3.1 percent in March 2006. The return of positive headline inflation rates reflected a combination of factors including a pick-up in wage costs; substantial increases in unprocessed food prices which were partly linked to price arbitrage as EU accession enabled the convergence of food prices; increases in indirect taxes and in administered prices; and higher energy prices. Inflation excluding administered and energy prices also edged up, from around 1 percent in the summer of 2005 to 2.7 percent on average in the first quarter of 2006, notably for food, transport and some services components, such as prices of restaurant services. While a tight budgetary stance had contributed to low inflation in 2001-2002, the budgetary stance eased in the next two years. Against the backdrop of an estimated positive output gap, the cyclically adjusted deficit widened to close to 2 percent of GDP in 2004 and decreased to 1.2 percent in 2005, while general government consumption growth was strong in the last two years.

Table 3.2.

Lithuania: Components of inflation[1)]
(percentage change)

	2001	2002	2003	2004	2005	2006[2)]
HICP	1.6	0.3	-1.1	1.2	2.7	3.3
Non-energy industrial goods	-2.6	-1.7	-1.5	-0.2	-0.7	0.2
Energy	0.0	1.7	1.1	2.7	7.2	9.7
Unprocessed food	9.0	-2.2	-11.9	2.3	6.4	6.7
Processed food	-0.2	0.8	3.1	2.4	1.4	0.9
Services	4.4	3.2	0.3	-0.3	3.3	4.0

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

2) Average of January-March 2006

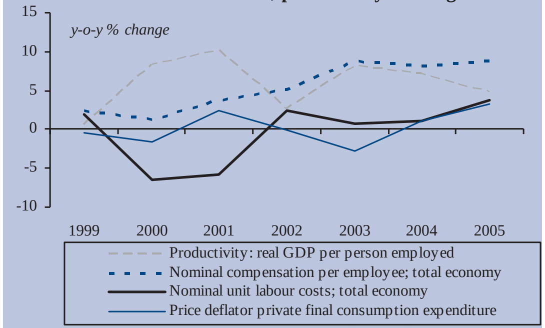
Source: Eurostat and Commission services

Wages and labour costs

The development of wages and unit labour costs in recent years reflected the lagged impact of buoyant economic activity on the labour market. While real GDP growth had been high since 2001, unit labour costs in Lithuania decreased markedly in 2000 and 2001 and rose only moderately in the period 2002-2004. This pattern mirrors the rapid gains in labour productivity in recent years (with the exception of 2002 when weaker productivity growth went hand in hand with moderate wage increases), initially coupled with relatively restrained wage gains. Labour compensation reacted only with a lag to productivity developments. The growth of nominal compensation per employee picked up gradually from 3.8 percent in 2001 to between 8 and 9 percent in the periods 2003-2005 amidst signs of a tightening labour market. Unit labour costs growth picked up in 2005 to 3.8 percent.

From a sectoral perspective, unit labour costs increased more rapidly in services than in manufacturing in recent years. Labour cost pressures on prices in the non-tradable sector strengthened notably from 2004 onwards. Unlike in manufacturing, a relatively high wage growth in the private non-tradable sectors was not matched by productivity increases and led to an increase in relative unit labour costs in services which fuelled services inflation. More generally, hourly labour cost increases accelerated to double digit figures in the course of 2005 in all industries and most strongly in the buoyant construction and real estate sector where there are indications of shortages in some categories of skilled workers partly driven by lower labour supply due to emigration.

Chart 3.3. **Lithuania: Inflation, productivity and wage trends**



Source: Commission services

Table 3.3.
Lithuania: Other inflation and cost indicators (annual percentage change)

	2001	2002	2003	2004	2005	2006[1)]
Private consumption deflator						
LT	2.4	-0.1	-2.7	1.1	3.3	3.5
euro area	2.4	1.9	2.0	2.0	1.9	2.1
Nominal compensation per employee						
LT	3.8	5.1	8.9	8.2	8.7	8.9
euro area	2.8	2.7	2.6	2.4	2.1	2.3
Labour productivity						
LT	10.1	2.7	8.0	7.1	4.7	5.5
euro area	0.5	0.4	0.6	1.7	0.9	1.3
Nominal unit labour costs						
LT	-5.7	2.4	0.8	1.0	3.8	3.2
euro area	2.3	2.3	2.0	0.7	1.2	1.1
Imports of goods deflator						
LT	-3.0	-4.7	-3.4	-0.5	9.0	7.5
euro area	0.4	-2.9	-2.2	1.5	4.0	4.1

1) Spring Forecast

Source: Commission services

Market functioning, domestic competition and EU accession

The disinflation process in Lithuania has been supported by a progressive improvement in competition environment on the domestic market as a result of liberalisation. This has been in particular visible in a subdued development of prices for non-energy industrial goods and in a marked slowdown of the price increases in telecommunications in recent years. The opening of retail trade to foreign entrants and increases in the scale of operations of retail outlets have also helped to boost competition and dampen consumer prices. However, inflows of foreign direct investment have been relatively low compared to most other new Member States, limiting the speed of industrial restructuring (see chapter "Additional factors").

EU accession on 1 May 2004 had important consequences for the opening of markets and for price developments in a number of areas. As a result of the alignment of trade policy to EU standards, a number of products from both EU and non-EU Member States obtained easier access to the Lithuanian market. This facilitated imports of goods from the other EU Member States, and helped strengthen competition on the domestic markets with arguably permanent effects on price formation for imported traded goods.
This notwithstanding, it is likely that the abolishment of the remaining tariffs on exports of food products to other EU Member States had an upward impact on food prices in Lithuania from mid-2004 onwards. It is difficult to identify the precise impact of accession-related factors on food prices, as other influences, such as weather conditions, arguably also played a role. However, it appears that the opening of EU markets and the availability of subsidies on exports to third countries encouraged the convergence of food prices in Lithuania and the EU. In combination with a harmonisation of food safety regulations, the shifting supply conditions on the domestic market are seen to have contributed to a sharp increase in prices for unprocessed food. Inflation in this category peaked at a rate of around 10 percent in early 2005 and initially declined after May 2005, as the base effect of price increases upon EU entry faded. Since then, however, prices for unprocessed food have trended up again, suggesting a more prolonged period of food price adjustments in the wake of EU accession and possibly also reflecting buoyant domestic demand.

In addition, like elsewhere in the EU, prices of traded goods in Lithuania benefited from a benign global environment in particular related to competition from Asia. The most noticeable contribution came from the segment of clothing and footwear, where competition from China led to a sharp drop in prices in 2005. To the extent that this segment has been directly influenced by a relaxation of trade restrictions in 2005, the favourable impact on inflation could be considered temporary. Indeed, price declines for these goods were less marked from the autumn of 2005 onwards.

External influences on domestic prices and changes to indirect taxation

The existence of a currency board in Lithuania contributed to negative import price inflation, thereby exerting a moderating impact on overall consumer prices for a series of years. The restraining impact of import prices on inflation was reinforced by the fact that the peg was changed from the US dollar to the euro in 2002. The decline in import prices in 2001 reflected the appreciation of the US dollar, while the euro appreciation in 2002 and 2003 contributed to the decrease in import prices in these two years. Import prices of goods declined by 3.4 percent in 2003 and 0.5 percent in 2004. Whereas the nominal effective exchange rate of the litas still appreciated by around 1 percent in 2004, the appreciation trend of previous years came to a halt in 2005. As a consequence, the continuing surge in commodity prices, in particular oil, led to a sharp increase in import prices in 2005 by 9 percent. Consumer prices for energy accelerated from around 2.7 percent in 2004 to 7.2 percent last year, leading to an increase in the contribution of the energy component from 0.4 percentage point in 2004 to 0.9 percentage point in 2005. Although the increase in electricity prices in 2005 also played a role, the largest part of the rise in the energy component of the HICP was accounted for by higher prices for motor fuels.

In the first months of 2006, import prices – especially of commodities – continued to increase sharply. Import prices for natural gas rose markedly as of 1 January 2006, by around 40 percent, after a multi-year agreement with the Russian gas exporter Gazprom had expired. This led to price hikes in gas used for cooking and direct heating, adding around 0.1 percentage point to inflation in January 2006. The main impact of higher import prices for gas is likely to occur with a delay, however, due to the lagged adjustment of regulated prices for distributed heat.

As regards changes in indirect taxes, several changes were implemented in 2004, at or just before EU accession. Excise taxes for fuels and tobacco were increased and a 5 percent VAT rate on drugs and other medical products was introduced. A higher VAT rate was applied on heating and on the publishing and printing of books, newspapers and magazines with a high share of advertisements. The impact of the VAT increase on heating was offset by the introduction of direct compensation for the heating costs of households and as of 2006 Lithuania obtained an exemption to apply a low VAT rate to heating. In the area of administered prices, the most important upward adjustments in 2004 and 2005 were to prices for electricity, public transport, and medical services. The adjustment of indirect taxes and administered prices contributed an estimated 0.4 and 0.9 percentage points to headline inflation in 2004 and 2005, respectively. For 2006 and 2007, no decisions have been taken yet with respect to changes in indirect taxes, but excises on tobacco products in particular will have to be increased in the coming years to reach the minimum level required in the EU, as derogations expire by 2010.[16]

Medium-term prospects

Inflation performance in the remainder of 2006 will reflect upward pressures stemming from labour cost developments and higher import prices, in particular for energy products, which will partly be reflected in consumer prices only with a lag. As a result, average inflation in 2006 is expected in the Commission spring 2006 forecast to increase to 3.5 percent, from 2.7 percent in 2005.

Beyond 2006, several upward risks to inflation can be identified. The economy is in an advanced stage of the cycle and the labour market has tightened. Apart from the impact of further increases in indirect taxes, there is a risk that buoyant domestic demand could add to inflationary pressures, supported by strong credit growth. The achievement and maintenance of a low level of inflation in the medium-term will therefore depend on wage growth being in line with productivity developments and on fiscal policy being geared towards containing demand pressures.

16 Without offsetting measures, the harmonisation of excise taxes on tobacco products is estimated to have a cumulative impact on inflation of some 2 percentage points in the period up to 2010.

4. Government budgetary position

4.1. Recent budgetary developments

Following a deterioration of the general government deficit in 2000, partly due to the impact of the Russian crisis in 1998-1999, fiscal consolidation efforts led to a decline in the deficit from 3.6 percent of GDP in 2000 to 1.2 percent of GDP in 2003. The deficit subsequently increased to 1.5 percent of GDP in 2004, following a more expansionary fiscal stance and the introduction of a funded pension system. Lithuania already presents the government accounts taking into account the Eurostat decision of March 2004 on the classification of second pillar pension systems and has included the pension reform costs in the deficit. In 2005, Eurostat decided on a methodological change for the classification of compensations related to real estate property confiscated in Soviet times and private savings lost due to currency devaluations in the early 1990s. Consequently, the related payments have been imputed to the deficit of the year when the liability was recognised. The payments were marginal in 2000 and 2001 but accounted for 0.1 percent of GDP in 2001, 0.1 percent in 2002, 0.7 percent in 2003, 1.1 percent in 2004 and 0.8 percent in 2005.

The general government deficit decreased to 0.5 percent of GDP in 2005. This compares to an estimated outcome of 1.5 percent of GDP in the December 2005 update of Lithuania's convergence programme and 2.0 percent in the Commission services' autumn 2005 forecasts. The more favourable result stems from a good budgetary performance at all levels of general government, which are estimated to have recorded higher-than-planned revenues while expenditure plans were broadly achieved. This was possible due to higher-than-foreseen economic activity and improvements in tax collection and enforcement. In contrast to previous practice, additional expenditure through supplementary budgets in the second half of the year was avoided. Good times were thus used to step up the budgetary consolidation effort in 2005, in line with the Council opinion on the previous convergence programmes of Lithuania.

Under a no-policy-change assumption, the deficit is expected to remain broadly stable in 2006, although there are some uncertainties related to the absorption of EU funds and the impact of the tax reform. The first steps of the tax reform approved in 2005 will be implemented in 2006. They mainly consist in a *de facto* temporary increase in the corporate income tax by 4 percentage points, applicable as of January 2006, and a reduction of the personal income tax rate from 33 percent of the gross salary to 27 percent from July 2006. While neutral in 2006, the net impact of the tax reform is expected to be negative in subsequent years, but this should be partly offset by high tax revenue growth and a lower increase of current government expenditure. The structural deficit (equal to the cyclically adjusted balance as there are no one-off measures) is expected to remain below 1¾ percent of GDP, which is the minimal benchmark for providing a safety margin against breaching the 3 percent of GDP reference value under normal cyclical conditions, in line with the Stability and Growth Pact.

Cyclical conditions contributed unevenly to fiscal consolidation in the period 2000-2004. A significant budgetary consolidation effort was made in 2001, when a decline in the structural general government deficit was achieved despite unfavourable cyclical conditions as suggested by the wide negative (although rapidly closing) output gap.[17] Since 2003, cyclical conditions became supportive, but the structural deficit deteriorated in 2003 and 2004, partly reflecting a higher primary deficit, to which the pension reform contributed. In 2005, the primary deficit improved, as did the structural deficit. Positive cyclical conditions are expected to continue over 2006, with the output gap remaining positive.

17 The calculations of potential growth (and hence the output gap) must be treated cautiously as they may be exposed to considerable uncertainty particularly for countries experiencing a catching-up process.

Table 4.1.
Lithuania: Budgetary developments
(as percentage of GDP unless otherwise indicated)

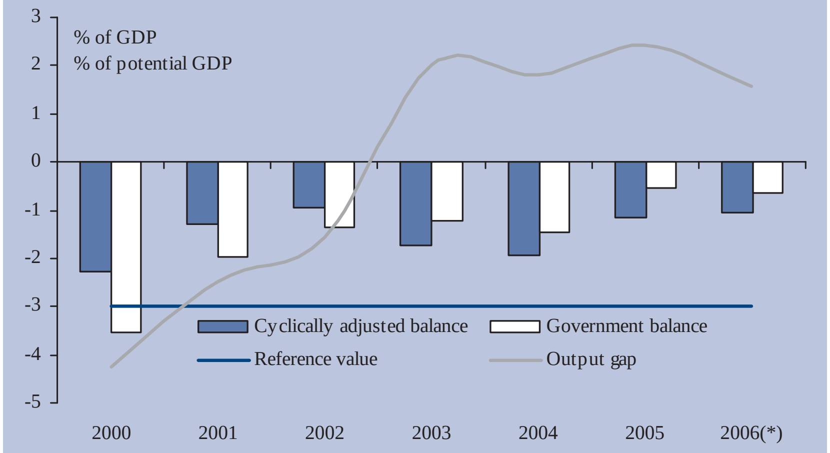
	2000	2001	2002	2003	2004	2005	2006(*)
General government balance[1)]	-3.6	-2.0	-1.4	-1.2	-1.5	-0.5	-0.6
- Total revenue	35.8	33.1	32.9	31.9	31.9	33.1	32.0
- Total expenditure	39.3	35.1	34.3	33.2	33.4	33.7	32.6
of which: interest	1.7	1.5	1.3	1.2	0.9	0.8	0.7
primary expenditure	37.6	33.6	33.0	31.9	32.5	32.8	31.9
GFCF	2.4	2.2	2.9	3.0	3.4	3.5	3.5
Primary balance	-1.8	-0.5	-0.1	0.0	-0.5	0.3	0.1
p.m. Tax burden	30.3	29.0	28.6	28.3	28.7	29.1	28.7
Government debt	23.6	22.9	22.3	21.2	19.5	18.7	18.9
p.m. Real GDP growth	3.9	6.4	6.8	10.5	7.0	7.5	6.5
p.m. HICP inflation	1.1	1.6	0.3	-1.1	1.2	2.7	3.5

(*) Spring Forecast

1) The costs of the ongoing pension reform (introduction of a second pillar) are included in the deficit. The costs are estimated at 0.3% of GDP in 2004, 0.5% in 2005 and 0.7% in 2006.

Source: Commission services

Chart 4.1. **Lithuania: Government balance and economic cycle**



(*) Spring Forecast *Source*: Commission services

The composition of the nominal budgetary adjustment in the period 2000-2004 has been mostly expenditure driven, as the revenue-to-GDP ratio gradually decreased. The primary expenditure ratio fell until 2003, but started increasing in 2004 on the back of a strong increase in social related expenditure, agricultural subsidies, public sector salaries and investment. Interest payments on public debt as a percentage of GDP gradually dropped from 1.7 percent in 2000 to 0.9 percent in 2004. After declining slightly in 2001, the public investment to GDP ratio increased steadily to 3.5 percent in 2005 and remains well above the EU average (2.5 percent of GDP). Unlike in previous years, the budgetary adjustment in 2005 was revenue-driven, mainly stemming from favourable tax collection, while current expenditure increased significantly. The tax burden fell below 30 percent of GDP in 2001 and remained at around 28-29 percent until 2005.

4.2. Government debt

Lithuania's government debt ratio declined steadily from 23.6 percent at the end of 2000 to 19.5 percent at the end of 2004 and is well below the 60 percent of

GDP reference value. The main factor contributing to the decrease was the impact of financial transactions of the government (stock-flow adjustment). This was mostly influenced by privatisation receipts and positive foreign debt valuation effects related to the nominal appreciation of the litas, which was initially pegged to the dollar until February 2002, and thereafter to the euro. The “snow-ball” effect, which is the combined effect of implicit interest rates and nominal GDP growth, contributed slightly to improve the debt ratio, primarily due to high real GDP growth, as inflation remained low. The primary deficit was the major factor increasing the debt ratio over 2000-2004. In 2005, the debt ratio decreased further to below 19 percent, led by the positive impact of the snow-ball effect. In 2006, the debt ratio is expected to remain broadly stable with the snow-ball effect largely offsetting a negative contribution of the primary balance.

4.3. Medium-term prospects

The sustainability of the budgetary position is examined in the most recent update of Lithuania's convergence programme, submitted in December 2005. The programme's main goal is to reduce the general government deficit in structural terms to or below 1 percent of GDP. This is the country's medium-term objective (MTO) for the budgetary position as meant in the Stability and Growth Pact.

Against the background of robust GDP growth, the update foresees the headline general government deficit to gradually decrease from 1.5 percent of GDP in 2005 to 1 percent in 2008. The time profile of the primary deficit is similar, with a decline from 0.6 percent of GDP in 2005 to 0.2 percent over the same period. Overall, the programme relies on a favourable economic outlook that would create good conditions for fiscal retrenchment. The consolidation foreseen in the programme is expenditure-driven, mostly due to cuts in collective consumption and social transfers in percent of GDP. A significant increase in government investment is planned, from 3.4 percent of GDP in 2004 to 5.2 percent in 2008. The revenue ratio is planned to drop by ½ percent of GDP over the programme period, mostly due to the impact of the pension and tax reforms.

The update of the convergence programme estimates Lithuania’s debt ratio to remain at about 19-20 percent of GDP throughout the remainder of the programme horizon. The debt-increasing contribution of the primary deficit is expected to progressively fade out. The combined effect of interest rates and GDP growth will have a decreasing effect on the debt ratio, while financial transactions are expected to increase the debt.

The Council examined the updated convergence programme on 14 March 2006. Overall, the programme's budgetary strategy was regarded as plausible and risks to the budgetary projections were judged broadly balanced. Nevertheless, the MTO might not be reached during the programme's period. A temporary deviation from the minimum adjustment path towards the MTO required by the pact was granted, justified by the pension reform costs. The allowance of a temporary deviation was conditional on meeting the minimum benchmark in 2006, as is expected in the Spring 2006 Commission forecasts. The general government deficit outcome in 2005 is estimated to have been lower than projected in the programme. A carry-over to 2006 would imply that outcomes could be better than targeted also in 2006.

With regard to the sustainability of public finances, Lithuania appears to be at low risk on grounds of the projected budgetary costs of ageing populations. Lithuania has enacted a pension reform which contributes significantly to contain the budgetary impact of ageing populations. Further changes to the pension system are envisaged, aiming at increasing the replacement rates for pensioners and at the same time gradually raising the retirement age.

Table 4.2.
Lithuania: Convergence programme projections for general government balance and debt (as percentage of GDP)

	2004	2005	2006	2007	2008
Balance[1)]	-1.4	-1.5	-1.4	-1.3	-1.0
Debt	19.5	19.2	19.9	19.8	18.9

1) The costs of the ongoing pension reform (introduction of a second pillar) are included in the deficit. The costs are estimated at 0.3% of GDP in 2004, 0.5% in 2005, 0.7% in 2006, 0.8% in 2007 and 0.8% in 2008.

Source: December 2005 convergence programme and Commission services

The Council invited Lithuania to strengthen the effort in the structural budgetary adjustment, in order to speed up the attainment of the MTO. In response, Lithuania announced its intention to carry over the better-than-projected deficit outcome in 2005 to 2006.

5. Exchange rate stability

Lithuania entered ERM II on 28 June 2004 and has, by the time of the drafting of this report, so far spent 22 months in ERM II. There has been no deviation from the central rate since the litas started participating in ERM II. The authorities have committed to unilaterally maintain the long-standing currency board in the mechanism.

Before ERM II entry, the Bank of Lithuania had already been operating its currency board as of April 1994 with the litas initially pegged to the US dollar at LTL 4 per USD. The litas peg was changed to the euro in February 2002 at the prevailing market rate of LTL 3.4528 per euro. The ERM II central parity corresponds to this exchange rate, which had been unchanged since repegging to the euro.

During more than a decade, the currency board arrangement has served as a disciplining force for imposing and maintaining prudent macro-economic policies. The currency board has proven its ability to withstand shocks, such as the banking crisis of 1996 and the Russian crisis of 1998, which in combination with a severe recession and a worsening fiscal position put the system under substantial strain. The success of re-pegging to the euro in 2002 was based on continuing sound macro-economic policies and thorough technical preparation. Public confidence in the currency board arrangement continues to be strong.

The development of additional indicators does not reveal any major exchange rate pressures on the litas. In accordance with the Litas Credibility Law, the Bank of Lithuania guarantees that the total amount of litas put into circulation does not exceed gold and foreign currency reserves. In practice, the ratio of official reserve assets to the monetary base has well exceeded 100 percent, underpinning the credibility of the currency board arrangement. On average, this backing was around 125 percent at at the end of 2005. Barring short-term changes in government deposits, the ratio of foreign reserves to GDP has also been relatively stable in recent years, indicating that the trend increase in official reserve assets moves in line with economic activity. Beyond the standard characteristics of a currency board, the Bank of Lithuania also has control of some money market instruments which it can use to influence liquidity. However, the Bank of Lithuania has not been actively using these discretionary facilities to any significant extent. Exchange rate stability in the period May 2004 – April 2006 has been achieved in the presence of a narrowing short-term interest rate differential vis-à-vis the euro area. While in April 2004 the 3-month VILIBOR on average stood around 65 basis points above the EURIBOR, the spread narrowed gradually since then to a mere 3 basis points on average in the period January-March 2006. The close alignment of short-term rates to the euro area illustrates the stability of the litas peg and suggests that no appreciable currency risk is priced in.

Chart 5.1. **Exchange rates: LTL/EUR**
(monthly averages)

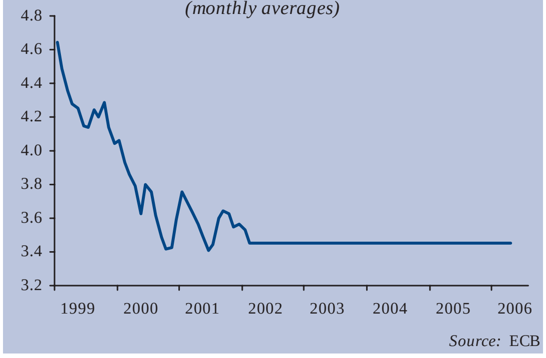
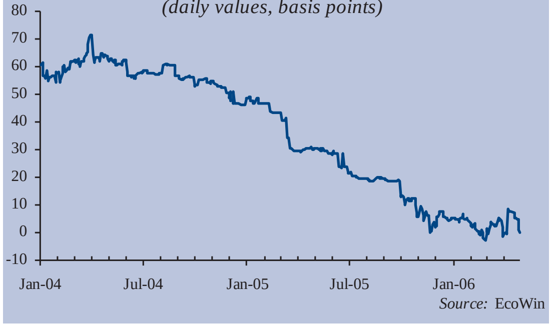


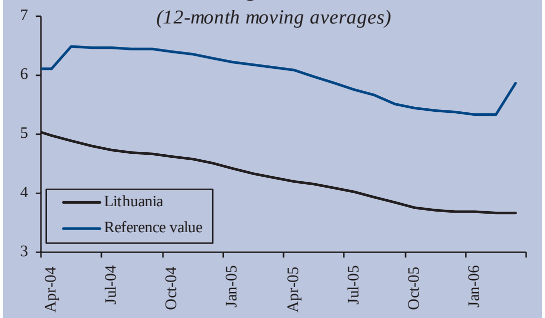
Chart 5.2. **Lithuania : 3-M Vilibor spread to 3-M Euribor**
(daily values, basis points)



6. Long-term interest rates

At the beginning of 2001, Lithuania was among the new Member States with the highest long-term interest rates of around 9½ percent. Long-term interest rates progressively declined in the following years, indicative of the credibility of Lithuanian macro-economic policies and the perspective of euro area accession. The spread vis-à-vis euro area average interest rates had been declining markedly in the run-up to ERM II entry in June 2004. Subsequently, spreads have fallen further from around 55 basis points in June 2004 to around 3 basis points in March 2006. Over the assessment period, foreign investors have generally shown strong interest in Lithuanian government securities, driving yields downwards as demand has exceeded supply in auctions. Since long-term interest rates for Lithuania reflect primary market rates, the short-term fluctuations in the spread mostly mirrored the volatility of euro area long-term interest rates. The remaining positive differential at auctions is accounted for by the illiquidity of the market for Lithuanian government bonds and by the remaining currency risk premium incurred by foreign investors.

Chart 6.1. **Long-term interest rates**
(12-month moving averages)



Source: ECB, Eurostat, Commission services

The Lithuanian 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion has continued to decline over the whole assessment period, largely reflecting a global decline in bond yields. The reference value for the long-term interest rate criterion has been declining at a broadly similar pace. In March 2006 the reference value, given by the average of long-term interest rates in Sweden, Finland and Poland plus 2 percentage points, stood at 5.9 percent. The twelve-month moving average of the yield on ten-year Lithuanian benchmark bond stood at 3.7 percent, below the reference value.

Table 6.1.
Lithuania: Long-term interest rates
(12-month averages)

	December 2003	December 2004	December 2005	March 2006
LT	5.3	4.5	3.7	3.7
Reference value[1)]	6.1	6.3	5.4	5.9

1) Average of interest rates of the three best performing Member States in terms of price stability plus 2 percentage points

Source: ECB, Eurostat, Commission services

7. Additional factors

7.1. Financial market integration[18]

Lithuania's financial system has substantially integrated into the broader EU financial system. The main channels of integration have been a high degree of foreign ownership of financial intermediaries associated with substantial foreign currency borrowing. Compliance with the *acquis communautaire* in the field of financial services was already broadly achieved on accession and good progress has been made in transposing the legislation adopted under the Financial Services Action Plan.[19]

The size of the financial system remains small relative to GDP, but financial development is catching-up broadly in line with economic development.[20] Reflecting low central government debt, outstanding debt securities are also low by EU-15 standards at less than 20 percent of GDP, while stock market capitalisation is a little higher at 25 percent of GDP *(Chart 7.1)*. Banks strongly predominate among financial intermediaries, while other financial intermediaries – i.e. insurance companies, investment funds, leasing companies and pension funds – are still at a very early stage of development.

Lithuania's banking system is fully privatised since 2002. Foreign ownership has progressively increased to represent 75 percent of total assets, with notably Swedish banks acquiring the two largest banks. The banking system is now highly concentrated, with a top five banks concentration ratio (CR5) of 80 percent *(Chart 7.2)*.

Reflecting progressive financial deepening, domestic lending to the private sector continued to expand strongly. *(Chart 7.3)*. While credit growth was the highest of all EU-10 Member States over the past years, it has to be noted that the expansion takes place from low levels. Debt dynamics are mitigated by the fact that Lithuania has still the lowest loan to GDP ratio among EU-10 Member States and that the wide majority are long-term loans (85 percent). The share of foreign currency loans rose to about 70 percent for companies and 60 percent for households. Following the re-pegging of the litas to the euro in 2002, the share of euro denominated loans increased rapidly and is now widely dominating in most sectors *(Chart 7.4)*.

Foreign currencies denominated credits are substantially higher than foreign currency deposits within the private sector. Given the high credibility of its currency-board arrangement, however, Lithuania's exposure to currency risk is mitigated, and short-term debt is broadly covered by official reserves.

The importance of capital markets remains limited in Lithuania. Government debt securities account for over 90 percent of debt securities outstanding, with about one third being denominated in euro. The Vilnius Stock Exchange (VSE) performed strongly following EU entry, but remains relatively illiquid. VSE is part of the Nordic Exchange (OMX), offering access to the Nordic and Baltic securities markets, and the three Baltic exchanges with harmonised market practices and rules.

High concentration and foreign ownership highlight the importance of cross-border cooperation to ensure adequate supervisory structures in safeguarding financial stability as the financial system develops and integrates further with the EU. The securities market is regulated and supervised by the Securities Commission of the Republic of Lithuania while the Bank of Lithuania supervises credit institutions. Both institutions are co-operating to improve the supervision of individual sectors.

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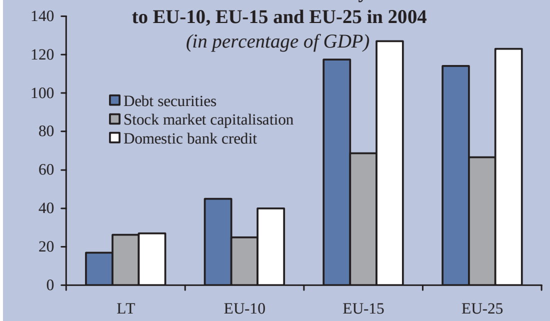
18 This section draws mainly on information provided by the Central Bank of Lithuania its Quarterly and Monthly Bulletins as well as a number of recent cross-country studies published by the ECB, the OeNB, the RZB Group and independent researchers.

19 See: Transposition of FSAP Directives - State of play http://europa.eu.int/comm/internal_market/finances/docs/actionplan/index/memberstate_en.pdf

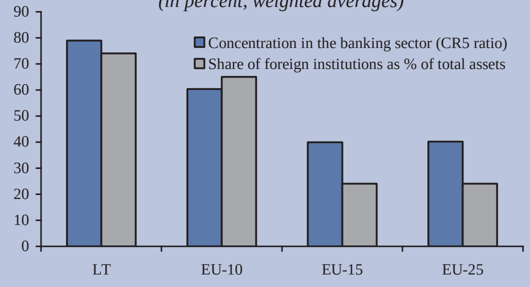
20 GDP per capital levels (PPP) in Lithuania are among the lowest in EU-10, broadly in line with Poland, Estonia and Latvia.

Chart 7.1. **Structure of financial system relative to EU-10, EU-15 and EU-25 in 2004**
(in percentage of GDP)



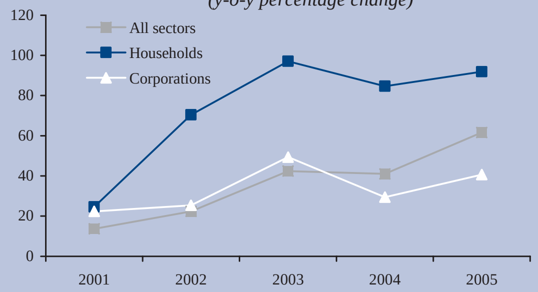
Source : European Banking Federation, Eurostat, ECB, Commission services

Chart 7.2. **Foreign ownership and concentration in the banking sector in 2004**
(in percent, weighted averages)



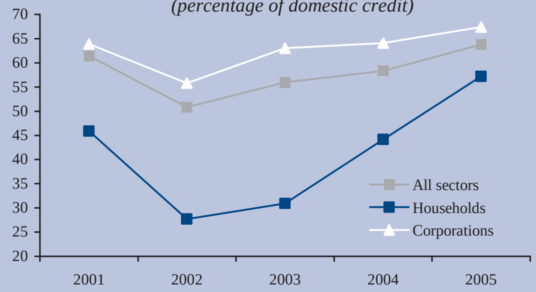
Source : ECB: EU Banking Structures (October 2005)

Chart 7.3. **Lithuania: Domestic credit expansion**
(y-o-y percentage change)



Source : Bank of Lithuania

Chart 7.4. **Lithuania: Share of foreign currency loans**
(percentage of domestic credit)



Source: Bank of Lithuania

7.2. Product market integration

Similarly to the other new Member States, Lithuania experienced an important structural change over the past 15 years, which was further promoted by the process of integration with the EU. Trade and foreign direct investment (FDI) data show that Lithuania has become increasingly integrated in the EU economy and the country is already among the most open economies in the EU-25. Differences regarding the sectoral composition of production in Lithuania *vis-à-vis* the EU remain, however considerable.

Important efforts have been made with respect to the adoption and application of the Internal Market *acquis* and improvement of the business environment in order to put in place the necessary conditions for a smooth process of integration.

Trade and FDI

The high degree of product market integration is desirable in view of the process of real convergence of the Lithuanian economy towards EU average income levels. Trade and investment links with the EU increase the scale of operations of local firms and enhance domestic competition levels eventually resulting in higher efficiency levels, better allocation of resources and enhanced adaptability to asymmetric shocks.

Lithuania is a small and fairly open market economy in the EU context. The degree of openness, defined as the average of imports and exports of goods and services divided by GDP, has been increasing over time. During the period 2000-2005, the degree of openness (around 60 percent) was already higher than the small EU Member States average (56 percent). The other EU Member States are Lithuania's main trading partners but trade with third countries remains important. While trade flows with the EU have increased with the general economic catching-up and continuous removal of barriers, between 2000 and 2005 the intra-EU trade to GDP ratio remained lower than the average for the small Member States. Moreover, it is among the lowest in the new Member States; only Poland and Cyprus (which trades mainly in services) have lower ratios.

Lithuania's sectoral export composition shows few similarities with the EU-15.[21] Despite having grown gradually more similar over time, Lithuania's export sectoral profile (with Latvia's) differs the most from that of the EU-15. This difference in trade structure reflects the much larger importance of labour-intensive industries in the total manufacturing value added compared to the EU average. The share of low-tech industries in Lithuania is also among the highest in the EU.[22]

Product market integration can also be assessed on the basis of FDI performance. Like in most new Member States, FDI inflows, particularly from the EU, have been substantial since the mid-nineties. However, in terms of inward FDI stocks Lithuania was still below the average for the new Member States in 2004. FDI has been particularly important in the industrial restructuring of the Lithuanian economy. It has been an important source of funding for private investment and has contributed to covering current account deficits. The presence of foreign firms has also been an important means for the transfer of technology, organisational and managerial skills and to boost competition pressure in the economy.

Implementation of the Internal Market

The building of an institutional framework conducive to adequate levels of competition in product markets is relatively well developed in Lithuania. Encouraging progress has been made in implementing the competition law and in establishing independent competition and regulatory authorities.

Lithuania is among the best performers as regards the transposition of Internal Market directives. In December 2005, only 0.4 percent of the directives were yet to be transposed (down from 1 percent in 2004) *vis-à-vis* 1.6 percent in the EU on average.

With respect to the business environment, important progress has also been achieved. Lithuania is the best performer among the new Member States in the World Bank ranking on the ease of doing business. Among the EU Member States, the country ranks sixth; only the Scandinavian countries, Ireland and the UK rank higher.

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[21] See "Patterns of Trade, Delocalisation Choices and Catching-up", Luca de Benedectis and Lucia Tajoli, 2005

[22] See "Statistics in Focus - Industry, trade and services", no. 41/2004, Eurostat

Table 7.1.
Lithuania: Product market integration

	Lithuania						EU-25					
	2000	2001	2002	2003	2004	2005	2000	2001	2002	2003	2004	2005
Trade openness [1] (%)	47.8	52.6	55.7	54.2	55.8	59.8(f)	36.2	36.0	34.8	34.3	35.5	36.7(f)
Extra-EU trade GDP ratio [2] (%)	14.4	15.8	17.2	18.5	17.0	-	10.2	9.9	9.4	9.2	9.6	-
Intra EU-trade GDP ratio [3] (%)	24.1	26.5	27.7	26.2	31.3	-	19.1	18.9	18.4	18.4	19.1	-
Intra-EU trade in services GDP ratio [4] (%)	-	-	-	4.5	4.8	-	-	-	-	4.6	4.7	-
Intra-EU trade balance [5]	-0.2	-0.2	-0.7	-0.9	-1.3	-1.1	84.5	104.2	115.0	97.3	77.9	79.9
Total FDI inflows GDP ratio [6] (%)	3.3	3.7	5.1	1.0	3.4	-		5.8	5.0	3.5	2.1	-
Intra-EU FDI inflows GDP ratio [7] (%)	-	-		0.5	2.5	-	-	4.3	3.7	2.3	1.4	-
FDI intensity [8]	-	-		0.3	1.7	-		3.9	3.7	2.5	1.7	-
Internal Market Directives [9] (%)	-	-	-	-	1.0	0.4	-	-	-	-	1.9	1.6
Price levels[10]	51.6	53.0	54.6	54.9	54.6	-	100.0	100.0	100.0	100.0	100.0	100.0

1) Average of exports and imports of goods and services at current prices (national accounts) in percentage of gross domestic product at market prices.
2) (Extra-EU Imports+Exports/2xGDP at current prices)*100.
3) (Intra-EU Imports+Exports/2xGDP at current prices)*100.
4) Balance of payments: Intra-EU25 trade in services (average credit and debit in % of GDP at current prices).
5) Difference between exports and imports in bn euros, based on monthly statistics.
6) Total FDI inflows as a % of GDP (at current prices).
7 Intra-EU total FDI inflows as a % of GDP (at current prices).
8) Average value of ntra-EU25 inward and outward foreign direct investment flows, divided by GDP and multiplied by 100.
9) Percentage of Internal Market directives not yet communicated as having been transposed in relation to the total number.
10) Comparative price levels of final consumption by private households including direct taxes (EU25=100).

Source: Eurostat, Commission services

7.3. Development of the balance of payments

As a consequence of strong domestic demand, in particular for investment, the Lithuanian current account deficit widened from 4.7 percent of GDP in 2003 to 7.7 percent of GDP in 2004. This trend was halted in 2005 as the current account balance in Lithuania recorded a deficit of 7.0 percent of GDP. The reduction in the current account deficit was due to improvements in the services and transfers balances (with the rise in the latter in the last two years mainly due to inflows of EU funds), while the deficit in goods trade widened and reached 11.2 percent of GDP as imports were buoyed by rapid real GDP growth. The balance on current income was negative at 2.4 percent of GDP, a similar figure as in the previous two years, mainly due to a sizeable repatriation of profits by foreign companies (underlining the healthy profitability of past foreign direct investment). The improvement in the current account went hand in hand with capital inflows and Lithuania recorded an increase in reserve assets, following a slight decline in 2004. Inflows of foreign direct investment increased to 2.6 percent of GDP in 2005, while loans from foreign banks to Lithuanian subsidiaries accounted for an appreciable share of inflows in other investment.

Lithuania has had rather large current account deficits for many years, principally in view of substantial deficits in goods trade partly offset by positive balances of services and current transfers. This pattern is consistent with the rapid catch-up path of the economy, where foreign savings are mobilised via external borrowing to increase domestic investment and productivity growth. In an environment of high prospective economic growth, foreign inflows thus compensate for lower domestic saving rates to finance the expansion path, as domestic agents increase consumption faster than income in anticipation of future increases in permanent income. From this intertemporal perspective, several studies indicate that the current account deficit in Lithuania has been within the range implied by underlying fundamentals.

So far, the financing of the current account deficits appears to have been unproblematic, but the external position reflects substantial financing needs in the medium term. The main challenge for Lithuania will be to ensure that there is no substantial widening of the external deficit and that growth rates can be sustained in the future without negatively impacting on competitiveness. To that end, investment needs to be channelled to sectors that will contribute to productivity growth. However, in recent years foreign direct investment inflows remained relatively modest, compared with some of the neighbouring countries. In order to avoid a too rapid increase in external debt, national savings need to remain at adequate levels. In this regard, a significant contribution to domestic investment is expected to come from EU structural funds, which will help to alleviate the external constraint without affecting external indebtedness.

Table 7.2.
Lithuania: Balance of payments
(percentage of GDP)

	2001	2002	2003	2004	2005
Current account	-4.7	-5.1	-6.8	-7.7	-7.0
Of which: Balance of trade in goods	-9.1	-9.4	-9.1	-10.6	-11.2
Balance of trade in services	3.8	3.8	3.3	3.6	4.1
Income balance	-1.5	-1.2	-2.6	-2.7	-2.4
Balance of current transfers	2.1	1.6	1.6	2.0	2.5
Financial and capital accounts	3.4	4.1	5.9	6.9	6.6
Of which: Net FDI	3.6	5.0	0.8	2.3	2.6
Net portfolio inflows	2.1	0.1	1.5	0.9	-1.5
Net other inflows	0.4	1.7	6.4	1.9	6.8
Net capital account	0.0	0.4	0.4	1.3	1.4
Change in reserves (+ is a decrease)	-2.7	-3.1	-2.9	0.5	-2.7
Errors and omissions	1.3	1.1	0.9	0.8	0.3
Gross capital formation	20.4	21.6	22.9	24.2	25.0
Gross saving	15.8	16.8	16.1	16.2	18.1

Source: Eurostat and Commission services

II. 2006 Convergence Report on Slovenia*

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

* This report was formally adopted by the College of Commissioners on 16 May 2006 (COM(2006) 223 final).

1. Purpose of the report

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

This report has been prepared at the request of Slovenia, submitted on 2 March 2006. A more detailed assessment of the state of convergence in Slovenia is provided in a technical annex to this report (SEC(2006) 615).

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

2. Legal compatibility

In its 2004 Convergence Report (COM(2004) 690), the Commission concluded that, as regards central bank integration into the ESCB at the time of euro adoption, legislation in Slovenia, in particular the Bank of Slovenia Act, was not fully compatible with Article 109 of the EC Treaty and the ESCB/ECB Statute. In addition, the correction of some residual imperfections was recommended, in particular with respect to the Bank's objectives as well as in the field of personal and institutional independence.

The incompatibilities have been removed by an amendment to the Bank of Slovenia Act adopted by the Slovenian Parliament on 30 March 2006. In particular, the amendment clarifies that the Bank of Slovenia competences in the area of monetary functions, operations and instruments shall be transferred to the ESCB as from the date of the introduction of the euro in Slovenia. Moreover, the possibility for the Government of being involved in the management of the Bank's foreign exchange assets has been removed. With respect to the identified imperfections, the grounds for dismissal of the members of the Governing Board of the Bank of Slovenia have been aligned with those stipulated in the ESCB/ECB Statute. Finally, the objectives of the Bank of Slovenia have been amended and reflect the wording of Article 105(1) of the EC Treaty more accurately. In particular, the Bank's secondary objective (supporting the general economic policy in accordance with the objectives set in the EC Treaty) is now clearly subordinated to the primary one (price stability). However, the third objective (linked to financial stability in line with the principles of an open market economy and free competition) is not clearly subordinated to the primary and secondary ones, which constitutes a residual imperfection.

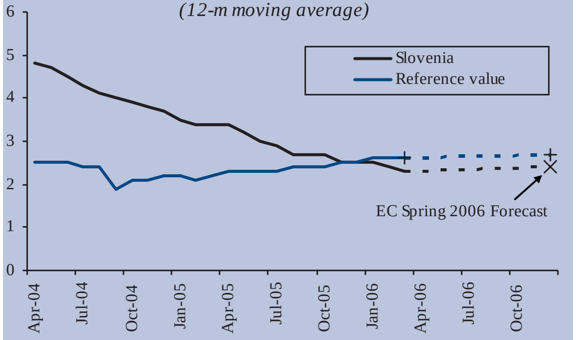
Legislation in Slovenia, in particular the Bank of Slovenia Act, is compatible with the requirements of the EC Treaty and the ESCB/ECB Statute.

3. Price stability

Evolution of the reference value

Slovenia did not fulfil the criterion on price stability in the 2004 Convergence Report. The average inflation rate in Slovenia during the 12 months to August 2004 was 4.1 percent, above the reference value of 2.4 percent.

Chart 1. **HICP Inflation**
(12-m moving average)



Source: Eurostat, Commission services

The 12-month average inflation, which is used for the convergence assessment, declined from 8.6 percent in 2001 to 2.3 percent in March 2006. As a result, it progressively approached the reference value and reached it for the first time in November 2005. The 12-month average inflation was below the reference value since January 2006. In March 2006, the reference value was 2.6 percent, calculated as the average of the 12-month average inflation rates in the three best-performing Member States (Sweden, Finland and Poland) plus 1.5 percentage points. The corresponding inflation rate in Slovenia was 2.3 percent, 0.3 percentage points below the reference value.

Underlying factors and sustainability

Inflation in Slovenia increased to around 9 percent between mid-1999 and mid-2000, mainly due to the impact of the introduction of the value-added tax. Inflation started to fall again in the second half of 2001, when also a new medium-term monetary policy framework was adopted by the Bank of Slovenia. Its main objective was to secure an early euro area entry by decreasing inflation and progressively stabilizing the exchange rate. Since 2003, the disinflation process has been underpinned by a coordinated policy approach of the Slovenian Government and the Bank of Slovenia. An effective control of administered prices, wage moderation in the public sector and a stabilisation of the exchange rate since mid-2004 reinforced the credibility of the disinflation process, which in turn translated into wage moderation in the private sector. Disinflation in recent years was also supported by a prudent policy mix and by growth below potential between 2001 and 2003. However, the progressive lowering of unemployment rates since 2003, in line with the economic upturn, was not associated with increased wage and price pressures, which signals that the decrease in inflation was rather driven by factors which should be expected to underpin a low inflationary environment also in the medium term.

Inflation performance in 2005 was affected by a favourable development of prices of certain categories of goods, mostly reflecting a favourable impact of EU accession, which helped to outweigh a large negative impact of the increase of oil prices on the world markets. While EU accession also contributed to increasing the level of competition on the domestic markets with permanent effects on inflation, part at least of the favourable impact on price developments is expected to progressively fade out.

In spite of this, the outlook for inflation in the remainder of 2006 remains favourable. The expected easing of the negative effects of the external environment on energy prices will be broadly compensated by a slow pick-up in non-energy related inflation from exceptionally low levels in 2005. At the same time, the decline in the growth rate of unit labour costs observed since 2002 is expected to continue also in 2006 and average inflation is forecast to slightly decrease from 2.5 percent in 2005 to 2.4 percent in 2006.

In a longer-term perspective, the final convergence of domestic interest rates to the euro area level and the possibility of an increase of the value-added tax rate envisaged in 2007 represent risk factors to inflation. Slovenia therefore needs to remain vigilant to protect its low inflationary environment and a favourable competitiveness position. A more ambitious fiscal policy stance would help to mitigate risks to inflation and wage moderation should be continued beyond 2006.

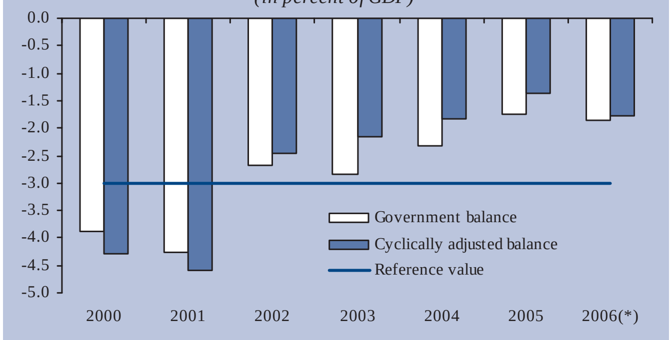
Slovenia has respected the reference value for inflation since November 2005 and is likely to continue to do so in the months ahead. Slovenia fulfils the criterion on price stability.

4. Government budgetary position

In the 2004 Convergence Report, the Commission stated that Slovenia was not subject to a Council decision on the existence of an excessive deficit and that it fulfilled the criterion on the government budgetary position.

Public finances in Slovenia worsened in 2000-2001 and the 2001 general government deficit reached a high of 4.3 percent of GDP. Following a correction in 2002-2003, the general government deficit has stayed below the 3 percent of GDP threshold since 2002.

Chart 2. **Slovenia: Government balance**
(in percent of GDP)



(*) Spring Forecast

Source : Commission services

A reinforced commitment to fiscal discipline and economic recovery since 2004 underpinned a further reduction of the general government deficit to 2.3 and 1.8 percent of GDP, respectively, in 2004 and 2005. The commitment of the government to a sound budgetary policy was most apparent in 2004 when a shortfall from value-added tax resources prompted cuts in expenditures in order to respect the deficit target.

Slovenia targets a general government deficit of 1.8 percent of GDP in 2006, somewhat below the Commission services' spring 2006 forecast. No deficit reduction compared to 2005 is planned. On the contrary, in view of the expected favourable economic environment, the structural deficit, which stood at 1.4 percent of GDP in 2005, is expected to deteriorate to 1.8 percent of GDP. At the same time, it is expected to stay below the minimal benchmark of 1.9 percent set in the Stability and Growth Pact for providing a safety margin against breaching the 3 percent of GDP reference value under normal macroeconomic fluctuations.

The general government debt has been lingering at slightly below 30 percent of GDP since 2000. At the end of 2005, the gross debt accounted for 29.1 percent of GDP, down from 29.5 percent in 2004. The general government debt is expected to stay below 30 percent of GDP over the medium term.

According to the December 2005 convergence programme, the budgetary strategy is to gradually reduce the general government deficit to 1 percent of GDP in 2008. The programme announced tax reform measures leading to a drop in the share of revenue as a percentage of GDP by 1.8 percentage points, and expenditure cuts, resulting in a decline in the expenditure ratio by 2.5 percentage points of GDP. Some concrete measures that would underpin this consolidation have been specified in the latest update of the Convergence programme, while further measures are being considered.

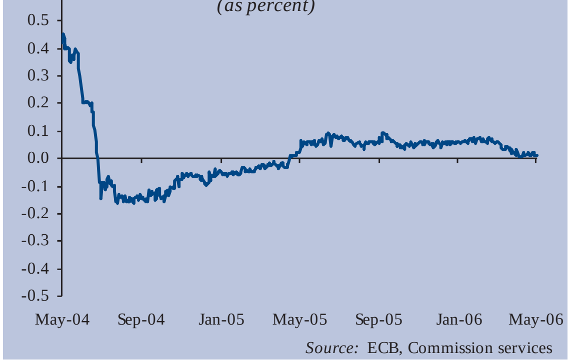
The Council examined the updated convergence programme of Slovenia on 14 February 2006. It regarded the budgetary strategy as having set plausible targets and saw the risks to the budgetary projections in the programme to be broadly balanced. Slovenia is, however, considered to be at high risk as regards long-term sustainability. According to the current projections based on existing measures, Slovenia appears at high risk with regard to the long-term sustainability of public finance due to a substantial rise in age-related expenditures. The Council therefore invited Slovenia to step-up the budgetary consolidation, especially by frontloading the adjustment effort and to undertake measures to improve the long-term sustainability of public finances.

Slovenia is not subject to a Council decision on the existence of an excessive deficit and fulfils the criterion on the government budgetary position.

5. Exchange rate stability

In the 2004 Convergence Report Slovenia was assessed not to fulfil the exchange rate criterion. By the time of the examination, the country had been participating in ERM II for two months.

Chart 3. **SIT: Spread vs central rate**
(as percent)



Source: ECB, Commission services

The two-year period relevant for the assessment of exchange rate stability extends from May 2004 to April 2006. Slovenia entered ERM II on 28 June 2004 and has so far spent 22 months in ERM II. The ERM II central parity retained for the tolar corresponds to the market exchange rate on the last trading date before the decision on ERM II entry. As the long-standing policy of continuous tolar depreciation went on until ERM II entry, the tolar-euro exchange rate in the two months prior to ERM II entry moved from 0.45 percent above the future central rate at the beginning of May 2004 to the central rate on 25 June 2004. Inside ERM II, the tolar-euro exchange rate has stayed close to the central rate with maximum deviations of 0.16 percent on the depreciation side and 0.10 percent on the appreciation side of the fluctuation band. The average absolute deviation of the tolar-euro exchange rate from the central parity in the period covered by this assessment was 0.08 percent.

Exchange rate stability within ERM II has been achieved in the presence of a stable interest rate differential vis-à-vis the euro area slightly below 2 percentage points for most of the period under examination. Following policy rates increases by the ECB since December 2005 and interest rate cuts by the Bank of Slovenia since January 2006, the differential recently decreased to below 1 percentage point. Together with a likely decrease in the risk premium of Slovenian assets in ERM II, the positive interest rate differential helped to underpin the strength of the tolar.

The stability of the tolar-euro exchange rate has been supported by an agreement concluded in 2001 between the Bank of Slovenia and most of the commercial banks on co-operation in interventions on the foreign exchange market. The Bank of Slovenia has in particular used the foreign exchange swap facility to maintain the remarkable stability of the tolar-euro exchange rate inside ERM II. As the ERM II central parity played well its role of anchoring financial markets expectations, the "price interventions" also inherent to this agreement (when the central bank sets the base exchange rate at which the commercial banks participating in the agreement are obliged to trade) have not been used since the first month following ERM II entry. The transition to the new system did require a temporary direct intervention in the foreign exchange markets in order to signal the effective change to the exchange rate regime. As the tolar stabilized in early July 2004, no further direct interventions have been necessary inside ERM II.

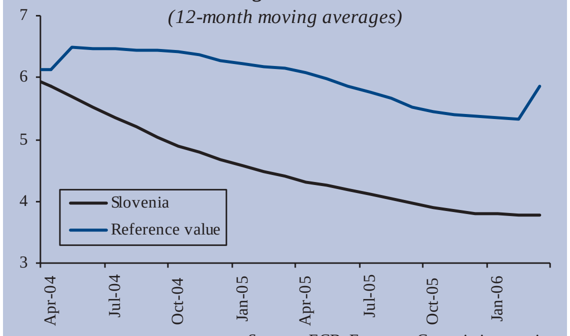
The tolar has remained very close to the ERM II central rate for the two years covered by this assessment. There has been no devaluation of the tolar's central parity inside ERM II on the initiative of Slovenia. By the time of a possible Council decision in July 2006, the tolar will have participated in ERM II for more than 24 months. Slovenia fulfils the exchange rate criterion.

6. Long-term interest rates

In the 2004 Convergence Report Slovenia fulfilled the criterion on the convergence of interest rates. The average long-term interest rate in Slovenia in the year to August 2004 was 5.1 percent, below the reference value of 6.4 percent.

The spread vis-à-vis euro area average long-term interest rates had been declining markedly between mid-2002 and end-2004 mainly reflecting a gradual decrease in Slovenian inflation rates accompanied by a reduction in short-term policy rates, decreasing country-risk premia and the perspective of euro area accession. Since ERM II entry in June 2004, the spread has remained between 10 and 70 basis points.

Chart 4. **Long-term interest rates**
(12-month moving averages)



Source: ECB, Eurostat, Commission services

The twelve-month moving average long-term interest rate relevant for the assessment of the Treaty criterion has continued to decline over the whole assessment period. In March 2006, the latest date for which data are available, the reference value, given by the average of long-term interest rates in Sweden, Finland and Poland plus 2 percentage points stood at 5.9 percent. The twelve-month moving average of the yield on ten-year Slovenian benchmark bond stood at 3.8 percent, below the reference value. Slovenia fulfils the criterion on long-term interest rate convergence.

7. Additional factors

Slovenia's financial system has substantially integrated into the broader EU financial system. Compliance with the acquis communautaire in the field of financial services was already broadly achieved on accession and good progress has been made in transposing the legislation adopted under the Financial Services Action Plan. The size of the financial system remains somewhat smaller than would be implied by the relatively high level of development of the economy. While competition via cross-border services provided by other EU financial institutions is increasing, Slovenia's financial system is not fully privatised with a level of foreign ownership close to the one of euro area Member States but lower than in other new Member States. Strong economic growth and convergence in interest rates have stimulated a progressive pick-up in the growth rate of bank lending to the private sector, notably to households. The share of foreign currency loans to household in particular has started to expand from negligible levels in 2003 to nearly 50 percent of new loans in 2005.

The Slovene economy is highly open to trade but it is relatively little receptive to foreign direct investment (FDI) inflows. Slovenia has also adopted a relatively gradual approach to structural reforms particularly with respect to liberalisation and privatisation. At the same time, Slovenia has an industrial structure similar to that of the euro area. The relatively low level of inward FDI is related to the privatisation process, which has been less receptive to the participation of foreign investors. The low intensity of FDI may limit competitive pressures in the domestic market. Also further progress on the transposition and application of EU-wide directives is important for the smooth functioning of the Internal Market in Slovenia.

Slovenia has a tradition of a broadly balanced current account, principally reflecting equilibrium between the deficit in trade in goods on one side and a surplus in trade in services together with a positive balance of current transfers on the other side. The Slovenian current account balance in 2005 recorded a deficit of 1.1 percent of GDP, down from 2.1 percent in 2004. This improvement mainly reflected the reversal of the trend of a progressive deterioration of the balance of trade in goods since the second quarter of 2005 and an accelerated improvement of the balance of trade in services. This suggests that the 2004 current account deterioration was most likely a temporary phenomenon and does not signal competitiveness problems for the Slovene economy or potential exchange rate pressures. The main challenge for Slovenia in the near future will be to safeguard a healthy competitiveness position, for which wage moderation will be essential. At the same time, despite a high domestic saving rate, Slovenia may have scope for a more extensive use of foreign savings for increasing domestic investment and productivity.

* * *

In the light of its assessment on the fulfilment of the convergence criteria, the Commission considers that Slovenia has achieved a high degree of sustainable convergence.

2006 Convergence Report on Slovenia – Technical Annex

Acknowledgements

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The paper was coordinated by Johan Baras, Economic Adviser, and approved by Servaas Deroose, Director, and Klaus Regling, Director-General.

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1. Introduction

1.1. Role of the report

The euro was introduced on 1 January 1999, following several years of successful adjustment efforts by the Member States to achieve a high degree of sustainable convergence. The decision[23] by the Council (meeting in the composition of the Heads of State or Government) on 3 May 1998 in Brussels on the eleven Member States deemed ready to participate in the single currency had, in accordance with the Treaty (Article 121(4)), been prepared by the Ecofin Council on a recommendation from the Commission. The decision was based on the two convergence reports made by the Commission[24] and the European Monetary Institute (EMI).[25] These reports, prepared in accordance with Article 121(1) of the Treaty, examined in considerable detail whether the Member States satisfied the convergence criteria and met the legal requirements.

Those Member States which are assessed as not fulfilling the necessary conditions for the adoption of the single currency are referred to as "Member States with a derogation". Article 122(2) of the Treaty lays down provisions and procedures for examining the situation of Member States with a derogation *(Box 1.1)*. At least once every two years, or at the request of a Member State with a derogation, the Commission and the European Central Bank (ECB) are required to prepare convergence reports on such Member States.

Box 1.1: **Article 122(2) of the Treaty**

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

Denmark and the United Kingdom negotiated opt-out arrangements before the adoption of the Maastricht Treaty[26] and do not participate in the third stage of EMU. Until these Member States indicate that they wish to participate in the third stage and join the single currency, they are not the subject of an assessment by the Council as to whether they fulfil the necessary conditions.

Greece submitted a request on 9 March 2000 for its convergence situation to be re-examined. The Ecofin Council adopted the decision[27] that Greece fulfilled the necessary conditions for adoption of the single currency on 19 June 2000. The decision was taken on the basis of a proposal from the Commission and having regard to the discussion of the Council, meeting in the composition of the Heads of State or Government. The decision was based on two convergence reports made by the Commission[28] and the ECB[29], which covered both Greece and Sweden. Greece adopted the single currency with effect from

[23] OJ L 139, 11.5.1998, pp. 30-35.
[24] Report on progress towards convergence and recommendation with a view to the transition to the third stage of economic and monetary union, COM(1998)1999 final, 25 March 1998.
[25] European Monetary Institute, Convergence Report, March 1998.

[26] Protocol (No 26) on certain provisions relating to Denmark, Protocol (No 25) on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland
[27] OJ L 167, 7.7.2000, pp. 19-21.
[28] European Commission, Convergence Report 2000, COM(2000) 277 final, 3 May 2000.
[29] European Central Bank, Convergence Report 2000, May 2000.

1 January 2001. Sweden was assessed in 2000 as not fulfilling the necessary conditions for the adoption of the single currency.

In 2002, the convergence assessment covered only Sweden and concluded that Sweden was not fulfilling the necessary conditions for the adoption of the single currency and continued to be referred to as a "Member State with a derogation".[30]

In 2004, Sweden was examined together with the ten countries that joined the EU on 1 May 2004. In accordance with Article 4 of the Act of Accession, the ten countries became upon entry “Member States with a derogation”. Although the maximum period referred to in Article 122(2) of the Treaty had not elapsed for these countries in 2004, the re-assessment of Sweden was seized as an opportunity to analyse also the state of convergence in the new Member States. None of the assessed countries was considered to have fulfilled the necessary conditions for the adoption of the single currency.[31]

In 2006, two years will have elapsed since the last reports were made. The Commission and the ECB envisage to prepare a comprehensive report in autumn 2006, assessing progress with convergence for all Member States with a derogation. On 2 March, Slovenia submitted a request for an earlier convergence assessment. As a response to this request, the Commission and the ECB prepared convergence reports for Slovenia.

This Commission services working paper is a technical annex to the convergence report on Slovenia and includes a detailed assessment of the progress with convergence. The remainder of the first chapter presents the methodology used for application of the assessment criteria and an overview of the main findings. Chapters 2 to 7 examine fulfilment of each of the convergence criteria and other requirements in the order as they appear in Article 121(1). The cut-off date for the statistical data included in this convergence report was 28 April 2006.

1.2. Application of the criteria

In accordance with Article 121(1), the convergence reports shall examine the compatibility of national legislation with the Treaty and the Statute of the European System of Central Banks (ESCB) and of the European Central Bank. The reports shall also examine the achievement of a high degree of sustainable convergence by reference to the fulfilment of the four convergence criteria dealing with price stability, the government budgetary position, exchange rate stability and long-term interest rates as well as some additional factors *(Box 1.2)*. The four convergence criteria have been developed further in a Protocol annexed to the Treaty (Protocol No 21 on the convergence criteria). A more detailed explanation of how to interpret and apply the criteria was provided in the convergence reports issued up to present.

[30] European Commission, Convergence Report 2002, COM(2002) 243 final, 22 May 2002; and European Central Bank, Convergence Report 2002, May 2002.

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

Box 1.2 : **Article 121(1) of the Treaty**

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

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

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

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

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

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

Compatibility of legislation

In accordance with Article 121(1) of the Treaty, the legal examination includes an assessment of compatibility between a Member State's legislation, including the statute of its national central bank, and Articles 108 and 109 of the Treaty and the Statute of the ESCB/ECB. This assessment mainly covers three areas. First, the objectives of the national central bank must be examined, in order to verify their compatibility with the objectives of the ESCB as formulated in Article 105(1) and Article 2 of the Statute of the ESCB/ECB. The ESCB's primary objective is to maintain price stability. Without prejudice to this objective, it shall support the general economic policies in the Community. Second, the independence of the national central bank and of the members of its decision-making bodies (Article 108) must be assessed. This assessment covers all issues linked to a National central bank's institutional and financial independence and to the personal independence of the members of its decision-making bodies. Third, the integration of the national central bank into the ESCB has to be examined, in order to ensure that the national central bank acts in accordance with the ECB's guidelines and instructions once the country concerned has adopted the single currency.

Price stability

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

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

Since national consumer price indices (CPIs) diverge substantially in terms of concepts, methods and practices, they do not constitute the appropriate means to meet the Treaty requirement that inflation must be measured on a comparable basis. To this end, the Council adopted on 23 October 1995 a framework regulation[32] setting the legal basis for the establishment of a harmonised methodology for compiling consumer price indices in the Member States. This process resulted in the production of the *Harmonised Indices of Consumer Prices (HICPs)*, which have been used for assessing the fulfilment of the price stability criterion. Until December 2005, HICP series had been based on 1996 as the reference period. A Commission Regulation (EC) No 1708/2005[33] provided the basis for a change of the HICP index base reference period from 1996=100 to 2005=100.

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

Over the 12 month period covering April 2005-March 2006, the three best-performing Member States in terms of price stability were Sweden (0.9 percent), Finland (1.0 percent) and Poland (1.5 percent) yielding a reference value of 2.6 percent.[34] Over the period January 1999 to March 2006, the reference value – based on the EU-15 until April 2004 and the EU-25 afterwards – fell to a low of 1.8 percent in July 1999 and peaked between February and April 2002 at 3.3 percent. In September 2004, the reference value fell for the first time below the euro area average when Lithuania entered the basket of three best performers.

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

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

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

[34] The reference values used in the 1998, 2000, 2002 and 2004 Convergence Reports were 2.7, 2.4, 3.3 and 2.4 percent, respectively. The ordering of best performers is based on unrounded data.

Table 1.1.

Evolution of the inflation reference value [1)]

	Three best performers [2)]	Reference value [3)]	Euro area average inflation rate [2)]
January 04	DE, FI, AT	2.7	2.1
February 04	DE, FI, AT	2.6	2.0
March 04	FI, DE, AT	2.5	1.9
April 04	FI, DE, AT	2.5	1.9
May 04	FI, CZ, DE	2.5	2.0
June 04	FI, DK, CZ	2.5	2.0
July 04	FI, DK, UK	2.4	2.1
August 04	FI, DK, SE	2.4	2.1
September 04	LT, FI, DK	1.9	2.1
October 04	FI, LT, DK	2.1	2.1
November 04	FI, LT, DK	2.1	2.1
December 04	FI, DK, SE	2.2	2.1
January 05	FI, DK, SE	2.2	2.1
February 05	FI, DK, SE	2.1	2.2
March 05	FI, DK, SE	2.2	2.2
April 05	FI, SE, DK	2.3	2.2
May 05	FI, SE, DK	2.3	2.2
June 05	FI, SE, DK	2.3	2.2
July 05	FI, SE, DK	2.3	2.1
August 05	FI, SE, DK	2.4	2.1
September 05	FI, SE, NL	2.4	2.2
October 05	FI, SE, NL	2.4	2.2
November 05	FI, SE, NL	2.5	2.2
December 05	FI, SE, NL	2.5	2.2
January 06	SE, FI, NL	2.6	2.2
February 06	SE, FI, NL	2.6	2.2
March 06	SE, FI, PL	2.6	2.3

1) EU-15 until April 2004; EU-25 from May 2004 onwards.

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

3) Unweighted arithmetic average of the three best performers in terms of inflation plus 1.5 pecentage points.

Source: Commission services

Government budgetary position

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

The convergence assessment in the budgetary area is thus directly linked to the excessive deficit procedure which is specified in Article 104 of the Treaty and further clarified in the Stability and Growth Pact.[35] The existence of an excessive deficit is determined in relation to the two criteria for budgetary discipline set in Article 104(2), namely on the government deficit and the government debt. Failure by a Member State to fulfil the requirements under either of these criteria can lead to a decision by the Council on the existence of an excessive deficit, in which case the Member State concerned does not comply with the budgetary convergence criterion.[36]

Exchange rates

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

Article 3 of the Protocol on the convergence criteria stipulates: *"The criterion on participation in the Exchange Rate Mechanism of the European Monetary System (…) shall mean that a Member State has respected the normal fluctuation margins provided for by the Exchange Rate Mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against any other Member State's currency on its own initiative for the same period"*. Based on the Council Resolution on the establishment of the ERM II[37], the European Monetary System has been replaced by the exchange-rate mechanism II upon the introduction of the euro, and the euro has become the centre of the mechanism.

As in previous reports, the assessment of this criterion verifies the participation in ERM II and examines exchange rate behaviour within the mechanism. The relevant period for assessing exchange rate stability in this Working Paper is May 2004 to April 2006.

Long-term interest rates

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

For the assessment of the criterion on the convergence of interest rates, yields on benchmark 10-year bonds have been taken, using an average rate over the latest 12 months. The reference value is calculated as the simple average of the average long-term interest rates of the three best-performing Member States in terms of price stability plus 2 percentage points. In March 2006, the reference value, derived from the average interest rate in Sweden (3.3 percent), Finland (3.3 percent), and Poland (5.0 percent), was 5.9 percent.

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35 Information regarding the excessive deficit procedure and its application to different Member States since 2002 can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/edp_en.htm.

36 The definition of the general government deficit used in this report is in accordance with the excessive deficit procedure, as was the case in previous convergence reports. In particular, interest expenditure, total expenditure and the overall balance include net streams of interest expenditure resulting from swaps arrangements and forward rate agreements. Government debt is general government consolidated gross debt at nominal value.

37 97/C 236/03 of 16 June 1997, OJ C 236, 2.8.1997, p.5.

Additional factors

The Treaty in Article 121(1) also requires an examination of other factors relevant to economic integration and convergence. These additional factors include the results of financial and product market integration and the development of the balance of payments. The examination of the development of unit labour costs and other price indices, which is also prescribed by Article 121 of the Treaty, is covered in the chapter on price stability.

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

2. Legal compatibility

2.1. Situation in the 2004 Convergence Report

In its 2004 Convergence Report, the Commission concluded that, as regards central bank integration into the ESCB at the time of euro adoption, legislation in Slovenia, in particular the Bank of Slovenia Act (BoSA), was not fully compatible with Article 109 of the EC Treaty and the ESCB/ECB Statute. In addition, the correction of some residual imperfections was recommended, in particular with respect to the Bank's objectives as well as in the field of personal and institutional independence.

The incompatibilities in the area of integration into the ESCB were linked to the holding and managing of foreign reserves; the right to authorise the issue of banknotes and the volume of coins; and the monetary functions, operations and instruments of the ESCB.

An imperfection subsisted as regards the Bank's objectives, as its secondary objective to support the general economic policy needed to reflect the wording of Article 105(1) EC more closely, while its third objective – safeguarding financial stability – should be subordinated to the second one.

Further imperfections subsisted as regards the bank's institutional and personal independence. The nature of the Government's involvement with respect to the management of foreign exchange assets required further clarification, while the grounds for dismissal of members of the Governing Board of the Bank of Slovenia needed to be aligned with those mentioned under Article 14(2) of the ESCB/ECB Statute.

2.2. Current legal situation

After its adoption by the Board of the Bank of Slovenia and approval by the Ministry of Finance, the draft Act amending the Bank of Slovenia Act (BoSA) was submitted to the ECB for consultation pursuant to Article 105(4) of the EC Treaty and the ECB delivered its Opinion on 13 March 2006 (CON/2006/17). On 16 March 2006, the Government submitted a revised draft Act to the Parliament for adoption. The revised Act was adopted without major changes by Slovenia's Parliament on 30 March 2006.

Integration into the ESCB

The incompatibilities raised in the 2004 Convergence Report have been removed. The Act amending the Bank of Slovenia Act removes Article 58(2) BoSA in its present form, while Articles 8, 9 and 45 BoSA will cease to apply from the day of the introduction of the euro in Slovenia. A new Article 61(2) BoSA clarifies that the Bank of Slovenia's competences in the area of monetary functions, operations and instruments as referred to in Articles 15-20 BoSA will be transferred to the ESCB as from the date of the introduction of the euro.

Objectives

The objectives of the Bank of Slovenia have been amended and reflect the wording of Article 105(1) of the EC Treaty more accurately. Moreover, the secondary objective (supporting the general economic policy in accordance with the objectives set in the EC Treaty) is now clearly subordinated to the primary one (price stability). However, the third objective (strive for financial stability, applying the principles of an open market economy and free competition) is not clearly subordinated to the primary and secondary ones.

Independence

The possibility for the Government of being involved into the management of the foreign exchange assets has been removed. The grounds for dismissal of the members of the Governing Board of the Bank of Slovenia have been aligned with those mentioned in Article 14(2) of the ESCB/ECB Statute.

Other issues

A safeguard clause has been inserted into Art 12(1)2 BoSA as regards the possible role of the Bank of Slovenia as a lender of last resort, so as to strengthen compliance with Art 101 EC and to avoid that the

Bank of Slovenia might eventually end up bearing financial costs which are in principle to be borne by the state.

Timing

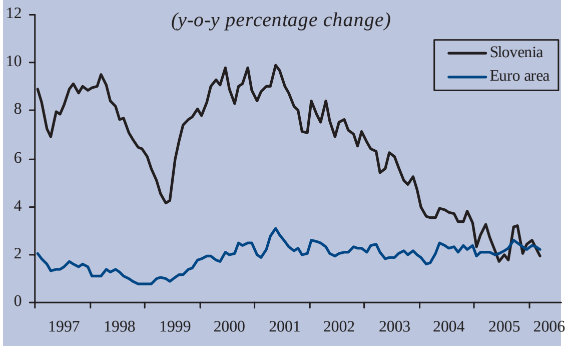
The legislative process has been completed. The Act amending the Bank of Slovenia Act entered into force on 14 April 2006. Arts 58 to 67b and Art 75 of the Bank of Slovenia revised Act will enter into force as from the date of the introduction of the euro in Slovenia.

3. Price stability

3.1. Recent inflation developments

The downward trend in annual HICP inflation, which had been observed since mid-2001 continued until early 2005 at a rather stable pace. Annual average HICP inflation progressively declined from 8.6 percent in 2001 to 2.5 percent in 2005. Since the beginning of 2005, year-on-year inflation rates stopped declining and their volatility increased mostly due to the fluctuation of oil prices on the world markets. As a result, the pace of decline of the 12-month average inflation slowed down in the course of 2005. The 12-month average slightly rose in January 2006 on the previous month before declining again in February and March.

Chart 3.1. **HICP inflation**
(y-o-y percentage change)

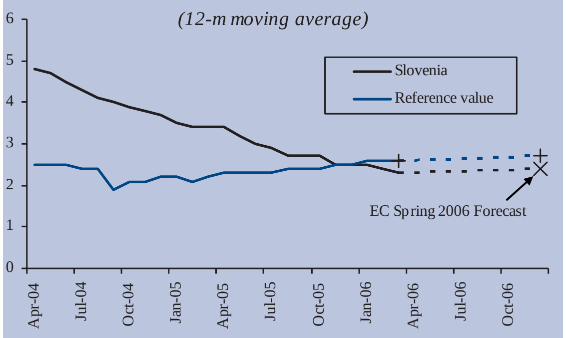


Source: Eurostat

3.2. Respect of the reference value

The 12-month average inflation rate which is used for the convergence assessment progressively approached the reference value and reached it for the first time in November 2005. The 12-month average inflation rate was below the reference value since January 2006 with a progressively increasing margin. In March 2006 the reference value was 2.6 percent, calculated as the average of the 12-month average inflation rates in the three best-performing Member States (Sweden, Finland and Poland) plus 1.5 percentage points. The corresponding inflation rate in Slovenia was 2.3 percent, 0.3 percentage points below the reference value.

Chart 3.2. **Inflation criterion**
(12-m moving average)



Source: Eurostat, Commission services

Table 3.1.

Slovenia: Average inflation rate (HICP) and the reference value[1)]
(percentage change)

	December 2002	December 2003	December 2004	December 2005	March 2006
SI	7.5	5.7	3.7	2.5	2.3
Reference value [2)]	2.9	2.7	2.2	2.5	2.6

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

2) Unweighted arithmetic average of the three best performers in terms of inflation plus 1.5 percentage points; only EU-15 Member States are used in the period prior to May 2004.

Source: Eurostat, Commission services

3.3. Underlying factors and sustainability of inflation

With independence in 1991 Slovenia inherited a triple-digit inflation rate, which further increased in 1992. Through a policy based on money supply control, the newly created Bank of Slovenia succeeded to bring down inflation to double-digit levels since 1993. Inflation, as measured by the national CPI, has been below 10 percent since the end of 1996. The progressive disinflation trend was interrupted in May 1999, when year-on-year HICP inflation bottomed at 4.2 percent and quickly rose to close to 10 percent year-on-year by mid-2000. Main factors explaining this increase in inflation rates included the direct impact of the introduction of the value-added tax on 1 July 1999 with a standard rate of 19 percent; a large increase in oil prices on the world markets; and the opening of a large positive output gap in Slovenia in 1999. Monetary policy reacted by increasing policy interest rates from 9 percent for the lending rate at the beginning of 1999 to a peak of 12 percent in April 2001, while the fiscal policy stance became more expansionary.

Despite the fact that the base effect of the VAT introduction had mostly disappeared from the data by mid-2000 and that oil prices broadly stabilised in the course of that year, headline inflation remained steady and only started to decline since mid-2001. The main reasons for inflation persistency were an acceleration of the growth in unit labour costs principally explained by a double-digit wage growth in both 2000 and 2001; and an upward adjustment of administered prices, which contributed around 1.1 and 1.7 percentage points to headline inflation, respectively, in 2000 and 2001.

In November 2001, the Bank of Slovenia adopted a new medium-term monetary policy framework, principally aiming at decreasing inflation in line with the new primary objective of price stability and progressively stabilising the exchange rate. The Bank also announced the objective to enter the euro area at the earliest possible date.

The initial stage of the disinflation process was helped by external factors, in particular by a progressive slowdown of imported inflation between 2000 and 2003. The development of imported inflation also benefited from a temporary slowdown of the annual pace of depreciation of the tolar-euro exchange rate in 2001.

Disinflation since 2003 has been underpinned by a coordinated policy approach of the Slovenian Government and the Bank of Slovenia based on an agreement concluded in November 2003 within the Joint Programme for ERM II Entry and the Adoption of the Euro. The main points of the agreement included the implementation of a progressive reform of the wage indexation mechanisms in the public and private sector; a commitment to control increases of administered prices to avoid that they contribute positively to inflation; increased pressure to improve efficiency in sectors naturally shielded from competition; progressive further stabilisation of the tolar-euro exchange rate in view of the expected ERM II entry soon after EU accession; and progress with fiscal consolidation. In addition, the central bank announced its intention to gradually decrease nominal interest rates to the euro area level, while at the same time signalling its willingness to support disinflation by maintaining an as-high-as-possible nominal interest rate differential vis-à-vis the euro area without generating overly strong nominal appreciation pressures.

The announcement and a rather rigorous implementation of these measures helped to anchor inflationary expectations of economic agents to the desired levels of inflation and the strong political commitment was an essential feature of the disinflation process in recent years.

Disinflation was further supported by a prudent policy mix in presence of a progressive opening of an important negative output gap between 2001 and 2003. The central bank lowered nominal interest rates as inflation slowed down since 2002, but real interest rates remained positive. The public finance stance supported the disinflation process in particular between 2001 and 2002 when, despite adverse economic conditions, the public finance structural deficit was cut from 4.6 percent to 2.1 percent of GDP, thus allowing the general government deficit to decrease despite the economic slowdown. While the slack in the economy helped to dampen demand pressures in the disinflation period, the progressive lowering of unemployment rates since 2003, in line with the economic revival, has not been associated with increased wage and price pressures, suggesting that the decrease in inflation is a structural rather than a cyclical phenomenon.

Table 3.2.
Slovenia: Components of inflation[1)]
(percentage change)

	2001	2002	2003	2004	2005	2006[2)]
HICP	8.6	7.5	5.7	3.7	2.5	2.3
Non-energy industrial goods	4.8	4.9	4.8	1.8	-0.3	-1.2
Energy	13.4	4.7	3.4	7.0	11.9	11.9
Unprocessed food	11.7	3.8	3.8	-1.4	-0.8	-0.6
Processed food	7.3	11.5	7.3	2.7	0.6	1.7
Services	10.4	10.2	7.1	5.8	3.3	3.1

1) Measured by the arithmetic average of the latest 12 monthly indices relative to the arithmetic average of the 12 monthly indices in the previous period
2) Average of January-March 2006

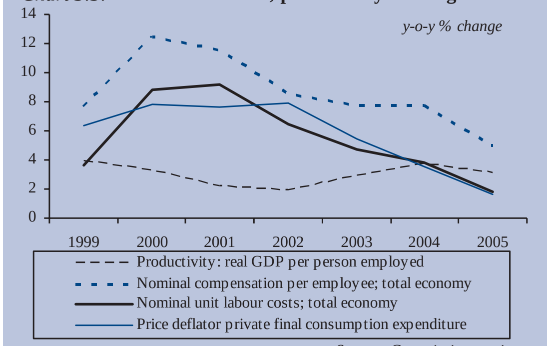
Source: Eurostat and Commission services

Wages and labour costs

The development of wages and unit labour costs in recent years reflected the overall commitment of social partners to the lowering of inflation. While unit labour costs in Slovenia strongly increased in 2000 and 2001 on the backdrop of a major wage increase in particular in the public sector, since 2002 the annual increase progressively eased, amid a marked slowdown of nominal wage growth and a progressive increase in the growth of labour productivity. Wage moderation in the private sector in the last two years was underpinned by the conclusion of a social agreement in April 2003 which, in a move to assist disinflation, foresaw a partial indexation of wages to EU along with domestic inflation and to the development of the euro/tolar exchange rate. Social partners agreed that real wages should lag productivity by 1 percentage point, which was effectively reflected in the pay policy agreement concluded for the period 2004-2005. This agreement was mirrored by a similar commitment to wage restraint in the public sector, which led to a lowering of nominal wage growth in the public sector from some 8 percent in 2003 to 1.7 percent in 2004 and to 3.9 percent in 2005.

Actual wage growth measured by nominal compensation per employee was higher than the minimum adjustments agreed by the social partners – at 7.7 percent in 2004 and an estimated 5.0 percent in 2005[38] – but was lower than the average nominal wage growth of around 10 percent registered in the previous four years. As a result, also growth of nominal unit labour costs slowed significantly, reaching 3.8 percent and an estimated 1.8 percent in 2004 and 2005, respectively, compared with an annual average of 7.3 percent between 2000 and 2003. Apart from wage moderation, the lower growth of unit labour costs in the last two years also reflected the impact of an increase in the threshold for the payment of the tax levied on employees' wages (payroll tax) effective since 2004.

Chart 3.3. **Slovenia: Inflation, productivity and wage trends**



Source: Commission services

From a sectoral perspective, a gap between productivity developments in the manufacturing sector and the service sector together with broadly comparable wage developments led to a large relative increase of unit labour costs in services over the last couple of years and fuelled inflation in this particular sector. While the disinflation process has also been visible in the services sector, further wage moderation and a continued search for higher efficiency will be key for price pressures in this sector to continue to ease.

38 Data for compensation per employee for 2005 are not yet available. The growth of average monthly gross earnings in 2005 reached 4.9 percent.

Table 3.3.
Slovenia: Other inflation and cost indicators (annual percentage change)

	2001	2002	2003	2004	2005[1)]	2006[2)]
Private consumption deflator						
SI	7.6	7.9	5.4	3.5	1.6	2.2
euro area	2.4	1.9	2.0	2.0	1.9	2.1
Nominal compensation per employee						
SI	11.6	8.5	7.8	7.7	5.0	5.2
euro area	2.8	2.7	2.6	2.4	2.1	2.3
Labour productivity						
SI	2.2	1.9	2.9	3.7	3.1	3.7
euro area	0.5	0.4	0.6	1.7	0.9	1.3
Nominal unit labour costs						
SI	9.2	6.5	4.7	3.8	1.8	1.4
euro area	2.3	2.3	2.0	0.7	1.2	1.1
Imports of goods deflator						
SI	5.8	1.7	1.5	4.1	6.0	3.7
euro area	0.4	-2.9	-2.2	1.5	4.0	4.1

1) Nominal compensation per employee and nominal unit labour costs are estimates
2) Spring Forecast

Source: Commission services

Market functioning, domestic competition and EU accession

The disinflation process in Slovenia has been to some extent underpinned by a progressive improvement of the competitive environment as a result of a gradual liberalisation process, in particular in network industries. This has been visible for instance in a marked slowdown of the increases in prices of electricity and telecommunications in recent years. However, Slovenia is still lagging behind in the opening of some sectors to effective competition and in its effective enforcement (see chapter "additional factors").

More important for increasing competition and consequently for easing price pressures in a number of sectors was EU accession on 1 May 2004. Following the alignment of Slovene trade policies to EU standards, a number of products from both EU and non-EU Member States obtained easier access to the Slovene market. This contributed to a marked increase in trade, particularly visible in imports of goods from EU Member States, which strengthened competition on the domestic market with arguably permanent effects on price formation. This has been an important factor in the remarkable slowdown of price increases in traded goods after EU accession with the exception of oil-related energy products.

At the same time, some of the favourable effects of EU accession on inflation are likely to progressively fade out. This is the case of a very favourable development of prices of food and cars in the last two years, mainly explained by the abolishment of the remaining tariffs on imports from other EU Member States. As a result, prices of both food and used cars decreased markedly in 2005, bringing inflation down by around half a percentage point. While it is difficult to disentangle the precise temporary favourable impact on inflation from a more permanent effect of higher competition, it is likely that food and car prices will progressively start growing again, be it at a lower rate than in the past.

In addition, prices of traded goods in Slovenia benefited from a benign global environment in particular related to high competition from Asia. The largest contribution came from the segment of clothing and footwear, where high competition from China also related to the easing of trade conditions by the EU since the beginning of 2005 led to a drop in prices by 1 percent in 2005. To the extent that this segment has been directly influenced by a relaxation of trade restrictions in 2005, the favourable impact on inflation could also be considered as a temporary phenomenon.

External influences on domestic prices and changes to indirect taxation

Inflation in 2004 and 2005 was negatively influenced by the development of import prices of goods, which from an annual average growth of 1.5 percent in 2003 accelerated to 4.1 and 6.0 percent, respectively, in 2004 and 2005. As the nominal effective exchange rate contribution to imported inflation substantially decreased, in particular helped by the stabilisation of the tolar-euro exchange rate on ERM II entry in June 2004, the increase in imported inflation is explained by the strong surge in world commodity and in particular oil prices in the last two years. As a result, inflation of energy products accelerated from 3.4 percent in 2003 to 7 percent in 2004 and to almost 12 percent in 2005. Associated with a relatively high weight of energy in the Slovenian HICP basket, this increase led to a large positive contribution of energy to inflation in Slovenia in the last two years.

The impact of the movement of oil prices on domestic inflation has been mitigated by a regular adjustment of excise taxes on mineral oils implemented by the Slovenian Government since early 2003. As by July 2005 Slovenia reached the minimum level of taxes allowed by EU legislation, increases of oil prices have since then been fully transmitted into consumer prices. Calculations by the authorities show that the adjustments of excise duties in the last two years to March 2006 have lowered headline inflation by around 0.2 percentage points on average between March 2005 and March 2006. In addition to excise tax adjustments, the authorities have been smoothing the impact of fluctuations of oil prices by setting the market price for motor fuels in regular intervals, which were extended from 14 to 28 days in October 2005. A comparison between developments of fuel and liquid oil prices in Slovenia and in the euro area shows very similar price movements and suggests that as level changes in oil prices have been broadly passed to consumers, no major pent-up price pressures should be expected from energy prices in the near future.

Concerning other indirect taxes, the introduction of the value-added tax in 1999 and an increase in the VAT rates to 8.5 and 20 percent in 2002 had a considerable one-off upward impact on headline inflation. At the same time, Slovenia has for several years been increasing excise taxes on cigarettes in regular six-month intervals. In line with the commitment made during EU accession negotiations to reach the minimum EU level by January 2008, tax adjustments will continue until this date. These excise tax increases have contributed to average HICP inflation by some 0.4 and 0.3 percentage points in 2004 and 2005, respectively. The remaining adjustments together with the carry-over of the effect on annual inflation of the increase from July 2005, will contribute around 0.2 percentage points in 2006 and 2007 and 0.1 percentage points in 2008.

The control of prices administratively determined by the government or other public authorities was a prominent feature of the Slovenian disinflation strategy since 2003. However, the surge in oil prices prevented the government from respecting its commitment to keep administered price growth in line with headline inflation. Energy-related administered prices (mainly passenger transport fuels and oil for heating) have considerably contributed to inflation in recent years, while non-energy related administered prices broadly grew in line with headline inflation.

Medium-term prospects

Inflation performance in 2006 will likely be the result of upward pressures stemming from an expected progressive increase of non-energy products price growth from the exceptionally low levels in the last two years and of the favourable effect of the expected somewhat lower average growth in oil prices on the world markets compared to 2005. As these two factors may broadly balance each other, inflation in 2006 is expected to stabilise at levels similar to 2005.

The large impact of specific factors on inflation in Slovenia in the last two years with a difficult-to-assess balance between one-off and permanent effects increases the uncertainty of any forecast. Notwithstanding this, the disinflation process in Slovenia has been driven by factors which could be expected to underpin a low inflationary environment in the medium term, including the reform of the wage-setting mechanisms associated with wage moderation, increase of competition, exchange rate stabilisation and fiscal consolidation.

At the same time, several upward risks to inflation can be identified. As euro area membership approaches, the effect of an expected opening of a small positive output gap in 2007 is likely to be further reinforced by a boost to domestic demand from the final convergence of interest rates and a release of liquidity resulting from euro area entry (see also section on exchange rate stability). An increase of the value-added tax rates in 2007, envisaged as a possibility in the 2006-2007 state budget to offset the revenue loss from the gradual abolishment of the payroll tax adds an additional risk to the inflation outlook. If implemented, the impact on inflation in 2007 could be as high as 0.7 percentage points. In the 2005 convergence programme the Slovenian authorities committed to continue to pursue fiscal consolidation and to achieve the medium-term objective of the revised Stability and Growth Pact by 2008. A more ambitious fiscal policy stance, however, would help to mitigate risks to inflation. In its opinion on the 2005 convergence programme, the Council called for "a more rapid progress towards achieving the programme’s MTO, especially by implementing the measures underlying the planned reduction of the expenditure ratio as well as by frontloading the adjustment effort".

The present low inflationary environment together with sound productivity growth should underpin a moderate development of unit labour costs in the near future. However, as the private sector pay-policy agreement for 2006 and 2007 has not yet been achieved, uncertainties remain. The government has already signalled its intention to maintain wage moderation in the public sector for the immediate future. Such policy could have a strong signalling effect on the private sector and would help to ensure that real wage adjustments continue to support a low inflationary environment and competitiveness.

4. Government budgetary position

4.1. Recent budgetary developments

Over the 2000-2005 period Slovenia recorded an average public finance deficit of 3.0 percent of GDP, following three consecutive alignments of government accounts to the ESA95 methodology. The public finance deficit reached a high of 4.3 percent of GDP in 2001 after the general government expenditure had been revised upwards based on court rulings[39] on the recognition of war claims to be paid by the Restitution Fund.[40] The general government deficit dropped below the 3 percent of GDP threshold in 2002 and has progressively declined to 1.8 percent of GDP in 2005. Alongside a reinforced commitment to fiscal discipline, the decline of the deficit has been facilitated by an economic upturn.

In December 2001 Slovenia started adopting budgets for two consecutive years simultaneously, which seems to have encouraged fiscal prudence. Furthermore, to strengthen budgetary planning, the Implementation Bill attached to the 2004 budget gave discretion to the government to react to an unexpected revenue shortfall within the thresholds set in the bill by suspending new spending commitments. The mechanism was successfully applied in October 2004 to contain the negative fiscal impact of a substantial loss in VAT resources, following the dismantling of border controls after EU accession.

In 2005, the general government deficit reached 1.8 percent of GDP, well below the deficit of 2.1 percent anticipated in the January 2005 update of the convergence programme and in line with the initial target set in the May 2004 convergence programme. A supplementary budget for 2005 adopted in June 2005 featured a 20 billion tolar (approximately 0.3 percent of GDP) lower deficit compared to the initial target, after the new government had revised upwards the revenue projections and reviewed the composition of expenditures according to its new priorities. Revenues came in even better than expected, as the tax collection resulting from the new personal income and corporate income tax regimes, in force since 1 January 2005, had been underestimated and higher indirect taxes compensated for lower revenues from excise duties. General government expenditure was contained through a restrictive employment and wage policy in the public sector and a rationalisation of government purchases of goods and services.

Due to the October 2004 parliamentary elections, the parliament endorsed the 2006 budget only on 12 December 2005 with a general government deficit target of 1.8 percent of GDP, implying no deficit reduction compared to 2005. The European Commission Spring 2006 forecast foresees a slight increase of the deficit to 1.9 percent of GDP. Given that the effects of the anticipated structural reforms and the relevant features of the pending EU financial perspective could not have been included in the budget bill, a further amendment is expected. On the revenue side, the budget mainly includes further adjustments in the personal and corporate income tax and a decrease of the payroll tax rate by 20 percent, a first step towards its gradual abolition. On the expenditure side, the measures related to employment and wage policies that enhance cost effectiveness and flexibility will be partly offset by the decision to index pensions to wages adopted in May 2005. The structural deficit, which stood at 1.4 percent of GDP in 2005, is expected to deteriorate, to reach 1.8 percent of GDP, still below the minimal benchmark of 1.9 percent set in the Stability and Growth Pact for providing a safety margin against breaching the 3 percent of GDP reference value under normal macroeconomic fluctuations.

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39 According to ESA95 rules, the recognition of liabilities by a court ruling should be recorded as expenditure (capital transfer, more specifically) at the time of the legal decision, irrespective of the timing for effective cash payment.

40 The Restitution Fund is a government body for restitution of nationalised and confiscated properties to the original owners before the second world war and for compensation of damages to war and post-war victims.

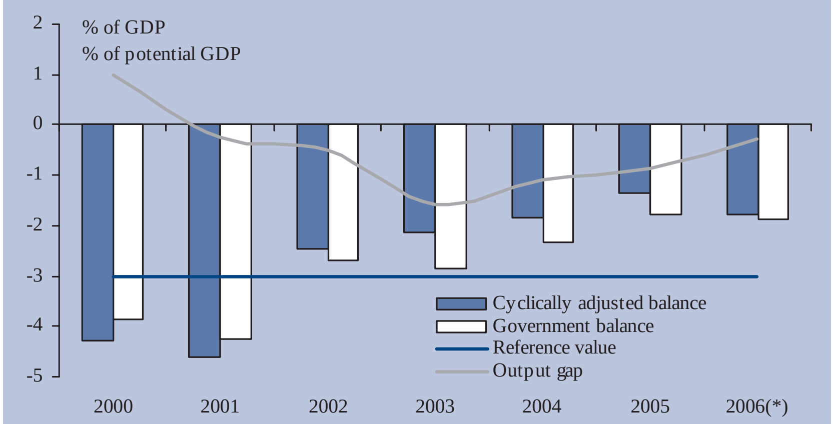
Table 4.1.
Slovenia: Budgetary developments
(as percentage of GDP unless otherwise indicated)

	2000	2001	2002	2003	2004	2005	2006(*)
General government balance	-3.9	-4.3	-2.7	-2.8	-2.3	-1.8	-1.9
- Total revenue	44.3	44.7	45.4	45.2	45.3	45.5	45.5
- Total expenditure	48.1	49.0	48.0	48.1	47.6	47.3	47.3
of which: interest	2.5	2.5	2.4	2.1	1.9	1.6	1.5
primary expenditure	45.7	46.5	45.7	46.0	45.8	45.7	45.8
GFCF	3.1	3.1	3.0	3.3	3.4	3.3	3.4
Primary balance	-1.4	-1.8	-0.3	-0.7	-0.5	-0.1	-0.4
p.m. Tax burden	38.9	39.1	39.5	39.7	39.9	40.1	40.1
Government debt	27.6	28.3	29.7	29.1	29.5	29.1	29.9
p.m. Real GDP growth	4.1	2.7	3.5	2.7	4.2	3.9	4.3
p.m. HICP inflation	8.9	8.6	7.5	5.7	3.7	2.5	2.4

(*) Spring Forecast

Source: Commission services

Chart 4.1. **Slovenia: Government balance and economic cycle**



(*) Spring Forecast

Source: Commission services

While structural efforts helped in containing the general government deficit in the period from 2001 up to 2003, when the output gap was widening, the deficit reductions in 2004 and 2005 were facilitated by a more favourable macroeconomic situation; the negative output gap is estimated to have narrowed from 1.6 percent of potential GDP in 2003 to below 1 percent in 2005.[41]

[41] The calculations of potential growth (and hence the output gap) must be treated cautiously as they are exposed to potentially considerable uncertainty particularly for countries experiencing a catching-up process.

The gradual fiscal consolidation was accompanied by a progressive restructuring of general government revenues and expenditures in order to enhance budgetary flexibility. Revenues relative to GDP rose slightly between 2000 and 2005, coming from 44.3 to 45.5 percent of GDP. The expenditure ratio, on the other hand, inched down, from a peak of 49.0 percent of GDP in 2001 to 47.3 percent in 2005 mainly thanks to lower interest payments. The rigid regulatory framework constrains the speed of fiscal adjustment, as the share of mandatory spending amounts to more than three quarters of the overall outlays. The share of investment spending remained at around 3 percent of GDP, justified by the need to improve infrastructure and business environment in order to underpin the catching-up in economic level. The need to bolster competitiveness of the Slovene industry has prompted adjustments in the direct tax regime and the payroll tax, as a means to ease the tax burden on labour. Nevertheless, the total share of taxes and social contributions to GDP has been increasing since 2000 and is now some 40 percent, slightly above the EU average.

4.2. Government debt

The general government debt has been lingering at slightly below 30 percent of GDP since 2000. At the end of 2005, the gross debt accounted for 29.1 percent of GDP, down from 29.5 percent in 2004. In June 2005, the government repaid debt in the amount of 80.9 billion tolars (1.2 percent of GDP) by using the remaining privatisation proceeds from the sale of a minority share in the biggest Slovene bank, the Nova Ljubljanska Banka in 2002.

4.3. Medium-term prospects

The sustainability of the budgetary position is examined in the second update of the convergence programme, covering the period 2005-2008, submitted on 8 December 2005. The macro-economic scenario underlying the programme foresees real GDP to grow close to 4 percent and inflation to settle around 2.5 percent. The budgetary strategy over the medium-term is to gradually reduce the general government deficit to 1 percent of GDP. The programme announces tax reform measures, leading to a drop in the share of revenue as a percentage of GDP by 1.8 percentage points, and measures on the expenditure side, resulting in a decline in the expenditure ratio by 2.5 percentage points of GDP. Over the medium-term horizon, the general government debt is expected to stay below 30 percent of GDP.

The Council examined the updated convergence programme of Slovenia on 14 February 2006 and regarded the budgetary strategy, aiming at a steady and smooth fiscal consolidation over the programme period, as having set plausible targets. The risks to the budgetary projections in the programme were considered as broadly balanced. While budgetary targets had been relatively well met in the recent years, the high share of mandatory expenditure still awaits political consensus to be restructured in a more flexible way and thus exposes fiscal targets to an implementation risk. The Council further judged that the medium-term objective (MTO), set a structural deficit of 1 percent of GDP, was consistent with the revised Stability and Growth Pact. As the MTO was lower than the minimum benchmark (estimated at a deficit of almost 2 percent of GDP), a safety margin against breaching the 3 percent of GDP deficit limit seemed assured in each year covered by the programme. While the MTO was likely to be achieved by 2008, as planned in the programme, the planned adjustment towards the MTO fell short of the benchmark, set at 0.5 percent of GDP for euro area and ERM II Member States in the Stability and Growth Pact.

Table 4.2.
Slovenia: Convergence programme projections for general government balance and debt (as percentage of GDP)

	2004	2005	2006	2007	2008
Balance	-2.0	-1.7	-1.7	-1.4	-1.0
Debt	29.5	29.0	29.6	29.8	29.4

Source: December 2005 convergence programme and Commission services

Moreover, Slovenia is considered to be at high risk as regards long-term sustainability, although government debt stands at only 30 percent of GDP. According to the current projections based on existing measures, Slovenia appears to be at high risk with regard to the long-term sustainability of public finance due to a substantial rise in age-related expenditures. The parametric pension reform in Slovenia has already produced a positive budgetary impact since its entry into force in 2000 as the average retirement age has increased and the share of pension expenditure in GDP has declined. However, the favourable effects of the reform in containing pension outlays have been partially offset by the change in the indexation rule applied to pensions, adopted in May 2005.

The Council invited Slovenia to step-up the budgetary progress towards achieving the MTO, especially by frontloading the adjustment effort and to undertake measures to improve the long-term sustainability of public finances.

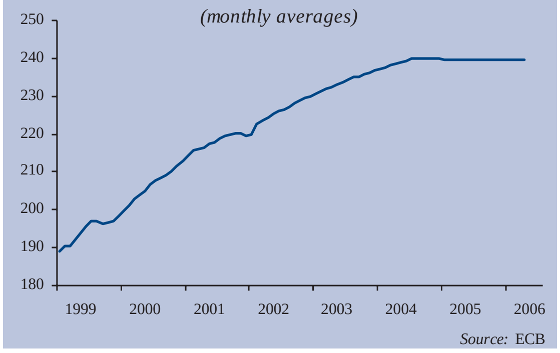
5. Exchange rate stability

Slovenia entered ERM II on 28 June 2004 and has, by the time of the drafting of this report, so far spent 22 months in ERM II. Inside ERM II, the tolar-euro exchange rate has stayed close to the central rate with maximum deviations of 0.16 percent on the depreciation side and 0.10 percent on the appreciation side of the fluctuation band. The average absolute deviation of the tolar-euro exchange rate from the central parity in the period covered by this assessment was 0.08 percent.

Before ERM II entry, Slovenia had been using a de facto crawling peg exchange rate system, where the Bank of Slovenia had actively managed the exchange rate on a depreciating path in order to discourage interest sensitive capital inflows. Nominal depreciation was used as a tool to decrease the expected capital gains on foreign investments into tolar assets due to the prevailing positive interest rate differential with the euro area (uncovered interest rate parity). Between the introduction of the euro in January 1999 and April 2004, the tolar-euro exchange rate depreciated by some 26 percent, while the nominal effective exchange rate decreased by some 19 percent. At the same time, in line with the progressive decrease in the interest rate differential with the euro area, the ex-post annual pace of depreciation decreased from 5 percent at the beginning of 2003 to nil in June 2005, one year after the stabilisation of the tolar-euro exchange rate upon ERM II entry.

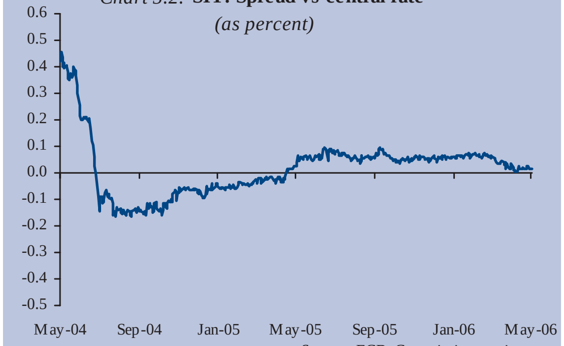
The ERM II central parity retained for the tolar corresponds to the market exchange rate on the last trading day before the decision on ERM II entry. As the policy of continuous tolar depreciation went on until ERM II entry, the tolar-euro exchange rate fell from 0.45 percent above the future central rate at the beginning of May 2004 to the central rate on 25 June 2004.

Chart 5.1. **Exchange rates: SIT/EUR**
(monthly averages)



Source: ECB

Chart 5.2. **SIT: Spread vs central rate**
(as percent)



Source: ECB, Commission services

Table 5.1.
Slovenia: Spread of SIT against the ERM II central parity
(in percent)

	Average	Average of absolute values	Maximum	Minimum	Standard deviation
ERM II[1)]	-0.01	0.07	0.10	-0.16	0.07
May 2004 - April 2006	0.02	0.08	0.45	-0.16	0.11

1) since 28/06/2004

Source: Commission services

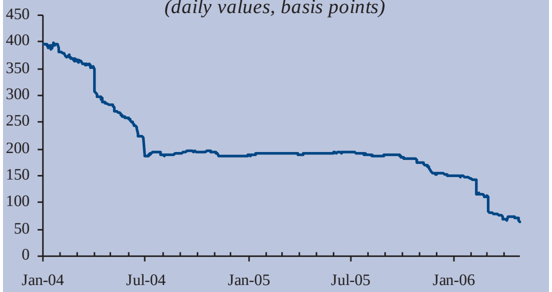
In the run up to ERM II entry, the Bank of Slovenia cut its main interest rates three times between April and June 2004, bringing down the interest rate on its main sterilisation instrument – the 60-day tolar bill – from 5.25 percent to 4 percent on 17 June and the buy/sell swap rate from 2.5 to 1 percent on ERM II entry. This alignment of interest rates closer to the euro area level was accompanied by several public statements aimed at signalling a progressive slowdown of the intended annualised rate of depreciation of tolar from 2 percent at the beginning of April to zero at ERM II entry.

In line with the strategy towards ERM II and euro adoption published in November 2003, the authorities started to stabilise the exchange rate upon ERM II participation. The tolar-euro exchange rate slightly depreciated in the first days of ERM II participation and despite subsequent stabilisation and appreciation since October 2004, the tolar remained in the weaker half of the fluctuation band until April 2005. At the same time, the tolar stayed very close to the central rate and the maximum deviation on the depreciation side of the fluctuation band, hit several times between July and October 2004, was 0.16 percent. Since April 2005, the tolar has been moving in the stronger half of the band and gradually appreciated to its strongest level against the euro of 0.10 percent above the central rate reached in June 2005. The exchange rate stabilised since then and moved in a very narrow band of 0.03 and 0.10 percent vis-à-vis the central rate.

Exchange rate stability within ERM II has been achieved in the presence of a positive interest rate differential vis-à-vis the euro area for the whole period under examination. Given the permanent surplus of tolar liquidity on the Slovene inter-bank market, tolar money market rates in Slovenia closely reflect the interest rate applied on the main liquidity sterilisation instrument – the 60-day tolar bill of the Bank of Slovenia. This rate remained unchanged at 4 percent for most of the period since June 2004 and was only decreased recently by two subsequent 25 basis points interest rate cuts in February and March 2006. Consequently, the short-term interest rate differential vis-à-vis the euro area remained stable at slightly below 2 percentage points since July 2004 and decreased to below 1 percentage point only in recent months. At the same time, it is worth noting that the uncovered interest parity, which indicates the attractiveness of Slovenian short-term money market instruments for foreign investors, increased on ERM II entry from 1 to 2 percentage points. The annualised intended short-term rate of depreciation of the tolar-euro exchange rate fell from an average of 2 percent in the first half of 2004 to 0 percent on ERM II entry, while the interest rate differential only decreased from around 3 to 2 percentage points. Together with a likely decrease in the risk-premium of Slovenian assets in ERM II, this differential helped to underpin the strength of the tolar.

Chart 5.3. **Slovenia : 3-M Sitibor spread to 3-M Euribor**

(daily values, basis points)



Source: EcoWin

Box 5.1: **Exchange rate management in Slovenia**

Exchange rate stability in Slovenia has been underpinned by an agreement concluded between the Bank of Slovenia and most of the commercial banks in 2001 and continued within ERM II. The agreement provides the participating banks with a standing facility for the temporary sale or purchase of foreign currency to the Bank of Slovenia with repurchase after seven days (swap) or the possibility to renew the contract at maturity. When commercial banks sell foreign exchange to the central bank, they pay a swap fee. This fee has been typically set in a way to close the gap between the ECB refinancing rate, the interest rate on the Bank of Slovenia tolar bills and a risk premium on tolar assets (and previously also the desired rate of depreciation of the tolar).

The official refinancing rate in Slovenia is formally set so as to equal the sum of the price of the buy/sell foreign exchange swap and of the ECB refinancing rate. In practice, however, foreign capital inflows helped to create a permanent liquidity surplus in the Slovene interbank market and made that liquidity-providing operations in tolars are not used. Instead, the participating banks have the possibility to obtain tolar liquidity by swapping their foreign exchange liabilities. They have been motivated to do so by the possibility not to have to respect the strict prudential rules for separately matching tolar and foreign currency denominated liabilities by assets of the same maturity and currency. Instead, for banks signatory to the agreement, the liquidity requirement holds for the sum of tolar and foreign currency denominated assets and liabilities, which is a substantially more flexible requirement. This relaxation was justified by the fact that the central bank, in the context of the swap arrangements, is committed to sell foreign currency upon simple demand to the participating banks and at the pre-agreed exchange rate. The risk of exchange rate depreciation has thus been transferred to the central bank.

To obtain this advantage, the participating banks committed to trade foreign currency on the foreign exchange market at the rate used in the transactions with the central bank. This rate can reflect the exchange rate determined by market forces, but can also deviate if the central bank wishes so. Given that most of the commercial banks have signed it, this agreement gives the Bank of Slovenia a close control of the tolar exchange rate. This possibility would, of course, be substantially reduced if fewer banks would participate in the agreement or if there were a significant market for tolar outside Slovenia, which is not the case.

The swap rate determines the cost for commercial banks to have access to tolar liquidity. As such, it can be seen as an indicator of the willingness of the Bank of Slovenia to influence the foreign exchange market. When the rate for exchanging foreign exchange for tolars with the central bank (buy/sell swap) increases, the central bank discourages commercial banks from using the swap instrument, while the lower the swap rate, the more automatic and cost-free window the banks have for obtaining tolar liquidity. Conversely, with an increasing sell/buy swap rate, which the central bank pays to the commercial banks when swapping tolars for foreign currency, the banks get easier access to foreign exchange.

The mechanism can be seen as a powerful tool to manage the exchange rate. At the same time, exchange rate pressures would still appear in changes in the swap rate; in fluctuations of central bank foreign exchange reserves (the net stock of swaps is part of the reserves) and in possible interventions; in large fluctuations of tolar-based monetary aggregates together with the stock of tolar bills issued by the Bank of Slovenia; and in the movement of interest rates combined with indications provided by balance of payments developments.

Ultimately, the mechanism would be unlikely to survive in case of a strong misalignment of the nominal exchange rate vis-à-vis an exchange rate preferred by the markets.

In case of strong depreciation pressures (overvaluation of the nominal exchange rate), commercial banks in search for foreign exchange liquidity would be unlikely to renew the buy/sell swap arrangements and ask instead for a higher sell/buy swap fee to be paid by the central bank. Ultimately, it would become too expensive for the central bank to run the system or it would run out of foreign exchange reserves. At the same time, such pressures would also be visible in a contraction of tolar-based monetary aggregates, since the central bank would have to buy tolars for foreign exchange.

As any fixed exchange rate system, the mechanism is better equipped to counter appreciation pressures. Still, to accept exchange rate stability in such a situation, the commercial banks would ask for free access to tolar liquidity. The central bank would either have to decrease interest rates to ward off the capital inflows potentially fuelling inflation pressures or increase its sterilisation activity, the cost of which would eventually become prohibitive.

The development of the tolar-euro exchange rate has also been influenced by the agreement concluded between the Bank of Slovenia and most of the commercial banks on co-operation in interventions on the foreign exchange market *(Box 5.1)*. This particular system enabled the Bank of Slovenia to pursue a policy of continuous depreciation of the tolar prior to ERM II entry despite a quasi-permanent excess of foreign currency inflows over outflows as reflected in a steady increase of the stock of foreign exchange reserves until end-2003.

The main feature of the system – the capacity of the bank of Slovenia to signal the desired exchange rate development – has been to some extent replaced by the signalling function of the central parity inside ERM II. The "price interventions" – when the central bank sets the base-exchange rate at which the commercial banks participating in the agreement are obliged to trade – have been used for the last time upon ERM II entry in order to signal to the market the intention to discontinue the depreciation and to henceforth stick to the ERM II central parity. The transition to the new exchange rate system within ERM II also required a temporary direct intervention in the foreign exchange markets and an adjustment in the swap rates to give banks easier access to foreign exchange liquidity. Following the stabilisation of the tolar in early July 2004, no further direct interventions have been necessary inside ERM II.

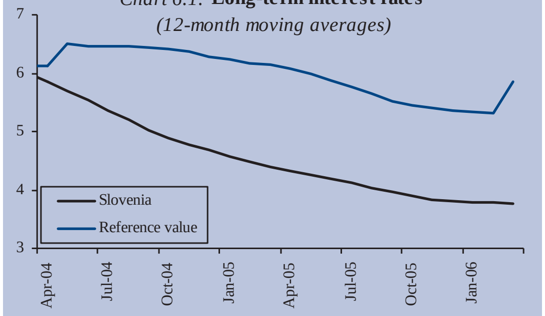
At the same time, the remarkable stability of the tolar-euro exchange rate has been supported through the use of exchange rate management instruments at the disposal of the Bank of Slovenia. Short-term volatility has been reduced through the foreign exchange swaps; and a compression of domestic interest rates in the presence of foreign exchange inflows was prevented by the issuance of central bank sterilisation bills. In addition, the Bank of Slovenia decreased the reserve requirement on short-term tolar deposits in March 2005 from 4.5 to 2 percent to align with the ECB standards, but at the same time, commercial banks were obliged to place the released liquidity into long-term deposits with the Bank of Slovenia maturing only in March 2007. The non-renewal of these instruments on euro-area entry or soon after is thus likely to temporarily boost liquidity of the domestic banking sector. The structural lack of liquidity in the euro area will absorb most of this liquidity release. Nevertheless, the existence of a possible home-investment bias together with the final convergence of nominal interest rates are likely to further ease monetary conditions in Slovenia at the beginning of euro area membership.

The evolution of additional indicators does not support the existence of major pressures on the tolar-euro exchange rate within ERM II. The diversification of portfolio investments towards foreign assets in the context of rapidly falling domestic interest rates in the first half of 2004 led to a temporary excess of demand for foreign exchange satisfied through the swap instruments and leading to a decrease of foreign exchange reserves of the central bank between April and July 2004. However, as foreign currency borrowing from abroad progressively accelerated with a built-in confidence in euro adoption and on the backdrop of the positive interest rate differential, the balance reversed in 2005 and, in spite of continuing portfolio investment outflows, the central bank had to absorb a large excess of foreign currency supply via its foreign exchange swap facility and through outright purchases into foreign exchange reserves. This has also been reflected in an increasing stock of issued tolar bills used to sterilise surplus tolar liquidity.

6. Long-term interest rates

Long-term interest rates in Slovenia progressively declined from levels around 9 percent in mid-2002 and have stayed below 4 percent since January 2005. The progressive decline in long-term interest rates reflected a gradual decrease in inflation rates accompanied by a reduction in short-term policy rates and the decreasing country-risk premia linked to the fiscal consolidation and to the perspective of euro area accession. The spread vis-à-vis euro area average interest rates had been declining until ERM II entry in June 2004 and has since then remained between 10 and 70 basis points. The fluctuations of the spread mostly reflected the volatility of euro area long-term interest rates. At the same time, the remaining positive differential is explained by a lower liquidity of the secondary market in tolar denominated bonds and by the remaining currency risk premium incurred by foreign investors.

Chart 6.1. **Long-term interest rates**
(12-month moving averages)



Source: ECB, Eurostat, Commission services

The Slovene 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion has continued to decline over the whole assessment period, largely reflecting a global decline in bond yields. The reference value for this criterion has been declining at a similar pace. In March 2006, the latest month for which data are available, the reference value, given by the average of long-term interest rates in Sweden, Finland and Poland plus 2 percentage points stood at 5.9 percent. The twelve-month moving average of the yield on ten-year Slovenian benchmark bond stood at 3.8 percent, below the reference value.

Table 6.1.
Slovenia: Long-term interest rates (12-month averages)

	December 2003	December 2004	December 2005	March 2006
SI	6.4	4.7	3.8	3.8
Reference value[1)]	6.1	6.3	5.4	5.9

1) Average of interest rates of the three best performing Member States in terms of price stability plus 2 percentage points

Source: ECB, Eurostat, Commission services

7. Additional factors

7.1 Financial market integration[42]

Slovenia’s financial system has substantially integrated into the broader EU financial system. The main channel of integration has been increased external borrowing and investment, and foreign currency borrowing by corporations, while foreign ownership of financial intermediaries remains limited. Compliance with the *acquis communautaire* in the field of financial services was already broadly achieved on accession and good progress has been made in transposing the legislation adopted under the Financial Services Action Plan.[43]

The size of the financial system remains somewhat smaller than would be implied by the relatively high level of development of the economy.[44] The relative size of loans, debt securities and equity markets to GDP is broadly in line with the EU-10 average but reaches only about one third of the EU-15 average *(Chart 7.1)*. Banks predominate among financial intermediaries. Insurance companies, investment funds, and leasing companies account for only about a quarter of total financial assets and pension funds are still at a very early stage of development.

Slovenia's financial system is quite concentrated, with a top five banks concentration ratio (CR5) of 65 percent in the banking and 80 percent in the insurance sector in 2004. While competition via cross-border services provided by other EU financial institutions is increasing, Slovenia’s financial system is not fully privatised with a level of foreign ownership close to the euro area Member States but lower than in other new Member States *(Chart 7.2)*.

Strong economic growth and convergence in interest rates have stimulated a progressive pick-up in the growth rate of bank lending to the private sector, notably to households *(Chart 7.3)*. Following the withdrawal of remaining restrictions on domestic foreign currency lending in autumn 2003, corporations shifted from direct foreign currency borrowing abroad to domestic long-term borrowing in foreign currency (predominantly in euro). This shift in borrowing behaviour was fostered by the stabilisation of the euro-tolar exchange rate and aggressive euro-denominated lending activity by foreign banks. Accordingly, the share of foreign currency loans to household has also started to expand from negligible levels in 2003 to nearly 50 percent of new loans in 2005 *(Chart 7.4)*.

Domestic lending growth has been to a large extent financed by external borrowing by banks and non-monetary financial institutions. On the other hand, there was also a sharp increase in institutional investment abroad. As banks’ foreign currency liabilities and assets match relatively closely and at the same time banks reduced their exposure with the use of foreign exchange swaps of the Central Bank of Slovenia, the net exposure of financial intermediaries to exchange-rate risk is low, but the indirect exposure of banks to unhedged foreign currency borrowing by clients is increasing.

The high level of investment abroad reflects the still relatively under-developed domestic securities markets. The debt securities market is dominated by central government bonds, which represent about 90 percent of outstanding issues. About one third of total outstanding debt securities are denominated in euro. Central government issues have been mostly denominated in Slovenian tolar since 2002 and have included a growing share of 10-year maturities. The number of actively traded companies on the Ljubljana Stock Exchange (LJSE) remains limited and includes no major financial institution. While the LJSE aims to become more attractive to international portfolio investors, participation of non-residents is so far very low (i.e. less than 5 percent of holdings and turnover).

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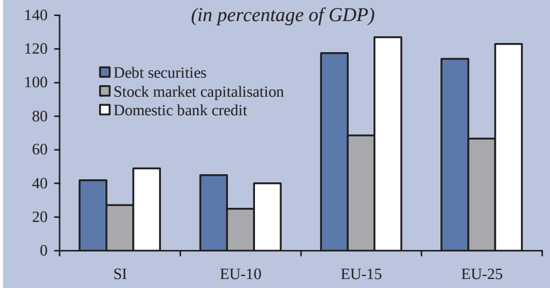
42 This section draws mainly on information provided by the Central Bank of Slovenia in its Financial Stability Report (June 2005) and Monthly Bulletins as well as a number of recent cross-country studies published by the ECB, the OeNB, the RZB Group and independent researchers.

43 See: Transposition of FSAP Directives - State of play http://europa.eu.int/comm/internal_market/finances/docs/actionplan/index/memberstate_en.pdf

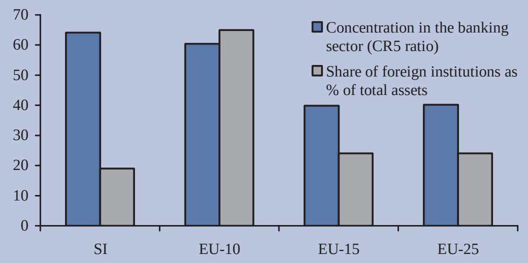
44 Slovenia’s GDP per capital level (PPP) is broadly comparably to Portugal, Greece, Cyprus and Malta

Chart 7.1. **Structure of financial system relative to EU-10, EU-15 and EU-25 in 2004**
(in percentage of GDP)



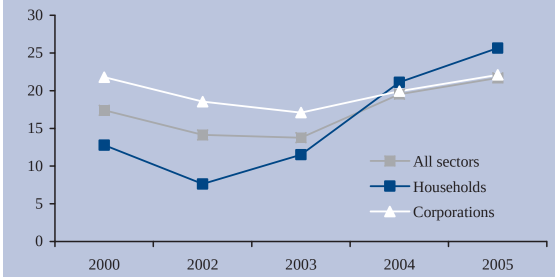
Source : European Banking Federation, Eurostat, ECB, Commission services

Chart 7.2. **Foreign ownership and concentration in the banking sector in 2004**
(in percent, weighted averages)



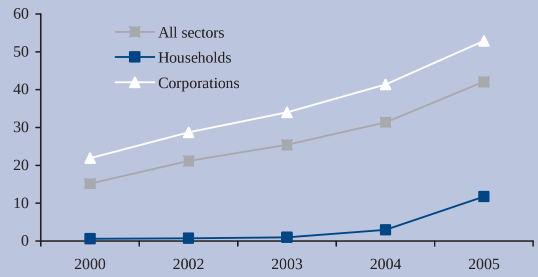
Source : ECB: EU Banking Structures (October 2005)

Chart 7.3. **Slovenia: Domestic credit expansion**
(y-o-y percentage change)



Source : Bank of Slovenia

Chart 7.4. **Slovenia: Share of foreign currency loans**
(percentage of domestic credit)



Source : Bank of Slovenia

Even though the importance of financial conglomerates and branches is so far limited in Slovenia's financial system, adequate supervisory structures will be essential in safeguarding financial stability as the financial system develops and becomes more integrated with the EU. Slovenia's three supervisory authorities – the Bank of Slovenia, the Securities Market Agency and the Insurance Supervisory Agency – have signed co-operation agreements among themselves and with a number of foreign supervisory authorities to increase the effectiveness of their activity. A consolidation of the various supervisory bodies into a single authority is being explored.

7.2. Product market integration

Slovenia experienced a considerable structural change over the past fifteen years as it laid down the foundations of a market economy fully integrated in the EU. The Slovene economy is highly open to trade but has experienced rather modest foreign direct investment (FDI) inflows. Nonetheless, its industrial structure is already more similar than that of other new Member States to that of the EU-15.

With respect to the creation of conditions for the smooth functioning of the Internal Market, Slovenia is lagging in the adoption and application of the body of Community legislation. Moreover, structural reforms aimed at improving the business environment and promoting higher levels of domestic competition appear to have stalled in recent years.

Trade and FDI

Trade flows are important catalysts for real convergence to the EU average income level for a small economy like Slovenia. Trade integration allows the production scale to expand and competition levels to increase, leading to benefits in terms of efficiency upgrades. The Slovene economy is increasingly open to trade. The average degree of trade openness, measured as the ratio of average of imports and exports of goods and services over GDP was higher than that of the EU small Member States in the period 2000-2005. The other Member States are the dominant trading partners and their share in total trade is growing over time.

In 2001 the importance of labour-intensive industries matched that of capital-intensive sectors in terms of value added while in the EU as a whole the latter was 2.2 times larger the former. This suggests a specialisation in labour-intensive industries. However, in terms of technology intensity, Slovenia's industrial structure reveals important similarities to that of the EU. The main difference *vis-à-vis* the EU is a lower share of the medium-high technology sectors.[45] This sectoral profile of Slovenia's industrial structure explains the relatively high degree of similarity with export sectoral profile of the euro area.[46]

FDI inflows play a more limited role in Slovenia's economy than in other new Member States. The stock of inward FDI in Slovenia in 2004 (equivalent to 21 percent of GDP) was the lowest among the new Member States. The relatively low level of inward FDI in Slovenia is related to the privatisation process, which has been less intense and less receptive to the participation of foreign investors than in the other new Member States. The relatively low FDI inflows may have important medium-term consequences as the potential for transfers of technology, organisational and managerial skills is more limited.

Implementation of the Internal Market

The low intensity of FDI may limit competitive pressures in the domestic market. In principle this can be overcome by promoting an adequate policy framework to ensure sufficient levels of contestability in the market. However, efforts have been limited so far in strengthening competition legislation and increasing resources available to competition authorities. Moreover, Slovenia adopted a relatively gradual approach to structural reforms particularly with respect to liberalisation and privatisation. While some liberalisation has proceeded in network industries, incumbents are still dominant players. Sectors like telecoms and electricity as well as professional services remain relatively sheltered from competition. Furthermore, measures to improve the business environment have also lagged. In the 2005 World Bank survey Slovenia is ranked as the third worst performer in the EU with respect to the ease of doing business.

Further progress on the transposition and application of the full body of EU-wide directives is important for the smooth functioning of the Internal Market in Slovenia. The Internal Market directives transposition deficit in December 2005 (1.2 percent) was only slightly below the EU average. Nonetheless, this is a substantial improvement since 2004 when the country was clearly underperforming the rest of the EU.

45 "Statistics in Focus - Industry, trade and services", no. 41/2004, Eurostat

46 "Patterns of Trade, Delocalisation Choices and Catching-up", Luca de Benedectis and Lucia Tajoli, 2005

Table 7.1.
Slovenia: Product market integration

	Slovenia						EU-25					
	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**
Trade openness [1] (%)	57.3	57.6	56.4	55.9	60.8	63.1(f)	36.2	36.0	34.8	34.3	35.5	36.7(f)
Extra-EU trade GDP ratio [2] (%)	12.9	13.3	13.3	13.5	13.7	-	10.2	9.9	9.4	9.2	9.6	-
Intra-EU trade GDP ratio [3] (%)	36.3	36.0	34.3	33.8	38.8	-	19.1	18.9	18.4	18.4	19.1	-
Intra-EU trade in services GDP ratio [4] (%)	-	-	-	5.7	6.1	-	-	-	-	4.6	4.7	-
Intra-EU trade balance [5]	-1.6	-1.4	-1.4	-1.7	-2.9	-2.4	84.5	104.2	115.0	97.3	77.9	79.9
Total FDI inflows GDP ratio [6] (%)	-	1.4	4.0	4.2	2.2	-		5.8	5.0	3.5	2.1	-
Intra-EU FDI inflows GDP ratio [7] (%)	-	1.3	2.5	1.7	1.9	-	-	4.3	3.7	2.3	1.4	-
FDI intensity [8]	-	0.8	1.5	0.9	1.4	-		3.9	3.7	2.5	1.7	-
Internal Market Directives [9] (%)	-	-	-	-	3.2	1.2	-	-	-	-	1.9	1.6
Price levels [10]	73.1	73.2	75.5	77.9	75.8	-	100.0	100.0	100.0	100.0	100.0	100.0

1) Average of exports and imports of goods and services at current prices (national accounts) in percentage of gross domestic product at market prices.
2) (Extra-EU Imports+Exports/2xGDP at current prices)*100.
3) (Intra-EU Imports+Exports/2xGDP at current prices)*100.
4) Balance of payments: Intra-EU25 trade in services (average credit and debit in % of GDP at current prices).
5) Difference between exports and imports in bn euros, based on monthly statistics.
6) Total FDI inflows as a % of GDP (at current prices).
7) Intra-EU total FDI inflows as a % of GDP (at current prices).
8) Average value of intra-EU25 inward and outward foreign direct investment flows, divided by GDP and multiplied by 100.
9) Percentage of Internal Market directives not yet communicated as having been transposed in relation to the total number.
10) Comparative price levels of final consumption by private households including direct taxes (EU25=100).
Source: Eurostat, Commission services

7.3. Development of the balance of payments

The Slovenian current account balance in 2005 recorded a deficit of 1.1 percent of GDP, down from 2.1 percent in 2004. While the trade balance deficit remained virtually unchanged at 3.8 percent of GDP, the services balance surplus increased from 2.6 percent in 2004 to 3.3 percent. The total of the income and current transfers' balances remained negative at 0.6 percent of GDP, with a negative contribution of the income balance and a positive contribution of the balance of current transfers.

Slovenia has a long tradition of a broadly balanced current account, principally reflecting a long-standing equilibrium between the deficit in trade in goods on one side and a surplus in trade in services together with a positive balance of current transfers on the other side. As an exception to this pattern, buoyant domestic demand led to a temporary deterioration of the trade balance in 1999-2000 pulling the current account into a deficit of 3.3 and 2.8 percent of GDP, respectively, in these two years. Subsequently, in line with the reversal of economic conditions, the current account rapidly improved and moved to a surplus or balance between 2001 and 2003. The current account deteriorated somewhat in 2004 as imports surged more than exports, partly as a direct effect of EU accession on 1 May 2004, which prompted a large surge in imports of food products from the EU Member States due to the abolishment of the outstanding trade restrictions. As the current account deterioration was not fully matched by capital inflows, Slovenia recorded a decrease in reserves for the first time since early 2000. This was also linked to the surge in portfolio outflows since early 2004 after the lifting of remaining legal constraints on outward investments and a decrease in domestic interest rates.

However, the reversal since the second quarter of 2005 of the trend of a progressive deterioration of the balance of trade in goods and an accelerated improvement of the balance of trade in services in the same period contributed to a renewed decrease of the current account deficit in 2005. This trend also shows that the 2004 current account deterioration was most likely a temporary phenomenon and does not signal competitiveness problems for the Slovene economy or potential exchange rate pressures. Export growth in goods and services accelerated in both real and nominal terms during 2004 and remained robust in 2005 as well. This was in line with the gradual revival in Slovenian main trading partners and also with an improvement in cost competitiveness resulting primarily from more moderate unit labour cost and price developments in recent years.

Looking forward, the main challenge for Slovenia will be to safeguard a healthy competitiveness position, for which wage moderation will be essential. At the same time, despite a high domestic savings rate, Slovenia may have scope for a more extensive use of foreign savings for increasing domestic investment and productivity. While foreign borrowing has recently substantially increased, direct investment inflows remain modest, in particular compared with some of the other new Member States. At the same time, a significant contribution to domestic investment will come from EU structural funds, which will help to alleviate the external constraint without affecting Slovenian external indebtedness.

Table 7.2.
Slovenia: Balance of payments
(percentage of GDP)

	2001	**2002**	**2003**	**2004**	**2005**
Current account	0.2	1.5	-0.3	-2.1	-1.1
Of which: Balance of trade in goods	-3.1	-1.1	-2.2	-3.9	-3.8
Balance of trade in services	2.4	2.6	2.2	2.6	3.3
Income balance	0.2	-0.6	-0.7	-0.9	-0.8
Balance of current transfers	0.6	0.6	0.4	0.1	0.2
Financial and capital accounts	-0.7	-0.6	-0.1	2.4	2.6
Of which: Net FDI	1.1	6.5	-0.5	0.8	-0.1
Net portfolio inflows	0.3	-0.3	-0.9	-2.2	-4.4
Net other inflows	4.4	1.8	3.1	3.2	8.3
Net capital account	0.0	-0.7	-0.7	-0.4	-0.5
Change in reserves (+ is a decrease)	-6.5	-8.0	-1.1	1.0	-0.7
Errors and omissions	0.5	-0.8	0.4	-0.4	-1.5
Gross capital formation	24.1	23.4	24.7	26.3	25.3
Gross saving	24.3	24.8	24.4	24.4	24.5

Source: Eurostat and Commission services

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