ISSN 0379-0991

EUROPEAN ECONOMY

No 6 / 2007

Convergence Report 2007 on Cyprus
Convergence Report 2007 on Malta

European Commission

Economic and Financial Affairs
DIRECTORATE-GENERAL

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European Commission

EUROPEAN ECONOMY

Directorate-General for Economic and Financial Affairs

2007 No 6

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Printed in Belgium

Convergence Report 2007 on Cyprus

Convergence Report 2007 on Malta

May 2007

Abbreviations and symbols used

Member States

BE	Belgium
BG	Bulgaria
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
RO	Romania
SI	Slovenia
SK	Slovakia
FI	Finland
SE	Sweden
UK	United Kingdom

EU10	European Union Member States that joined the EU on 1 May 2004 (CZ, EE, CY, LT, LV, HU, MT, PL, SI, SK)
EUR13	European Union Member States having adopted the single currency (BE, DE, EL, ES, FR, IE, IT, LU, NL, AT, PT, SI, FI)
EU15	European Union, 15 Member States before 1 May 2004 (EUR-12 plus DK, SE and UK)
EU25	European Union, 25 Member States before 1 January 2007
EU27	European Union, 27 Member States

Currencies

EUR	euro
ECU	European currency unit
USD	US dollar
CYP	Cyprus pound
MTL	Maltese lira

Other abbreviations

CBC	Central Bank of Cyprus
CBM	Central Bank of Malta
COLA	Cost of Living Allowance
CPI	Consumer price index
CR5	Concentration ratio (defined as the aggregated market share of five banks with the largest market share)
ECB	European Central Bank
EDP	Excessive Deficit Procedure
EMI	European Monetary Institute
EMU	economic and monetary union
ERM II	exchange rate mechanism II
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
ICT	information and communications technology
MFSA	Malta Financial Services Authority
MTO	medium-term objective
NGCAs	non-government controlled areas
PPS	Purchasing Power Standard
SFAs	stock flow adjustments
SGP	Stability and Growth Pact
ULC	unit labour costs
VAT	value added tax

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I. Convergence Report 2007 on Cyprus[*]

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

[*] This report was formally adopted by the College of Commissioners on 16 May 2007 (COM(2007) 255 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 by the Member States in fulfilling their obligations regarding the achievement of economic and monetary union.

This report has been prepared in response to the request of Cyprus, submitted on 13 February 2007. A more detailed assessment of the state of convergence in Cyprus is provided in a technical annex to this report (SEC(2007) 623).

The content of the reports prepared by the Commission and the ECB is governed by Article 121(1) of the Treaty. This Article requires the reports to 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 (ESCB Statute). The reports must also examine whether a high degree of sustainable convergence has been achieved 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 by taking 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).

This report only examines the areas in which the Government of the Republic of Cyprus exercises effective control, as defined in Protocol No 10, annexed to the 2003 Act of Accession, as has been done in all other relevant procedures (e.g. EDP, Lisbon, participation in ERM II).

The examination of the compatibility of ***national legislation***, including the statutes of the national central banks, with Articles 108 and 109 of the Treaty and the ESCB Statute requires an assessment of compliance with the prohibition of monetary financing (Article 101 EC) and the prohibition of privileged access (Article 102 EC); consistency with ESCB's objectives (Article 105(1) EC); central bank independence (Article 108 EC); and integration of national central banks into the ESCB (several EC Treaty and ESCB Statute articles).

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”. The requirement of sustainability implies that the satisfactory inflation performance must essentially be attributable to the behaviour of input costs and other factors influencing price developments in a structural manner, rather than the influence of temporary factors. Therefore, the convergence examination includes an assessment of the factors underlying inflation and of medium-term prospects. It also assesses whether the country is

likely to meet the reference value in the months ahead. [1]

The inflation reference value was calculated to be 3.0% in March 2007[2] with Finland, Poland and Sweden as the three best-performing Member States.

The Treaty refers to the ***exchange rate criterion*** in the third indent of Article 121 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".

The relevant two-year period for assessing exchange rate stability in this report is 27 April 2005 to 26 April 2007.

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 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".

The interest rate reference value was calculated to be 6.4% in March 2007.

Article 121 of the Treaty also requires an examination of other factors relevant to economic integration and convergence. These additional factors include financial and product market integration, the development of the balance of payments on current account and the development of unit labour costs and other price indices. The latter are covered within the assessment of price stability.

In the December 2006 Convergence Report, the Commission assessment was that Cyprus

[1] The forecast of the reference value is subject to significant uncertainties given that it is calculated on the basis of the inflation forecasts for the three Member States projected to have the lowest inflation in the forecast period, thereby increasing the possible margin of error.

[2] The cut-off date for the data used in this report is 26 April 2007.

fulfilled three of the convergence criteria (on price stability, government budgetary situation and long-term interest rates). Pending the adoption of the draft Law amending the Central Bank of Cyprus Law of 2002 and 2003, legislation in Cyprus, in particular the Central Bank of Cyprus law, was considered not fully compatible with Article 109 of the Treaty and the ESCB Statute as regards central bank integration into the ESCB at the time of the adoption of the euro.

2. Legal compatibility

All outstanding incompatibilities have been addressed in a Law amending the Central Bank of Cyprus Laws of 2002 and 2003 adopted by Parliament on 15 March 2007. The Law entered into force on the day of its adoption, though certain provisions will take effect on the date of the introduction of the euro in Cyprus. In particular, the Law has repealed or amended a series of articles so as to take account of the respective roles and competences assigned by the EC Treaty to the ECB, ESCB and EC Council. This concerns notably provisions on monetary policy, on monetary operations and instruments of the ESCB, on the conduct of foreign exchange operations and on the issue of banknotes and coins.

Legislation in Cyprus, in particular the Central Bank of Cyprus Law, is compatible with the requirements of the EC Treaty and the ESCB Statute.

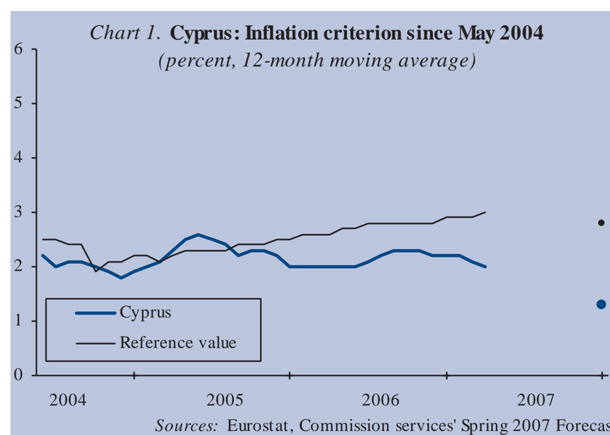
3. Price stability

Evolution of the reference value

12-month average inflation in Cyprus has been below the reference value since August 2005. The average inflation rate in Cyprus during the 12 months to March 2007 was 2.0%, below the reference value of 3.0%, and it is likely to remain below the reference value in the months ahead.[3]

Underlying factors and sustainability

Cyprus has traditionally enjoyed relatively low, although at times volatile, inflation, reflecting the sensitivity of its small and open economy to external price shocks. HICP inflation was 2.6% on average in 1999-2006. However, inflation reached highs of around 6% in the spring of 2000 and again in the winter of 2003, in the first case largely owing to higher energy and food prices and in the latter case primarily due to accession-



[3] According to the Commission Spring 2007 Forecast, 12-month average inflation in Cyprus will decrease to 1.3% in December 2007, while the reference value is forecast to stand at 2.8%.

related increases in VAT rates and excise duties.Inflation increased in the first half of 2006, but declined thereafter to 1.4% in March 2007, largely as a reflection of swings in energy and food prices.

HICP inflation excluding energy and unprocessed food has been contained, averaging below 1 % since 2004. Moderate core inflation suggests that underlying inflationary pressures have remained limited, against the background of a negative output gap and moderate increases in unit labour costs (between 1 and 2% annually since 2004). Wage pressures in recent years, in the context of tightening labour market, were mitigated by an increasing share of foreign workers in the labour force and exemplary wage discipline in the public and private sectors. The effective exchange rate of the Cypriot pound was stable in 2005-2006, thus remaining neutral with respect to import prices.

Inflation is expected to remain low in the coming months largely due to a favourable oil price base effect, lower prices of clothing and footwear and the reduction of excises on cars.Inflation performance over the medium term will, to a large extent, depend on the development of energy and other import prices and on the containment of possible wage and demand pressures in a context of strong cyclical conditions and interest rate and reserve requirement convergence. Increases in VAT rates on foodstuff, pharmaceuticals and restaurants that are related to fulfilling EU requirements, as the current derogations expire at the end of 2007, are expected to have a significant (around one percentage point) impact on inflation., Although this impact is expected to be temporary, some second-round effects cannot be excluded, in particular via the inclusion of VAT increases in the cost of living index.

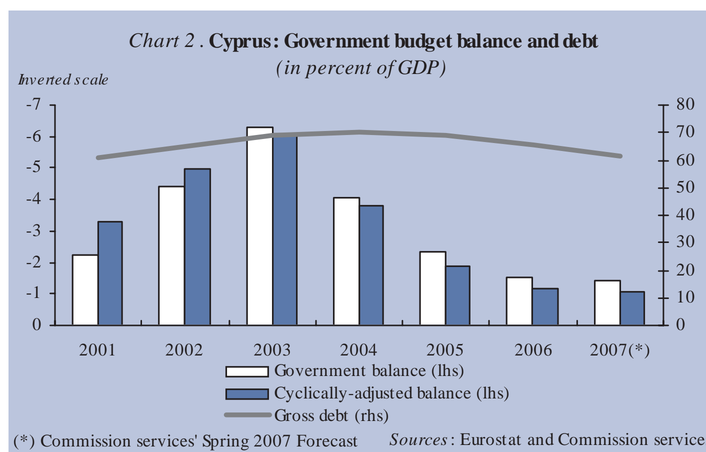
Cyprus fulfils the criterion on price stability.

4. Government budgetary position

Cyprus is not at present the subject of a Council Decision on the existence of an excessive deficit, the Decision on the existence of such deficit in Cyprus adopted by the Council on 5 July 2004[4] having been abrogated by the Council Decision of 11 July 2006[5].

The general government deficit peaked at 6.3% of GDP in 2003, but was reduced markedly in the following years, to 1.5% of GDP in 2006, following the implementation of a strong fiscal adjustment in 2004 and 2005. For 2007, the Commission services' Spring 2007 Forecast projects an almost unchanged deficit (1.4% of GDP).

Chart 2 . **Cyprus: Government budget balance and debt**
(in percent of GDP)



(*) Commission services' Spring 2007 Forecast *Sources*: Eurostat and Commission services

In its Opinion on the December 2006 update of the Convergence Programme of Cyprus, the Council considered that after the correction of the excessive deficit in 2005,

[4] 2005/184/EC, OJ L 62, 9.3.2005, p.19.

[5] 2006/627/EC, OJ L 256, 20.9.2006, pp.13-14

Cyprus was making good progress towards the medium-term objective (MTO) and that the budgetary strategy in the programme seemed sufficient to ensure that the MTO is achieved by 2008. At the same time, the Council invited Cyprus to control public pension expenditure and implement further reforms in the areas of pensions and health care in order to improve the long-term sustainability of the public finances and to implement the fiscal consolidation path as foreseen in the programme.

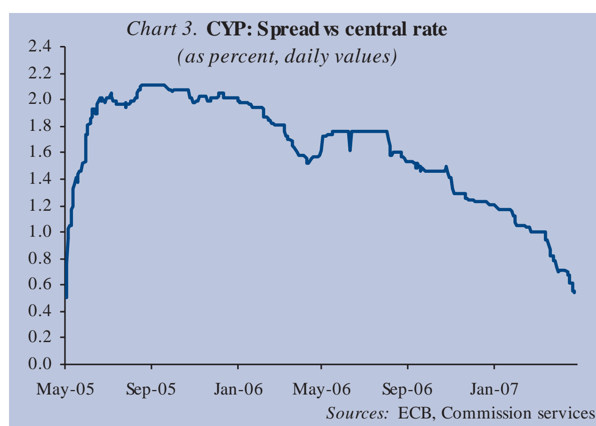
During the seven years to 2006, both total revenue and total expenditure ratios followed, on average, an upward trend. Total revenue increased, mainly owing to a mix of structural and one-off measures. The former included the alignment of VAT tax rates with the *acquis* in May 2004 and measures to discourage tax evasion, while the one-off measures took the form of an exceptional dividend on past profits of semi-governmental organisations and a tax amnesty. Current primary expenditures increased, mainly owing to increases of wages and salaries and social transfers. From 2005 onwards, expenditure growth was restricted by the imposition of a ceiling on the nominal growth rates of current primary and capital expenditure.

Government debt followed an upward trend between 2000 and 2004 but has been on a declining path since 2005. It decreased to 65.3% of GDP in 2006, and according to the Commission services' Spring 2007 Forecast, will continue to decline in 2007, reaching some 61.5% of GDP.

Cyprus fulfils the criterion on the government budgetary position.

5. Exchange rate stability

The Cyprus pound has participated in ERM II since 2 May 2005, i.e. for 24 months at the time of adoption of this report. Before ERM II entry, the Central Bank of Cyprus had been operating a unilateral peg vis-à-vis the euro, containing fluctuations within relatively narrow margins. During the period of the assessment not covered by ERM II participation (27 April – 1 May 2005), the pound stayed close to the future central rate. Since ERM II entry, the pound has consistently traded in the upper half of the fluctuation band, close to the central rate, and it has not experienced severe tensions. Additional indicators, such as developments in short-term interest rates and foreign exchange reserves, do not point to pressures on the exchange rate.

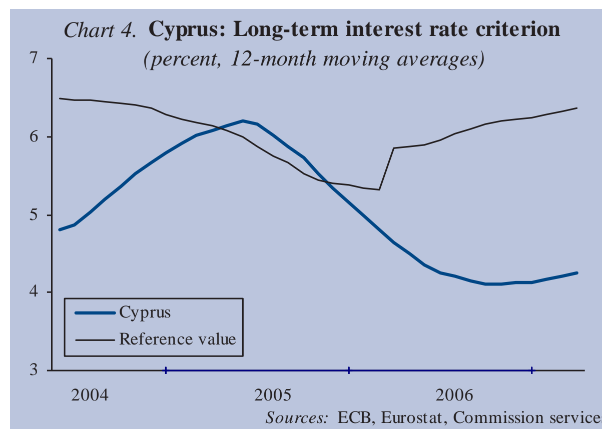


Cyprus fulfils the exchange rate criterion.

6. Long-term interest rates

The average long-term interest rate in Cyprus in the year to March 2007 was 4.2%, below the reference value of 6.4%. Average long-term interest rates in Cyprus have been below the reference value since November 2005. Long-term interest rates in Cyprus have decreased substantially in the past few years as have spreads to the euro area. Low yield spreads *vis-à-vis* the euro area indicate that the residual country risk priced in by markets is limited.

Chart 4. **Cyprus: Long-term interest rate criterion**
(percent, 12-month moving averages)



Sources: ECB, Eurostat, Commission services

Cyprus fulfils the criterion on the convergence of long-term interest rates.

7. Additional factors

Additional factors have been examined, including product and financial market integration and balance of payments developments. The Cypriot economy is highly integrated with the EU. In particular, trade and FDI are increasing, and the Cypriot financial system is substantially inter-linked with the financial systems of the EU and other countries in terms of branches and subsidiaries of foreign banks operating in Cyprus. The Cypriot current account deficit has widened in recent years, from 3.2% of GDP in 2003 to 5.9% of GDP in 2006. The deficit in the combined current and capital account increased from 1.9 to 5.9% of GDP in this period. The current account deficit reflects large disparities in net trade in goods and services. Traditionally, substantial surpluses on services trade have not fully offset very large deficits in goods trade and negative income balances. On the financing side, net FDI inflows have covered a substantial share of the current account balance.

* * *

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

Convergence Report 2007 on Cyprus – Technical Annex

Acknowledgements

The Convergence Report and its Technical Annex were prepared in the Directorate-General for Economic and Financial Affairs. The main contributors were Geraldine Mahieu, Ronald Albers and Pavlína Žáková.

Other contributors to the paper were Sean Berrigan, Mateo Capo Servera, Polyvios Eliofotou, Christine Gerstberger, Fabienne Ilzkovitz, Baudouin Lamine, Claudia Lindemann, Carlos Martinez Mongay, Lucio R. Pench, Nuno Sousa, Charlotte Van Hooydonk and Johan Verhaeven.

Statistical assistance was provided by André Verbanck and Gerda Symens.

The paper was coordinated by Massimo Suardi, 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 by eleven Member States, following several years of successful adjustment efforts to achieve a high degree of sustainable convergence. The decision[6] 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[7] and the European Monetary Institute (EMI), respectively.[8] 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*)*. 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: 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[9] 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[10] 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[11] and the ECB[12], which covered both Greece and Sweden. Greece adopted the single currency with effect from

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

7 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.

8 European Monetary Institute, Convergence Report, March 1998.

9 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.

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

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

12 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".[13]

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 eleven assessed countries was considered to have fulfilled the necessary conditions for the adoption of the single currency.[14]

In 2006, two convergence assessments have been carried out. In May, the Commission and the ECB presented reports on Lithuania and Slovenia, prepared at the request of the national authorities.[15] While Slovenia was deemed to fulfil all the convergence criteria and to be ready to adopt the euro in January 2007, the report on Lithuania suggested that there should be no change in the status of Lithuania as a Member State with the derogation. The remaining nine Member States with a derogation were assessed in regular Convergence Reports issued in December 2006.[16] None of the countries assessed was deemed to meet the necessary conditions for adopting the single currency.

On 13 February 2007, Cyprus submitted a request for a convergence assessment. As a response to this request, the Commission and the ECB prepared Convergence Reports for Cyprus. This report examines only the areas in which the Government of the Republic of Cyprus exercises effective control, as defined in Protocol No 10, annexed to the 2003 Act of Accession, as has been done in all other relevant procedures (e.g. EDP, Lisbon, participation in ERM II).

This Commission services working paper is a technical annex to the Convergence Report 2007 on Cyprus 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. 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 the convergence report and in this technical annex is 26 April 2007.

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 2). The four convergence criteria have been developed further in a Protocol annexed to the Treaty (Protocol No 21 on the convergence criteria).

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

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

[15] European Commission, Convergence Report 2006 on Lithuania, COM(2006) 223 final, 16 May 2006; European Commission, Convergence Report 2006 on Slovenia, COM(2006) 224 final, 16 May 2006; and European Central Bank, Convergence Report, May 2006, May 2006. On the basis of the reports, the Ecofin Council adopted on 11 July 2006 the Decision that Slovenia fulfilled the necessary conditions for adoption of the single currency (OJ L 195, 15.7.2006, pp 25-27).

[16] European Commission, Convergence Report, December 2006, COM(2006) 762 final, 6 December 2006; and European Central Bank, Convergence Report, December 2006, December 2006.

Box 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[17] 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[18] 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 (Box 3).

Over the 12 month period covering April 2006-March 2007, the three best-performing Member States in terms of price stability were Finland, (1.3%), Poland (1.5%) and Sweden (1.6%) yielding a reference value of 3.0%.

The Protocol on the convergence criteria not only requires Member States to have achieved a high degree of price stability but also calls for a price performance that is sustainable. The requirement of *sustainability* aims at ensuring that the degree of price stability and inflation convergence achieved in previous years will be maintained after adoption of the euro. This implies that the satisfactory inflation performance must essentially be due to the adequate behaviour of input costs and other factors influencing price developments in a structural manner, rather than reflecting the influence of temporary factors. Therefore, this technical annex examines also developments in unit labour costs as a result of trends in labour productivity and nominal compensation per head, and developments in import prices to assess whether and how external price developments have impacted on domestic inflation. From a forward-looking perspective, the report includes an assessment of medium-term prospects for inflation. The analysis of factors that have an impact on the inflation outlook, such as credit developments and cyclical conditions, is complemented by a reference to the most recent Commission forecast of inflation. That forecast can subsequently be used to assess whether the country is likely to meet the reference value also in the months ahead. [19]

[17] 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).

[18] 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.

[19] According to the Commission Spring 2007 Forecast, the reference value is forecast to stand at 2.8% in December 2007. The forecast of the reference value is subject to significant uncertainties given that it is calculated on the basis of the inflation forecasts for the three Member States projected to have the lowest inflation in the forecast period, thereby increasing the possible margin of error.

Box 3: Assessment of price stability and the reference value

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

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

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

The ***reference value*** is calculated as the unweighted average of the average rates of inflation of, at most, the three best-performing Member States in terms of price stability plus 1.5 percentage points. The outcome is rounded to one decimal. While in principle the reference value could also be calculated on the basis of the price performance of only one or two best performing Member States in terms of price stability, it has been existing practice to select the three best performers.

The reference value has been defined in the Maastricht Treaty in a relative way. An absolute reference value could, depending on the overall economic circumstances at the time of the assessment, be considered to be unduly harsh or too loose. Alternatively, using the average of the inflation rates of all Member States as a basis for the reference value would imply that high inflation rates of a few countries could increase the average to undesired levels. These problems are avoided in the Treaty by requiring convergence towards the best performing Member States within a margin of 1.5 percentage points. As the reference value is a relative concept based on the Member States with the lowest rate of inflation, a margin of 1.5 percentage points is added.

Article 121(1) of the Treaty refers to 'Member States' and does not make a distinction between euro area and other Member States. The Convergence Reports therefore select the three best performers from all Member States – EU-15 for the Convergence Reports before 2004 and EU-25 for the reports as of 2004.

As a principle, and in line with what was intended by the authors of the Maastricht Treaty, the Commission and ECB reports select as best performers in terms of price stability those Member States which have the lowest average rate of inflation. In the 2004 report, the Commission decided to exclude countries in deflation from the calculation of the reference value because these countries could not be considered to be 'best performers' in terms of price stability – as suggested by the Treaty Protocol, which refers only to an average rate of inflation.

Table 1 lists the reference value as used in the Convergence Reports issued since 1998.

Table 1.
Inflation reference value in previous and current Convergence Reports [1)]

Convergence Report adoption date	Cut-off month	Three best performers [2)]	Reference value	Euro area average inflation rate [2)]
1998	January 1998	Austria, France, Ireland	2.7	1.5
2000	March 2000	Sweden, France, Austria	2.4	1.4
2002	April 2002	United Kingdom, Germany, France	3.3	2.4
2004	August 2004	Finland, Denmark, Sweden	2.4	2.1
2006 May	March 2006	Sweden, Finland, Poland	2.6	2.3
2006 December	October 2006	Poland, Finland, Sweden	2.8	2.2
2007	March 2007	Finland, Poland, Sweden	3.0	2.1

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

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. 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 (for further information on this procedure, see Box 4).[20]

[20] 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.

Box 4: The excessive deficit procedure [21]

The excessive deficit procedure (EDP) is specified in Article 104 of the Treaty, the associated Protocol on the EDP and Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the EDP[22], which is the "dissuasive arm" of the Stability and Growth Pact (SGP). Together, they determine the steps to be followed to reach a Council decision on the existence of an excessive deficit, which forms the basis for the assessment of compliance with the convergence criterion on the government budgetary position, and the steps to be followed to correct a situation of excessive deficit. According to Article 104(2), compliance with budgetary discipline is to be examined by the Commission on the basis of the following two criteria:

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

— *either the ratio has declined substantially and continuously and reached a level that comes close to the reference value;*

— *or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;*

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

According to the Protocol, the Commission provides the statistical data for the implementation of the procedure. As part of the application of this Protocol, Member States have to notify data on government deficits, government debt and nominal GDP and other associated variables twice a year, namely before 1 April and before 1 October[23]. After each reporting date, Eurostat examines whether the data are in conformity with ESA95[24] rules and related Eurostat decisions and, if they are, validates them.

The Commission is required to prepare a report if a Member State does not fulfil the requirements under one or both of the criteria given above (Article 104(3)). The report also has to take into account whether the government deficit exceeds government investment expenditure and all other relevant factors (considerations related to the medium-term economic and budgetary position of the Member State). These factors should be considered in the steps of the EDP leading to the decision on the existence of an excessive deficit only under the double condition that the deficit is close to the reference value and its excess over it is temporary. Special provisions are foreseen for pension reforms introducing a multi-pillar system including a mandatory, fully-funded pillar (for further details, see Box 1.5 of the December 2006 Convergence Report).

The next step in the procedure is the formulation by the Economic and Financial Committee of an opinion on this report within two weeks of its adoption by the Commission (Article 104(4)). If it considers that an excessive deficit exists or may occur, the Commission then addresses an opinion to the Council (Article 104(5)). On the basis of a Commission recommendation, the Council decides, after an overall assessment, whether an excessive deficit exists (Article 104(6)). Any such decision has to be adopted as a rule within four months of the reporting dates (1 April, 1 October).

When it decides that an excessive deficit exists, the Council has to issue a recommendation to the Member State concerned with a view to bringing that situation to an end within a given period, also on the basis of a Commission recommendation (Article 104(7)). The Council recommendation has to specify when the correction of the excessive deficit should be completed, namely in the year following its identification unless there are

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

[22] OJ L 209, 2.8.1997, p. 6. Regulation as amended by Regulation (EC) No 1056/2005 (OJ L 174, 7.7.2005, p. 5).

[23] Council Regulation (EC) No 3605/93 on the application of the Protocol on the excessive deficit procedure (OJ L 332, 31.12.1993, p. 7). Regulation as last amended by Regulation (EC) No 2103/2005, (OJ L 337, 22.12.2005, p. 1).

[24] European System of National and Regional Accounts, adopted by Council Regulation (EC) No 2223/96 (OJ L 310, 30.11.1996, p. 1). Regulation as last amended by Regulation (EC) No 1267/2003 of the European Parliament and of the Council (OJ L 180, 18.7.2003, p. 1).

special circumstances, and has to include a deadline of six months at most for effective action to be taken by the Member State concerned. The recommendation should also specify that the Member State concerned has to achieve a minimum annual improvement of at least 0.5% of GDP as a benchmark in its cyclically-adjusted balance net of one-off and temporary measures.

If effective action has been taken in compliance with a recommendation under Article 104(7) and, compared with the economic forecasts in this recommendation, unexpected adverse economic events with major unfavourable consequences for government finances occur subsequent to its adoption, the Council may decide, on a recommendation from the Commission, to adopt a revised recommendation under the same article, which may notably extend the deadline for the correction of the excessive deficit by one year. Where it establishes that there has been no effective action in response to its recommendations, the Council adopts a decision under Article 104(8) on the basis of a Commission recommendation immediately after the expiry of the deadline for taking action (or at any time thereafter when monitoring of the action taken by the Member State indicates that action is not being implemented or is proving to be inadequate). The provisions of Article 104(9 and 11), on enhanced Council surveillance and ultimately sanctions in case of non-compliance, are not applicable to Member States with a derogation (that is, those that have not yet adopted the euro), which is the case of the Member States considered in this report.

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

Exchange rate stability

The Treaty refers to the exchange rate criterion in the third indent of Article 121 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[25], 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 technical annex is 27 April 2005 to 26 April 2007.

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

[25] 97/C 236/03 of 16 June 1997, OJ C 236, 2.8.1997, p.5.

2007, the reference value, derived from the average interest rate in Finland (3.9%), Poland (5.3%) and Sweden (3.8%), was 6.4%.

Additional factors

The Treaty in Article 121 also requires an examination of other factors relevant to economic integration and convergence. These additional factors include financial and product market integration and the development of the balance of payments. The examination of the development of unit labour costs and other price indices, which is also prescribed by Article 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 the *integration of financial markets*, the 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 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.

2. LEGAL COMPATIBILITY

2.1. Legal situation

The Central Bank of Cyprus (CBC) was established by the Central Bank of Cyprus Law in 1963, shortly after the island gained its independence in August 1960. The law was replaced by the Central Bank of Cyprus Law of 2002 (138(I) 2002), as amended by the CBC (amending) Law of 31 October 2003. A Law amending the Central Bank of Cyprus Laws of 2002 and 2003 was adopted by Parliament on 15 March 2007. The law entered into force on the same day, while certain provisions will take effect on the date of the introduction of the euro in Cyprus.

The CBC is a corporate entity with its capital fully paid up by the government. As from the date of the introduction of the euro in Cyprus, the decision-making bodies of the CBC will be the Board of Directors, the Governor and the Deputy Governor. The governor shall seat, ex officio, as an independent personality, in the General Council and the Governing Council of the ECB and shall have the exclusive competence to carry out the tasks and exercise the powers conferred upon the Bank by or in accordance with the provisions of the ESCB Statute.

Objectives

The primary objective of the CBC is to ensure price stability. The secondary objective of the CBC (Article 5) refers to the general economic policy of the State. It moreover makes reference to the general economic policies in the Community, with the latter taking precedence over the former.

Independence

According to Article 108 of the Treaty neither a national central bank nor any member of its decision-making bodies shall, when exercising the powers and carrying out the tasks and duties conferred upon them by the EC Treaty and the ESCB Statute, seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body. Inversely, the Community institutions and bodies and the governments of the Member States have to respect this principle and may not seek to influence the members of the decision-making bodies of the national central banks in the performance of their tasks. The different features which make up independence may be grouped into three categories: institutional, personal and financial independence.[26] In particular concerning personal independence, the ESCB Statute contains specific provisions, for example, on the term of office of the governor of a national central bank and the grounds for his dismissal (Article 14.2 ESCB Statute).

The 2006 Convergence Report concluded that the CBC Law was compatible with the Treaty as regards independence. The amendment to Article 13(3) enacted since then has further strengthened the personal independence of the members of the CBC's Board other than the Governor and the Deputy Governor: in case of an unexpected vacancy a new Board member shall systematically be appointed for a term of office of 5 years, as opposed to the remainder of the term of office of the outgoing Board member.

Integration in the ESCB

The incompatibilities raised in the 2006 Convergence Report have been removed. The Law on the amendments to the Central Bank of Cyprus Laws of 2002 and 2003 notably repeals Articles 10, 27(2), 37, 40, and 44. Moreover, a series of articles have been amended so as to take account of the respective roles and competences assigned by the EC Treaty to the ECB, ESCB and the EC Council. This concerns in particular Article 6(2)a on monetary policy, Article 6(2)b on the conduct of foreign exchange operations, Articles 29, 30 and 31(2) on the issue of banknotes and the volume of coins, Articles 27 and 28 on the definition of the monetary unit, as well as Articles 39(2), 41, 42, 46(2) and (3) and 65 on the monetary functions, operations and instruments of the ESCB.

Prohibition of monetary financing

In line with the prohibition of monetary financing (Article 101(1) of the Treaty), overdraft facilities or

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26 See European Commission, Convergence Report 2004, p. 10-11.

any type of credit facility with the CBC in favour of Community institutions or bodies, the government, regional, local or other public authorities, public corporations or public undertakings are prohibited. Moreover, the CBC may not directly purchase debt instruments of such entities (Article 49(1)).

Pursuant to Article 46(3) the CBC may grant advances against collateral to commercial banks. A specific safeguard clause has been inserted in this Article as regards the role of the CBC as lender of last resort, so as to strengthen compliance with Article 101 of the Treaty and to avoid that the CBC might eventually end up bearing financial costs which are in principle to be borne by the state.

2.2 Assessment of compatibility

Legislation in Cyprus is compatible with the requirements of the EC Treaty and the ESCB Statute.

3. PRICE STABILITY

3.1. Respect of the reference value

The 12-month average inflation rate, which is used for the convergence assessment, hovered around the reference value from spring 2004 to late 2005. From December 2005 onwards, average annual inflation has been below the reference value by half a percentage point or more. In March 2007, the reference value was 3.0%, calculated as the average of the 12-month average inflation rates in the three best-performing Member States (Finland, Poland and Sweden) plus 1.5 percentage points. The corresponding inflation rate in Cyprus was 2.0%, 1 percentage point below the reference value.

3.2. Recent inflation developments

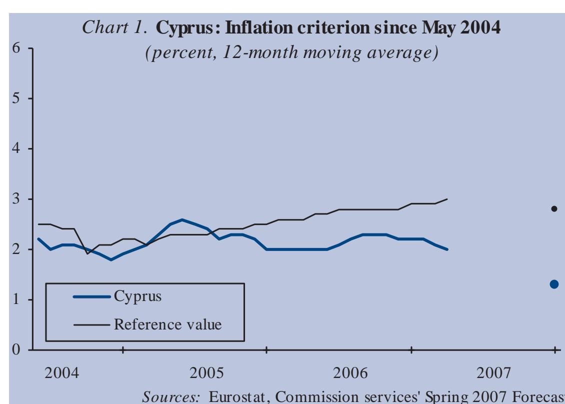
Cyprus has traditionally enjoyed relatively low, albeit at times volatile, inflation, reflecting the high sensitivity of the small and open economy to external price shocks and exchange rate fluctuations. Between January 1997 and March 2007, year-on-year HICP inflation[27] averaged 2.6%, despite the two peaks of around 6% recorded in the spring of 2000 and again in the winter of 2003, in the first case largely owing to higher energy and food prices and in the latter case primarily due to accession-related increases in VAT rates and excises.

Inflation fell in the course of 2005, from a peak of 3.9% in December 2004 to a low of 1.4% in December 2005, prompted notably by lower price increases for food and by a drop in the prices for telecommunications and pharmaceutical products.

External factors, such as low import prices of specific goods, notably clothing and footwear, further contributed to subdued consumer price inflation.

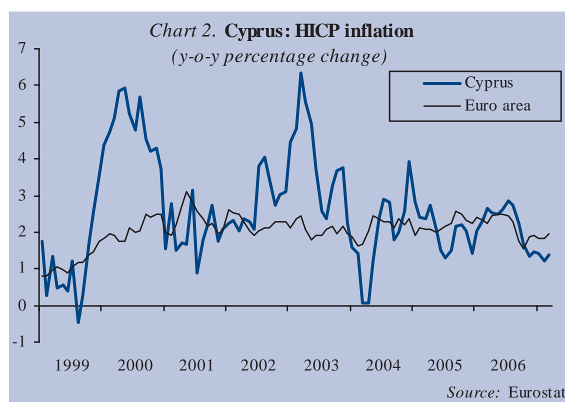
From January 2006 onwards, headline inflation picked up again and peaked at 2.8% in July 2006, buoyed by higher energy prices. In the following months inflation declined, to 1.4% in March 2007, largely mirroring the fall in oil prices. Inflation developments in 2006 and early 2007 were also characterized by a marked upturn in food prices due to weather conditions. Reductions in the prices of imported clothing and footwear continued to exert downward pressure on inflation.

Chart 1. **Cyprus: Inflation criterion since May 2004**
(percent, 12-month moving average)



Sources: Eurostat, Commission services' Spring 2007 Forecast

Chart 2. **Cyprus: HICP inflation**
(y-o-y percentage change)



Source: Eurostat

27 In the context of compliance monitoring and quality assurance, Eurostat has been reviewing the statistical practices used to compile the HICP for Cyprus against HICP methodology and other guidelines and good practices in the field of consumer price indices. Eurostat concluded that, in general, the methods used for producing the Cypriot HICP are of good standard. The methodological basis for compiling the Cypriot HICP conforms to HICP requirements and should be considered comparable to the HICPs of other EU countries. The compliance report published in November 2006 is available at http://epp.eurostat.ec.europa.eu/pls/portal/url/page/PGP_DS_HICP.

Table 2.

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

	2001	2002	2003	2004	2005	2006	Mar-07	weights in total 2007
HICP	2.0	2.8	4.0	1.9	2.0	2.2	2.0	1000
Non-energy industrial goods	-1.3	-0.9	-0.7	-3.0	-1.1	-1.8	-1.8	296
Energy	1.9	6.9	12.3	11.3	12.9	8.9	4.4	114
Unprocessed food	5.7	4.2	4.5	2.8	2.7	8.0	9.0	85
Processed food	3.0	7.5	9.1	5.7	1.6	2.8	2.7	128
Services	4.0	2.9	4.5	2.5	2.1	1.9	2.3	377
HICP excl. energy and unproc. food	1.6	2.1	3.1	0.8	0.8	0.8	0.9	801

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.

Sources: Eurostat, Commission services.

As regards the evolution of the price of services in 2006, relatively high increases were notably recorded in transport, education and health, with the latter two categories continuing to show high increases in early 2007. In addition, the fall observed over the previous five years in the price of telecommunications services, due to intensified competition, moderated in the course of 2006. By contrast, falling prices for accommodation services, as a result of increased competition and an ongoing shift in the tourism sector towards more permanent tourists who purchase holiday houses in Cyprus, exerted a significant downward effect on inflation. Due to the importance of tourism, accommodation services have a relatively high expenditure share in private consumption on the domestic territory.

3.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and cyclical stance

Real GDP growth was quite strong in the period 2004-2006, with annual growth at slightly below 4% on average. Although for Cyprus estimates of potential growth have to be treated with caution, economic growth is expected to remain around potential in the coming years. Exchange rate stability and a credible monetary policy have contributed to keep inflation at relatively low levels, in a context of tightening labour market conditions. The increased supply of foreign workers has helped to address labour shortages in a number of key sectors and to curb wage growth. The unemployment rate fell to 4.8% in 2006 and is expected to further decline to about 4½% in the coming years.

Cyprus has shown a mixed record on fiscal consolidation in the past years. In 2002 and 2003 fiscal policy was expansionary and deficit outturns were well above the official targets. However, since 2004, the fiscal stance has been tightened substantially, leading to a strong reduction of the government deficit. Following sharp decreases in 2005 and 2006, the cyclically-adjusted primary balance is expected to remain unchanged in 2007, which corresponds to a broadly neutral fiscal stance.

Wages and labour costs

Cyprus registered relatively moderate wage increases in the late 1990s, and this trend mostly continued in subsequent years, with the notable exception of 2002-2003. In these two years, unit labour costs surged in response to a strong pick-up in wage growth and weak labour productivity, putting upward pressure on consumer prices.

Cyprus has a backward-looking system of wage setting based on a Cost of Living Allowance (COLA). The system has not fundamentally changed in the past decade. Under COLA, wages are adjusted twice a year to inflation in the preceding six months. Although the system is a potentially complicating factor in the wage setting process, wage pressures in recent years, including those due to tax harmonisation in the run-up to EU membership, were mitigated by a relatively flexible labour market, an increasing share of foreign workers in the labour force and the exclusion of excise duties from the calculation of the cost of living index.[28]

[28] Indirect taxes such as VAT are however included in the cost of living index.

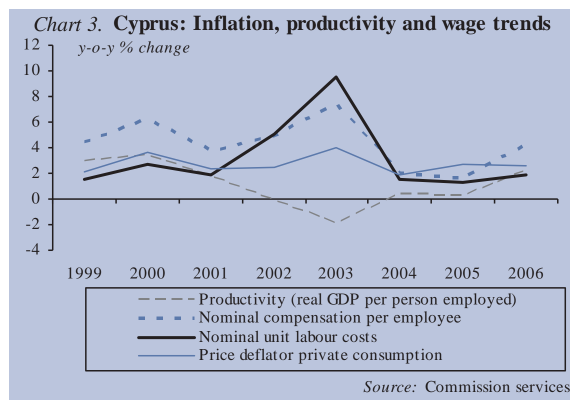


Chart 3. **Cyprus: Inflation, productivity and wage trends**

Source: Commission services

During the last five years, wage setting in the public sector has acted as a guide for private sector wage negotiations. In 2004 and 2005, the government reached an agreement with public sector unions not to give any contractual salary increases, as an important element of the fiscal consolidation strategy. The example of the government was followed by the banking sector and had a moderating impact on wage settlements in the private sector at large. Moderate overall wage gains contributed to a sharp deceleration in unit labour costs from 9.5% in 2003 to about 1½% on average in 2004 and 2005, helped by a progressive cyclical pick-up in labour productivity growth. For 2006 and 2007, contractual wage increases in the public sector have been agreed, amounting to 2 and 1% respectively. In line with the increase in contractual wages in the public sector, nominal compensation per employee in the whole economy seems to have picked-up in 2006, leading to an increase of almost 2% in nominal unit labour costs, despite a strong acceleration of labour productivity.

Import prices

As a small and very open economy, inflation in Cyprus has been substantially affected by changes in import prices, in particular energy. Since 2002, Cyprus has been confronted with swings both in energy inflation and its contribution to the HICP that were larger than in most Member States, although the uptrend in the nominal effective exchange rate in 2001 to 2005 helped to dampen the impact. Energy prices strongly increased between mid-2002 and mid-2003 reflecting the rises of crude oil price.

A temporary easing of energy price increases was then followed by a further uptrend in 2004 and 2005, in response to the pick-up in crude oil prices. The contribution of energy to headline HICP inflation peaked in January 2006 at 2 percentage points and gradually eased thereafter. It dropped to close to zero by September and has thereafter been slightly negative.

The prices for imported unprocessed food have been largely affected by weather conditions, with a net upward impact in the course of 2006 and early 2007. By contrast, changes in import prices for manufactured goods have exerted downward pressure on inflation in the last three years, notably due to decreases in the prices of clothes, footwear and motor vehicles.

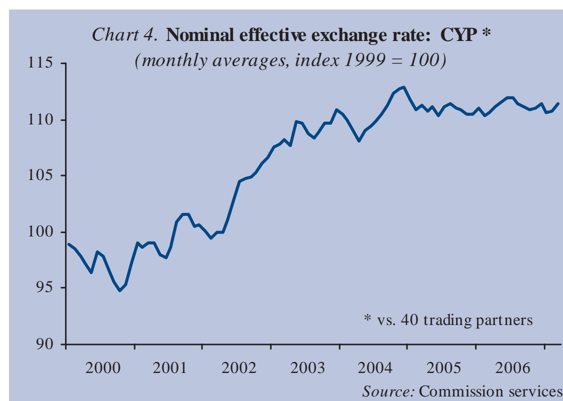


Chart 4. **Nominal effective exchange rate: CYP ***

Source: Commission services

Table 3.
Cyprus: Other inflation and cost indicators (annual percentage change)

	2001	2002	2003	2004	2005	2006[1)]	2007[2)]
Private consumption deflator							
Cyprus	2.4	2.4	4.0	1.9	2.7	2.6	1.9
Euro area	2.3	1.8	2.1	2.0	2.0	2.0	1.8
Nominal compensation per employee							
Cyprus	3.7	4.9	7.4	2.0	1.6	4.2	3.5
Euro area	2.7	2.7	2.8	2.5	1.9	2.2	2.6
Labour productivity							
Cyprus	1.8	-0.1	-1.9	0.4	0.3	2.3	2.3
Euro area	0.5	0.4	0.8	1.6	0.9	1.4	1.4
Nominal unit labour costs							
Cyprus	1.9	5.1	9.5	1.6	1.3	1.9	1.2
Euro area	2.2	2.4	2.0	0.9	1.0	0.9	1.2
Imports of goods deflator							
Cyprus	0.2	0.3	-0.9	4.0	6.4	3.8	1.2
Euro area	0.2	-2.9	-2.2	1.5	4.0	4.7	0.7

1) Nominal compensation per employee, labour productivity and nominal unit labour costs are estimates.
2) Commission services' Spring 2007 Forecast.
Source: Commission services.

Administered prices and taxes

Price regulations apply mainly to government services, public transport, and energy prices. The weight of administered prices in the Cypriot HICP is relatively low compared to other new Member States. Nevertheless, a rise in gas and electricity prices had an upward impact on HICP inflation estimated at around 0.3 percentage point in 2005 and around 0.4 percentage point in 2006. In addition, increases in VAT rates in the run-up to EU accession, required to bring them in line with the *acquis*, had a large upward impact on consumer prices, estimated at about 0.7 percentage point in 2002 and 1.7 percentage points in 2003. However, in these two episodes, consumer prices did not increase by the full amount of VAT increases and the impact on inflation was only temporary, with year-on-year inflation reverting to its long-term trend after about a year.

By contrast, substantial decreases in excises on cars lowered headline inflation by an average 0.7% between 2002 and 2004. The further decrease in excises on cars enacted in October 2006 is estimated to have an annual downward impact of about 0.4 percentage point. Multiple increases in minimum excises duties on diesel and unleaded petrol between 2002 and 2004 have only had a minor impact on inflation, as are likely to have the additional increases scheduled for 2008 and 2010.

Medium-term prospects

Consumer prices in Cyprus have already converged relatively closely to the EU average, broadly in line with Cyprus' relatively high income level (Cyprus' GDP per capita (PPS) was 83% of the EU25 average in 2005). Due to the substantial impact of energy inflation on HICP, the inflation performance in the medium term will to a large extent depend on the development of energy prices.

Broad money and credit growth have gathered pace, partly in response to relatively strong capital inflows. Further interest rate convergence to the euro area and further reduction in reserve requirements from the current ratio of 5% to the euro area reserve requirement of 2% will provide a monetary stimulus, which, in a context of strong growth, could feed into inflation.

Changes in administered prices are not expected to add substantially to inflation, but further increases in VAT rates that are related to fulfilling EU

requirements are expected to have a notable upward effect on inflation. With a view to completing tax harmonisation, Cyprus must abolish zero and reduced VAT rates for foodstuffs, pharmaceuticals and restaurants, as current derogations expire at the end of 2007. The resulting total cumulated increase in HICP inflation is estimated at around one percentage point. By the time of the adoption of this report, the authorities have not yet adopted any legislative measures to harmonize VAT rates. While the impact of VAT increases would be expected to be temporary, there is some risk of second-round effects, particularly through their inclusion in the cost of living index and in the context of strong cyclical conditions.

According to the Commission Spring 2007 Forecasts, overall HICP inflation is expected to moderate to 1.3% in 2007, due to favourable oil price base effect and the reduction on excises on cars. It is expected to increase to 2.0% in 2008. These forecasts however do not include the effects of VAT adjustments, as their precise timing and implementation modalities are not yet known.

Maintaining sustainable low inflation in the medium term depends on the success of efforts to contain a potentially inflationary impact of further interest rate and reserve requirements convergence, to mitigate credit growth and to avoid second-round effects from increases in indirect taxes. A prudent fiscal stance, in particular aiming at avoiding the build-up of excessive demand pressures, and wage developments in line with productivity gains would be required.

4. GOVERNMENT BUDGETARY POSITION

4.1. The excessive deficit procedure for Cyprus[29]

In July 2004, the Council decided that Cyprus was in excessive deficit, based on a deficit of 6.3% of GDP in 2003 and a rising debt ratio, which stood at 72.2% of GDP in 2003. At the same time, the Council issued recommendations to correct the excessive deficit. In particular, Cyprus was recommended to bring the deficit below 3% of GDP by 2005 in a credible and sustainable manner, in line with the Council Opinion on the May 2004 Convergence Programme. The Council endorsed the intermediate targets for the general government deficit of 5.2% of GDP in 2004 and 2.9% in 2005. Cyprus was also recommended to bring the rise in the debt ratio to a halt in 2004.

In July 2006 the Council found that the excessive deficit had been corrected and decided to abrogate its July 2004 Decision on the existence of an excessive government deficit in Cyprus.

4.2. Developments until 2006

The general government deficit in 2000 was 2.3% of GDP. It peaked at 6.3% of GDP in 2003 before subsiding back to 2.3% by 2005. This was the result of the implementation of a strong fiscal adjustment in 2004 and 2005. For 2006, the December 2006 update of the Convergence Programme estimated the government deficit at just below 2% of GDP. However, according the EDP notification of April 2007, the final outcome for the government deficit in 2006 is estimated at 1.5% of GDP. This is 0.4 percentage points of GDP lower than initially projected, in particular on the back of higher-than-expected tax revenues, which largely reflect the buoyant performance of the construction and real estate sector as well as efficiency improvements in the Land and Survey Department.

With interest expenditure broadly stable at 3.3% of GDP, the primary balance was in a range between 1% of GDP in 2000 and around -3% in 2003, before turning positive again in 2005 (to around 1% of GDP). Between 2000 and 2006, total revenues increased by 7.7 percentage points of GDP, mainly due to a mix of structural (alignment of VAT tax rates with the *acquis* in May 2004 and measures to discourage tax evasion) and one-off measures (exceptional dividend on past profits of the semi-governmental organisations and a tax amnesty). In parallel, total expenditures increased by 6.9 percentage points of GDP between 2000 and 2006. Current primary expenditures increased by 6.0 percentage points of GDP, mainly due to increases of wages and salaries and social transfers. From 2005 onwards, the implementation of a ceiling on the nominal growth rates of current primary expenditures (containment of current transfers and subsidies in line with inflation and an increase in the retirement age of public sector employees) and capital expenditure helped curbing expenditure growth.

The cyclically-adjusted deficit increased from 3% of GDP in 2000 to just above 6% in 2003 but declined to 1.9% of GDP in 2005. One-off and other temporary measures amounted to 1.8% of GDP in 2003 and to about 1% both in 2004 and 2005. The structural deficit (i.e. the cyclically-adjusted deficit net of one-off and other temporary measures) rose from 3% of GDP in 2000 to around 8% of GDP in 2003, but declined to 2.8% of GDP in 2005, a reduction of some 5 percentage points. For 2006, the structural deficit is estimated to have declined further to around 1.2% of GDP.

During 2004-2006, fiscal consolidation gained momentum, taking advantage of the relatively strong economic growth (3.9% per year on average, although the output gap remained negative). The high tax content of growth, which has been almost fully based on domestic consumption and accompanied by sustained employment growth and a buoyant

[29] All documents related to the excessive deficit procedure for Cyprus can be found at: http://ec.europa.eu/economy_finance/about/activities/sgp/procedures_en.htm.

construction and real estate sector, has been helpful in this respect.

General government debt followed an upward trend until 2004, rising to 70.3% of GDP (from 58.8% of GDP in 2000). In 2005, the debt ratio fell to 69.2% of GDP and a further decrease to 65.3% of GDP was recorded in 2006. Cyprus' stock-flow adjustments (SFAs), of a debt-increasing nature, have been among the highest in the EU and the highest among the EU-10 Member States, averaging about 2.5% of GDP during 2000-2004. These SFAs were mainly associated with the accumulation of financial assets by the government in the form of deposits in sinking funds with the Central Bank.[30] Deposits in sinking funds, which have been used for the repayment of long-term loans, according to the most recent update of the convergence programme amounted to some 7% of GDP by the end of 2005. As of 2003, the policy of sinking funds was abolished[31] and their decumulation, which is planned to be completed by 2009, is projected to contribute by about 6 percentage points to a reduction in the gross debt-to-GDP ratio.

4.3. Medium-term prospects

The Budget for 2007 was approved by the Parliament on 21 December 2006. It targeted a general government deficit of 1.6% of GDP. The Commission services project an almost unchanged deficit (1.4% of GDP), despite the lower-than-anticipated outturn for the 2006 deficit, to account for the announcement of a package of social transfers amounting to almost ¼% of GDP. Compared to 2006, total revenues would increase by some ¼ percentage points of GDP, on the back of tax-rich buoyant GDP growth but without resorting to one-offs. The main measures are improved tax administration and collection by the Land and Survey Department, which, coupled with the buoyant activity of the construction sector, would increase the amount of collected taxes. Total expenditures would remain unchanged as a percentage of GDP, as savings from lower interest expenditure and from the implementation of ceilings on nominal growth of government final consumption are offset by an increase in social transfers. The main measures include the maintenance of a ceiling on the rate of growth of both current and capital expenditure, the continuation of the restrictive recruitment and wage policy in the general government sector, the limitation of the rate of growth of current transfers (pensions, monetary allowances and other benefits) to the rate of inflation, a more targeted social policy, and the reduction of net interest payments by running down the stock of debt using the sinking fund deposits.

Net of one-offs, the fiscal adjustment in 2007 would be marginal, which corresponds to a broadly neutral fiscal stance. This would reflect the deterioration of Cyprus' net position vis-à-vis the EU budget induced by the termination in 2006 of the provision of temporary compensating grants through the EU budget for the period 2004-2006. These temporary grants, associated with Cyprus' accession to the EU, are only partially compensated in the 2007 budget.

The December 2006 update of the Convergence Programme covers the period 2006 to 2010.[32] After the correction of the excessive deficit in 2005 and the abrogation of the excessive deficit procedure in July 2006, the programme aims at further consolidating public finances. The general government balance is projected to improve from a deficit of 1.9% of GDP in 2006 to a balanced position in 2010 entirely due to expenditure retrenchment. The revenue ratio is expected to remain constant over the programme period, without any reliance on one-offs. The medium-term objective (MTO) for the budgetary position is a deficit of 0.5% of GDP in structural terms, which the Convergence Programme aims to achieve by 2008.

According to the Commission services' Spring 2007 Forecast, the debt ratio would continue to decline in 2007, reaching 61.5% of GDP. The December 2006 Convergence Programme envisages the debt ratio to

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[30] According to the provisions of the Development Loans Law the Cypriot Government was obliged to contribute annually, for every government stock issued, to a so-called 'sinking fund' held in the national central bank. The purpose of these contributions was to accumulate by the maturity of every stock issued the amount that was to be repaid. The contributions to the sinking funds were financed by borrowing, thus leading to an increase of gross government debt. Repayments of debt using the sinking funds contribute to the reduction of gross government debt.

[31] The relevant Law was amended in July 2003 removing the obligation of the Government to contribute annually to sinking funds. Nonetheless, annual contributions continued to be made for government stocks issued prior to 2003.

[32] The successive updates of the Convergence Programme and the assessments by the Commission and Council of them can be found at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

decline more rapidly to 60.5% of GDP in 2007 and plummet further thereafter, to just above 46% of GDP by the end of the programme period.

The Council, in its Opinion of 27 February 2007 on the December 2006 update of the Convergence Programme of Cyprus, considered that after the correction of the excessive deficit in 2005, Cyprus was making good progress towards the MTO over the programme period, owing to expenditure restraint and in a context of strong growth prospects. The Council noted that, given that risks to the budgetary projections in the programme seemed broadly balanced, the budgetary strategy in the programme seemed sufficient to ensure that the MTO is achieved by 2008. The Council invited Cyprus to control public pension expenditure and implement further reforms in the areas of pensions and health care in order to improve the long-term sustainability of the public finances and to implement the fiscal consolidation path as foreseen in the programme.

Table 4.
Cyprus: Budgetary developments and projections
(as percentage of GDP unless otherwise indicated)

Outturn and forecast [1]	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**			
General government balance	-2.3	-2.2	-4.4	-6.3	-4.1	-2.3	-1.5	-1.4			
- Total revenues	34.7	35.9	35.9	38.8	38.8	41.2	42.4	42.6			
- Total expenditure	37.0	38.2	40.3	45.1	42.9	43.6	43.9	44.0			
Of which: - Interest expenditure	3.4	3.4	3.2	3.4	3.3	3.4	3.3	3.1			
- Current primary expenditure	28.6	30.0	31.9	35.9	33.6	34.7	34.6	34.9			
- Gross fixed capital formation	2.9	2.9	3.0	3.4	4.0	3.1	3.3	3.3			
Primary balance	1.0	1.1	-1.2	-2.9	-0.8	1.1	1.7	1.7			
p.m. Tax burden	30.0	30.9	31.2	33.1	33.5	35.6	37.0	37.6			
Cyclically-adjusted balance	-3.0	-3.3	-5.0	-6.1	-3.8	-1.9	-1.2	-1.1			
One-off and temporary measures	0.0	0.0	0.0	1.8	1.1	0.9	0.0	0.0			
Structural balance [2]	-3.0	-3.3	-5.0	-7.9	-4.8	-2.8	-1.2	-1.1			
Structural primary balance	0.3	0.1	-1.8	-4.5	-1.6	0.7	2.1	2.1			
Government gross debt	58.8	60.7	64.7	69.1	70.3	69.2	65.3	61.5			
p.m. Real GDP (% change)	5.0	4.0	2.0	1.8	4.2	3.9	3.8	3.8			
p.m. Output gap	2.1	2.9	1.4	-0.5	-0.7	-1.2	-1.0	-0.8			
p.m. GDP deflator (% change)	3.8	3.4	1.2	5.1	3.3	2.4	2.5	2.3			
Convergence programme						**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
General government balance						-2.3	-1.9	-1.6	-0.7	-0.4	-0.1
Primary balance						1.1	1.4	1.4	2.1	2.1	2.2
Structural balance [2] [3]						-3.3	-1.9	-1.2	-0.3	0	0.3
Government gross debt						69.2	64.7	60.5	52.5	49	46.1
p.m. Real GDP (% change)						3.9	3.7	3.9	4.1	4.1	4.1

[1] Commission services' Spring 2007 Forecast.
[2] Cyclically-adjusted balance excluding one-off and other temporary measures.
[3] Commission services' calculations on the basis of the information in the programme. One–off and other temporary measures according to the programme are 1.3% of GDP in 2005 and 0.4% of GDP in 2006, both deficit-reducing. These one-off measures include 0.4% of GDP in both years accounting for EU funds-related transactions, which the Commission services do not consider as one-off measures.

Sources: Eurostat, Commission services and December 2006 update of the convergence programme.

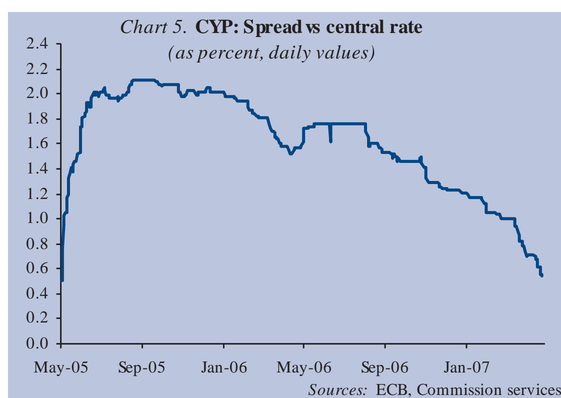
5. EXCHANGE RATE STABILITY

The Cyprus pound entered ERM II on 2 May 2005 at a central parity of 0.585274 pounds per euro (unchanged from the parity at which it had been linked unilaterally to the euro since 1999), with a standard fluctuation band of ±15 percent. By the time of the adoption of this report, it has spent 24 months in the mechanism.

Before ERM II entry, the Central Bank of Cyprus had been operating a system to contain fluctuations against the euro within a relatively narrow band of ±2¼ percent from the central rate. A wider ±15 percent official fluctuation band had been effective as of 2001, but the wider fluctuation margins were not used in practice. In the two years preceding ERM II entry, the Cyprus pound showed some short-term volatility against the euro, but deviations from the future central rate have been no more than around 2%. Immediately after entry into ERM II, the Cyprus pound appreciated to around two percent above the central parity. Subsequently, the currency has gradually weakened, to 0.5 percent above the central parity at the end of the reference period (26 April 2007). Within the ERM II period, the average spread to the central parity was 1.6 percent in the stronger half of the fluctuation band, with minimum and maximum deviations of 0.5 and 2.1% respectively.

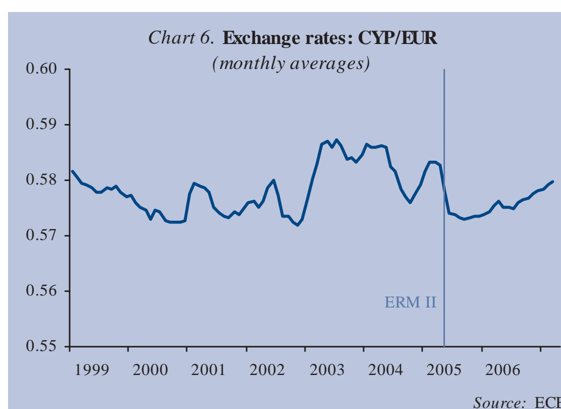
The development of additional indicators does not point to exchange rate pressures on the Cyprus pound. Due to the relatively thin foreign exchange market, on most business days, the central bank clears the market to smooth exchange rate fluctuations. The regular operations of the Central Bank of Cyprus in the exchange markets in the context of stabilising the exchange rate mainly reflect a response to foreign exchange flows. They also exhibit a marked seasonal pattern partly related to the time profile of activity in the tourism sector. Since 2005, the central bank has mainly been purchasing foreign currency in response to foreign inflows. This has led to an increase in foreign exchange reserves to about 29% of GDP by end-2006 from about 22% of GDP at end-2004.

Chart 5. **CYP: Spread vs central rate**
(as percent, daily values)



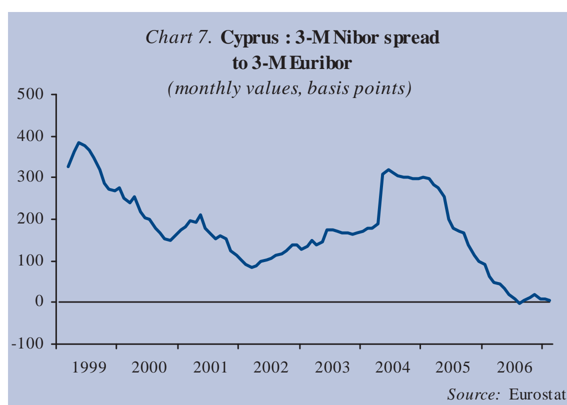
Sources: ECB, Commission services

Chart 6. **Exchange rates: CYP/EUR**
(monthly averages)



Source: ECB

Chart 7. **Cyprus : 3-M Nibor spread to 3-M Euribor**
(monthly values, basis points)



Source: Eurostat

The Central Bank of Cyprus has substantially cut official interest rates since ERM II entry, while preserving a stable exchange rate to the euro. The Central Bank of Cyprus lowered the official interest rate by 25 basis point in February 2005 and then by a total of 100 basis points in May and June 2005. The easing of policy interest rates reflects the relatively favourable development of underlying inflation and attempts not to encourage further capital inflows. The official interest rate was left unchanged during the first half of 2006, but was raised by 25 basis points in September 2006 in order to counteract inflationary pressures and strong credit growth.[33] The 2006 monetary tightening was however substantially smaller than the 100 basis points hike in euro area official interest rates in the course of 2006.

As a result, money markets interest spreads *vis-à-vis* the euro area have declined sharply after ERM II accession, reflecting the policy rate convergence as well as abundant liquidity due to significant capital inflows. Since August 2006, 3-month NIBOR money market spreads have almost vanished, although their interpretation is hindered by the fact that these are primary rates, due to illiquid secondary markets.

[33] In interpreting changes in policy interest rates, due account has to be taken of the change in operational framework on 1 September 2006. From that day onwards the Central Bank of Cyprus decided to use the bid rate on the main refinancing operations as the basis for the pricing of credit institution loans in Cyprus pounds, instead of the interest rate on the marginal lending facility (Lombard) that had been used previously. This was done to achieve gradual harmonisation with euro area practice, but did imply a substantial increase in the minimum bid rate of 125 basis points, whereas the rate actually used as a reference by the banking sector for granting loans was only raised by 25 basis points in the switch-over to the new system.

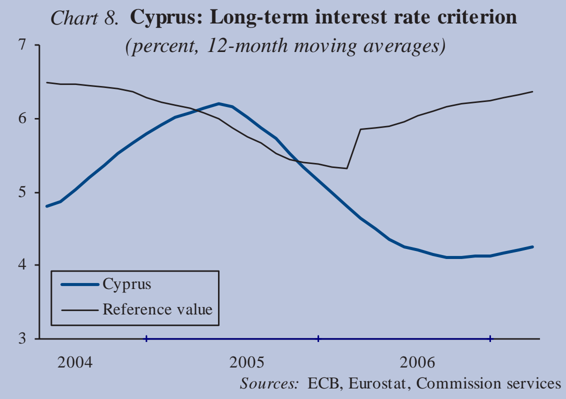
6. LONG TERM INTEREST RATES

Long-term interest rates in Cyprus used for the convergence examination reflect primary market yields on a benchmark government bond, due to a lack of a liquid secondary market for government bonds. Hence, short-term fluctuations in the spread mostly mirror the volatility of government bond yields in the euro area.

In March 2007 the reference value, calculated on the basis of long-term interest rates in Finland, Poland and Sweden, stood at 6.4%. For Cyprus, the 12-month moving average long-term interest rate relevant for the assessment has declined from a peak of slightly above 6% in mid-2005 to 4.2% in March 2007, 2.2 percentage points below the reference value.

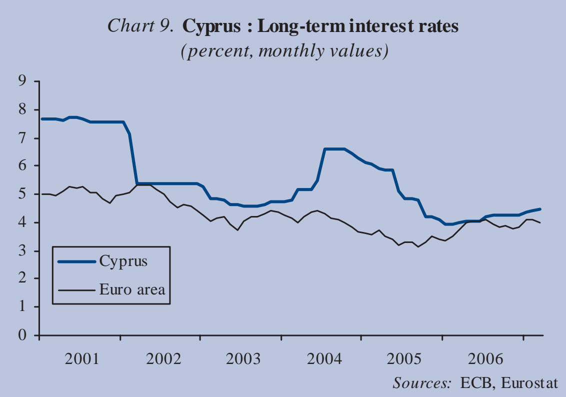
Long-term interest rates in Cyprus have decreased substantially in the past few years as have spreads to the euro area. Spreads decreased from around 230 basis points on long-term government bonds issued in April 2005, shortly before ERM II entry, to about 30 basis points at the most recent auction in early April 2007.[34] This trend is indicative of higher capital inflows upon ERM II entry, an improved fiscal situation, and increased confidence in the financial markets about the convergence process. The remaining positive differential at auctions is accounted for by the illiquidity of Cypriot government securities and by the residual currency risk premium incurred by foreign investors.

Chart 8. **Cyprus: Long-term interest rate criterion**
(percent, 12-month moving averages)



Sources: ECB, Eurostat, Commission services

Chart 9. **Cyprus : Long-term interest rates**
(percent, monthly values)



Sources: ECB, Eurostat

34 The temporary narrowing of the spreads in mid-2006 is due the fact that there was no Cypriot government auction between March and June 2006, a period during which the ECB raised interest rate.

7. ADDITIONAL FACTORS

7.1. Financial market integration[35]

Reflecting its history as a regional financial centre, the Cypriot financial system is substantially interlinked with the financial systems of the EU and other countries in terms of branches and subsidiaries of foreign banks operating from Cyprus. In the context of EU accession, Cyprus has progressively dismantled its off-shore centre and the former international banking units (IBUs) have been fully incorporated into the domestic banking system since 1 January 2006. Compliance with the *acquis communautaire* in the field of financial services was already broadly achieved on accession and the transposition process of legislation adopted under the Financial Services Action Plan is close to completion.[36]

The financial sector in Cyprus is well developed in relation to its stage of economic development.[37] The banking sector intermediates the largest share of funds, but other financial intermediaries are also established in the market. In terms of GDP, the value of outstanding bank credit exceeds the euro area average, while the importance of the Cypriot capital market for private sector funding remains limited despite a relatively high value of outstanding domestic fixed-income securities and stock market capitalisation compared to the EU10 average.

Banks predominate among financial intermediaries. Commercial banks account for the bulk of total bank lending, but co-operative credit and savings societies have also a significant market share, especially in rural areas. In 2005, Cypriot banks expanded their overseas operations, with a notable growth in deposits and loans particularly in Greece. There are 32 foreign-owned banking institutions operating in Cyprus, originating from 11 different countries.[38] Despite the latest developments, foreign ownership remains low relative to elsewhere in the EU10, while the degree of market concentration in terms of a CR5 ratio[39] of 59 per cent is not unusual for a relatively small market and broadly in line with the EU10 average. Other intermediaries are of limited importance in the sector, with the pensions mainly provided via public funding.

Private sector credit has expanded at an annual rate of about 10% in recent years, with credit growth accelerating to 19% in the course of 2006. This can mainly be related to an expansion of personal and professional loans by over 25%, as well as loans to the building and construction sector, which account for a share of 50 and 20% of outstanding loans, respectively. The share of foreign currency loans in outstanding claims on the private sector from domestic banks is still comparatively moderate, but continued to increase to 17% in December 2006. While euro-denominated loans accounted for 55% of outstanding foreign currency in December 2006, the share of Swiss franc loans expanded to 37%.

The Cypriot capital market remains comparatively small. While the stock market capitalisation in terms of GDP has more than doubled over 2006, this reflects in fact only the rally of shares prices of two major banks. Fixed-income securities, which have been mainly issued by the central government, are almost exclusively long-term and denominated in euro. The limited private-sector issuance originates mainly from the financial sector.

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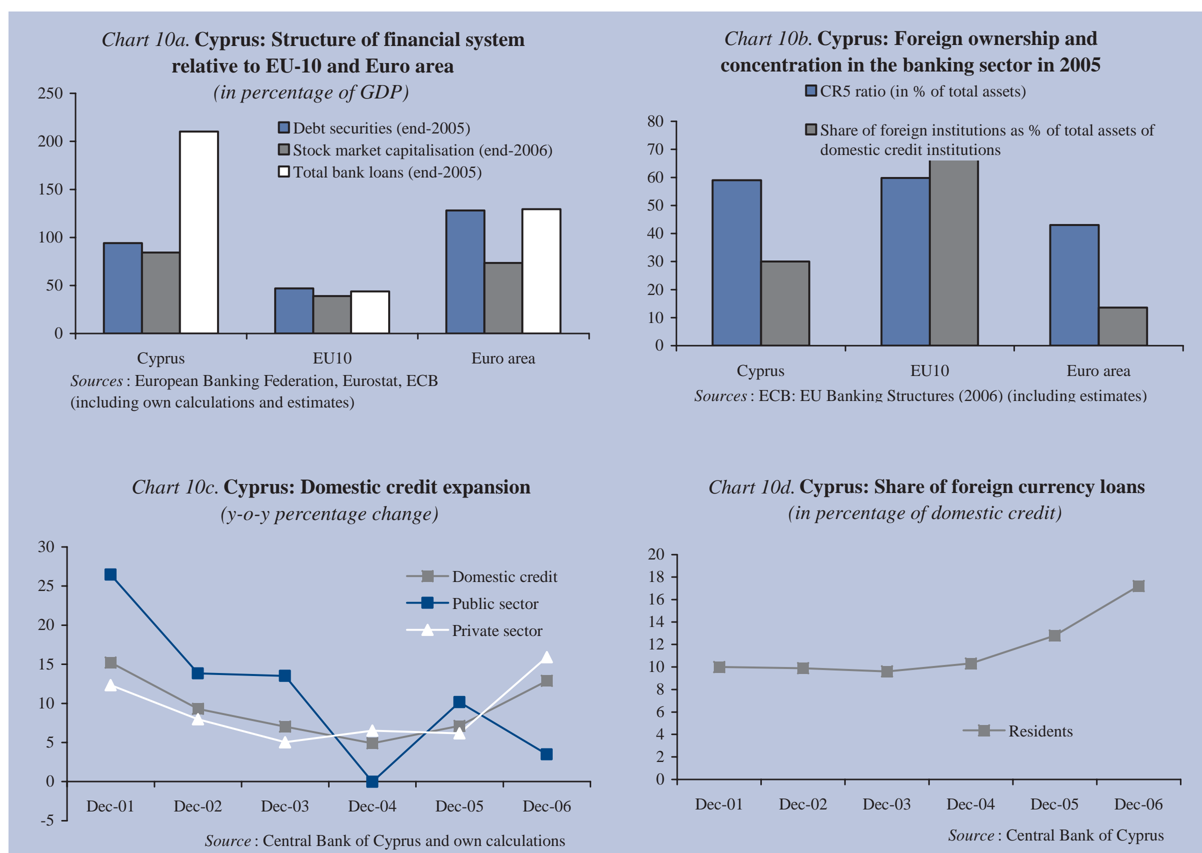
35 This section draws mainly on information provided in recent publications of the Central Bank of Cyprus and the Cyprus Stock Exchange as well as a number of recent cross-country studies published by the ECB, IMF, World Bank, OeNB, RZB Group and independent researchers.

36 See: Transposition of FSAP Directives - State of play as of 15/01/2007. http://ec.europa.eu/internal_market/finances/docs/actionplan/index/070124_annex_b_en.pdf

37 Cyprus' GDP per capita level (PPS) stood at 83% of the EU-25 average, which is the highest level among the New Member States before Slovenia (80), the Czech Republic (73) and Malta (69).

38 Austria, Bulgaria, France, Greece, United Kingdom, Jordan, Ireland, Lebanon, Ukraine, Russia and Tanzania.

39 The CR5 concentration ratio is defined as the aggregated market share of five banks with the largest market share.



The importance of adequate supervisory structures is heightened by Cyprus' importance as a regional financial centre, the integration of the former international banking units in the domestic banking sector and increased competitive pressure after joining the EU. Supervisory duties remain split between a number of bodies. However, the central bank (entrusted with the supervision of commercial banks), the Securities and Exchange Commission and the Insurance Companies' Control Service signed a Memorandum of Understanding on cross-sector supervisory co-operation and coordination in 2003. Moreover, the central bank has continued to establish and promote bilateral ties with overseas supervisory authorities.

7.2. Product market integration

Cyprus is a small open economy highly integrated in terms of trade and FDI with the EU25 and the euro-area. This reinforces competition pressures on product markets and therefore promotes efficiency. However, the small size of the economy hampers the scope for the diversification of production activities and leads to a high degree of trade specialisation, which increases its exposure to asymmetric shocks determined by the evolution of international markets. The ongoing transition towards a more diversified and innovation-driven economy is important to increase the resilience of the economy to the inevitable competition pressure from lower-cost economies.

The ratio of trade openness is well above the EU25 average revealing a high degree of trade integration. However, trade openness is below the average for the small EU Member States, which suggests that there is still scope for further integration. Increasingly, the EU25 reinforces its position as the main trading partner and the importance of trade with extra-EU Member States decreases. In 2005 the share of extra-EU trade in total trade was around 35%, which was similar to that observed in the EU25. Moreover, trade integration with the euro-area is particularly well advanced. In 2005, 70% of the total trade of Cyprus with the EU25 was with euro-area partners.

International trade is highly specialised. In 2005, the share of intra-industry trade in total manufacturing

trade with the EU25 was the lowest among the EU25 Member States. The importance of services, primarily tourism, business and financial services which exploit the country's abundant endowments of skilled labour and good infrastructure as well as its geographic location is another outstanding feature of Cyprus' external trade. In 2005, services contributed to around 55% of total trade flows in contrast with the EU25 where services accounted for 22% of total trade. Moreover, services also dominate trade flows with the rest of the EU and the surplus of the balance of trade in services partly compensates the deficit in goods with the EU25. In manufacturing, with the exception of pharmaceuticals, Cyprus' revealed comparative advantage is concentrated in low and medium-low tech sectors namely food, drink and tobacco, non-metallic mineral products and clothing.[40]

The process of integration with the EU is also fuelled by important inflows of FDI from the EU25, while FDI outflows remain very limited. In 2004 the stock of inward FDI represented around 50% of GDP, which is similar to the EU25 average. The EU25 Member States are the main investors accounting for around 51% of all inward FDI stock (34% of total inward stock comes from the euro-area). The foreign capital is overwhelmingly concentrated in tradable services, particularly financial services but also increasingly in other business services like accounting, legal and consulting as well as computer activities.

As a result of the ongoing integration with the rest of the EU, price convergence to the EU average level is well advanced. Aggregate price levels for goods and services are now just slightly below the EU25 average. However, price convergence is less advanced for services where important gaps vis-à-vis the EU25 average price level persist, notably in communication services, for which in 2005 prices were around 43% of the EU25 average level.[41]

The still relatively important specialisation of manufacturing trade in low and medium technology sectors reflects the low level of technological sophistication of the economy. The improvements in the functioning of product and labour markets and the initiatives to develop a comprehensive research and innovation system play an important role in facilitating the restructuring of production towards more innovation-driven manufacturing and services activities which would prevent competitiveness strains as income catches up with EU average levels.

While structural factors, like the importance of services such as tourism and business services partly explains the low investment in R&D, there are signs that the economy is catching-up with the EU average in terms of innovation performance.[42] According to recent survey evidence, 46% of firms declare innovation activity (against 42% for the EU27). ICT diffusion, namely broadband penetration, which is particularly important to increase tradability in services, remains one of the lowest in the EU25.[43]

The business environment is generally favourable and recently efforts were stepped up to speed up and simplify the administrative procedures to start up companies. Dynamism in the business sector is also ensured by effective competition pressure in much of the economy. There are however exceptions, notably in the professional services sectors where restrictions such as pricing regulation and prohibition of advertising remain in place. Furthermore, while in sectors like electricity and telecommunications barriers to market access have been removed, competition remains limited and the market is still dominated by incumbents.

The improvement of the business environment and the innovation capacity of the economy should also contribute to attract more FDI, which could play a greater role in the future as a channel for technology, organisational- and managerial-skill transfer. The ongoing investment effort to upgrade basic transport and interconnection infrastructure with the rest of the EU economy is important in order to improve accessibility from abroad, thus promoting trade and investment links with the rest of the EU. The ongoing process of integration is also facilitated by the swift transposition of the EU directives that contributes to the smooth functioning of the Internal Market. According to the December 2006 Internal Market Scoreboard n° 15bis[44], in 2006 Cyprus managed to further reduce the deficit in the transposition of Internal Market directives, which is now at 0.8% compared to the EU25 average of 1.2%.

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40 See: *EU Industry Structure*, DG ENTR, forthcoming.

41 See: "Comparative Price Levels for Selected Consumer Services in Europe for 2005", *Statistics in Focus* no.12/2006, Eurostat.

42 See: *2006 European Innovation Scoreboard.*

43 See: *Fourth Community Innovation Survey.*

44 http://ec.europa.eu/internal_market/score/index_en.htm

Table 5.
Cyprus: Product market integration

	Cyprus						EU25					
	2001	2002	2003	2004	2005	2006	2001	2002	2003	2004	2005	2006
Trade openness [1] (%)	-	49.0	45.5	48.6	50.1	-	-	-	35.4	36.7	38.3	-
Extra-EU trade in goods GDP ratio [2] (%)	8.3	8.4	6.9	6.6	7.1	7.4	9.9	9.4	9.1	9.6	10.4	11.1
Intra-EU trade in goods GDP ratio [3] (%)	11.3	11.1	10.1	13.8	15.8	15.2	19.0	18.5	18.4	19.0	19.6	21.0
Intra-EU trade in services GDP ratio [4] (%)	-	14.1	15.5	16.6	17.0	-	-	-	4.6	4.7	4.9	-
Intra-EU trade balance in goods [5]	-1.9	-2.0	-1.9	-2.5	-2.6	-3.0	89.4	96.2	90.7	77.9	72.6	81.4
Intra-EU trade balance in services [6]	-	1.4	1.5	1.7	1.8	-	-	-	1.9	17.0	15.9	-
Intra-EU trade balance GDP ratio [7] (%)	-	-5.4	-3.0	-6.7	-5.8	-	-	-	0.9	0.9	0.8	-
Total FDI inflows GDP ratio [8] (%)	9.8	10.1	6.7	6.9	7.2	-	5.8	5.0	3.6	2.2	4.6	-
Intra-EU FDI inflows GDP ratio [9] (%)	4.3	4.1	5.0	4.8	4.2	-	4.3	3.7	2.3	1.6	3.7	-
FDI intensity [10]	3.2	4.0	4.0	3.8	2.8	-	3.9	3.7	2.5	1.9	3.8	-
Internal Market Directives [11]	-	-	-	4.4	1.1	0.8	-	-	-	3.6	1.6	1.2
Price levels [12]	91.9	90.9	90.4	89.8	90.2	-	100	100	100	100	100	100

1) (Imports + Exports of goods and services/2xGDP at current prices)*100. (Foreign trade statistics/ Balance of payments).
2) (Extra-EU Imports+Exports/2xGDP at current prices)*100. (Foreign trade statistics).
3) (Intra-EU Imports+Exports/2xGDP at current prices)*100. (Foreign trade statistics).
4) Intra-EU25 trade in services (average credit and debit in % of GDP at current prices). (Balance of payments).
5) Difference between export and imports of goods (credit minus debit) in bn euros. (Foreign trade statistics).
6) Difference between export and imports of services (credit minus debit) in bn euros. (Balance of payments).
7) Difference between export and imports of goods and services as a % of GDP. (Foreign trade statistics/ Balance of payments).
8) Total FDI inflows as a % of GDP (at current prices).
9) Intra-EU total FDI inflows as a % of GDP (at current prices).
10) Average value of Intra-EU25 inward and outward FDI flows, divided by GDP and multiplied by 100.
11) Percentage of Internal Market directives not yet communicated as having been transposed in relation to the total number.
12) Comparative price levels of final consumption by private households including direct taxes (EU25=100). Provisional data for 2004 and 2005.

Sources: Eurostat, Commission services.

7.3. Development of the balance of payments

Cyprus's current account balance has been persistently negative over the last ten years, averaging about -3.5% of GDP. The current account deficit has widened from 2.3% of GDP in 2003 to 5.9 of GDP in 2006 (from 1.9 to 5.9% of GDP taking the combined current and capital account).

The development of the Cypriot balance of payments shows large disparities in net trade in goods and services. The persistently very high deficit in goods trade notably reflects the relatively weak competitive position of goods producing industries, with a high concentration in low technology sectors which have suffered from increased competition from lower-wage exporters and the shift of the Cypriot economy towards the tertiary sector. Buoyant domestic demand also contributed to the widening of the merchandise trade deficit, notably in 2004. In 2005 and 2006, the trade balance was also significantly affected by soaring oil prices. In 2006, the effect of higher oil prices on import growth was compounded by lower-than-expected export growth, largely reflecting subdued re-export activity following its sharp expansion in 2005.

The negative trade balance in goods is only partly compensated for by substantial surplus on services trade, which mirrors the competitive advantages Cyprus has in services sectors such as tourism, financial services and business services (where the export shipping services has been growing very rapidly). The services trade surplus has little changed in 2004-06, as a sluggish tourism sector was offset by some improvement in the non-tourism services balance. The balance of income registered a deficit of 2.8% of GDP in 2006. However, about three quarter of the net income outflows are reinvested earnings of foreign firms based in Cyprus, which are treated as FDI inflows in the financial account. The relatively small net transfers inflows have been boosted by EU transfers connected to accession.

The worsening of the current account deficit in the last three years is essentially private sector-driven. It mainly reflects an increase in private investment together with a sharp reduction in private savings rate, the latter being partially offset by the reduction of

government deficit following fiscal consolidation efforts.

A substantial part of the current account balance is covered by net FDI inflows. Net FDI inflows covered more than 100% of the current account deficit between 1995 and 2003, about half of the deficit in 2004 and about three-quarters in 2005 and 2006. More than half of net FDI inflows are reinvested earnings. Real estate and trade are the two largest FDI items and have attracted the majority of foreign investment in recent years. In 2004, substantial net portfolio investments (essentially bonds and money market instruments issued by banks and by the government) provided additional financing. Net other inflows were also sizeable in 2005 and 2006, essentially reflecting the growth in non-residents deposits held in the Cypriot financial sector. As a result of large capital inflows, the net reserve position has markedly increased since 2004.

Looking forward, exploiting comparative advantages in traded goods and especially traded services is important to maintain a sustainable current account balance in the medium term. In addition, for exporting industries limiting increases in prices and wage costs *vis-à-vis* competitors is important to safeguard external competitiveness. On the financial account side, ensuring a positive investment climate is vital to underpin FDI inflows.

Table 6.
Cyprus: Balance of payments
(percentage of GDP)

	2001	2002	2003	2004	2005	2006
Current account	-3.3	-3.7	-2.3	-5.0	-5.6	-5.9
Of which: Balance of trade in goods	-26.6	-27.3	-23.9	-25.6	-25.0	-27.5
Balance of trade in services	28.2	26.2	23.4	22.9	22.4	23.4
Income balance	-5.4	-3.7	-2.8	-3.3	-3.5	-2.8
Balance of current transfers	0.6	1.1	1.1	1.1	0.5	1.1
Financial and capital accounts	3.7	4.4	2.1	4.1	5.0	6.7
Of which: Net FDI	7.2	5.1	2.4	2.5	4.3	4.2
Net portfolio inflows	2.8	-5.1	1.9	7.2	-0.9	-3.3
Net other inflows (1)	-0.1	8.5	-4.2	-3.7	5.3	11.2
Net capital account	0.1	0.2	0.4	0.6	0.5	0.0
Change in reserves (+ is a decrease)	-6.3	-4.3	1.6	-2.4	-4.3	-5.5
Errors and omissions	-0.4	-0.7	0.2	0.9	0.6	-0.7
Gross capital formation	16.4	18.8	17.4	20.2	19.4	19.6
Gross saving	13.2	15.1	15.2	15.2	13.8	13.7

(1) Including financial derivatives

Sources: Eurostat and Commission services.

II. Convergence Report 2007 on Malta*

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

* This report was formally adopted by the College of Commissioners on 16 May 2007 (COM(2007) 258 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 by the Member States in fulfilling their obligations regarding the achievement of economic and monetary union.

This report has been prepared in response to the request submitted by Malta on 27 February 2007. A more detailed assessment of the state of convergence in Malta is provided in a technical annex to this report (SEC(2007) 622).

The content of the reports prepared by the Commission and the ECB is governed by Article 121(1) of the Treaty. This Article requires the reports to 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 (ESCB Statute). The reports must also examine whether a high degree of sustainable convergence has been achieved 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 by taking 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).

The examination of the compatibility of national legislation, including the statutes of the national central banks, with Articles 108 and 109 of the Treaty and the ESCB Statute requires an assessment of compliance with the prohibition of monetary financing (Article 101 EC) and the prohibition of privileged access (Article 102 EC); consistency with the ESCB's objectives (Article 105(1) EC); central bank independence (Article 108 EC); and integration of national central banks into the ESCB (several EC Treaty and ESCB Statute articles).

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”. The requirement of sustainability implies that the satisfactory inflation performance must essentially be attributable to the behaviour of input costs and other factors influencing price developments in a structural manner, rather than the influence of temporary factors. Therefore, the convergence examination includes an assessment of the factors underlying inflation and of medium-term prospects. It also assesses whether the country is likely to meet the reference value in the months ahead.[45]

The inflation reference value was calculated to be 3.0% in March 2007[46], with Finland, Poland and Sweden as the three best-performing Member States.

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[45] The forecast of the reference value is subject to significant uncertainties given that it is calculated on the basis of the inflation forecasts for the three Member States projected to have the lowest inflation in the forecast period, thereby increasing the possible margin of error.

[46] The cut-off date for the data used in this report is 26 April 2007.

The Treaty refers to the ***exchange rate criterion*** in the third indent of Article 121 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".

The relevant two-year period for assessing exchange rate stability in this report is 27 April 2005 to 26 April 2007.

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 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".

The interest rate reference value was calculated to be 6.4% in March 2007.

Article 121 of the Treaty also requires an examination of other factors relevant to economic integration and convergence. These additional factors include financial and product market integration, the development of the balance of payments on current account and the development of unit labour costs and other price indices. The latter are covered within the assessment of price stability.

In the December 2006 Convergence Report, the Commission assessment was that Malta fulfilled one of the convergence criteria (on long-term interest rates). Pending the adoption of the draft law amending the Central Bank of Malta Act, legislation in Malta was considered not fully compatible with Article 109 of the Treaty and the ESCB Statute as regards central bank integration into the ESCB at the time of the adoption of the euro.

2. Legal compatibility

All outstanding incompatibilities have been addressed in an Act amending the Central Bank of Malta Act that was adopted by Parliament on 28 February 2007 and should enter into force on the date of the introduction of the euro in Malta. In particular, the Act has repealed or amended a series of articles so as to take account of the respective roles and competences assigned by the EC Treaty to the ECB, ESCB and EC Council. This concerns notably provisions on the monetary functions, operations and instruments of the ESCB, on the holding and managing of foreign reserves and on the right to authorise the issue of banknotes and the volume of coins.

Legislation in Malta, in particular the Central Bank of Malta Act, is compatible with the requirements of the EC Treaty and the ESCB Statute.

3. Price stability

Evolution of the reference value

12-month average inflation in Malta has been at or below the reference value since July 2005 except for the period May – October 2006. The average inflation rate in Malta during the 12 months to March 2007 was 2.2%, below the reference value of 3.0%, and is likely to remain below the reference value in the months ahead.[47]

Underlying factors and sustainability

HICP inflation in Malta has fluctuated around 2.5% over recent years. There has been some volatility, primarily due to the fact that Malta is a small and open economy vulnerable to external shocks (particularly in food and energy prices), and to changes in indirect taxes. Inflation picked up considerably in autumn 2005, mainly reflecting a sharp rise in regulated prices for energy and related products in response to higher oil prices. When the impact of the energy price shock ebbed away, inflation dropped markedly at the end of 2006 to below 1%. In addition to the significant base effects in energy inflation, the decline reflected a drop in prices of clothing and footwear and air transport.

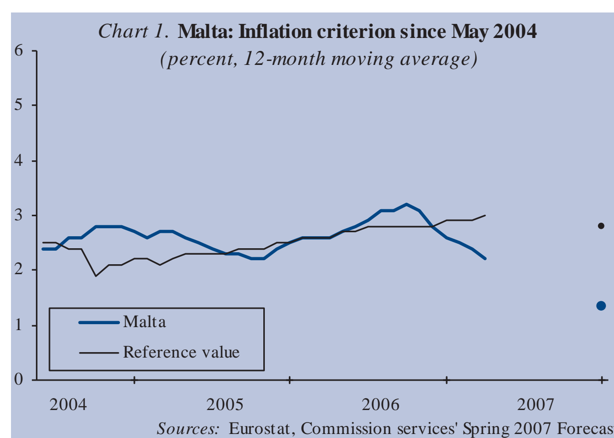


Chart 1. **Malta: Inflation criterion since May 2004**
(percent, 12-month moving average)
Sources: Eurostat, Commission services' Spring 2007 Forecast

HICP inflation excluding energy and unprocessed food declined to 1.6% in 2006, from 2% in 2005. Moderate core inflation suggests that underlying inflationary pressures have remained limited, against the background of a negative output gap and low wage pressures. Unit labour costs have been decreasing since 2005, reflecting strong wage discipline both in the private and public sector. There have been no signs of second-round effects from energy prices so far,

[47] According to the Commission Spring 2007 Forecast, 12-month average inflation in Malta will decrease to 1.4% in December 2007, while the reference value is forecast to stand at 2.8%.

suggesting that inflationary expectations remain well-anchored. The effective exchange rate broadly stabilised in 2005 and 2006, thus remaining roughly neutral with regard to import prices

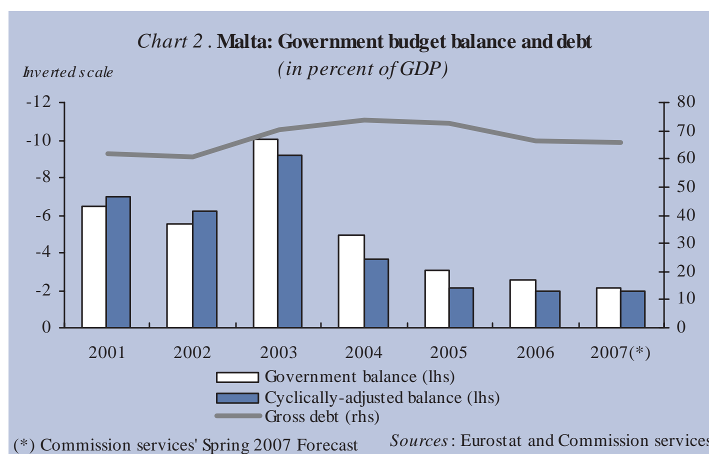
Looking ahead, headline inflation is expected to remain on a moderate path in the medium term, although it is projected to increase somewhat from the current low levels as favourable base effects in energy prices subside. Risks to the outlook appear broadly balanced. The main risks are related to oil prices and are two-sided. Otherdownward risks include the on-going liberalisation of the energy sector in Malta and the other structural reforms improving functioning of product markets. Upward risks could stem from the tightening of the labour market as cyclical conditions improve.

Malta fulfils the criterion on price stability.

4. Government budgetary position

Malta is at present the subject of a Council Decision on the existence of an excessive deficit (Council Decision of 5 July 2004).[48]

Malta's general government deficit was relatively high at the beginning of the 2000s, reaching a high of around 10% of GDP in 2003 (mainly due to a significant one-off operation). Since then, the budget deficit has considerably decreased in the context of the government's fiscal consolidation programme. The deficit-to-GDP ratio reached 2.6% in 2006 and according to the Commission services' Spring 2007 Forecast will amount to 2.1% of GDP in 2007. The revenue ratio has followed an upward trend, whilst expenditure as a share of GDP increased until 2003 but decreased thereafter.



General government debt increased significantly in the first half of the decade, peaking at around 74% in 2004. However, starting from 2005 the debt ratio followed a downward path reaching around 66.5% of GDP in 2006. The Commission services' spring 2007 forecast projects a general government debt of 65.9% of GDP for 2007.

In its Opinion of 27 February 2007 on the December 2006 update of the Convergence Programme, the Council noted that the debt ratio appeared to be diminishing at a satisfactory pace towards the 60% of GDP reference value and that the programme was consistent with a correction of the excessive deficit by 2006. At the same time, the Council noted that there were risks to the budgetary projections in the programme, especially with regard to the assumed favourable macroeconomic assumptions in 2008 and 2009. The Council invited Malta to

[48] 2005/186/EC, OJ L 62, 9.3.2005, p.21.

pursue the planned progress towards the MTO, ensure that the debt-to-GDP ratio was reduced accordingly and to make further progress in the design and implementation of the healthcare reform in order to improve the long-term sustainability of public finances.

In view of these developments and the Commission services' Spring 2007 Forecast, the Commission considers that the excessive deficit has been corrected with a credible and sustainable reduction of the budget deficit below 3% of GDP and the debt-to-GDP ratio diminishing towards the reference value of 60%. The Commission is therefore recommending that the Council abrogate the decision on the existence of an excessive deficit for Malta (SEC(2007) 621). If the Council decides to abrogate the excessive deficit procedure for Malta, Malta will fulfil the criterion on the government budgetary position.

5. Exchange rate stability

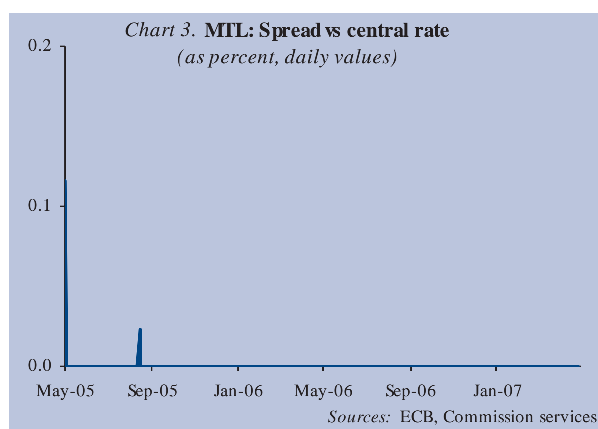


Chart 3. **MTL: Spread vs central rate**
(as percent, daily values)
Sources: ECB, Commission services

The Maltese lira has participated in ERM II since 2 May 2005, i.e. for 24 months at the time of adoption of this report. Before entering ERM II, the lira was pegged to a euro-dollar-sterling basket. During the period of the assessment not covered by ERM II participation (27 April – 1 May 2005), the lira stayed close to the future central rate. Upon ERM II entry, the Maltese authorities unilaterally committed to maintain the lira at the central rate. During ERM II participation, the lira has remained stable vis-à-vis the central rate and has not experienced severe tensions. Additional indicators, such as developments in short-term interest rates and foreign exchange reserves, do not point to pressures on the exchange rate.

Malta fulfils the exchange rate criterion.

6. Long-term interest rates

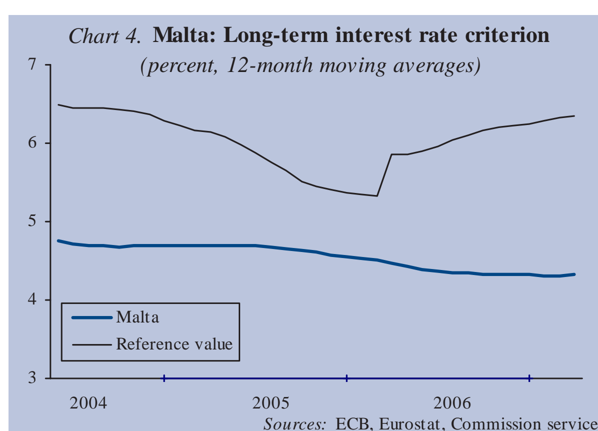


Chart 4. **Malta: Long-term interest rate criterion**
(percent, 12-month moving averages)
Sources: ECB, Eurostat, Commission services

The average long-term interest rate in Malta in the year to March 2007 was 4.3%, below the reference value of 6.4%. Average long-term interest rates in Malta have been below the reference value since EU accession. Long-term yield spreads vis-à-vis the euro area have fluctuated at relatively moderate levels over the past years, hovering around 30 basis points in the first quarter of 2007. Contained yield spreads

indicate that the residual country risk priced in by markets is limited.

Malta fulfils the criterion on the convergence of long-term interest rates.

7. Additional factors

Additional factors have also been examined, including product and financial market integration and balance of payments developments. The Maltese economy is highly integrated with the EU. In particular, trade and FDI relations with other Member States are extensive and Malta’s financial system is substantially inter-linked with the financial systems of other countries, both in and outside the EU, via the establishment of financial intermediaries and the provision of cross-border services. Malta's current account balance has been rather volatile over the past years, reflecting the small size and narrow sectoral base of the economy. The external position shows large disparities in net trade in goods and services, with a high deficit in goods trade being partly compensated for by a substantial services surplus. The current account deficit has increased significantly in recent years, reaching a level of 8.2% of GDP in 2005. This increase reflected difficult market conditions in the dominant electronics and tourism sectors and, in 2005, a strong increase in the oil bill. In 2006, the current account deficit fell to 6.3% of GDP on account of a significant increase in current transfers due to increased receipts from the booming online services industry. The deficit in the combined current and capital account decreased from around 4.9% of GDP in 2004-2005 to 3.2% of GDP in 2006. On the financing side, net FDI inflows have largely covered the current account deficits.

* * *

In the light of its assessment on the fulfilment of the convergence criteria and assuming that the Council will follow the Commission's recommendation for the abrogation of the excessive deficit, the Commission considers that Malta has achieved a high degree of sustainable convergence.

Convergence Report 2007 on Malta – Technical Annex

Acknowledgements

The Convergence Report and its Technical Annex were prepared in the Directorate-General for Economic and Financial Affairs. The main contributors were Pavlína Žáková and Paul Kutos.

Other contributors to the paper were Sean Berrigan, Ivan Ebejer, Christine Gerstberger, Fabienne Ilzkovitz, Baudouin Lamine, Claudia Lindemann, Lucio R. Pench, Nuno Sousa, Andreas Trokkos, Charlotte Van Hooydonk and Johan Verhaeven.

Statistical assistance was provided by André Verbanck and Gerda Symens.

The paper was coordinated by Massimo Suardi, 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 by eleven Member States, following several years of successful adjustment efforts to achieve a high degree of sustainable convergence. The decision[49] 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[50] and the European Monetary Institute (EMI), respectively.[51] 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). 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: 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[52] 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[53] 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[54] and the ECB[55], which covered both Greece and Sweden.

[49] OJ L 139, 11.5.1998, pp. 30-35.

[50] 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.

[51] European Monetary Institute, Convergence Report, March 1998.

[52] 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.

[53] OJ L 167, 7.7.2000, pp. 19-21.

[54] European Commission, Convergence Report 2000, COM(2000) 277 final, 3 May 2000.

[55] 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".[56]

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 eleven assessed countries was considered to have fulfilled the necessary conditions for the adoption of the single currency.[57]

In 2006, two convergence assessments have been carried out. In May, the Commission and the ECB presented reports on Lithuania and Slovenia, prepared at the request of the national authorities.[58] While Slovenia was deemed to fulfil all the convergence criteria and to be ready to adopt the euro in January 2007, the report on Lithuania suggested that there should be no change in the status of Lithuania as a Member State with the derogation. The remaining nine Member States with a derogation were assessed in regular Convergence Reports issued in December 2006.[59] None of the countries assessed was deemed to meet the necessary conditions for adopting the single currency.

On 27 February 2007, Malta submitted a request for a convergence assessment. As a response to this request, the Commission and the ECB prepared Convergence Reports for Malta.

This Commission services working paper is a technical annex to the Convergence Report on Malta and includes a detailed assessment of the progress with convergence. The remainder of the first chapter presents the methodology used for application of the assessment criteria. Chapters 2 to 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 the convergence report and in this technical annex is 26 April 2007.

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 2). The four convergence criteria have been developed further in a Protocol annexed to the Treaty (Protocol No 21 on the convergence criteria).

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

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

[58] European Commission, Convergence Report 2006 on Lithuania, COM(2006) 223 final, 16 May 2006; European Commission, Convergence Report 2006 on Slovenia, COM(2006) 224 final, 16 May 2006; and European Central Bank, Convergence Report May 2006, May 2006. On the basis of the reports, the Ecofin Council adopted on 11 July 2006 the Decision that Slovenia fulfilled the necessary conditions for adoption of the single currency (OJ L 195, 15.7.2006, pp 25-27).

[59] European Commission, Convergence Report December 2006, COM(2006) 762 final, 6 December 2006; and European Central Bank, Convergence Report December 2006, December 2006.

Box 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[60] 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[61] 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 (Box 3).

Over the 12 month period covering April 2006-March 2007, the three best-performing Member States in terms of price stability were Finland, (1.3%), Poland (1.5%) and Sweden (1.6%) yielding a reference value of 3.0%.

The Protocol on the convergence criteria not only requires Member States to have achieved a high degree of price stability but also calls for a price performance that is sustainable. The requirement of *sustainability* aims at ensuring that the degree of price stability and inflation convergence achieved in previous years will be maintained after adoption of the euro. This implies that the satisfactory inflation performance must essentially be due to the adequate behaviour of input costs and other factors influencing price developments in a structural manner, rather than reflecting the influence of temporary factors. Therefore, this technical annex examines also developments in unit labour costs as a result of trends in labour productivity and nominal compensation per head, and developments in import prices to assess whether and how external price developments have impacted on domestic inflation. From a forward-looking perspective, the report includes an assessment of medium-term prospects for inflation. The analysis of factors that have an impact on the inflation outlook, such as credit developments and cyclical conditions, is complemented by a reference to the most recent Commission forecast of inflation. That forecast can subsequently be used to assess whether the country is likely to meet the reference value also in the months ahead. [62]

[60] 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).

[61] 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.

[62] According to the Commission Spring 2007 Forecast, the reference value is forecast to stand at 2.8% in December 2007. The forecast of the reference value is subject to significant uncertainties given that it is calculated on the basis of the inflation forecasts for the three Member States projected to have the lowest inflation in the forecast period, thereby increasing the possible margin of error.

Box 3: Assessment of price stability and the reference value

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

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

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

The ***reference value*** is calculated as the unweighted average of the average rates of inflation of, at most, the three best-performing Member States in terms of price stability plus 1.5 percentage points. The outcome is rounded to one decimal. While in principle the reference value could also be calculated on the basis of the price performance of only one or two best performing Member States in terms of price stability, it has been existing practice to select the three best performers.

The reference value has been defined in the Maastricht Treaty in a relative way. An absolute reference value could, depending on the overall economic circumstances at the time of the assessment, be considered to be unduly harsh or too loose. Alternatively, using the average of the inflation rates of all Member States as a basis for the reference value would imply that high inflation rates of a few countries could increase the average to undesired levels. These problems are avoided in the Treaty by requiring convergence towards the best performing Member States within a margin of 1.5 percentage points. As the reference value is a relative concept based on the Member States with the lowest rate of inflation, a margin of 1.5 percentage points is added.

Article 121(1) of the Treaty refers to 'Member States' and does not make a distinction between euro area and other Member States. The Convergence Reports therefore select the three best performers from all Member States – EU15 for the Convergence Reports before 2004 and EU25 for the reports as of 2004.

As a principle, and in line with what was intended by the authors of the Maastricht Treaty, the Commission and ECB reports select as best performers in terms of price stability those Member States which have the lowest average rate of inflation. In the 2004 report, the Commission decided to exclude countries in deflation from the calculation of the reference value because these countries could not be considered to be 'best performers' in terms of price stability – as suggested by the Treaty Protocol, which refers only to an average rate of inflation.

Table 1 lists the reference value as used in the Convergence Reports issued since 1998.

Table 1.

Inflation reference value in previous and current Convergence Reports [1)]

Convergence Report adoption date	Cut-off month	Three best performers [2)]	Reference value	Euro area average inflation rate [2)]
1998	January 1998	Austria, France, Ireland	2.7	1.5
2000	March 2000	Sweden, France, Austria	2.4	1.4
2002	April 2002	United Kingdom, Germany, France	3.3	2.4
2004	August 2004	Finland, Denmark, Sweden	2.4	2.1
2006 May	March 2006	Sweden, Finland, Poland	2.6	2.3
2006 December	October 2006	Poland, Finland, Sweden	2.8	2.2
2007	March 2007	Finland, Poland, Sweden	3.0	2.1

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

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. 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 (for further information on this procedure, see Box 4).[63]

[63] 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.

Box 4: The excessive deficit procedure [64]

The excessive deficit procedure (EDP) is specified in Article 104 of the Treaty, the associated Protocol on the EDP and Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the EDP[65], which is the "dissuasive arm" of the Stability and Growth Pact (SGP). Together, they determine the steps to be followed to reach a Council decision on the existence of an excessive deficit, which forms the basis for the assessment of compliance with the convergence criterion on the government budgetary position, and the steps to be followed to correct a situation of excessive deficit. According to Article 104(2), compliance with budgetary discipline is to be examined by the Commission on the basis of the following two criteria:

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

— *either the ratio has declined substantially and continuously and reached a level that comes close to the reference value;*

— *or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;*

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

According to the Protocol, the Commission provides the statistical data for the implementation of the procedure. As part of the application of this Protocol, Member States have to notify data on government deficits, government debt and nominal GDP and other associated variables twice a year, namely before 1 April and before 1 October[66]. After each reporting date, Eurostat examines whether the data are in conformity with ESA95[67] rules and related Eurostat decisions and, if they are, validates them.

The Commission is required to prepare a report if a Member State does not fulfil the requirements under one or both of the criteria given above (Article 104(3)). The report also has to take into account whether the government deficit exceeds government investment expenditure and all other relevant factors (considerations related to the medium-term economic and budgetary position of the Member State). These factors should be considered in the steps of the EDP leading to the decision on the existence of an excessive deficit only under the double condition that the deficit is close to the reference value and its excess over it is temporary. Special provisions are foreseen for pension reforms introducing a multi-pillar system including a mandatory, fully-funded pillar (for further details, see Box 1.5 of the December 2006 Convergence Report).

The next step in the procedure is the formulation by the Economic and Financial Committee of an opinion on this report within two weeks of its adoption by the Commission (Article 104(4)). If it considers that an excessive deficit exists or may occur, the Commission then addresses an opinion to the Council (Article 104(5)). On the basis of a Commission recommendation, the Council decides, after an overall assessment, whether an excessive deficit exists (Article 104(6)). Any such decision has to be adopted as a rule within four months of the reporting dates (1 April, 1 October).

When it decides that an excessive deficit exists, the Council has to issue a recommendation to the Member State concerned with a view to bringing that situation to an end within a given period, also on the basis of a Commission recommendation (Article 104(7)). The Council recommendation has to specify when the correction of the excessive deficit should be completed, namely in the year following its identification unless there are

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

[65] OJ L 209, 2.8.1997, p. 6. Regulation as amended by Regulation (EC) No 1056/2005 (OJ L 174, 7.7.2005, p. 5).

[66] Council Regulation (EC) No 3605/93 on the application of the Protocol on the excessive deficit procedure (OJ L 332, 31.12.1993, p. 7). Regulation as last amended by Regulation (EC) No 2103/2005, (OJ L 337, 22.12.2005, p. 1).

[67] European System of National and Regional Accounts, adopted by Council Regulation (EC) No 2223/96 (OJ L 310, 30.11.1996, p. 1). Regulation as last amended by Regulation (EC) No 1267/2003 of the European Parliament and of the Council (OJ L 180, 18.7.2003, p. 1).

special circumstances, and has to include a deadline of six months at most for effective action to be taken by the Member State concerned. The recommendation should also specify that the Member State concerned has to achieve a minimum annual improvement of at least 0.5% of GDP as a benchmark in its cyclically-adjusted balance net of one-off and temporary measures.

If effective action has been taken in compliance with a recommendation under Article 104(7) and, compared with the economic forecasts in this recommendation, unexpected adverse economic events with major unfavourable consequences for government finances occur subsequent to its adoption, the Council may decide, on a recommendation from the Commission, to adopt a revised recommendation under the same article, which may notably extend the deadline for the correction of the excessive deficit by one year. Where it establishes that there has been no effective action in response to its recommendations, the Council adopts a decision under Article 104(8) on the basis of a Commission recommendation immediately after the expiry of the deadline for taking action (or at any time thereafter when monitoring of the action taken by the Member State indicates that action is not being implemented or is proving to be inadequate). The provisions of Article 104(9 and 11), on enhanced Council surveillance and ultimately sanctions in case of non-compliance, are not applicable to Member States with a derogation (that is, those that have not yet adopted the euro), which is the case of the Member States considered in this report.

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

Exchange rate stability

The Treaty refers to the exchange rate criterion in the third indent of Article 121 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[68], 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 technical annex is 27 April 2005 to 26 April 2007.

[68] 97/C 236/03 of 16 June 1997, OJ C 236, 2.8.1997, p.5.

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 2007, the reference value, derived from the average interest rate in Finland (3.9%), Poland (5.3%) and

Sweden (3.8%), was 6.4%.

Additional factors

The Treaty in Article 121 also requires an examination of other factors relevant to economic integration and convergence. These additional factors include financial and product market integration and the development of the balance of payments. The examination of the development of unit labour costs and other price indices, which is also prescribed by Article 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 the *integration of financial markets*, the 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 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.

2. LEGAL COMPATIBILITY

2.1. Legal situation

Following Malta's independence in 1964, the Central Bank of Malta (CBM) was established in April 1968 on the basis of the Central Bank of Malta Act (1967). It is a corporate body with a distinct legal personality. The CBM became an independent central bank pursuing price stability as its primary objective following amendments to the Act adopted in October 2002. The CBM Act was amended twice in 2005. A further Act (Act n° I of 2007) amending the CBM Act was adopted by Parliament on 28 February 2007, entering into force on the date to be established by the Minister of Finance. This date should be the date of the introduction of the euro in Malta.

The decision-making bodies of the CBM are the Governor and the Board of Directors. The sole authority (and responsibility) to take decisions and to perform any function or duty or to exercise any power relating to monetary policy is vested in the Governor, who, when performing this function, shall act in accordance with the powers and duties conferred by the Treaty and the ESCB Statute. The Governor may establish a Monetary Policy Advisory Council to advise him on matters relating to monetary policy.

Objectives

The primary objective of the CBM is to maintain price stability. The secondary objective of the CBM (Article 4(1)) has been amended and fully reflects the ESCB's secondary objective.

Independence

According to Article 108 of the Treaty neither a national central bank nor any member of its decision-making bodies shall, when exercising the powers and carrying out the tasks and duties conferred upon them by the EC Treaty and the ESCB Statute, seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body. Inversely, the Community institutions and bodies and the governments of the Member States have to respect this principle and may not seek to influence the members of the decision-making bodies of the national central banks in the performance of their tasks. The different features which make up independence may be grouped into three categories: institutional, personal and financial independence.[69] In particular concerning personal independence, the ESCB Statute contains specific provisions, for example, on the term of office of the governor of a national central bank and the grounds for his dismissal (Article 14.2 ESCB Statute).

The CBM Act was already considered compatible with the Treaty as regards independence in the 2006 Convergence Report.

Integration in the ESCB

The incompatibilities raised in the 2006 Convergence Report have been removed. The Act on the amendments to the Central Bank of Malta Act notably repeals Articles 4(2)a, 17A, 17D, 19, 37(2) and (3), 39, 40, 41 as well as Article 43(3) and (4) of the initial Act. Moreover, a series of articles have been amended so as to take account of the respective roles and competences assigned by the EC Treaty to the ECB, ESCB and the EC Council. This concerns in particular Articles 15(2) on the holding and managing of foreign reserves, Articles 42 and 43(1) and (2) on the right to authorise the issue of banknotes and the volume of coins, Articles 15(1) and 37(1) on the monetary functions, operations and instruments of the ESCB, Article 52a on the imposition of sanctions and Article 22 on the financial provisions related to the ESCB.

Prohibition of monetary financing

In line with the prohibition of monetary financing (Article 101(1) of the Treaty), the CBM shall not grant overdrafts or any other type of credit facility to Community institutions or bodies, to the government or any public authority, to bodies governed by public law, public undertakings or government-owned

[69] See European Commission, Convergence Report 2004, p. 10-11.

corporations of any Member State. Moreover, the CBM shall not directly purchase debt instruments of such entities (Article 27(1)).

However, an imperfection subsists in this respect: Article 17(1)g of the revised Act (Article 15(1)g of the initial Act) offers the possibility for the CBM of providing lending to any Maltese credit institution in order to safeguard financial stability and in other exceptional circumstances. It should be ensured, e.g. through a specific safeguard clause, that the CBM does not possibly end up bearing financial costs to be borne by the state. Otherwise monetary financing would be involved, which would be contrary to Article 101 of the Treaty. Moreover, the CBM's financial independence could be put at risk.

2.2. Assessment of compatibility

Legislation in Malta is compatible with the requirements of the EC Treaty and the ESCB Statute.

One residual imperfection subsists in the Central Bank of Malta Act with respect to the prohibition of monetary financing.

3. PRICE STABILITY

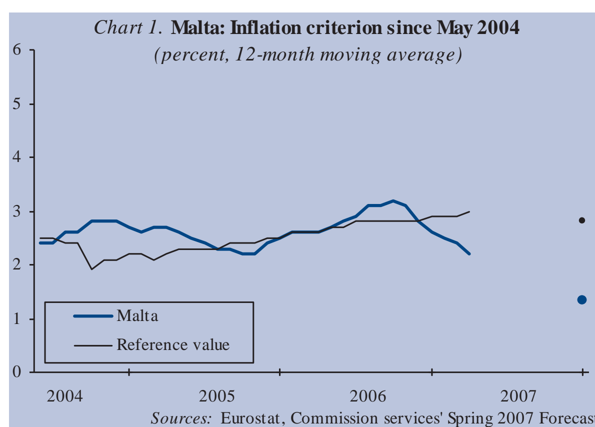
3.1. Respect of the reference value

The 12-month average inflation rate for Malta, which is used for the convergence assessment, has fluctuated around the reference value for the past years. 12-month average inflation has been at or slightly below the reference value since July 2005 except for the period May – October 2006. In March 2007, the reference value was 3.0%, calculated as the average of the 12-month average inflation rates in the three best-performing Member States (Finland, Poland and Sweden) plus 1.5 percentage points. The corresponding inflation rate in Malta was 2.2%, i.e. 0.8 percentage point below the reference value.

3.2. Recent inflation developments

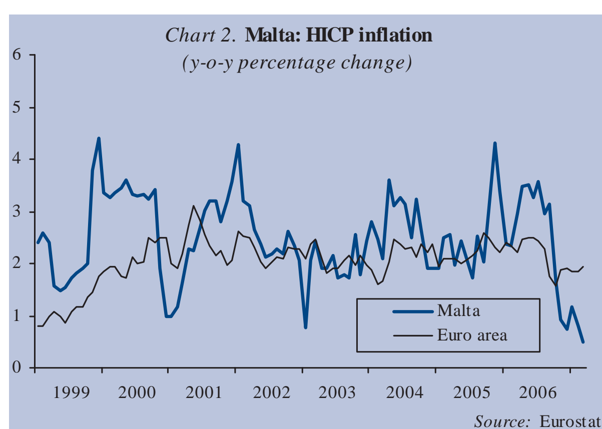
Since 1999, HICP inflation in Malta[70] has been moderate with annual averages between 2 and 3%. At the same time, Malta's inflation has been characterised by marked intra-year volatility reflecting the high sensitivity of the small and open economy to external price shocks and exchange rate fluctuations. Having stayed close to 2% since 2002, inflation picked up in 2004, mainly due to indirect tax increases, but it returned to around 2% at the beginning of 2005. In autumn 2005, inflation increased again and more considerably, reflecting a strong rise in energy prices related to higher oil prices. Between October 2005 and September 2006, headline inflation hovered around 3.5%. When the impact of higher oil prices ebbed away, inflation dropped markedly to below 1% at the end of 2006 and it has stayed close to that level since then. Since November 2006, Malta has been the EU Member State with the lowest HICP inflation rate. Apart from the significant base effects in energy inflation, the decline reflects a drop in prices of clothing and footwear and air transport (following the arrival of low-cost airlines in November 2006).

Chart 1. **Malta: Inflation criterion since May 2004**
(percent, 12-month moving average)



Sources: Eurostat, Commission services' Spring 2007 Forecast

Chart 2. **Malta: HICP inflation**
(y-o-y percentage change)



Source: Eurostat

[70] In the context of compliance monitoring and quality assurance, Eurostat has been reviewing the statistical practices used to compile the HICP for Malta against HICP methodology and other guidelines and good practices in the field of consumer price indices. Eurostat considers that in general the methods used for producing the Maltese HICP are satisfactory. The Maltese data passes all standard HICP validation tests, and should be considered broadly comparable to the HICPs of other EU countries. While the accuracy and reliability of the HICP are judged as generally adequate, some points for improvement are suggested. The compliance report is available under http://epp.eurostat.ec.europa.eu/pls/portal/docs/page/pgp_ds_hicp/TAB61582098/information%20note%20on%20cm%20-%20malta%202006-10.pdf

Table 2.
Malta: Components of inflation[1)]
(percentage change)

	2001	2002	2003	2004	2005	2006	Mar-07	weights in total 2007
HICP	2.5	2.6	1.9	2.7	2.5	2.6	2.2	1000
Non-energy industrial goods	0.2	0.4	-1.3	1.5	1.7	1.7	1.4	321
Energy	0.3	3.7	2.2	5.9	15.9	17.1	9.6	56
Unprocessed food	6.6	0.6	2.3	-1.0	2.2	2.2	2.8	79
Processed food	3.0	5.1	1.5	4.5	1.5	1.6	1.8	143
Services	3.7	3.6	4.6	3.2	2.3	1.4	1.4	401
HICP excl. energy and unproc. food	2.3	2.7	1.9	2.8	2.0	1.6	1.5	865

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.

Sources: Eurostat, Commission services.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) has remained contained at an average of 2% in 2005 and 1.6% in 2006, though this masks considerable intra-year volatility amid fluctuations in sub-items such as food, clothing, accommodation and administered prices (water). At the end of 2006, this measure of core inflation fell to historically low levels below 1% before rebounding to 1.2% in the first quarter of 2007. Moderate core inflation dynamics suggest that underlying inflationary pressures have remained limited, against the background of a negative output gap and low wage pressures. In particular, there have been no signs of second-round effects from energy prices so far, suggesting that inflationary expectations remain well-anchored.

3.3. Underlying factors and sustainability of inflation

Macroeconomic policy-mix and cyclical stance

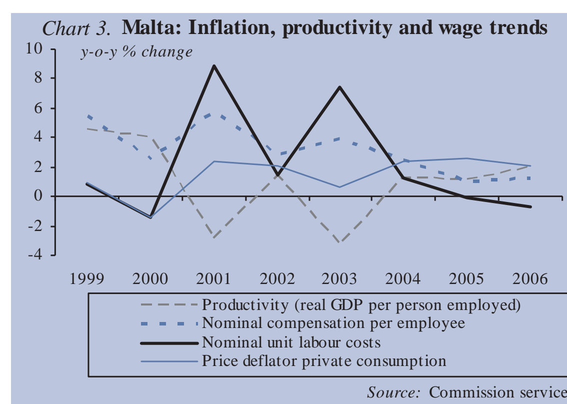
The Maltese economy is estimated to be operating below potential, following two years of negative or flat real GDP growth in 2003 and 2004, and despite a relatively robust recovery to a growth rate of around 3% in 2005 and 2006. Real GDP growth is expected to stay around 3% in 2007 and 2008, which would narrow but not close the negative output gap. While in 2005 the recovery was based on relatively robust growth in both private and public investment and a revival of private consumption, a rebound of exports was an additional impetus in 2006. The main drivers in 2007 should be foreign investment and strong private consumption stemming from a lower income tax and cash de-hoarding in anticipation of the euro changeover. Unemployment has been stable at around 7.4% since 2004, but is expected to decrease in the period ahead.

The fiscal stance, as measured by changes in the cyclically-adjusted primary balance, has been tightened in 2004 and 2005 and was roughly neutral in 2006. Fiscal impulses have thus not been a driver of inflation. A moderate decline of the cyclically-adjusted primary surplus is expected for 2007, though against the background of a still negative output gap. Exchange rate stability and a credible monetary policy have also contributed to keep inflation at relatively low levels.

Wages and labour costs

Inflationary pressures from the labour cost side appear contained at present, amid slow growth of both wages and labour productivity. Following a few years of deceleration (from 5.8% in 2001 to slightly above 1% in 2005 and 2006), annual growth of nominal compensation per employee is expected to recover moderately to some 1.6% this year. Labour productivity has recorded strong cyclical fluctuations (as GDP volatility was not directly translated into employment) around a low trend rate. Productivity fell alongside real GDP in 2003 and grew at around 1.2% annually in the following two years. A slight pick-up to around 2% is estimated for 2006 and 2007. Together, wage and

Chart 3. **Malta: Inflation, productivity and wage trends**



Source: Commission services

Table 3.
Malta: Other inflation and cost indicators
(annual percentage change)

	2001	2002	2003	2004	2005	2006	2007[1)]
Private consumption deflator							
Malta	2.4	2.1	0.6	2.4	2.6	2.0	1.4
Euro area	2.3	1.8	2.1	2.0	2.0	2.0	1.8
Nominal compensation per employee							
Malta	5.8	2.8	3.9	2.5	1.1	1.2	1.6
Euro area	2.7	2.7	2.8	2.5	1.9	2.2	2.6
Labour productivity							
Malta	-2.8	1.4	-3.3	1.2	1.2	2.0	2.1
Euro area	0.5	0.4	0.8	1.6	0.9	1.4	1.4
Nominal unit labour costs							
Malta	8.9	1.4	7.4	1.2	-0.1	-0.7	-0.5
Euro area	2.2	2.4	2.0	0.9	1.0	0.9	1.2
Imports of goods deflator							
Malta	-4.2	2.5	-5.7	-3.3	3.1	12.2	1.0
Euro area	0.2	-2.9	-2.2	1.5	4.0	4.7	0.7

1) Commission services' Spring 2007 Forecast.
Source: Commission services.

productivity developments in 2000-2004 have yielded somewhat volatile results in terms of nominal unit labour costs (ULC). Since 2005, ULC have been decreasing, and slightly negative growth is expected also in 2007.

Negative ULC growth confirms that wage agreements in the private sector have in the recent past tended to broadly take account of productivity concerns. It also suggests that no second-round effects from recent energy price increases through the wage-setting process have materialised so far. Public sector wage discipline has been fostered through a multi-year collective agreement concluded in late 2005. Wage agreements in private sector reflect a need to regain competitiveness. Flexibility of the wage setting process in Malta is somewhat diminished by partial wage indexation (cost-of-living adjustment based on the "social wage", which is lower than the average wage), although indexation can be waived at firm level. Preserving wage discipline in both the public and private sector will be important to contain spillover risks from temporary factors affecting headline inflation.

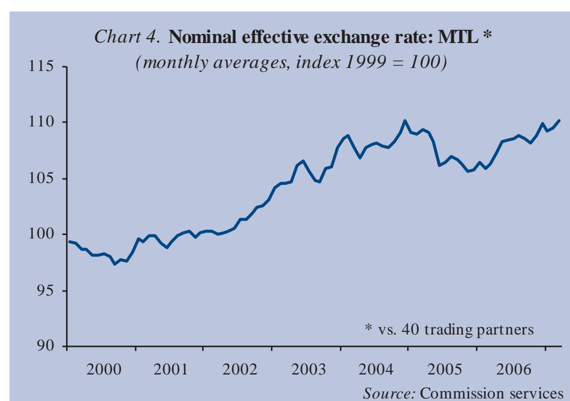
Import prices

Given Malta's small size and high degree of openness, imported goods account for a large share of the consumer basket. Import price developments, as measured by the import of goods deflator in the national accounts, have been favourable to disinflation in 2003 and 2004, with decreases of 5.7 and 3.3%, respectively. Import price inflation strengthened to around 3% in 2005 and is estimated to have increased further in 2006, thus generating upward pressure on headline inflation.[71]

Import price fluctuations have been heavily influenced by global oil price developments, with year-on-year fuel price inflation accelerating from 12% on average in 2005 to some 21% on average during the first 9 months of 2006, though followed by a 10% year-on-year drop since November. High commodity prices have been partly counterbalanced by favourable effects from trade liberalisation, including in the context of EU accession, and increased global market integration, which may have held down import price inflation in some sectors (e.g. food, clothing, furniture). Exchange rate developments have also had a bearing on import price dynamics over the past years. The nominal effective exchange rate of the lira, measured against a group of

[71] However, it should be noted that the current statistics suggesting a surge in the import deflator by 12 percent in 2006 is surrounded by some uncertainty due to the specifics of such a small economy (non-availability of comparable products for one-off imports, new products, etc.).

40 trade partners, appreciated steadily by around 10% between 2000 and 2004, dampening import price dynamics. The effective exchange rate broadly stabilised in 2005 and 2006, thus remaining roughly neutral with regard to import prices.



Administered prices and taxes

The share of administered prices in the Maltese HICP basket is relatively low, reflecting *inter alia* a comparatively small share of energy products in the basket. Still, Malta's inflation profile in the last years has been strongly shaped by developments in regulated prices for energy and related products, as pent-up price pressures have been released. In particular, electricity and water supply prices were increased significantly in January 2005 through the imposition of a "surcharge"[72], with a particularly sharp hike in November 2005.

Due to the introduction of the surcharge, the impact of higher oil prices on inflation was more pronounced in Malta than in other EU Member States, despite a lower share of energy in the HICP basket (at some 6%, compared to around 9% in the euro area). During the first 10 months of 2006, electricity prices were 37% higher than one year before and energy accounted for around 1.5 percentage points of Malta's HICP inflation. A 30-percent increase in the administered price of water supply in November 2005, which added another 0.2 percentage point to headline inflation, was also related to higher oil prices, given the energy-intensive desalination process used to generate drinking water. The combined impact of a drop in energy and water inflation – resulting from both strong base effects and falling prices of fuel in autumn 2006 - contributed by almost 2 percentage points to the sharp decline in headline inflation in October and November 2006. In the first quarter of 2007, energy and water contributed to inflation negatively, by about -0.3 percentage point.

VAT and excise increases, partly related to EU accession, had a relatively strong impact on inflation in Malta in 2004, but Malta's inflation profile since 2005 has not been appreciably influenced by changes in indirect taxes.

Medium-term prospects

Inflation performance in 2007 will mainly reflect the path of prices for energy and related products. As base effects related to strong price increases in these categories in late-2005 subside towards the end of 2007, headline inflation is expected to move back towards rates more consistent with medium-term trends. The Commission 2007 Spring Forecast projects a deceleration of annual average HICP inflation from 2.6% in 2006 to 1.4% in 2007 and an increase in 2008 to 2.1%.

Risks to this inflation outlook appear broadly balanced. The main risks are related to energy prices and are two-sided. Apart from the development of oil prices, uncertainties arise as regards the planned expiry of the energy surcharge scheme in late 2007, although no significant impact is expected. The on-going liberalisation of the energy sector in Malta could result in downward pressure on energy prices

Consumer prices in Malta are some 70-75% of the EU average. This suggests some potential for some gradual further price level convergence in the long-term, as income levels (currently abut 70% of the EU25 average in PPS) rise towards the EU average.

Medium-term inflation prospects will also depend strongly on wage and productivity developments as well as the competitive environment. Measures should be taken (including in the field of education and labour market regulation) in order to prevent labour shortages and skill mismatches, in particular in the light of some upcoming large investment projects (e.g. "Smart City – Malta"). Advancing structural reforms to improve the functioning of product

72 A surcharge on electricity and water prices was introduced in January 2005 to reflect the development of oil price. In the previous regime, the prices of electricity and water had been kept constant and all losses resulting from higher international oil prices were absorbed by state-owned electricity and water providers. The surcharge is currently adjusted bi-monthly in light of developments in oil prices.

markets (in particular utilities) is warranted with a view to price developments. Fiscal discipline will also be important to stem inflationary risks as cyclical conditions improve.

4. GOVERNMENT BUDGETARY POSITION

4.1. The excessive deficit procedure for Malta[73]

In July 2004, the Council decided that Malta was in excessive deficit, based on a deficit of 9.7% of GDP in 2003 and a rising debt ratio, which stood at 72% of GDP in 2003. At the same time, the Council issued a recommendation to correct the excessive deficit. In particular, Malta was recommended to take action in a medium-term framework in order to bring the deficit below 3% of GDP by 2006 in a credible and sustainable manner, in line with the Council Opinion on the May 2004 Convergence Programme. The Council endorsed the following intermediate targets for the general government deficit: 5.2% of GDP in 2004, 3.7% in 2005 and 2.3% in 2006. Malta was also recommended to bring the rise in the debt ratio to a halt in 2005.

In its Opinion on the December 2006 update of the Convergence Programme, the Council noted that the debt ratio seemed to be diminishing at a satisfactory pace towards the 60% of GDP reference value and that the programme was consistent with a correction of the excessive deficit by 2006. In view of these developments and the Commission services' Spring 2007 Forecast, the Commission considers that the excessive deficit has been corrected with a credible and sustainable reduction of the deficit below 3% of GDP and the rise in the debt to GDP ratio has been decreasing since 2004. The Commission is therefore recommending to the Council to abrogate the decision on the existence of an excessive deficit for Malta.

4.2. Developments until 2006

Over the 2000-2006 period, the general government deficit averaged around 5.5% of GDP reaching a high of 10% of GDP in 2003, when a one-off expenditure-increasing transaction amounting to some 3% of GDP in relation to the restructuring of the shipyards took place. Since then, the deficit-to-GDP ratio has progressively declined, reaching 2.6% of GDP in 2006. The 2006 outcome is 0.1 percentage points better than the official target of 2.7% of GDP set in the January 2006 update of the convergence programme. The primary balance, after reaching a through of -6.5% of GDP in 2003, turned into a surplus in 2005 and stood at 1.1% in 2006. Interest expenditure was relatively stable in a range between 3.4% and 3.8% of GDP during this period.

The revenue-to-GDP ratio followed an upward trend between 2000 and 2005, increasing by 8 percentage points, on account of both new and higher taxes and in response to the government's drive to achieve a more efficient tax collection. In 2006, total revenue declined marginally in relation to GDP and stood at 42.7% mainly reflecting a fall in both social contributions and capital transfers. Nevertheless, capital transfers rose substantially in 2004 and 2005, supported by financial inflows from the Italian financial protocol[74] and EU funds. Total expenditure as a% of GDP increased until 2003, but declined thereafter. Rising current spending - mainly as a result of higher final consumption expenditure and social transfers - underpinned the upward trend in total expenditure up to 2003. Capital spending also contributed to the rise in expenditure primarily reflecting spending related to the building of the *Mater Dei* hospital. The decline in total expenditure in 2004 occurred on the back of a fall in capital outlays as current expenditure continued to rise. In 2005, the fall in the general government expenditure ratio to GDP was due to a decline in current spending which more than offset higher total capital expenditure. In 2006, the further decline in total expenditure ratio reflected both lower current spending and public investment, the latter mainly reflecting constraints in the capacity to absorb EU funds.

[73] All documents related to the excessive deficit procedure for Malta can be found at: http://ec.europa.eu/economy_finance/about/activities/sgp/procedures_en.htm.

[74] Co-operation agreement signed between Italy and Malta providing grants to finance public projects in Malta.

Recourse to one-off and other temporary measures was substantial since 2003. Apart from 2003, one-off measures in the other years under consideration were deficit-reducing operations consisting mainly of sale of land averaging around 1% of GDP each year. The structural deficit (i.e. cyclically-adjusted deficit net of one-off and other temporary measures) improved from a high of 6.4% of GDP in 2003 to 3.8% in 2005. In 2006, the structural deficit declined further to 2.7% of GDP.

As a result of the deficit recorded in successive years, the general government debt moved from a position below 60% of GDP in 2000 to one substantially above the reference value. Specifically, the debt ratio increased from around 56% of GDP in 2000 to slightly below 74% of GDP in 2004. The acceleration in debt accumulation which occurred in 2003 reflects a one-off transaction as government took over debt incurred in the past by the shipyards as part of restructuring this sector. However, starting from 2005 the debt ratio followed a downward path reaching around 66.5% of GDP in 2006. During these years, stock-flow adjustments – specifically, proceeds from privatisation - dampened the rise in debt. In particular, the decline in the general government debt in 2006 was to a large extent due to substantial privatisation proceeds amounting to around 3.5% of GDP.

4.3. Medium-term prospects

The Budget for 2007 was approved by Parliament on 17 November 2006. The main measures presented in the Budget include a reform of the personal income tax regime, a new licensing system for gaming machines, lower social contributions for certain categories of part-time employment, tax deductions for parents utilising the services of childcare facilities, a reduction in the airport tax, an energy benefit aimed at alleviating the cost of energy to low-income households and improvements in certain social benefits. The Budget also announced the securitisation of certain government property (estimated at around 1 percentage point of GDP) to finance payment for expropriated land. The 2007 Budget targets a further decline in the general government deficit to 2.3% of GDP in 2007, which was subsequently improved to 1.9% of GDP in the April 2007 fiscal notification. Compared to the April 2007 fiscal notification, the Commission services' Spring 2007 forecast projects a slightly more cautious adjustment to 2.1% of GDP in 2007, primarily due to lower revenue from social contributions as compared to the projections of the Maltese authorities.

The structural deficit is projected to improve marginally from 2.7% of GDP in 2006 to 2.6% of GDP in 2007. This suggests that the relatively high economic growth and the progressive closing of the output gap anticipated for 2007 are not being utilised fully to speed up the pace of adjustment.

The December 2006 update of the convergence programme covers the period from 2006 to 2009. The budgetary strategy outlined in the update aims at reducing the deficit below the 3% of GDP reference value in 2006 and at pursuing fiscal consolidation thereafter, to a broadly balanced budget by 2009.[75] The medium–term objective (MTO) for the budgetary position is a balanced position in structural terms. According to the December 2006 programme, the MTO will be achieved beyond the programme period.

The Commission services' Spring 2007 forecast projects general government debt of 65.9% of GDP for 2007, down from 66.5% of GDP recorded in the previous year. According to the December 2006 convergence programme, the debt ratio is foreseen to follow a downward path between 2007 and 2009, when it is expected to reach 59.4% of GDP.

In its Opinion of 27 February 2007 on the December 2006 update of the Convergence Programme, the Council noted that, in a context of strong growth prospects, the programme envisaged adequate progress towards the MTO but that there were risks to the achievement of the budgetary targets after 2007. In particular, while in the years following the correction of the excessive deficit, the pace of adjustment towards the MTO implied by the programme was broadly in line with the Stability and Growth Pact, there were some risks to the budgetary projections in the programme, especially with regard to the assumed favourable macroeconomic assumptions in 2008 and 2009. The Council invited Malta to pursue the planned progress towards the MTO, ensure that the debt-to-GDP ratio was reduced accordingly and to make further progress in the design and implementation of the healthcare reform in order to improve the long-term sustainability of public finances.

[75] The successive updates of the convergence programme and the assessments by the Commission and Council can be found at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

Table 4.
Malta: Budgetary developments and projections
(as percentage of GDP unless otherwise indicated)

Outturn and forecast [1]	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
General government balance	-6.2	-6.4	-5.5	-10.0	-4.9	-3.1	-2.6	-2.1
- Total revenues	34.9	36.7	38.2	38.6	41.9	42.9	42.7	42.2
- Total expenditure	41.0	43.1	43.8	48.6	46.8	46.0	45.2	44.3
Of which: - Interest expenditure	3.6	3.4	3.6	3.5	3.7	3.8	3.7	3.3
- Current primary expenditure	33.6	36.4	36.5	37.8	39.0	37.9	37.6	36.6
- Gross fixed capital formation	4.2	3.7	4.5	5.1	2.1	5.3	4.6	5.2
Primary balance	-2.5	-3.1	-1.9	-6.5	-1.2	0.7	1.1	1.2
p.m. Tax burden	28.2	30.4	31.9	31.8	33.8	34.5	34.9	35.2
Cyclically-adjusted balance	-7.8	-6.9	-6.2	-9.2	-3.6	-2.2	-2.0	-1.9
One-off and temporary measures	-	-	-	-2.9	0.7	1.7	0.7	0.6
Structural balance [2]	-	-	-	-6.4	-4.3	-3.8	-2.7	-2.6
Structural primary balance	-	-	-	-2.9	-0.6	0.0	1.0	0.8
Government gross debt	56.0	62.1	60.8	70.4	73.9	72.4	66.5	65.9
p.m. Real GDP (% change)	6.4	-1.1	1.9	-2.3	0.4	3.0	2.9	3.0
p.m. Output gap	5.5	1.4	2.0	-2.1	-3.4	-2.5	-1.5	-0.6
p.m. GDP deflator (% change)	1.7	2.9	2.7	4.6	1.4	2.4	2.6	2.3

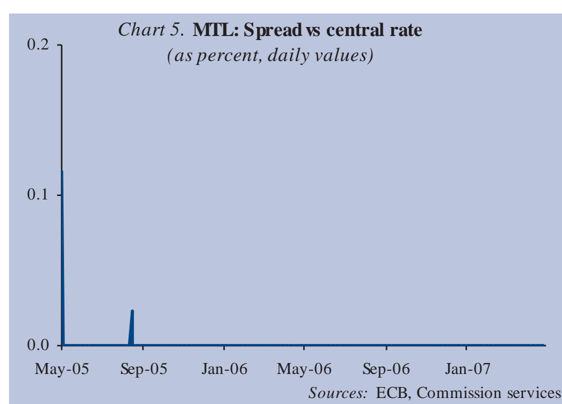
Convergence programme	**2005**	**2006**	**2007**	**2008**	**2009**
General government balance	-3.2	-2.6	-2.3	-0.9	0.1
Primary balance	0.8	1.1	1.1	2.5	3.2
Structural balance [2] [3]	-3.8	-2.9	-2.0	-1.0	-0.4
Government gross debt	74.2	68.3	66.7	63.2	59.4
p.m. Real GDP (% change)	2.2	2.9	3.0	3.1	3.1

[1] Commission services' Spring 2007 Forecast.
[2] Cyclically-adjusted balance excluding one-off and other temporary measures.
[3] Commission services' calculations on the basis of the information in the programme. One–off and other temporary measures according to the programme are 1.6% of GDP in 2005, 1.1% of GDP in 2006, 0.2% of GDP in 2007, 0.2% of GDP in 2008 and 0.2% of GDP in 2009, all deficit-reducing.

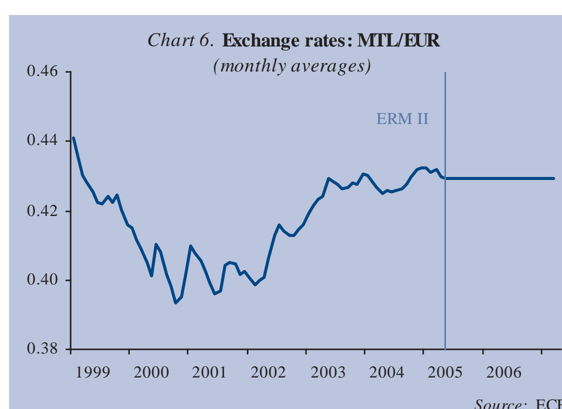
Sources: Eurostat, Commission services and December 2006 update of the convergence programme.

5. EXCHANGE RATE STABILITY

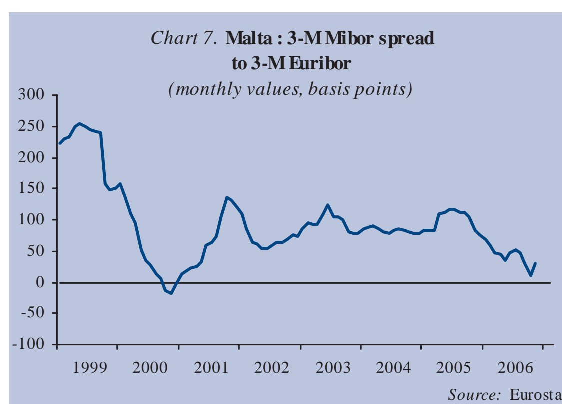
On 2 May 2005, the Maltese lira entered ERM II at the previous trading day's ECB reference rate of 0.4293 MTL/EUR, with a standard fluctuation band of ±15%. Upon joining ERM II, the Maltese authorities unilaterally committed to maintain the lira exchange rate at the central rate. At the time of the adoption of this report, the lira has been participating in ERM II for 24 months.



Before ERM II entry, Malta had followed a basket peg since the 1970s. Within this regime, the only exchange rate realignment occurred in 1992, when the lira was devalued by 10% against the basket, in response to devaluations by major trade partners and competitors in the context of the ERM crisis. The last basket adjustment occurred in August 2002, raising the share of the euro in the basket to 70%, with the US dollar and British pound accounting for the remaining share at 10 and 20%, respectively. At the time of ERM II entry, the lira was re-pegged to the euro. This step did not affect the external value of the lira.



Since mid-2003, the lira stayed very close to its future central rate, with monthly average deviations smaller than 0.8%. During its participation in ERM II, the lira has exhibited no fluctuations against the central rate, save for two minor technical deviations on the stronger side of the band, with a maximum deviation of 0.12% recorded on the first day of ERM II participation.

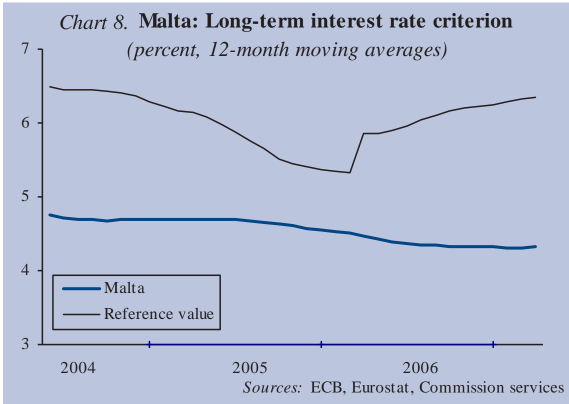


Additional indicators do not point to pressures on the exchange rate. The Central Bank of Malta (CBM) is under a legal obligation to hold at least 60% of its currency and deposit liabilities as foreign currency reserves, thus ensuring a significant reserve buffer. In practice, despite some fluctuations, the reserve cover has consistently exceeded 100% of liabilities. At the end of February 2007, reserves stood at 103% of currency and deposit liabilities, equivalent to around 132% of the monetary base.

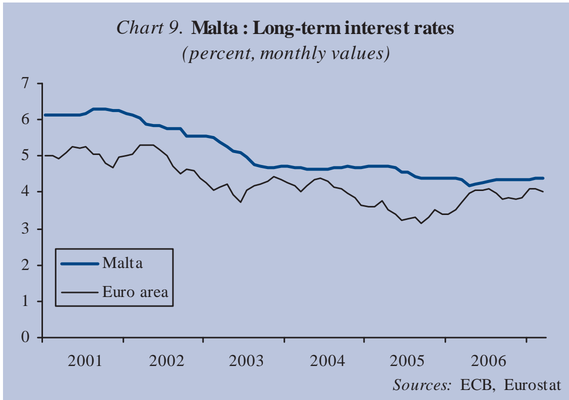
The CBM closely monitors reserve developments in setting policy interest rates. Following significant monetary easing between 2001 and 2003, mirroring developments in the countries represented in the pegging basket, the CBM left its main policy rate on hold between September 2003 and April 2005 at a level of 3%, i.e. 100 basis points above euro area rates. In view of adverse reserve developments since late-2004, reflecting pressures on the current account as well as portfolio shifts by investors, the CBM raised rates by 25 basis points in April 2005. Together with ERM II entry in May, this served to underpin investor sentiment and restore reserve stability. Since the start of monetary tightening by the ECB in late-2005, the policy interest rate differential between Malta and the euro area has narrowed significantly, from 125 to currently 25 basis points. The CBM slowed the pace of policy rate convergence through three 25 basis point rate hikes in May and October 2006 and in January 2007 with a view to ensuring stable foreign reserves and providing sufficient support to the exchange rate peg. Spreads on Maltese money market rates vis-à-vis the euro area, which had hovered around 80-90 basis points until spring 2005, widened in line with the interest rate hike in April 2005, but have narrowed to about 30 basis points currently in tandem with policy rate convergence.

6. LONG-TERM INTEREST RATES

Long-term interest rates in Malta used for the convergence examination reflect secondary market yields on a basket of benchmark government bonds.



The Maltese 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion has progressively declined over the whole assessment period, reflecting a global decline in bond yields as well as a decreasing country risk premium. In March 2007, the reference value, given by the average of long-term interest rates in Finland, Poland and Sweden plus 2 percentage points stood at 6.4%. The 12-month moving average of the yield on ten-year Maltese benchmark bond stood at 4.3%, 2.1 percentage points below the reference value.



At the beginning of 2001, Malta had the lowest long-term interest rate among the new Member States. Since then, Maltese long-term interest rates have declined further towards euro area levels, albeit not on a continuous path. Maltese long-term interest rates decreased by around 150 basis points during the period of monetary easing between 2001 and autumn 2003, and subsequently remained stable at a level of 4.7% through mid-2005. This has implied some fluctuation in spreads vis-à-vis the euro area, with spreads dropping to a low of around 25 basis points in mid-2004 and widening to around 135 basis points by mid-2005. Spreads recorded a broad narrowing trend since then, reflecting both a moderate decrease in Maltese long-term rates and rising yields in the euro area. Having dropped to around 4.4% in August 2005, Maltese long-term rates recorded a further slight decrease in spring 2006, but increased at the beginning of 2007. Yield spreads vis-à-vis the euro area narrowed to a low of around 20 basis points in spring 2006, widened moderately to around 50 basis points in late 2006 and narrowed back to around 30 basis points in the first quarter of 2007.

7. ADDITIONAL FACTORS

7.1. Financial market integration

Reflecting its history as a regional financial centre, Malta’s financial system is substantially inter-linked with the financial systems of other countries, both in and outside of the EU, via the establishment of financial intermediaries and the provision of cross-border services. Over the past decade, Malta has moved from being an offshore to an onshore jurisdiction by reforming its finance sector legislation in line with international best practice. All offshore licences terminated in 2004. Compliance with the *acquis communautaire* in the field of financial services was already broadly achieved on accession and the transposition process of legislation adopted under the Financial Services Action Plan is close to completion.[76]

Malta's financial sector is well-developed in relation to its stage of economic development.[77] Bank intermediation is predominant, but activities of other financial intermediaries are developing also. In terms of GDP, the value of outstanding credit in terms of GDP exceeds the euro area average, while the importance of the Maltese capital market for private sector funding remains limited despite the relatively high value of outstanding domestic fixed-income securities and stock market capitalisation compared to the EU 10 average.

The banking sector expanded considerably in 2005, as new licences were issued to a number of credit and financial institutions and 29 banks from other Member States were authorised to provide cross-border services in Malta. While the market share of foreign owned credit institutions is still a bit lower than for the EU10 average, and the degree of concentration in terms of CR5 ratio[78] of 75% would not be unusual in such a small market, domestic lending is de facto dominated by only two institutions. There was also an increase in the number of licensed insurance companies, insurance managers and affiliated insurance companies as well as a rapid growth of investment funds in 2005. However, insurance and investment funds are still of minor importance when compared to the banking system and private pension funds are just developing.

The growth rate in domestic credit picked up to 9% over 2006, as negative net lending to the central government compensated only partly a significant 15% rise in claims on other residents, which reflected mainly an increase in household borrowing for house purchases and associated borrowing by the construction sector. According to the Central Bank of Malta, the share of foreign currency loans in domestic lending has increased over the past years, but was still limited at 8% at the end of 2006. Moreover, exchange-rate risk for the economy should be mitigated by the domestic currency denomination of central government debt and the fact that net foreign assets of deposit money banks and international banking institutions have either stabilised or increased over the past years. Malta's capital markets remain relatively small and illiquid. The decline of the Maltese stock market since March 2006 had a negative impact on trading activity, which was mostly concentrated in bank equities. The number of actively traded corporate bonds was also very limited. Secondary market turnover fell also for government bonds, which dominate the fixed income market, and for which the central bank acts as market maker.

The importance of adequate supervisory structures is heightened by Malta's role as a regional financial centre and the activity of foreign banks within the system. Regulatory and supervisory responsibilities have been consolidated in the Malta Financial Services Authority (MFSA) since 2002. The MFSA

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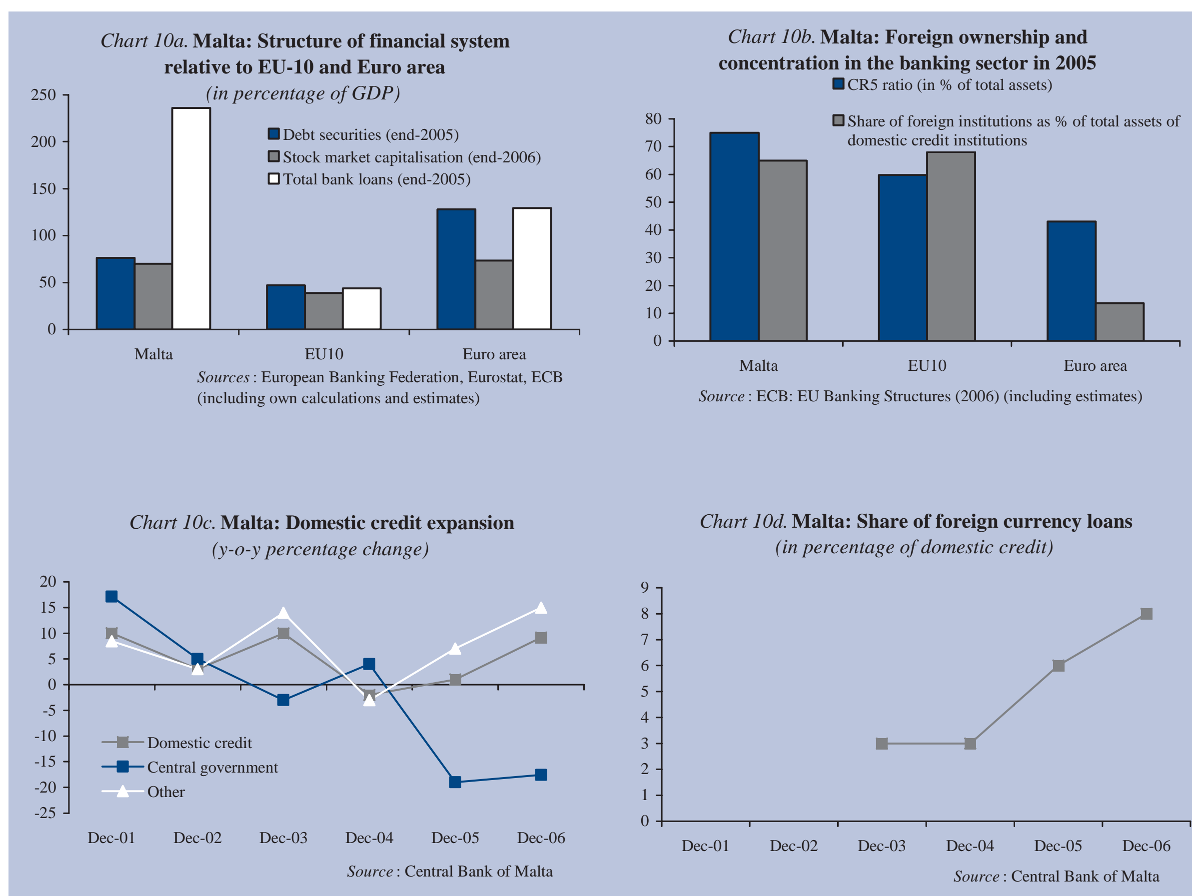
76 See: Transposition of FSAP Directives - State of play as of 15/01/2007. http://ec.europa.eu/internal_market/finances/docs/actionplan/index/070124_annex_b_en.pdf

77 Malta's GDP per capital level (PPS) stood at 69% of the EU25 average in 2005, which is the fourth highest level after Cyprus (83%), Slovenia (80) and the Czech Republic (73%).

78 The CR5 concentration ratio is defined as the aggregated market share of five banks with the largest market share.



supervises the banking, securities and insurance sectors, but the central bank retains responsibility for monitoring the financial system's overall stability. These institutional changes have been accompanied by measures to facilitate cross-border co-operation between Malta and foreign supervisory bodies, and the MFSA has continued to increase the number of bilateral and multilateral Memoranda of Understanding with other regulators over 2006.

7.2. Product market integration

The high degree of openness and the intensity of integration with the EU are outstanding features of the Maltese economy. This promotes competition pressure across the economy and therefore ensures that firms are given the right incentives to improve their level of efficiency. However, the small size of the Maltese economy hampers the scope for the diversification of production activities and leads to a high degree of trade specialisation in a small number of sectors, notably electronics (in particular semiconductors) and tourism. Such dependence on a few sectors increases the exposure of the economy to asymmetric shocks determined by the evolution of international markets. Nonetheless, there is evidence of progress in terms of the diversification of economic activities, namely with the expansion of other services sectors like financial services and ICT and the build-up of clusters in manufacturing sectors like pharmaceuticals.

Malta is among the most open economies in the EU25 and in the euro-area. The trade openness ratio has decreased during the first half of the decade but this evolution is largely driven by cyclical developments, namely the downturn at the beginning of the decade in the tourism industry and in the semiconductors sectors, which dominate Malta's trade. Over time the EU25 has been reinforcing its position as Malta's main trading partner. In 2005, the weight of extra-EU trade in Malta's total trade (around 32%) was lower than the weight of extra-EU trade in the total trade of the EU25 (36%). Moreover, trade integration with the euro-area is particularly well advanced. In 2005, 77% of Malta's intra-EU trade flows were with euro-area Member States.

With respect to the composition of trade, the relatively low share of intra-industry trade in total manufacturing trade with the EU25 is striking, reflecting the high level of specialisation. Manufacturing trade is dominated by the electronics industry. However, this is largely driven by the presence of one large manufacturer affiliated to a multinational company of semi-conductors.[79] The pattern of trade specialisation reveals considerable duality with respect to the level of technology intensity.[80] While there is a dominance of high technology sectors (largely due to the semiconductors sector), the other sectors where the country has comparative advantage are mostly of low and medium-low technology, like for example clothing. The relatively high transport costs contribute to explaining the importance of the services sectors in trade flows, namely tourism and financial services. In 2005, the share of services in total trade was around 30% compared to 22% in the EU25.

FDI has also been an important channel for economic integration with the EU. The evolution of FDI inflows in recent years has been volatile but on average the ratio of FDI inflows to GDP remained above the EU25 average over the period 2001-2006. FDI outflows remain very limited. In 2004, the ratio of inward FDI stock to GDP reached 67.5% in 2004 which is among the highest in the EU25. The EU25 is by far the main investor in Malta and investment flows overwhelmingly target services sectors, in particular financial services.[81]

Despite the increasing market integration with the EU25, the price level of goods and services remained around 25% below the EU25 average in 2005. The remaining price gap is mainly driven by services as the price level of goods was already around 91% of the EU25 level. In contrast, price levels remain particularly low in services sectors such as recreational and cultural services and energy where prices are still administered (41% of the EU25 average price level in 2005).[82]

The relative underdevelopment of the medium-high technology manufacturing sectors when compared to the EU25 and the dependence on the electronics and tourism sectors are important features of the integration of Malta in the EU economy. A process of restructuring towards other innovation-driven sectors and activities to reduce the economy's exposure to the fluctuations of these sectors and to prevent competitiveness strains from the increasing competition pressure in low technology sectors from lower-cost economies is underway. However, the conditions for such a successful and sustained transition are not yet fully in place.

Malta's innovation performance remains well below the EU average.[83] Recent survey data show that while 42% of EU27 enterprises are actively engaged in innovation, only 21% of Maltese enterprises do so.[84] R&D spending is still well below the EU average level, despite the ongoing efforts led by the authorities to promote research and innovation performance across the business sector. Efforts to foster the adoption and diffusion of ICT are also underway which could have an important impact on the prevalent services sectors. There is already evidence of good progress for example regarding ICT diffusion as the rate of broadband penetration approaches the EU25 average.

The promotion of a market-based adjustment is facilitated by improvements in the business environment, namely regarding the speeding up of the process for starting up a company and the increase of the quality of the regulatory framework. However, barriers to further restructuring remain as many activities, namely in professional services, are still heavily regulated. Competition pressure is also not yet fully ensured in some sectors such as importation and distribution of fuel products, retail, transport and construction. Sectoral state aids also remain relatively high and their redirection towards horizontal objectives in particular R&D is also lagging.

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79 This operator accounts for more than half of the industry's total output and exports, see "Malta's growth predicament: from runner to laggard and back?", *ECFIN Country Focus*, vol. III, issue 14.

80 See: EU *Industry Structure*, DG ENTR, (forthcoming).

81 See: *Balance of Payments - Direct Investment in Malta and Abroad*, National Statistics Office, News release, 2 February 2007.

82 See: "Comparative Price Levels for Selected Consumer Services in Europe for 2005", *Statistics in Focus*, no.12/2006, Eurostat.

83 See: *2006 European Innovation Scoreboard.*

84 See: *Fourth Community Innovation Survey.*

Table 5.
Malta: Product market integration

	Malta						EU25					
	2001	**2002**	**2003**	**2004**	**2005**	**2006**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
Trade openness [1] (%)	-	-	-	79.5	73.1	-	-	-	35.4	36.7	38.3	-
Extra-EU trade in goods GDP ratio [2] (%)	22.9	22.8	22.2	20.4	17.4	21.3	9.9	9.4	9.1	9.6	10.4	11.1
Intra-EU trade in goods GDP ratio [3] (%)	33.6	32.9	33.5	35.7	33.6	32.8	19.0	18.5	18.4	19.0	19.6	21.0
Intra-EU trade in services GDP ratio [4] (%)	-	-	-	16.2	15.6	-	-	-	4.6	4.7	4.9	-
Intra-EU trade balance in goods [5]	-0.8	-0.9	-1.0	-1.1	-1.2	-1.1	89.4	96.2	90.7	77.9	72.6	81.4
Intra-EU trade balance in services [6]	-	-	-	0.4	0.4	-	-	-	1.9	17.0	15.9	-
Intra-EU trade balance GDP ratio [7] (%)	-	-	-	-15.8	-17.0	-	-	-	0.9	0.9	0.8	-
Total FDI inflows GDP ratio [8] (%)	7.3	-10.2	19.5	7.3	11.0	-	5.8	5.0	3.6	2.2	4.6	-
Intra-EU FDI inflows GDP ratio [9] (%)	-	-	-	5.3	1.1	-	4.3	3.7	2.3	1.6	3.7	-
FDI intensity [10]	-	-	-	2.3	0.2	-	3.9	3.7	2.5	1.9	3.8	-
Internal Market Directives [11]	-	-	-	6.0	1.2	1.0	-	-	-	3.6	1.6	1.2
Price levels [12]	75.5	73.7	71.2	71.8	72.5	-	100	100	100	100	100	100

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

Sources: Eurostat, Commission services.

Further economic integration with the EU, improvements in the business environment and upgrading of the innovation performance of the economy will also promote the attraction of more FDI. FDI has been contributing to the diversification of the economy's production structure, namely towards financial services and can also play an important role as a means for technology, organisational- and managerial-skill transfer. Trade and investment relations with the EU will also benefit from the envisaged improvements in Malta's infrastructure, namely regarding port and interconnections to connection to Europe's energy networks. The ongoing process of integration is also facilitated by the swift transposition of the EU directives. According to the December 2006 Internal Market Scoreboard n° 15bis[85], Malta further reduced the deficit in the transposition of Internal Market directives in 2006, which is now at 1% compared to the EU25 average of 1.2%.

85 http://ec.europa.eu/internal_market/score/index_en.htm

7.3. Development of the balance of payments

Malta's current account balance has been in deficit since 1998 (except for 2002), averaging -5% of GDP, with large merchandise trade deficits not fully compensated by sizeable surpluses in the services balance. Year-on-year swings were large, partly reflecting one-off factors that disproportionately affect the aggregate in an economy of Malta's size. After having recorded a surplus in 2002, the current account balance worsened sharply to -8.2% of GDP in 2005. This was primarily due to a marked worsening of the trade balance, whose deficit increased from 8 to 20% of GDP between 2002 and 2005, while the services balance remained stable in that period. The adverse trend was compounded by a steady deterioration of the income balance. As a mitigating influence, net current transfers picked up strongly in 2005, following several years of marginal increases.

Over the last years, the Maltese current account balance has been strongly affected by swings in the tourism and electronics sectors, as well as stronger exposure to import competition in previously well-protected manufacturing sectors, partly related to EU accession. The electronics sector alone accounts for well over half of total goods exports, with one large semi-conductor firm dominating the market. The sector's performance has reflected difficult global market conditions after 2001, thus underscoring the vulnerability associated with a narrow sectoral base in a small economy. At the same time, Malta's tourism industry has performed sluggishly during the past years, reflecting both a fallout from geopolitical concerns and intensified competitive pressure. Imports were underpinned by strong investment activity, including by the public sector, while the oil bill increased strongly in line with global market developments.

In 2006, the current account balance improved to 6.3% of GDP on account of a significant increase in current transfers due to increased receipts from the booming online gaming industry. A slight deterioration in trade balance was triggered by higher imports of capital goods (such as cranes, ships) which masked a strong recovery in exports (especially pharmaceuticals, scientific instruments and electronics). The deterioration in surplus of services trade reflected mainly a weak performance of the tourism industry. There is however a revival in this sector following the arrival of low-cost airlines in November 2006.

Table 6.
Malta: Balance of payments
(percentage of GDP)

	2001	2002	2003	2004	2005	2006
Current account	-3.8	2.4	-3.2	-6.4	-8.2	-6.3
Of which: Balance of trade in goods	-14.3	-8.1	-13.1	-16.0	-19.6	-19.8
Balance of trade in services	8.9	9.4	9.8	9.8	8.0	6.2
Income balance	1.0	0.7	-0.5	-1.2	-2.8	-1.5
Balance of current transfers	0.6	0.5	0.6	1.0	6.2	8.8
Financial and capital accounts	-2.9	-1.0	2.6	5.1	8.2	9.2
Of which: Net FDI	6.4	-10.0	8.5	7.4	10.5	27.4
Net portfolio inflows	-12.6	-8.6	-32.3	-38.2	-46.1	-39.6
Net other inflows (1)	9.9	24.2	28.9	30.8	44.5	20.0
Net capital account	0.0	0.2	0.4	1.5	3.4	3.1
Change in reserves (+ is a decrease)	-6.7	-6.7	-2.9	3.6	-4.1	-1.7
Errors and omissions	6.7	-1.5	0.6	1.3	0.0	-2.9
Gross capital formation	18.7	14.3	17.5	17.0	21.6	19.8
Gross saving	14.9	17.0	14.7	10.6	13.3	13.5

(1) Including financial derivatives

Sources: Eurostat and Commission services.

So far, the financing of the current account deficits has been largely unproblematic, but the external position reflects substantial financing needs. While in 2004 net capital inflows did not fully match the current account deficit, leading to a drop in external reserves, this was reversed again in 2005 in line with longer-term trends. Net FDI inflows constituted the dominant category of external financing over the past years, generally exceeding the current account shortfall, though with some large year-to-year volatility. Reflecting sizeable capital transfers from the EU and Italy, the capital account improved to a surplus of 3.4% of GDP in 2005 and 3.1% in 2006. As a result, the deficit in the combined current and capital account decreased from slightly below 5% of GDP in 2004-2005 to 3.2% of GDP in 2006.

Some caution is warranted in interpreting Malta's balance of payments data, as in recent years the residual “net errors and omissions” were consistently strongly positive, implying an overestimation of the current account deficit and/or an underestimation of net inflows on the capital and financial account in the order of 2-3% of GDP.

The outlook for Malta's balance of payments is influenced by external factors (such as developments on global energy and electronics markets), but also crucially depends on prospects to improve the competitive position of the Maltese economy.

Extensive restructuring has taken place in the last few years, with activity in shrinking sectors (such as clothing) being progressively replaced by sectors with competitive edge (pharmaceuticals, remote gaming, aircraft maintenance, financial services, auditing), and with product upgrading in the main exporting industry (electronics). Increased openness to the world trade after EU accession has contributed significantly to this process.

A narrowing of the current account deficit to some 3-4% of GDP is expected in the coming years. The main factors behind this improvement should be exports of manufacturing goods (pharmaceuticals), higher revenues from travel industry and tourism and higher current transfers (as a result of the buoyant remote gaming industry).

A sustained improvement in Malta's external balance will need to be supported by strengthened efforts to maintain external competitiveness, including through policies fostering productivity growth, appropriate wage developments, and further progress in diversifying the sectoral export structure. A prudent fiscal stance is important to underpin domestic savings. On the financial account side, ensuring a positive investment climate is vital to underpin FDI inflows.

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