COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 5.12.2006
COM(2006) 762 final

REPORT FROM THE COMMISSION

CONVERGENCE REPORT DECEMBER 2006

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

{SEC(2006) 1570}

1. PURPOSE OF THE REPORT

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

The latest Commission and ECB regular convergence reports, adopted in October 2004, covered the ten Member States that joined the EU in May 2004 and Sweden[1]. At the request of the respective national authorities, Lithuania and Slovenia were assessed in convergence reports issued in May 2006[2]. The present report covers the other nine Member States with a derogation: the Czech Republic, Estonia, Cyprus, Latvia, Hungary, Malta, Poland, Slovakia and Sweden[3]. A more detailed assessment of the state of convergence in these countries is provided in a technical annex to this report (SEC(2006) 1570).

The content of the reports prepared by the Commission and the ECB is governed by Article 121(1) of the Treaty. This Article requires that the reports include an examination of the compatibility of national legislation with Articles 108 and 109 of the Treaty and the Statute of the ESCB and of the ECB. The reports also have to examine the achievement of a high degree of sustainable convergence in the Member State concerned by reference to the fulfilment of the convergence criteria (price stability, government budgetary position, exchange rate stability, long-term interest rates), and take account of several other factors mentioned in the final sub-paragraph of Article 121(1). The four convergence criteria are further developed 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 Statute of the ESCB/ECB requires an assessment of compliance with the prohibition of monetary financing (Article 101 EC); 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”.

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1 European Commission, Convergence Report 2004 - COM(2004) 690, 20.10.2004 - and European Central Bank, Convergence Report 2004, October 2004.

2 European Commission, Convergence Report 2006 on Lithuania - COM(2006) 223, 16.5.2006; European Commission, Convergence Report 2006 on Slovenia - COM(2006) 224, 16.5.2006; and European Central Bank, Convergence Report May 2006, May 2006.

3 Denmark and the United Kingdom negotiated opt-out arrangements before the adoption of the Maastricht Treaty 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 for euro adoption.

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 a satisfactory inflation performance must essentially be achieved by the adequate behaviour of input costs and other factors influencing price developments in a structural manner, rather than reflect the influence of temporary factors. Therefore, the convergence examination includes an assessment of the underlying factors of inflation and of medium-term prospects. It is also assessed whether the country is likely to meet the reference value in the months ahead.

The inflation reference value was calculated to be 2.8 percent in October 2006[4], with Poland, Finland and Sweden 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 November 2004 to October 2006.

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

[4] The cut-off date for the data used in this report is 17 November 2006.

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 6.2 percent in October 2006.

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.

2. ASSESSMENT BY MEMBER STATE

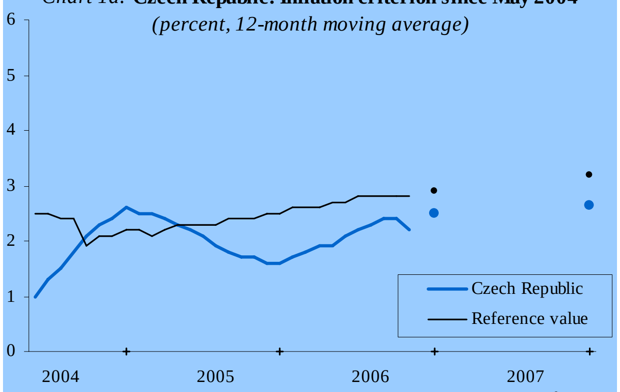
2.1. The Czech Republic

In the 2004 Convergence Report, the Commission assessment was that the Czech Republic fulfilled two of the convergence criteria (on price stability and long-term interest rates). The assessment on legal convergence concluded that legislation in the Czech Republic was not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

The Act on the Czech National Bank (CNB) has been amended several times in recent years, notably in 2005 and 2006. However, the incompatibilities highlighted in the 2004 Convergence Report have not been addressed.

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

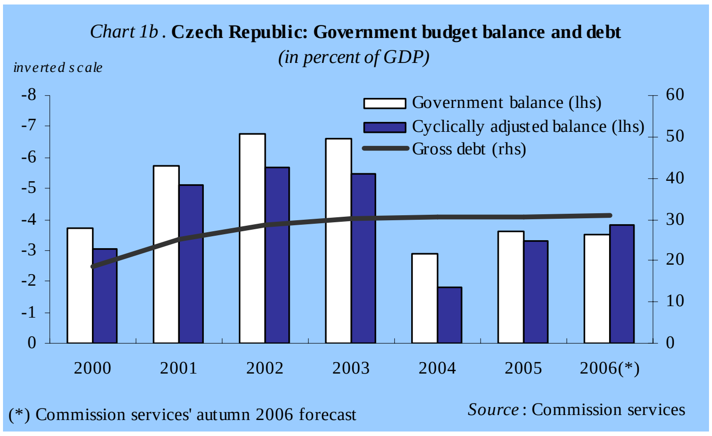
Chart 1a. **Czech Republic: Inflation criterion since May 2004**
(percent, 12-month moving average)



Sources: Eurostat, Commission services' autumn 2006 forecast

Annual HICP inflation in the Czech Republic has been below 3½ percent since early 2002, and the average over 1999-2005 stood at 2.3 percent. Underlying inflationary pressures appear to have been contained over the last years. Wage inflation has been restrained by labour market slack, although cyclical conditions gradually improved during 2003-2005. Growth in import prices has been largely limited by a trend appreciation of the koruna exchange rate in nominal effective terms. Czech inflation has nonetheless been somewhat volatile due to the impact of administred prices, the effect of EU accession and swings in food and import prices. A modest pick-up in inflation is expected for 2007-2008, on the back of improved cyclical conditions and planned increases in excise duties and regulated prices. Inflation performance in the medium term will also depend on exchange rate developments, given the high degree of openness of the Czech Republic, and on the fiscal policy stance. 12-month average inflation in the Czech Republic has been at or below the reference value since April 2005. The average inflation rate in the Czech Republic during the 12 months to October 2006 was 2.2 percent, below the reference value of 2.8 percent, and is likely to remain below the reference value in the months ahead. The Czech Republic fulfils the criterion on price stability.

The Czech Republic is at present subject to a Council decision on the existence of an excessive deficit (Council decision of 5 July 2004)[5]. The Council recommended the Czech Republic to bring the deficit below 3 percent of GDP by 2008 in a credible and sustainable manner. The widening of the government deficit after 2000 was largely due to transition-related one-offs, notably connected to restructuring in the enterprise and banking sectors, and increasing social expenditures. The significant narrowing of the deficit in 2004, to 2.9% of GDP, was mainly attributable to a pick-up in economic growth and the possibility given to government departments to carry over unspent funds. Economic conditions have aided fiscal consolidation in recent years; however, strong growth has not been fully exploited to speed up the pace of fiscal adjustment. While the government debt ratio has increased substantially compared to 2000, it remains relatively low at around 30% of GDP. The general government deficit was 3.6 percent of GDP in 2005, and government debt was 30.4 percent of GDP[6]. The Czech Republic does not fulfil the criterion on the government budgetary position.



The Czech koruna is not participating in ERM II. Since 1998, the Czech Republic has been operating explicit inflation targeting combined with a floating exchange rate regime. The Czech koruna has experienced a long period of nominal appreciation since the end of the 1990s, with an interruption between mid-2002 and spring 2004. During the two years before this assessment, i.e. between November 2004 and October 2006, the koruna appreciated against the euro by about 10 percent. The Czech Republic does not fulfil the exchange rate criterion.

The average long-term interest rate in the Czech Republic in the year to October 2006 was 3.8 percent, below the reference value of 6.2 percent. Average long-term interest rates in the Czech Republic have been below the reference value since

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5 Decision 2005/185/EC - OJ L 62, 9.3.2005, p. 20.

6 For 2006, the Commission services' autumn forecast projects a general government deficit of 3.5 percent of GDP.

accession to the EU. Since early 2005, yields on Czech government bonds have closely mirrored those of the euro area, with spreads not exceeding 35 basis points. After a period of a moderate positive differential in 2005, the spread turned slightly negative in the first half of 2006. The Czech Republic fulfils the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including product and financial market integration and balance of payments developments. The Czech economy is highly integrated with the EU. In particular, trade and FDI relations with other Member States are extensive and integration of the domestic financial sector into the broader EU sector has progressed substantially, mainly through a high degree of foreign ownership of financial intermediaries. The external position of the Czech Republic has improved in recent years. The current account deficit has significantly narrowed, from around 6 percent of GDP in 2003 to close to 2 percent of GDP in 2005, chiefly on account of a surge in merchandise exports. On the financing side, the financial account is in surplus reflecting notably a substantial increase in the inflow of net foreign direct investment, which reached about 8 percent of GDP in 2005.

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

2.2. Estonia

In the 2004 Convergence Report, the Commission assessment was that Estonia fulfilled two of the convergence criteria (on price stability and the government budgetary position) and that there was no reason to conclude that Estonia would not fulfil the interest rate criterion. The assessment on legal convergence concluded that legislation in Estonia was not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

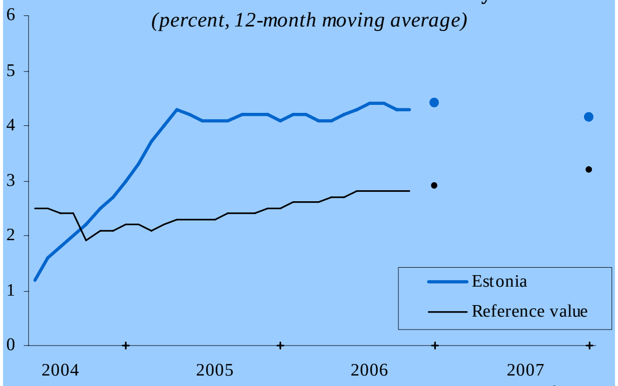
As regards central bank integration into the ESCB at the time of euro adoption, legislation in Estonia (in particular, the Eesti Pank Act, the Constitution of the Republic of Estonia as well as the Currency Law and the Law on the Security for Estonian kroon) was assessed as not fully compatible with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

A draft Act amending the Eesti Pank Act was submitted to the Riigikogu (Parliament) in September 2005 and adopted on 7 June 2006. With respect to the Eesti Pank Act, the incompatibilities raised in the 2004 Convergence Report have been removed. As regards central bank integration into the ESCB at the time of euro adoption, Article 111 of Estonia's Constitution is not formally compatible with the requirements of the Treaty and the ESCB Statute. However, the ruling of 11 May 2006 of the Constitutional Review Chamber of Estonia's Supreme Court provides legal clarity, in particular on the inapplicability of Article 111 after the introduction of the euro in Estonia, and therefore removes the need for further amendment.

National legislation in Estonia can be considered fully compatible with the requirements of the Treaty and the ESCB Statute, subject to the repeal of the Currency Law and the Law on the Security of the Estonian Kroon with effect from the date of the introduction of the euro.

HICP inflation in Estonia recorded a strong trend deceleration over the past decade, bottoming out at 1.4 percent in 2003. However, inflation picked up to 3 percent in 2004 and to 4.1 percent in 2005, and has remained at high levels since then. While this was initially mainly due to external price shocks (notably higher global oil prices) and adjustments in indirect taxes, underlying inflationary pressures also appear to have picked up more recently, as buoyant demand growth and a rapidly tightening labour market are imposing increasing capacity constraints on the economy. Inflation is expected to remain elevated for some time, reflecting strong demand and wage growth, higher prices for household energy, and increases in indirect taxes to comply with EU requirements. Estonia's 12-month average inflation has been above the reference value since September 2004. The average inflation rate in Estonia during the 12 months to October 2006 was 4.3 percent, above the reference value of 2.8 percent, and it is likely to remain above the reference value in the months ahead. Estonia does not fulfil the criterion on price stability.

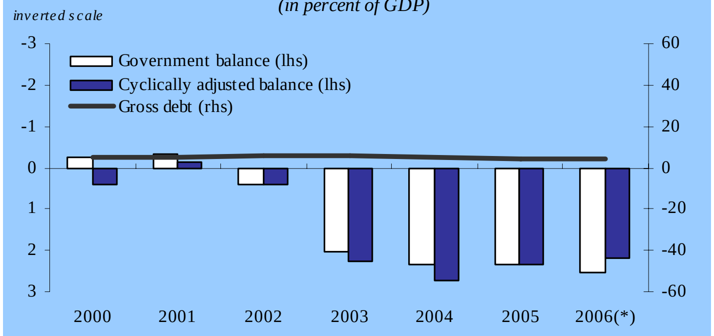
Chart 2a. **Estonia: Inflation criterion since May 2004**
(percent, 12-month moving average)



Sources: Eurostat, Commission services' autumn 2006 forecast

Estonia is not subject to a Council decision on the existence of an excessive deficit. Between 2000 and 2005, Estonia recorded an average general government surplus of 1.1 percent of GDP. Budgetary targets have been regularly outperformed, notably on account of buoyant revenue developments. In 2005, Estonia recorded a general government surplus of 2.3 percent, the same level as one year earlier[7]. The cyclically-adjusted surplus has been declining somewhat in 2005, implying an expansive fiscal stance in a period of very strong growth. This general government gross debt ratio stood at 4.5 percent of GDP in 2005, the lowest of all the EU Member States. The authorities have used the period of strong growth to build up considerable government reserves. Estonia fulfils the criterion on the government budgetary position.

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



(*) Commission services' autumn 2006 forecast

Source : Commission services

The Estonian kroon has participated in ERM II since 28 June 2004, i.e. for more than two years at the time of adoption of this report. Before ERM II entry, Estonia had successfully pursued a currency board regime anchored to the D-Mark, and later the euro, since 1992. Upon ERM II entry, Estonia unilaterally committed to maintain its

7 For 2006, the Commission services' autumn forecast projects a general government surplus of 2.5 percent of GDP.

currency board in the mechanism. Additional indicators, such as developments in short-term interest rates and foreign exchange reserves, do not point to pressures on the exchange rate. The currency board enjoys high credibility with financial markets and the public. During the two-year period under review, the Estonian kroon has not deviated from its central parity and has not experienced severe tensions. Estonia fulfils the exchange rate criterion.

As a result of Estonia's low level of government indebtedness, no benchmark long-term government bond or comparable security is available to assess the durability of convergence as reflected in long-term interest rates. An interest rate indicator based on long-term kroon-denominated bank loans to households and non-financial businesses stood, on average, at 4.1 percent in the year to September 2006[8]. On the basis of developments in the interest rate indicator and taking into account, inter alia, the low level of government debt, there is no reason to conclude that Estonia would not fulfil the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including product and financial market integration and balance of payments developments. The Estonian economy is highly integrated with the EU. In particular, trade and FDI relations with other Member States are extensive and integration of the domestic financial sector into the broader EU sector has progressed substantially, mainly through a high degree of foreign ownership of financial intermediaries and the extensive use of the euro as a borrowing and investment currency. Estonia's current account deficit has exceeded 10 percent of GDP since 2002. The high current account deficit largely reflects the rapid catching-up process, where foreign savings are mobilised via external borrowing to increase domestic investment and productivity growth. However, the external position implies substantial financing needs in the medium term and inflows need to be used productively. The external shortfall has been mainly financed by sizeable FDI inflows and intra-group bank lending.

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

2.3. Cyprus

In the 2004 Convergence Report, the Commission assessment was that Cyprus fulfilled two of the convergence criteria (on price stability and long-term interest rates). The assessment on legal convergence concluded that legislation in Cyprus was not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

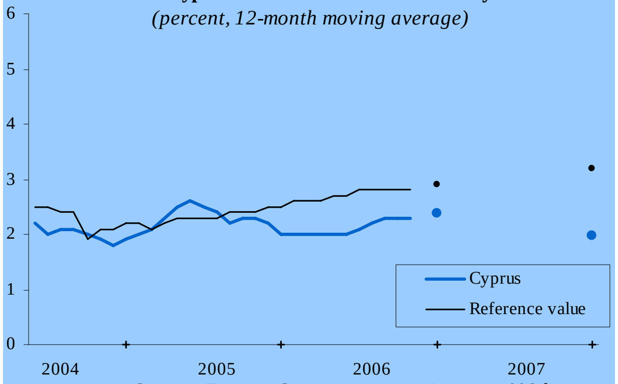
No national legislation has been enacted so far resolving the legal convergence issues identified in the 2004 Convergence Report. However, a draft Law amending the Central Bank of Cyprus Law of 2002 and 2003 was submitted to Parliament on 12 October 2006 in order to address these issues and to ensure full compatibility with the Treaty and the ESCB/ECB Statute. In its present form, this draft Law removes all incompatibilities raised in the Convergence Report of 2004.

[8] The latest data available.

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

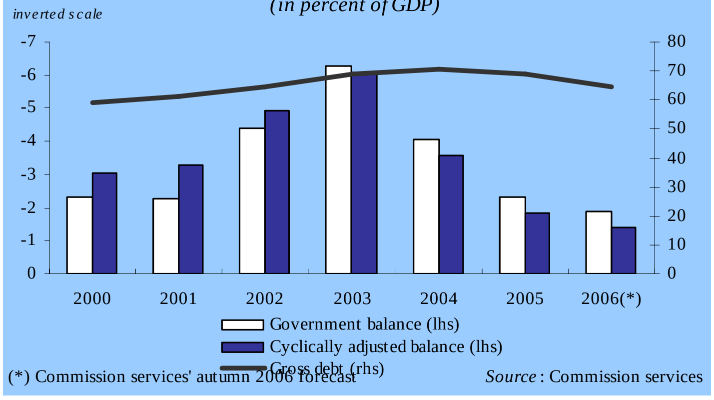
Cyprus has traditionally enjoyed relatively low, although at times volatile, inflation, reflecting the sensitivity of its small and open economy to external price shocks. HICP inflation was 2.7 percent on average in 1999-2005 but it reached highs of around 6 percent in the spring of 2000 and again in the winter of 2003, in the latter case partly due to accession-related increases in VAT rates and excises. Inflation picked up in early 2006, but has moderated in recent months, to 1.7 percent in October 2006. These swings largely reflect the impact of energy and food prices. As the energy price shock fades away, inflation is expected to decline gradually. However, increases in VAT and excises that are related to fulfilling EU requirements are expected to have a notable upward effect on inflation at the latest when the current derogations expire at the end of 2007. The inflation performance over the medium term will, to a large extent, depend on the containment of possible wage pressures. 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 October 2006 was 2.3 percent, below the reference value of 2.8 percent, and it is likely to remain below the reference value in the months ahead. Cyprus fulfils the criterion on price stability.

Chart 3a. **Cyprus: Inflation criterion since May 2004**
(percent, 12-month moving average)



Sources: Eurostat, Commission services' autumn 2006 forecast

Chart 3b . **Cyprus: Government budget balance and debt**
(in percent of GDP)



(*) Commission services' autumn 2006 forecast *Source* : Commission services

Cyprus is at present not 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[9] having been abrogated by the Council decision of 11 July 2006[10]. The general government deficit peaked at 6.3 percent of GDP in 2003, but was reduced markedly in the following years, to 2.3 percent of GDP in 2005[11]. During the six years to 2005, both total revenue and total expenditure

9 Decision 2005/184/EC - OJ L 62, 9.3.2005, p. 19.

10 Decision 2006/627/EC - OJ L 256, 20.9.2006, pp. 13-14.

11 For 2006, the Commission services' autumn forecast projects a general government deficit of 1.9 percent of GDP.

ratios followed, on average, an upward trend. Total revenue increased due to a mix of structural and one-off measures. The former included the alignment of VAT tax rates with the *acquis* 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. Expenditure growth was restricted by the imposition of a ceiling on the nominal growth rates of current primary and capital expenditure, a policy which has been continued in subsequent budgets. Government debt decreased to 69.2 percent of GDP in 2005. Cyprus fulfils the criterion on the government budgetary position.

The Cyprus pound has participated in ERM II since 2 May 2005, i.e. for 19 months at the time of adoption of this report. 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 since 2001, but the wider fluctuation margins were not used in practice. In the period of the assessment not covered by ERM II participation, the pound stayed close to the future central rate. Since ERM II entry, the pound has remained close to the central rate and has not experienced severe tensions. Cyprus does not fulfil the exchange rate criterion.

The average long-term interest rate in Cyprus in the year to October 2006 was 4.1 percent, below the reference value of 6.2 percent. 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. Low yield spreads *vis-à-vis* the euro area testify to the low residual country risk priced in by markets. Cyprus fulfils the criterion on the convergence of long-term interest rates.

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, reaching 5.7 percent of GDP in 2005. 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 been substantial, albeit volatile.

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

2.4. Latvia

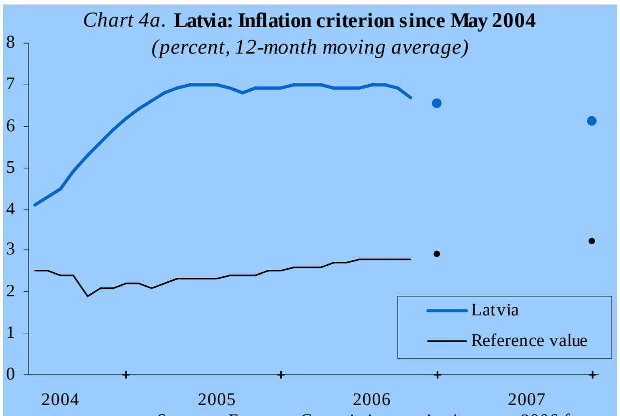
In the 2004 Convergence Report, the Commission assessment was that Latvia fulfilled two of the convergence criteria (on the government budgetary position and long-term interest rates). The assessment on legal convergence concluded that legislation in Latvia was not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

The Law on the Bank of Latvia has been amended twice since the adoption of the 2004 Convergence Report (December 2005 and June 2006). However, only a limited number of the incompatibilities highlighted have been resolved.

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

Annual average inflation in Latvia has been mostly above 6 percent since 2004, reflecting the impact of external price shocks and adjustments in administered prices and indirect taxes as well as increasing capacity constraints in a context of prolonged very rapid real GDP growth. Most recently, headline inflation has moderated slightly, to 5.6 percent in October 2006. While external factors (notably energy prices) have had a substantial upward impact on recent inflation outturns, demand-side factors appear to have become increasingly important in sustaining inflation at elevated levels, as shown by relatively high core inflation rates. Inflation is expected to remain at elevated levels for some time, reflecting upward pressures stemming from labour cost developments against the background of a tight labour market, buoyant economic activity, increases in excise taxes, and pro-cyclical fiscal policies. 12-month average inflation in Latvia has been above the reference value since EU accession. The average inflation rate in Latvia during the 12 months to October 2006 was 6.7 percent, above the reference value of 2.8 percent, and it is likely to remain above the reference value in the months ahead. Latvia does not fulfil the criterion on price stability.

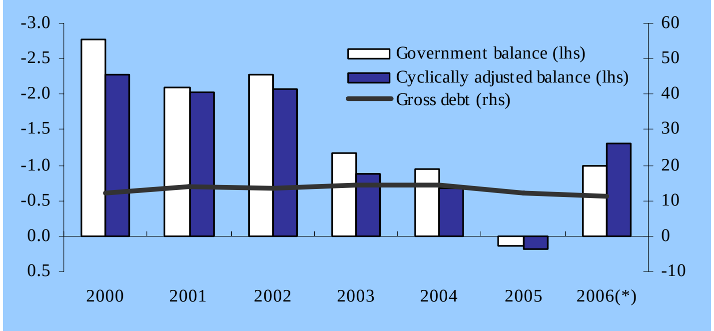
Chart 4a. **Latvia: Inflation criterion since May 2004**
(percent, 12-month moving average)



Sources: Eurostat, Commission services' autumn 2006 forecast

Latvia is not the subject of a Council decision on the existence of an excessive deficit. Following the 1998 Russian currency crisis, a period of fiscal consolidation ended abruptly in 1999 when the deficit surged to 5.3 percent of GDP. Subsequently, the general government balance registered smaller deficits averaging 1.8 percent of GDP over the period 2000-2004, while 2005 recorded a marginal surplus of 0.1 percent of GDP. At the same time, the tax burden on the economy continued to decline, from 32 percent of GDP in 1999 to 29 percent in 2005. Both revenue and primary expenditure ratios to GDP have declined steadily. The general government position was balanced in 2005 and government debt was

Chart 4b. **Latvia: Government budget balance and debt**
(in percent of GDP)



(*) Commission services' autumn 2006 forecast

Source: Commission services

12.1 percent of GDP[12]. Latvia fulfils the criterion on the government budgetary position.

The Latvian lats has participated in ERM II since 2 May 2005, i.e. for 19 months at the time of adoption of this report. Before ERM II entry, the lats was pegged to the SDR until end-2004 and to the euro from 1 January 2005 onwards. In the period of the assessment not covered by ERM II participation, the lats depreciated moderately against the euro and then stabilised following the re-peg. Upon ERM II entry, Latvia unilaterally committed to maintain the lats in a range of ± 1 percent around the central rate. Since ERM II entry, the lats has remained close to 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. Latvia does not fulfil the exchange rate criterion.

The average long-term interest rate in Latvia in the year to October 2006 was 3.9 percent, below the reference value of 6.2 percent. Average long-term interest rates in Latvia have been below the reference value since EU accession. Since ERM II entry long-term interest rate spreads to the euro area have fluctuated at relatively moderate levels, illustrating the stability of the currency peg and the confidence that investors have in it. Latvia fulfils the criterion on the convergence of long-term interest rates.

Additional factors have been examined, including product and financial market integration and balance of payments developments. The Latvian economy is becoming increasingly integrated with the EU. In particular, trade and FDI relations with other Member States are extensive and integration of the domestic financial sector into the broader EU sector has progressed substantially, mainly through a high degree of foreign ownership of financial intermediaries and the merger of the domestic stock exchange into the OMX Group of Nordic exchanges. Latvia's current account deficit has exceeded 10 percent of GDP since 2004, reaching 12.7 percent of GDP in 2005. The pattern of high current account deficits, principally accounted for by substantial deficits in goods trade partly offset by positive balances in services and current transfers, largely reflects the rapid catch-up path of the economy, whereby foreign savings have been mobilised via external borrowing to increase domestic investment and productivity growth. However, the external position implies substantial financing needs in the medium term and inflows need to be used productively. The current account deficits have been mainly financed by positive net FDI inflows and large intra-group bank lending, as well as sizeable foreign residents' deposits.

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

2.5. Hungary

In the 2004 Convergence Report, the Commission assessment was that Hungary fulfilled none of the convergence criteria. The assessment on legal convergence

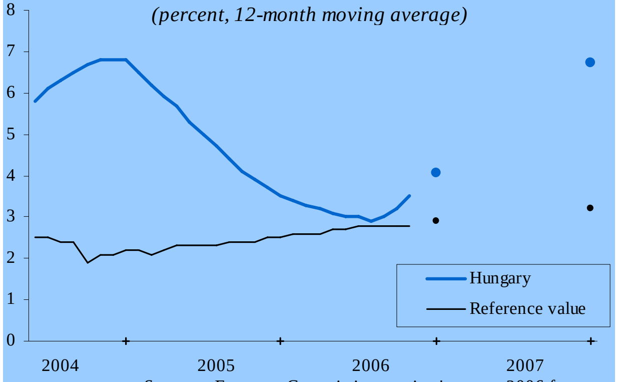
[12] For 2006, the Commission services' autumn forecast projects a general government deficit of 1.0 percent of GDP.

concluded that legislation in Hungary was not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

The Hungarian Parliament amended the Act of the Magyar Nemzeti Bank at the end of 2004. The amendments did not however remove the incompatibilities raised in the 2004 Convergence Report. Furthermore, an incompatibility exists with respect to the prohibition of monetary financing.

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

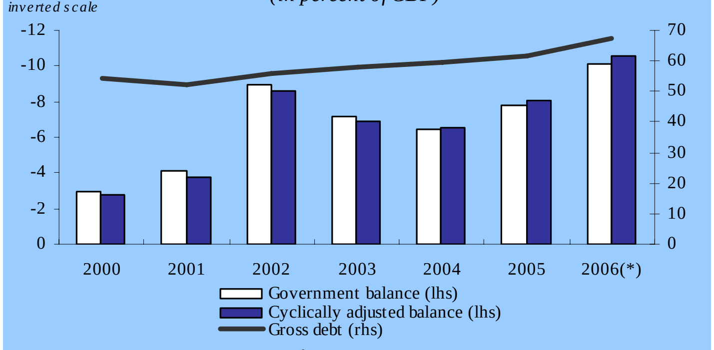
Chart 5a. **Hungary: Inflation criterion since May 2004**
(percent, 12-month moving average)



Sources: Eurostat, Commission services' autumn 2006 forecast

After declining from around 10 percent in the early-2000s to around 4 percent in 2003, HICP inflation picked up again in 2004, mainly due to increases in the prices of energy and food. Inflation has however moderated since the end of 2004 and stood at just above 2 percent at the beginning of 2006, largely as a result of an abrupt decline in processed food prices coupled with a decrease in energy prices. Inflation in Hungary has picked up again more recently, driven by rises in food prices, changes in indirect taxes and administered prices enacted during the summer and the lagged impact of the depreciation of the exchange rate in the first half of 2006. Inflation is expected to accelerate further due to the carry-over effects of several measures implemented in the course of 2006 as well as significant increases in administered prices and indirect taxes foreseen for 2007. In addition, several reforms in the health and education systems expected before the end of 2007 will likely put upward pressure on prices. 12-month average inflation in Hungary has been above the reference value since EU accession. The average inflation rate in Hungary during the 12 months to October 2006 was 3.5 percent, above the reference value of 2.8 percent, and it is likely to remain above the reference value in the months ahead. Hungary does not fulfil the criterion on price stability.

Chart 5b . **Hungary: Government budget balance and debt**
(in percent of GDP)



(*) Commission services' autumn 2006 forecast *Source* : Commission services

Hungary is at present the subject of a Council decision on the existence of an excessive deficit (Council decision of 5 July 2004)[13]. The Council recommended Hungary to take action in a medium-term framework in order to

13 Decision 2004/918/EC - OJ L 389, 30.12.2004, p. 27.

bring the deficit below 3 percent of GDP by 2008 in a credible and sustainable manner. In November 2005, the Council decided that Hungary had not taken adequate action in response to its recommendations. On 1 September 2006, Hungary presented an adjusted convergence programme on the basis of which, on 9 October 2006, the Council granted Hungary an additional year to correct its deficit (until 2009). Every year since 2001, the orientation of fiscal policy in Hungary has been expansive, fuelled by large increases in public expenditure (particularly in public wages and social transfers) and tax cuts which have not been offset by corresponding reductions in expenditure. Since 2002, each year the budget deficit has been well over 6 percent of GDP, reaching 7.8 percent of GDP in 2005, including the costs of pension reform. In 2006, the Government announced major budgetary slippages. After corrective measures, the authorities are now targeting a deficit of 10.1 percent of GDP this year[14]. Government debt has increased to 61.7 percent of GDP, in spite of massive privatisation receipts. Hungary does not fulfil the criterion on the government budgetary position.

The Hungarian forint, which is unilaterally pegged to the euro with a ± 15 percent fluctuation margin since 2001, is not participating in ERM II. For most of the period since the introduction of the unilateral peg to the euro, the forint has fluctuated within the upper part of the band. However, from August 2005 onwards, the forint depreciated substantially *vis-à-vis* the euro, to a low point in June 2006, after which it gradually started to strengthen again. During the two years before this assessment, i.e. between November 2004 and October 2006, the forint depreciated against the euro by about 9 percent. Hungary does not fulfil the exchange rate criterion.

The average long-term interest rate in Hungary in the year to October 2006 was 7.1 percent, above the reference value of 6.2 percent. Average long-term interest rates in Hungary have been above the reference value since EU accession. Bond yield spreads with the euro area widened from a level of around 280 basis points in June 2006 to approximately 350 basis points in August 2006, and to around 375 basis points in October 2006. Hungary does not fulfil the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including product and financial market integration and balance of payments developments. The Hungarian economy is highly integrated with the EU. In particular, trade and FDI relations with other Member States are extensive and integration of the domestic financial sector into the broader EU sector has progressed substantially, mainly through a high degree of foreign ownership of financial intermediaries. The current account deficit declined from a peak of 8.5 percent of GDP in 2004 to 6.8 percent of GDP in 2005, as a result of a smaller deficit in goods and services trade. The substantial current account deficits in recent years, which reflect *inter alia* a shortfall in public savings, have been mainly financed by sustained high net FDI (with the exception of 2003 when they dropped considerably) and portfolio inflows. In the first half of 2006, a worsening in foreign investors' assessment of Hungarian economic fundamentals led to a sharp fall in portfolio inflows.

[14] The Commission services' autumn forecast projects a general government deficit at the same level.

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

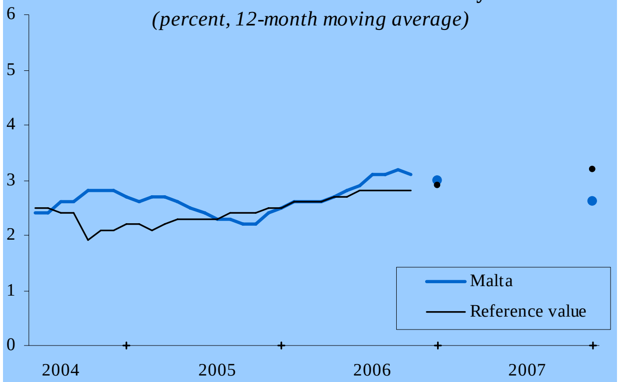
2.6. Malta

In the 2004 Convergence Report, the Commission assessment was that Malta fulfilled one of the convergence criteria (on long-term interest rates). The assessment on legal convergence concluded that legislation in Malta was not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

Although the Central Bank of Malta Act was amended twice in 2005, the amending acts did not remove all the incompatibilities highlighted in the 2004 Convergence Report. A new draft Act amending the Central Bank of Malta Act was submitted to Parliament on 13 November 2006 in order to address the remaining issues and to ensure full compatibility with the Treaty and the ESCB/ECB Statute. In its present form, this draft Act removes all incompatibilities raised in the 2004 Convergence Report.

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

Chart 6a. **Malta: Inflation criterion since May 2004**
(percent, 12-month moving average)



Sources: Eurostat, Commission services' autumn 2006 forecast

HICP inflation in Malta has fluctuated around a level of some 2.5 percent over recent years, with some volatility, primarily due to the fact that Malta is an 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. It has shown considerable volatility during 2006, with a strong decline in October, mainly on the back of favourable oil price developments. HICP inflation excluding energy has remained contained at an average of below 2 percent in 2006. Moderate core inflation dynamics suggest that underlying inflationary pressures have remained limited, against the background of a negative output gap and low wage pressures. Inflation is expected to remain on a moderate path in the medium term as the energy price shock ebbs away. The emergence of indirect or second-round effects from energy price increases remains a risk, though there has been no indication of significant spillovers so far. 12-month average inflation in Malta has been above the reference value since May 2006. The average inflation rate in Malta during the 12 months to October 2006 was 3.1 percent, above the reference value of 2.8 percent, and it is likely to return to a position close to the reference value in the months ahead. Malta does not fulfil the criterion on price stability.

Malta is at present the subject of a Council decision on the existence of an excessive deficit (Council decision of 5 July 2004)[15]. The Council recommended Malta to take action in a medium-term framework in order to bring the deficit below 3 percent of GDP by 2006 in a credible and sustainable manner. Malta's general government deficit has fluctuated at relatively high levels over the past years (including due to one-off operations), reaching a high of around 10 percent of GDP in 2003 and decreasing in the following years in the context of the government's fiscal consolidation programme. The revenue ratio has followed an upward trend, whilst expenditure increased until 2003 but decreased thereafter. General government debt increased significantly in the first half of the decade, peaking at around 75 percent in 2004. The general government deficit was 3.2 percent of GDP in 2005 and government debt decreased slightly to 74.2 percent of GDP[16]. Malta does not fulfil the criterion on the government budgetary position.

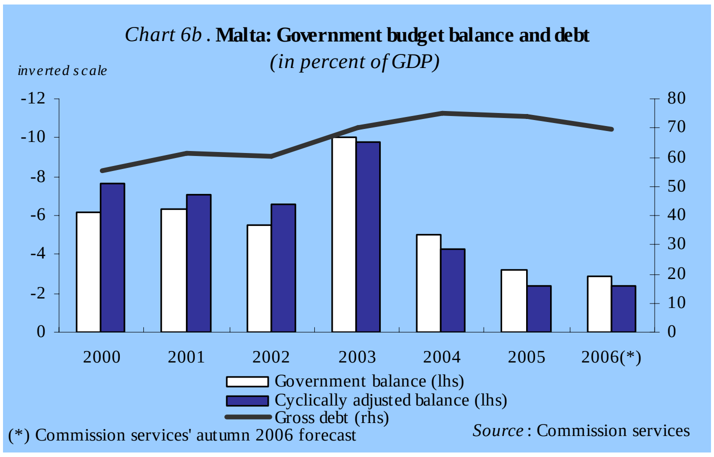


Chart 6b. **Malta: Government budget balance and debt**
(in percent of GDP)

The Maltese lira has participated in ERM II since 2 May 2005, i.e. for 19 months at the time of adoption of this report. Before entering ERM II, the lira was pegged to a euro-dollar-sterling basket. In the period of the assessment not covered by ERM II participation, 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 does not fulfil the exchange rate criterion.

The average long-term interest rate in Malta in the year to October 2006 was 4.3 percent, below the reference value of 6.2 percent. 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 50 basis points in autumn 2006. Contained yield spreads testify to limited residual country risk priced in by markets. Malta fulfils the criterion on the convergence of long-term interest rates.

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

15 Decision 2005/186/EC - OJ L 62, 9.3.2005, p. 21.

16 For 2006, the Commission services' autumn forecast projects a general government deficit of 2.9 percent of GDP.

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 10.6 percent 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. On the financing side, net FDI inflows have been substantial, albeit volatile. The external position implies substantial financing needs in the medium term.

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

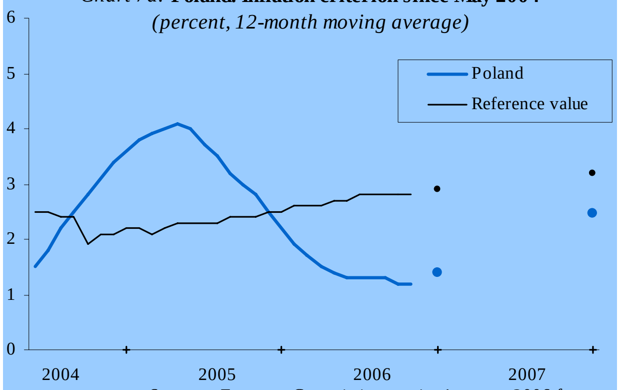
2.7. Poland

In the 2004 Convergence Report, the Commission assessment was that Poland fulfilled none of the convergence criteria. The assessment on legal convergence concluded that legislation in Poland was not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

Amendments were made to the Act on the National Bank of Poland in 2004 and 2006, although none of them address the incompatibilities highlighted in the 2004 Convergence Report. Furthermore, incompatibilities exist with respect to the prohibition of monetary financing.

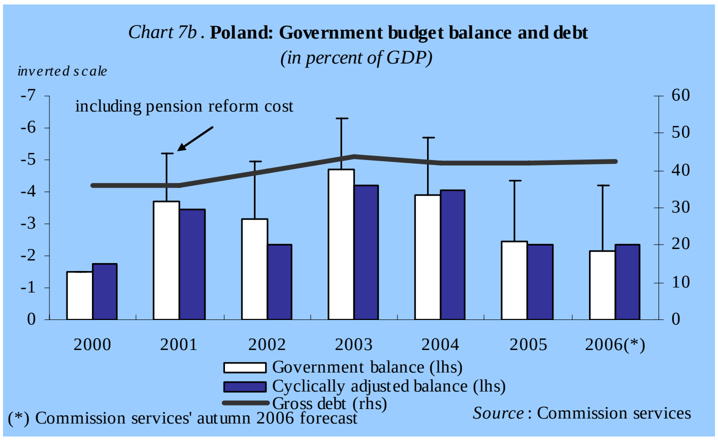
As regards central bank integration into the ESCB at the time of euro adoption and the prohibition of monetary financing, legislation in Poland (in particular, the Act on the National Bank of Poland, the Constitution of Poland and the Law on the Bank Guarantee Fund) is not fully compatible with Article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

Chart 7a. **Poland: Inflation criterion since May 2004**
(percent, 12-month moving average)



Sources: Eurostat, Commission services' autumn 2006 forecast

Following high and volatile inflation in the 1990s, HICP inflation in Poland has decreased sharply to a very low level, averaging 2.1 percent over the period 2002-2005. Underlying inflationary pressures have been contained over the last few years. Wage inflation has been restrained by labour market slack, although cyclical conditions have gradually improved in 2005-2006. Growth in import prices has decelerated substantially since 2004, notably reflecting the appreciation of the zloty's nominal exchange rate in effective terms. Nonetheless, Polish inflation has been somewhat volatile, notably due to the effect of EU accession and fluctuations in food and import prices. A slight pick-up in inflation from the current low level is expected on the back of improved cyclical conditions and planned increases in indirect taxes in the course of 2007-2008. Maintaining a satisfactory inflation performance in the medium term will hinge on keeping wage growth in line with productivity developments, as the expected fall in unemployment could somewhat add to wage pressures. 12-month average inflation in Poland has been at or below the reference value since November 2005. The average inflation rate in Poland during the 12 months to October 2006 was 1.2 percent, below the reference value of 2.8 percent, and it is likely to remain below the reference value in the months ahead. Poland fulfils the criterion on price stability.



Poland is at present the subject of a Council decision on the existence of an excessive deficit (Council decision of 5 July 2004)[17]. The Council recommended Poland to bring the deficit below 3 percent of GDP by 2007 in a credible and sustainable manner. On 28 November 2006, the Council decided that the action taken by Poland in response to its recommendations of July 2004 was proving to be inadequate. The general government balance was negative during the period 2000-2005, recording a deficit of 3.2 percent of GDP on average. The deficit deteriorated in 2001 and again in 2003, when the expenditure-to-GDP ratio peaked. The deficit narrowed during 2004-2005, notably on account of income tax reforms, a freezing of the indexation of social transfers, lower-than-expected public investment and some changes in the accrual methodology. The general government deficit was 2.5 percent of GDP in 2005. If the mandatory funded pension scheme were excluded from the government sector, the general government deficit would total 4.4 percent of GDP[18,19]. The general government debt ratio increased by around 6 percentage points between 2000 and 2005. Government debt was 42.0 percent of GDP; the figure excluding the mandatory funded pension scheme would be 47.3 percent of GDP. Poland does not fulfil the criterion on the government budgetary position.

The Polish zloty is not participating in ERM II. Since the abandonment of the crawling peg regime in 2000, Poland has been operating an inflation targeting regime combined with a floating exchange rate. The zloty exchange rate has fluctuated widely over the past few years. The currency strongly appreciated during 2000-2001, but then experienced a significant correction until early 2004. During the two years before this assessment, i.e. between November 2004 and October 2006, the zloty

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17 Decision 2005/183/EC - OJ L 62, 9.3.2005, p. 18.

18 Poland has availed itself of a transitional period to implement the Eurostat decision of 2 March 2004 on classification of funded pension schemes. During this period, which will expire with the first fiscal notification of 2007, Poland can record revenues and expenditures incurred by funded pension schemes within the government sector, resulting in a lower general government deficit.

19 For 2006, the Commission services' autumn forecast projects a general government deficit of 2.2 percent of GDP (the figure excluding the mandatory funded pension scheme would be 4.2 percent of GDP).

appreciated against the euro by about 8½ percent. Poland does not fulfil the exchange rate criterion.

The average long-term interest rate in Poland in the year to October 2006 was 5.2 percent, below the reference value of 6.2 percent. Average long-term interest rates in Poland have been at or below the reference value since August 2005. Polish long-term interest rates have fluctuated over the past years reflecting notably shifts in the inflation outlook and monetary policy stance as well as changes in market sentiment that impacted on country risk premia. The long-term spread *vis-à-vis* the euro area declined significantly as compared to the early 2000s. Spreads narrowed to around 100 basis points in spring 2006, but widened again to above 150 basis points in the summer. Poland fulfils the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including product and financial market integration and balance of payments developments. The Polish economy is highly integrated with the EU. In particular, trade and FDI relations with other Member States are growing, and integration of the domestic financial sector into the broader EU sector has progressed substantially, mainly through a high degree of foreign ownership of financial intermediaries. Poland's current account deficit temporarily widened to just above 4 percent of GDP in 2004, largely due to a surge in the income deficit which primarily reflected robust profits from FDI, but declined to 1.7 percent of GDP in 2005. FDI inflows, though at a low level compared to other new Member States, were largely sufficient to finance current account deficits in the past years.

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

2.8. Slovakia

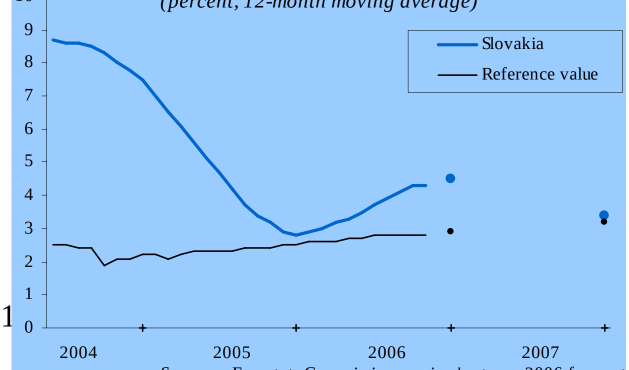
In the 2004 Convergence Report, the Commission assessment was that Slovakia fulfilled one of the convergence criteria (on long-term interest rates). The assessment on legal convergence concluded that legislation in Slovakia was not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

The Act on the National Bank of Slovakia was amended in 2004 and in 2005, without however addressing the incompatibilities highlighted in the 2004 Convergence Report. Furthermore, an incompatibility exists with respect to the prohibition of monetary financing.

As regards central bank integration into the ESCB at the time of euro adoption as well as the prohibition of monetary financing, legislation in Slovakia (in particular, the Act on the National Bank of Slovakia and the Law on the Protection of Bank Deposits) is not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

In recent years, Slovakia has experienced volatile, and at times high, HICP inflation, reflecting the impact of external factors and adjustments in administered prices

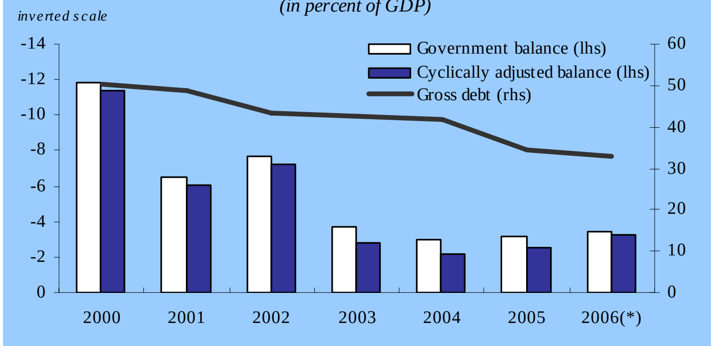
Chart 8a. **Slovakia: Inflation criterion since May 2004**
(percent, 12-month moving average)



Sources: Eurostat, Commission services' autumn 2006 forecast and indirect taxes. The koruna's trend exchange rate appreciation in 2002-2005 exerted a moderating effect on inflation. Adjusted for the impact of administered price increases, developments in underlying inflation have on the whole been relatively favourable. More recently, domestic demand pressures and energy prices have contributed to a pick-up in inflation from 2.8 percent on average in 2005 to about 5 percent in the summer of 2006. Inflation is expected to moderate in 2007 and 2008, mainly in view of lower increases in administered prices, while strong demand and wage growth are expected to put some upward pressure on inflation. 12-month average inflation in Slovakia has been above the reference value since EU accession. The average inflation rate in Slovakia during the 12 months to October 2006 was 4.3 percent, above the reference value of 2.8 percent, and it is likely to remain above the reference value in the months ahead. Slovakia does not fulfil the criterion on price stability.

Slovakia is at present the subject of a Council decision on the existence of an excessive deficit (Council decision of 5 July 2004)[20]. The Council recommended Slovakia to take action in a medium-term framework in order to bring the deficit below 3 percent of GDP by 2007 in a credible and sustainable manner. Slovakia's general government deficit reached levels around 7 percent of GDP at the beginning of the decade but has been reduced substantially since 2002. Both the revenue and expenditure ratio have decreased, the latter at a higher rate. General government debt has declined significantly since 2000, when it stood at some 50 percent of GDP. The general government deficit was 3.1 percent of GDP in 2005, while government debt was 34.5 percent of GDP[21]. Slovakia does not fulfil the criterion on the government budgetary position.

Chart 8b . **Slovakia: Government budget balance and debt**
(in percent of GDP)



(*) Commission services' autumn 2006 forecast
Source : Commission services

The Slovak koruna has participated in ERM II since 28 November 2005, i.e. for 12 months at the time of adoption of this report. Before ERM II entry, Slovakia operated a managed floating exchange rate regime. In the period of the assessment not covered by ERM II participation, the koruna initially appreciated moderately against the euro and then remained close to the future central rate. Since ERM II entry, the koruna has remained above the central rate except for a limited period in the summer of 2006 when post-election uncertainty about the euro adoption date and fiscal uncertainties combined with broader pressures on the central European currencies led to significant downward pressures, which were countered by central bank action. Since July 2006, the koruna has been on a marked appreciating path, which brought

20 Decision 2005/182/EC - OJ L 62, 9.3.2005, pp. 16-17.
21 For 2006, the Commission services' autumn forecast projects a general government deficit of 3.4 percent of GDP.

it 5.5 percent above the central parity at the end of the assessment period. Slovakia does not fulfil the exchange rate criterion.

The average long-term interest rate in Slovakia in the year to October 2006 was 4.3 percent, below the reference value of 6.2 percent. Average long-term interest rates in Slovakia have been below the reference value since EU accession. The spread *vis-à-vis* euro area long-term benchmark bonds had been declining markedly since the adoption of the government's reform programme in 2002 and had become negative for several months in 2005, before turning positive again in 2006 in response to a pick-up in inflation and subsequent hikes in the key policy rates. Slovakia fulfils the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including product and financial market integration and balance of payments developments. The Slovak economy is highly integrated with the EU. In particular, trade and FDI relations with other Member States are extensive and integration of the domestic financial sector into the broader EU sector has progressed substantially, mainly through a significant degree of foreign ownership of financial intermediaries. Slovakia's current account balance has been highly volatile in recent years reflecting swings in export performance driven by new FDI-related production capacities, in particular in the automotive sector. Following a substantial improvement in 2003, the current account deficit widened to 8.6 percent of GDP in 2005. The worsening of Slovakia's external position in the last years has been driven by dynamic private consumption and an increase in FDI-related imports. Substantial new export-oriented production capacity is expected to boost exports in the coming years. The current account deficit has been mainly financed by large net FDI inflows.

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

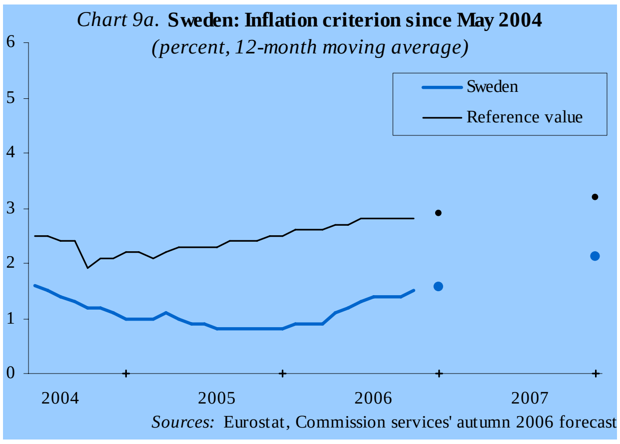
2.9. Sweden

In the 2004 Convergence Report, the Commission assessment was that Sweden fulfilled three of the convergence criteria (on price stability, the government budgetary position and long-term interest rates). The assessment on legal convergence concluded that legislation in Sweden was not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

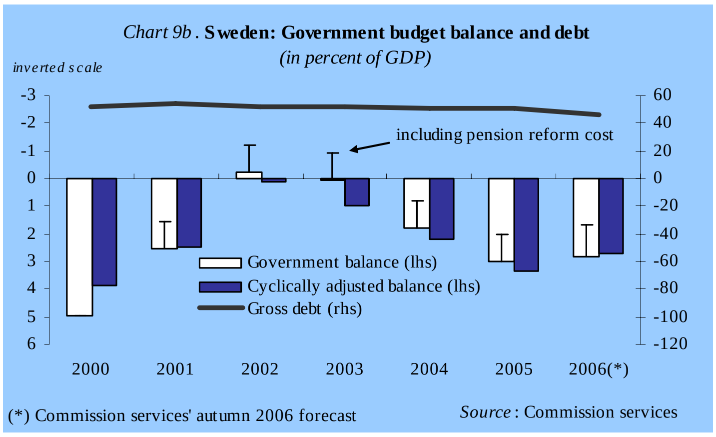
The Riksbank Act was amended in 2004 and 2006, without however addressing the incompatibilities highlighted in the 2004 Convergence Report. Moreover, incompatibilities have been identified in the Law on the Exchange Rate Policy.

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

HICP inflation in Sweden has generally been below 2 percent over the past few years, with the exception of periods in 2001 and 2003 when rises in electricity prices contributed to higher headline inflation. Relatively robust economic growth has mainly been driven by high productivity gains, which have largely offset the impact of wage growth on unit labour costs. A gradual pass-through of the strengthening of the krona exchange rate between 2002 and 2004 and the disinflationary impact of international competition and globalisation on the prices of imported manufactured goods have also contributed to low inflation. Strong demand growth and improving labour market conditions are expected to put some moderate upward pressure on inflation. However, medium-term inflationary prospects remain favourable in view of positive supply factors and well-anchored inflation expectations. 12-month average inflation in Sweden has consistently been below the reference value in recent years. The average inflation rate in Sweden during the 12 months to October 2006 was 1.5 percent, below the reference value of 2.8 percent, and it is likely to remain below the reference value in the months ahead. Sweden fulfils the criterion on price stability.



Sweden is not the subject of a Council decision on the existence of an excessive deficit. Sweden ran a general government surplus over the period 2000-2005 averaging 2.0 percent of GDP. This high average surplus reflects the Swedish rules-based budgetary framework. In 2005, the surplus stood at 3.0 percent of GDP. If the mandatory funded pension scheme were excluded from the government sector, the general government surplus would total 2.0 percent of GDP[22,23]. Government debt was 50.4 percent of GDP in 2005; the figure excluding the mandatory funded pension scheme would be to 50.9 percent of GDP. Sweden fulfils the criterion on the government budgetary position.



The Swedish krona is not participating in ERM II. Sweden operates an inflation targeting regime combined with a floating exchange rate. Apart from a rapid

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22 Sweden has availed itself of a transitional period to implement the Eurostat decision of 2 March 2004 on classification of funded pension schemes. During this period, which will expire with the first fiscal notification of 2007, Sweden can record revenues and expenditures incurred by funded pension schemes within the government sector, resulting in a higher general government surplus.

23 For 2006, the Commission services' autumn forecast projects a general government surplus of 2.8 percent of GDP (the figure excluding the mandatory funded pension scheme would be 1.7 percent of GDP).

depreciation of the exchange rate immediately after abandoning a fixed exchange rate system in 1992, the krona/euro exchange rate has mostly moved in a relatively narrow range *vis-à-vis* the Deutsche mark and subsequently the euro. Between November 2004 and October 2006, the krona depreciated against the euro by just below 3 percent. Sweden does not fulfil the exchange rate criterion.

The average long-term interest rate in Sweden in the year to October 2006 was 3.7 percent, below the reference value of 6.2 percent. Average long-term interest rates in Sweden have consistently been below the reference value in recent years. The spread *vis-à-vis* euro area long-term interest rates declined markedly since 2003, from around 50 basis points to currently minus 10 basis points, reflecting among other things a negative policy rate differential *vis-à-vis* the euro area. Sweden fulfils the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including product and financial market integration and balance of payments development. The Swedish economy is highly integrated with the EU. In particular, trade relations with other Member States are growing and the domestic financial sector is highly integrated with the broader EU sector, mainly through Swedish ownership of financial intermediaries in the Nordic/Baltic region and the merger of the Swedish stock exchange into the OMX Group of Nordic stock exchanges. Sweden has had a current account surplus of around 6-7 percent of GDP for several years as a result of strong export performance. Net FDI outflows largely account for the financial account deficits.

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