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EUROPEAN CENTRAL BANK

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MAY 2007

CONVERGENCE REPORT

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In 2007 all ECB publications feature a motif taken from the €20 banknote.

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CONTENTS

1 INTRODUCTION 6

2 FRAMEWORK FOR ANALYSIS
2.1 Economic convergence 7
2.2 Compatibility of national legislation with the Treaty 14

3 COUNTRY SUMMARIES
3.1 Cyprus 27
3.2 Malta 29

4 EXAMINATION OF ECONOMIC CONVERGENCE
4.1 Cyprus 33
4.2 Malta 49

ANNEX
STATISTICAL METHODOLOGY OF CONVERGENCE INDICATORS 65

5 EXAMINATION OF COMPATIBILITY OF NATIONAL LEGISLATION WITH THE TREATY
5.1 Cyprus 73
5.2 Malta 77

GLOSSARY 84

ABBREVIATIONS

COUNTRIES

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

OTHERS

BIS	Bank for International Settlements
b.o.p.	balance of payments
BPM5	IMF Balance of Payments Manual (5th edition)
CD	certificate of deposit
CPI	Consumer Price Index
ECB	European Central Bank
EDP	excessive deficit procedure
EER	effective exchange rate
EMI	European Monetary Institute
EMU	Economic and Monetary Union
ERM	exchange rate mechanism
ESA 95	European System of Accounts 1995
ESCB	European System of Central Banks
EU	European Union
EUR	euro
GDP	gross domestic product
HICP	Harmonised Index of Consumer Prices
ILO	International Labour Organization
IMF	International Monetary Fund
MFI	monetary financial institution
NCB	national central bank
OECD	Organisation for Economic Co-operation and Development
PPI	Producer Price Index
ULCM	unit labour costs in manufacturing
ULCT	unit labour costs in the total economy

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

I INTRODUCTION

The euro was introduced on 1 January 1999. As of now, 13 European Union (EU) Member States have adopted the euro in line with the requirements of the Treaty, the most recent one being Slovenia on 1 January 2007. At the same time, following the enlargements of the EU in 2004 and 2007, 14 Member States are at present not full participants in Economic and Monetary Union (EMU) and have not yet adopted the euro.

This Convergence Report has been prepared following requests for a country examination received from Cyprus on 13 February 2007 and from Malta on 27 February 2007. In producing this report, the European Central Bank (ECB) fulfils the requirement of Article 122(2) in conjunction with Article 121(1) of the Treaty establishing the European Community (the Treaty) to report to the Council of the European Union (the EU Council) at least once every two years or at the request of a Member State with a derogation "on the progress made in the fulfilment by the Member States of their obligations regarding the achievement of economic and monetary union". The same mandate has been given to the European Commission, which has also prepared a report, and the two reports are being submitted to the EU Council in parallel.

In this report, the ECB uses the framework applied in its previous Convergence Reports. It examines, for the two countries concerned, whether a high degree of sustainable economic convergence has been achieved, whether the national legislation is compatible with the Treaty and whether the statutory requirements are fulfilled for national central banks (NCBs) to become an integral part of the Eurosystem.

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

This Convergence Report is structured as follows. Chapter 2 describes the framework used for the examination of economic and legal convergence. Chapter 3 contains the country summaries, which provide the main results of the examination of economic and legal convergence. Chapter 4 examines the state of economic convergence in each of the two Member States under review in more detail and provides an overview of the statistical methodology of convergence indicators. Finally, Chapter 5 examines the compatibility between each of these Member States' national legislation, including the statutes of their NCB, and Articles 108 and 109 of the Treaty and the Statute of the European System of Central Banks (ESCB).

2 FRAMEWORK FOR ANALYSIS

2.1 ECONOMIC CONVERGENCE

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

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

In this respect, economic developments in the countries concerned are reviewed from a backward-looking perspective, covering, in principle, the past ten years. This helps to better determine the extent to which current achievements are the result of genuine structural adjustments, which in turn should lead to a better assessment of the sustainability of economic convergence.

In addition, and to the extent appropriate, a forward-looking perspective is adopted. In this context, particular attention is drawn to the fact that the sustainability of favourable economic developments hinges critically on appropriate and lasting policy responses to existing and future challenges. Overall, it is emphasised that ensuring the sustainability of economic convergence depends both on the achievement of a sound starting position and on the policies pursued after the adoption of the euro.

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

The cut-off date for the statistics included in this Convergence Report was 26 April 2007. The statistical data used in the application of the convergence criteria have been provided by the European Commission (see also the statistical annex and the tables and charts), in cooperation with the ECB in the case of the long-term interest rates. Convergence data on price and long-term interest rate developments are presented up to March 2007, the latest month for which data on HICPs were available. For monthly data on exchange rates, the period considered in this report ends in March 2007, whereas daily data have been included until 26 April 2007. Data for fiscal positions cover the period up to 2006. Account is also taken of forecasts from various sources, together with the most recent convergence programmes of the Member States and other information considered to be relevant to a forward-looking consideration of the sustainability of convergence. The release date of the European Commission's spring 2007 forecast, which is also taken into account in this report, was 7 May 2007. The report was adopted by the General Council of the ECB on 14 May 2007.

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

Box 1

PRICE DEVELOPMENTS

1 Treaty provisions

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

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

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

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

2 Application of Treaty provisions

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

– First, with regard to "an average rate of inflation, observed over a period of one year before the examination", the inflation rate has been calculated using the change in the latest available 12-month average of the HICP over the previous 12-month average. Hence, with regard to the rate of inflation, the reference period considered in this report is April 2006 to March 2007.

– Second, the notion of "at most, the three best performing Member States in terms of price stability", which is used for the definition of the reference value, has been applied by taking the unweighted arithmetic average of the rate of inflation of the following three EU countries with the lowest inflation rates: Finland (1.3%), Poland (1.5%) and Sweden (1.6%). As a result, the average rate is 1.5% and, adding 1½ percentage points, the reference value is 3.0%.

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

To allow a more detailed examination of the sustainability of price developments, the average rate of HICP inflation over the 12-month reference period from April 2006 to March 2007 is reviewed in the light of the Member States' economic performance over the last ten years in terms of price stability. In this connection, attention is drawn to the orientation of monetary policy, in particular to whether the focus of the monetary authorities has been primarily on achieving and maintaining price stability, as well as to the contribution of other areas of economic policy to this objective. Moreover, the implications of the macroeconomic environment for the achievement of price stability are taken into account. Price developments are examined in the light of demand and supply conditions, focusing on, inter alia, factors influencing unit labour costs and import prices. Finally, trends in other relevant price indices (such as the HICP excluding unprocessed food and energy, the national CPI, the CPI excluding changes in net indirect taxation, the private consumption deflator, the GDP deflator and producer prices) are considered. From a forward-looking perspective, a view is provided of prospective inflationary developments in the coming years, including forecasts by major international organisations and market participants. Moreover, structural aspects which are relevant for maintaining an environment conducive to price stability after adoption of the euro are discussed.

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

Box 2

FISCAL DEVELOPMENTS

1 Treaty provisions

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

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

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

"the criterion on the government budgetary position referred to in the second indent of Article 121(1) of this Treaty shall mean that at the time of the examination the Member State is not the subject of a Council decision under Article 104(6) of this Treaty that an excessive deficit exists".

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

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

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

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

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

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

2 Application of Treaty provisions

For the purpose of examining convergence, the ECB expresses its view on fiscal developments. With regard to sustainability, the ECB examines key indicators of fiscal developments from 1997 to 2006, considers the outlook and challenges for general government finances and focuses on the links between deficit and debt developments.

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

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

The examination of fiscal developments is based on data compiled on a national accounts basis, in compliance with the European System of Accounts 1995 (see the statistical annex). Most of the figures presented in this report were provided by the Commission in April 2007 and include government financial positions from 1997 to 2006 as well as Commission forecasts for 2007.

With regard to the sustainability of public finances, the outcome in the reference year, 2006, is reviewed in the light of the Member States' performance over the last ten years. As a starting-point, the development of the government debt ratio in this period is considered, as well as the factors underlying it, i.e. the difference between nominal GDP growth and interest rates, the primary balance, and the deficit-debt adjustment. Such a perspective can offer further information on the extent to which the macroeconomic environment, in particular the combination of growth and interest rates, has affected the dynamics of debt. It can also provide more information on the contribution of fiscal consolidation efforts, as reflected in the primary balance, and on the role played by special factors as included in the deficit-debt adjustment. In addition, the structure of government debt is considered, focusing in particular on the shares of debt with a short-term maturity and foreign currency debt, as well as their development. By comparing these shares with the current level of the debt ratio, the sensitivity of fiscal balances to changes in exchange rates and interest rates is highlighted.

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

Turning to a forward-looking perspective, national budget plans and recent forecasts by the European Commission for 2007 are recalled and account is taken of the medium-term fiscal strategy, as reflected in the convergence programme. This includes an assessment of the projected attainment of its medium-term objective, as foreseen in the Stability and Growth Pact, as well as of the outlook for the debt ratio on the basis of current fiscal policies. Furthermore, long-term challenges to the sustainability of budgetary positions are emphasised, particularly those related to the issue of unfunded government pension systems in connection with demographic change and to guarantees given by the government.

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

Box 3

EXCHANGE RATE DEVELOPMENTS

1 Treaty provisions

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

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

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

"the criterion on participation in the exchange-rate mechanism of the European Monetary System referred to in the third indent of Article 121(1) of this Treaty shall mean that a Member

State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against any other Member State's currency on its own initiative for the same period."

2 Application of Treaty provisions

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

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

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

All bilateral exchange rates for the reference period from May 2005 to April 2007 are official ECB reference rates (see the statistical annex).

Both Cyprus and Malta have participated in ERM II with effect from 2 May 2005, i.e. for slightly more than two years prior to the finalisation of this report. The performance of their currencies is shown against the euro during the period from 27 April 2005 to 26 April 2007 (i.e. the cut-off date for data used in this report). Between 26 April 2007 and 14 May 2007 (the finalisation date of this report) the exchange rates of the currencies of both countries vis-à-vis the euro were stable.

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

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

Box 4

LONG-TERM INTEREST RATE DEVELOPMENTS

1 Treaty provisions

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

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

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

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

2 Application of Treaty provisions

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

– First, with regard to "an average nominal long-term interest rate" observed over "a period of one year before the examination", the long-term interest rate has been calculated as an arithmetic average over the latest 12 months for which HICP data were available. The reference period considered in this report is April 2006 to March 2007.

– Second, the notion of "at most, the three best performing Member States in terms of price stability" which is used for the definition of the reference value has been applied by using the unweighted arithmetic average of the long-term interest rates of the same three EU countries entering the calculation of the reference value for the criterion on price stability (see Box 1). Over the reference period considered in this report, the long-term interest rates of these three countries were 3.8% (Sweden), 3.9% (Finland) and 5.3% (Poland); as a result, the average rate is 4.4% and, adding 2 percentage points, the reference value is 6.4%.

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

For a country where no harmonised long-term interest rate is available, a broad analysis of financial markets is conducted to the extent possible, taking into account the level of government debt and other relevant indicators, with a view to assessing the durability of the convergence achieved by the Member State and of its participation in ERM II.

As mentioned above, the Treaty makes explicit reference to the "durability of convergence" being reflected in the level of long-term interest rates. Therefore, developments over the reference period from April 2006 to March 2007 are reviewed against the background of the path of long-term interest rates over the last ten years (or the period for which data are available) and the main factors underlying differentials vis-à-vis the average long-term interest rate prevailing in the euro area.

Finally, Article 121(1) of the Treaty requires this report to take account of several other relevant factors, namely "the development of the ECU, the results of the integration of markets, the situation and development of the balances of payments on current account and an examination of the development of unit labour costs and other price indices". These factors are reviewed in Chapter 4 under the individual criteria listed above. In the light of the launch of the euro on 1 January 1999, there is no longer a discussion of the development of the ECU.

2.2 COMPATIBILITY OF NATIONAL LEGISLATION WITH THE TREATY

2.2.1 INTRODUCTION

Article 122(2) of the Treaty requires the ECB (and the Commission) to report, at least once every two years or at the request of a Member State with a derogation, to the EU Council in accordance with the procedure laid down in Article 121(1). Each such report must include an examination of the compatibility between, on the one hand, the national legislation of each Member State with a derogation, including the statutes of its NCB, and, on the other hand, Articles 108 and 109 of the Treaty and the Statute of the European System of Central Banks and of the European Central Bank (hereinafter the "Statute"). This Treaty obligation applying to Member States with a derogation is also referred to as "legal convergence". When assessing legal convergence, the ECB is not limited to a formal assessment of the letter of national legislation but may also consider whether the implementation of the relevant provisions complies with the spirit of the Treaty and the Statute. The ECB is particularly concerned about recent growing signs of pressure being put on the decision-making bodies of some Member States' NCBs, which would be inconsistent with the spirit of the Treaty as regards central bank independence. Therefore, the ECB will closely monitor any developments prior to any final positive assessment concluding that a Member State's national legislation is compatible with the Treaty and the Statute.

MEMBER STATES WITH A DEROGATION AND LEGAL CONVERGENCE

Cyprus and Malta, whose national legislation is examined in this report, have the status of Member States with a derogation, i.e. they have not yet adopted the euro. Article 4 of the Act concerning the conditions of accession[1] provides that: "Each of the new Member States shall participate in Economic and Monetary Union from the date of accession as a Member State with a derogation within the meaning of Article 122 of the EC Treaty".

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

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

1 Act concerning the conditions of accession of the Czech Republic, the Republic of Estonia, the Republic of Cyprus, the Republic of Latvia, the Republic of Lithuania, the Republic of Hungary, the Republic of Malta, the Republic of Poland, the Republic of Slovenia and the Slovak Republic and the adjustments to the Treaties on which the European Union is founded (OJ L 236, 23.9.2003, p. 33). For Bulgaria and Romania, see Article 5 of the Act concerning the conditions of accession of the Republic of Bulgaria and Romania and the adjustments to the treaties on which the European Union is founded (OJ L 157, 21.6.2005, p. 203).

the NCBs' legal integration into the Eurosystem.

STRUCTURE OF THE LEGAL ASSESSMENT

The legal assessment broadly follows the framework of the ECB's and the EMI's previous reports on legal convergence, in particular the ECB's Convergence Reports of December 2006 (on the Czech Republic, Estonia, Cyprus, Latvia, Hungary, Malta, Poland, Slovakia and Sweden), of May 2006 (on Lithuania and Slovenia), of 2004 (on the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia, Slovakia and Sweden), of 2002 (on Sweden) and of 2000 (on Greece and Sweden) and the EMI's Convergence Report of 1998. The compatibility of national legislation is also considered in the light of any legislative amendments enacted before 15 March 2007.

2.2.2 SCOPE OF ADAPTATION

2.2.2.1 AREAS OF ADAPTATION

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

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

– compatibility with the prohibitions on monetary financing (Article 101 of the Treaty) and privileged access (Article 102 of the Treaty) and compatibility with the single spelling of the euro required by Community law; and

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

2.2.2.2 "COMPATIBILITY" VERSUS "HARMONISATION"

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

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

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

2 See, inter alia, Case 167/73 *Commission of the European Communities* v *French Republic* [1974] ECR 359 ("Code du Travail Maritime").

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

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

2.2.3 INDEPENDENCE OF NCBS

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

2.2.3.1 CENTRAL BANK INDEPENDENCE

In November 1995 the EMI established a list of features of central bank independence (later described in detail in its Convergence Report of 1998) which were the basis for assessing the national legislation of the Member States at that time, in particular the NCB statutes. The concept of central bank independence includes various types of independence that must be assessed separately, namely functional, institutional, personal and financial independence. Over the past few years, there has been further refinement of the analysis of these aspects of central bank independence in the opinions adopted by the ECB. These aspects are the basis for assessing the level of convergence between the national legislation of the Member States with a derogation, on the one hand, and the Treaty and Statute, on the other.

FUNCTIONAL INDEPENDENCE

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

As regards timing, the Treaty is unclear as to when the NCBs of Member States with a derogation had to comply with the primary objective of price stability set out in Article 105(1) of the Treaty and Article 2 of the Statute. In the case of Sweden, the question was whether this obligation should run either from the time the ESCB was established or from adoption of the euro. For those Member States that joined the EU on 1 May 2004, the question was whether it should run either from that date or from adoption of the euro. While Article 105(1) of the Treaty does not apply to Member States with a derogation (see Article 122(3) of the Treaty), Article 2 of the Statute does apply to such Member States (see Article 43.1 of the Statute). The ECB takes the view that the obligation on NCBs to have price stability as

3 OJ L 189, 3.7.1998, p. 42.

their primary objective runs from 1 June 1998 in the case of Sweden and from 1 May 2004 for the Member States that joined the EU on that date. This is based on the fact that one of the guiding principles of the Community, namely price stability (Article 4(3) of the Treaty), applies also to Member States with a derogation. It is also based on the Treaty objective that all Member States should strive for macroeconomic convergence, including price stability, which is the intention behind these regular reports of the ECB and the Commission. This conclusion is also based on the underlying rationale of central bank independence, which is only justified if the overall objective of price stability has primacy.

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

INSTITUTIONAL INDEPENDENCE

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

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

Prohibition on giving instructions

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

Prohibition on approving, suspending, annulling or deferring decisions

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

Prohibition on censoring decisions on legal grounds

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

Prohibition on participating in decision-making bodies of an NCB with a right to vote

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

Prohibition on ex ante consultation relating to an NCB's decision

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

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

– this does not result in interference with the independence of the members of the NCB's decision-making bodies;
– the special status of Governors in their capacity as members of the ECB's General Council is fully respected; and
– confidentiality requirements resulting from the Statute are observed.

Discharge provided for the duties of members of the NCB's decision-making bodies

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

PERSONAL INDEPENDENCE

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

Minimum term of office for Governors

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

Grounds for dismissal of Governors

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

Security of tenure and grounds for dismissal of members of NCBs' decision-making bodies, other than Governors, who are involved in the performance of ESCB-related tasks

Personal independence would be jeopardised if the same rules for the security of tenure of office and grounds for dismissal of Governors did not also apply to other members of the decision-making bodies of NCBs involved in the performance of ESCB-related tasks.[4]

4 See: paragraph 8 of ECB Opinion CON/2004/35 of 4 November 2004 at the request of the Hungarian Ministry of Finance on a draft law amending the Law on Magyar Nemzeti Bank; paragraph 8 of ECB Opinion CON/2005/26 of 4 August 2005 at the request of Národná banka Slovenska on a draft law amending the Act No 566/1992 Coll. on Národná banka Slovenska, as amended, and on amendments to certain laws; paragraph 3.3 of ECB Opinion CON/2006/44 of 25 August 2006 at the request of the Banca d'Italia on the amended Statute of the Banca d'Italia; paragraph 2.6 of ECB Opinion CON/2006/32 of 22 June 2006 at the request of the French Senate on a draft law on the Banque de France; and paragraphs 2.3 and 2.4 of ECB Opinion CON/2007/6 of 7 March 2007 at the request of the German Ministry of Finance on a draft Eighth Law amending the Law on the Deutsche Bundesbank.

Various Treaty and Statute provisions require comparable security of tenure. Article 14.2 of the Statute does not restrict the security of tenure of office to Governors, whilst Article 108 of the Treaty and Article 7 of the Statute refer to "members of the decision-making bodies" of NCBs, rather than to Governors specifically. This applies in particular where a Governor is first among equals between colleagues with equivalent voting rights or where such other members may have to deputise for the Governor.

Right of judicial review

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

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

National legislation should also provide for a right of review by the national courts of a decision to dismiss any other member of the decision-making bodies of the NCB involved in the performance of ESCB-related tasks. This right can either be a matter of general law or can take the form of a specific provision. Even though it may be said that this right is available under the general law, for legal certainty reasons it could be advisable to provide specifically for such a right of review.

Safeguards against conflict of interest

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

FINANCIAL INDEPENDENCE

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

Member States may not put their NCBs in a position where they have insufficient financial resources to carry out their ESCB- or Eurosystem-related tasks, as applicable. It should be noted that Articles 28.1 and 30.4 of the Statute provide for the possibility of further calls on the NCBs to make contributions to the ECB's capital and make further transfers of foreign reserves.[5] Moreover, Article 33.2 of the Statute provides[6] that in the event of a loss incurred by the ECB which cannot be fully offset against the general reserve fund, the ECB's Governing Council may decide to offset the remaining loss against the monetary income of the relevant financial year in proportion and

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

up to the amounts allocated to the NCBs. The principle of financial independence requires that compliance with these provisions leaves an NCB's ability to perform its functions unimpaired.

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

The concept of financial independence should therefore be assessed from the perspective of whether any third party is able to exercise either direct or indirect influence not only over an NCB's tasks but also over its ability (understood both operationally in terms of manpower, and financially in terms of appropriate financial resources) to fulfil its mandate. The four aspects of financial independence set out below are particularly relevant in this respect, and some of them have only been refined quite recently.[7] These are the features of financial independence where NCBs are most vulnerable to outside influence.

Determination of budget

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

The accounting rules

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

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

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

Distribution of profits, NCBs' capital and financial provisions

With regard to profit allocation, an NCB's statutes may prescribe how profits are to be allocated. In the absence of such provisions, the decision on allocation of profits should be taken by the NCB's decision-making bodies on professional grounds, and should not be subject to the discretion of third parties unless there is an express safeguard clause stating that this is

7 The main formative ECB opinions in this area are the following:
– CON/2002/16 of 5 June 2002 at the request of the Irish Department of Finance on a draft Central Bank and Financial Services Authority of Ireland Bill, 2002;
– CON/2003/22 of 15 October 2003 at the request of the Finnish Ministry of Finance on a draft government proposal to amend the Suomen Pankki Act and other related acts;
– CON/2003/27 of 2 December 2003 at the request of the Austrian Federal Ministry of Finance on a draft Federal law on the National Foundation for Research, Technology and Development;
– CON/2004/1 of 20 January 2004 at the request of the Economic Committee of the Finnish Parliament on a draft government proposal to amend the Suomen Pankki Act and other related acts;
– CON/2006/38 of 25 July 2006 at the request of the Bank of Greece on a draft provision on the Bank of Greece's powers in the field of consumer protection;
– CON/2006/47 of 13 September 2006 at the request of the Czech Ministry of Industry and Trade on an amendment to the Law on Česka národní banka;
– CON/2007/8 of 21 March 2007 at the request of the Czech Ministry of Industry and Trade on certain provisions of a draft law amending the Law on consumer protection relating to Česka národní banka.

without prejudice to the financial means necessary for carrying out the NCB's ESCB-related tasks.

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

Financial liability for supervisory authorities

Some Member States place their financial supervisory authorities within their NCB. This poses no problems if such authorities are subject to the NCB's independent decision-making. However, if the law provides for separate decision-making by such supervisory authorities, it is important to ensure that decisions adopted by them do not endanger the finances of the NCB as a whole. In those cases, the national legislation should enable the NCBs to have ultimate control over any decision by the supervisory authorities that could affect an NCB's independence, in particular its financial independence.

2.2.3.2 CONFIDENTIALITY

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

2.2.4 PROHIBITION ON MONETARY FINANCING AND PRIVILEGED ACCESS

2.2.4.1 PROHIBITION ON MONETARY FINANCING

The monetary financing prohibition is laid down in Article 101(1) of the Treaty, which prohibits overdraft facilities or any other type of credit facility with the ECB or the NCBs of Member States in favour of Community institutions or bodies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States; and the purchase directly from these public sector entities by the ECB or NCBs of debt instruments. The Treaty contains one exemption from the prohibition: it does not apply to publicly-owned credit institutions which, in the context of the supply of reserves by central banks, must be given the same treatment as private credit institutions (Article 101(2) of the Treaty). Moreover, the ECB and the NCBs may act as fiscal agents for the public sector bodies referred to above (Article 21.2 of the Statute). The precise scope of application of the monetary financing prohibition is further clarified by Council Regulation (EC) No 3603/93 of 13 December 1993 specifying definitions for the application of the prohibitions referred to in Articles 104 and 104b(1) of the Treaty[8] (now Articles 101 and 103(1)), which makes clear that the prohibition includes any financing of the public sector's obligations vis-à-vis third parties.

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

8 OJ L 332, 31.12.1993, p. 1.

on draft national legislation under Article 105(4) of the Treaty.[9]

NATIONAL LEGISLATION TRANSPOSING THE MONETARY FINANCING PROHIBITION

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

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

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

ASSUMPTION OF PUBLIC SECTOR LIABILITIES

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

FINANCIAL SUPPORT FOR CREDIT AND/OR FINANCIAL INSTITUTIONS

National legislation foreseeing the financing by NCBs of credit institutions other than in connection with central banking tasks (such as

9 Some formative EMI/ECB opinions in this area are the following:
– CON/95/8 of 10 May 1995 on a consultation from the Swedish Ministry of Finance under Article 109(f)(6) of the Treaty establishing the European Community ("the Treaty") and Article 5.3 of the Statute of the EMI ("the Statute"); on a draft government bill introducing a ban on monetary financing ("the Bill");
– CON/97/16 of 27 August 1997 on a consultation from the Austrian Federal Ministry of Finance under Article 109(f)(6) of the Treaty establishing the European Community (the "Treaty") and Article 5.3 of the Statute of the EMI as elaborated in the Council Decision of 22 November 1993 (93/717/EC) (the "Decision") concerning a draft Federal Act on the participation of Austria in the New Arrangement to Borrow with the International Monetary Fund;
– CON/2001/32 of 11 October 2001 at the request of the Portuguese Ministry of Finance on a draft decree law amending the legal framework of credit institutions and financial companies;
– CON/2003/27 of 2 December 2003 at the request of the Austrian Federal Ministry of Finance on a draft Federal law on the National Foundation for Research, Technology and Development;
– CON/2005/1 of 3 February 2005 at the request of the Italian Ministry of Economic Affairs and Finance on a draft law amending Law Decree No 7 of 25 January 1999, as converted by Law No 74 of 25 March 1999, concerning urgent provisions on Italian participation in the International Monetary Fund's interventions to confront severe financial crises of its member countries;
– CON/2005/24 of 15 July 2005 at the request of the Ministry of Finance of the Czech Republic on a draft law on the integration of financial market supervisors;
– CON/2005/29 of 11 August 2005 at the request of the Austrian Federal Ministry of Finance concerning a draft Federal law on the payment of a contribution by Austria to the trust fund administered by the International Monetary Fund for low income developing countries affected by natural disasters;
– CON/2005/50 of 1 December 2005 at the request of Národná banka Slovenska on a draft law amending the Act No 118/1996 Coll. on the protection of bank deposits and on amendments to certain laws, as last amended;
– CON/2005/60 of 30 December 2005 at the request of Lietuvos bankas on a draft law amending the Lietuvos bankas Act;
– CON/2006/4 of 27 January 2006 at the request of the Central Bank of Cyprus on a draft law amending the Central Bank of Cyprus Laws of 2002 and 2003;
– CON/2006/15 of 9 March 2006 at the request of the Polish Minister of Finance on a draft law on the supervision of financial institutions;
– CON/2006/17 of 13 March 2006 at the request of the Slovenian Ministry of Finance on a draft law amending the Law on Banka Slovenije;
– CON/2006/23 of 22 May 2006 at the request of the Central Bank of Malta concerning a draft law amending the Central Bank of Malta Act; and
– CON/2006/58 of 15 December 2006 at the request of the Central Bank of Malta concerning amendments to the Central Bank of Malta Act.

monetary policy, payment systems or temporary liquidity support operations), in particular to support insolvent credit and/or other financial institutions, is incompatible with the monetary financing prohibition.

FINANCIAL SUPPORT FOR DEPOSIT INSURANCE AND INVESTOR COMPENSATION SCHEMES

The Deposit Guarantee Schemes Directive[10] and the Investor Compensation Schemes Directive[11] provide that the costs of financing deposit guarantee schemes and investor compensation schemes must be borne, respectively, by credit institutions and investment firms themselves. National legislation foreseeing the financing by NCBs of a public sector national deposit insurance scheme for credit institutions or a national investor compensation scheme for investment firms would not be compatible with the monetary financing prohibition, if it is not short term, it does not address urgent situations, systemic stability aspects are not at stake, and decisions do not remain at the NCB's discretion.

2.2.4.2 PROHIBITION ON PRIVILEGED ACCESS

NCBs may not, as public authorities, take measures granting privileged access by the public sector to financial institutions if such measures are not based on prudential considerations. Furthermore, the rules on mobilisation or pledging of debt instruments enacted by the NCBs must not be used as a means of circumventing the prohibition on privileged access.[12] Member States' legislation in this area may not establish such privileged access.

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

2.2.5 SINGLE SPELLING OF THE EURO

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

At its meeting in Madrid on 15 and 16 December 1995, the European Council decided that "the name given to the European currency shall be Euro", that "the name … must be the same in all the official languages of the European Union, taking into account the existence of different alphabets" and that "the specific name Euro will be used instead of the generic term 'ECU' used by the Treaty to refer to the European currency unit". Finally, the European Council concluded that: "The Governments of the fifteen Member States have achieved the common agreement that this decision is the agreed and definitive interpretation of the relevant Treaty provisions." This unambiguous and definitive agreement by the heads of state and government of the Member States has been confirmed in all Community legal acts that refer to the euro, which always use a single spelling in all official Community languages. Of particular importance is the fact that the single spelling of the euro agreed by the Member States has been retained in Community monetary

10 Recital 23 to Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes (OJ L 135, 31.5.1994, p. 5).
11 Recital 23 to Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor-compensation schemes (OJ L 84, 26.3.1997, p. 22).
12 See Article 3(2) of and recital 10 to Council Regulation (EC) No 3604/93 of 13 December 1993 specifying definitions for the application of the prohibition of privileged access referred to in Article 104a (now Article 102) of the Treaty (OJ L 332, 31.12.1993, p. 4).

law.[13] The recent Council Regulation (EC) No 2169/2005 of 21 December 2005 amending Regulation (EC) No 974/98 on the introduction of the euro[14] confirms the correct spelling of the single currency. First, Regulation (EC) No 974/98 states in all language versions that "the name given to the European currency shall be the 'euro'". Second, all language versions of Regulation (EC) No 2169/2005 refer to the "euro".

In 2003 all the Member States ratified the Decision of the Council, meeting in the composition of the Heads of State or Government of 21 March 2003 amending Article 10.2 of the Statute of the European System of Central Banks and of the European Central Bank[15], where, once more, this time in a legal act pertaining to primary law, the name of the single currency is spelled identically in all language versions.

This unambiguous and definitive position of the Member States is also binding on the Member States with a derogation. Article 5(3) of the Act concerning the conditions of accession stipulates that "the new Member States are in the same situation as the present Member States in respect of declarations or resolutions of, or other positions taken up by, the European Council or the Council and in respect of those concerning the Community or the Union adopted by common agreement of the Member States; they will accordingly observe the principles and guidelines deriving from those declarations, resolutions or other positions and will take such measures as may be necessary to ensure their implementation".

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

2.2.6 LEGAL INTEGRATION OF NCBs INTO THE EUROSYSTEM

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

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

13 See Council Regulation (EC) No 1103/97 of 17 June 1997 on certain provisions relating to the introduction of the euro (OJ L 162, 19.6.1997, p. 1), Council Regulation (EC) No 974/98 of 3 May 1998 on the introduction of the euro (OJ L 139, 11.5.1998, p. 1) and Council Regulation (EC) No 2866/98 of 31 December 1998 on the conversion rates between the euro and the currencies of the Member States adopting the euro (OJ L 359, 31.12.1998, p. 1), all three of which were amended in 2000 for the introduction of the euro in Greece; see also the legal acts adopted by the Community regarding euro coins in 1998 and 1999.

14 OJ L 346, 29.12.2005, p. 1.

15 OJ L 83, 1.4.2003, p. 66.

provisions; exchange rate policy; and international cooperation. Finally, other areas where an NCB's statutes may need to be adapted are mentioned.

2.2.6.1 ECONOMIC POLICY OBJECTIVES

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

2.2.6.2 TASKS

The tasks of an NCB of a Member State that has adopted the euro are predominantly determined by the Treaty and the Statute, given that NCB's status as an integral part of the Eurosystem. In order to comply with Article 109 of the Treaty, provisions on tasks in NCB statutes therefore need to be compared with the relevant provisions of the Treaty and the Statute, and any incompatibility must be removed.[16] This applies to any provision that, after adoption of the euro and integration into the Eurosystem, constitute an impediment to the execution of ESCB-related tasks and in particular to provisions which do not respect the ESCB's powers under Chapter IV of the Statute.

Any national legislative provisions relating to monetary policy must recognise that the Community's monetary policy is a task to be carried out through the Eurosystem.[17] The NCB statutes may contain provisions on monetary policy instruments. Such provisions should be compared with those in the Treaty and the Statute and any incompatibility must be removed, in order to comply with Article 109 of the Treaty.

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

With regard to foreign reserve management[18], any Member States that have adopted the euro which do not transfer their official foreign reserves[19] to their NCB are in breach of the Treaty. In addition, the right of a third party – for example, the government or parliament – to influence an NCB's decisions with regard to management of the official foreign reserves is inconsistent with the third indent of Article 105(2) of the Treaty. Furthermore, NCBs have to provide the ECB with foreign reserve assets in proportion to their shares in the ECB's subscribed capital. This means that there must be no legal obstacles to NCBs transferring foreign reserve assets to the ECB.

2.2.6.3 FINANCIAL PROVISIONS

The financial provisions in the Statute comprise rules on financial accounts[20], auditing[21], capital subscription[22], the transfer of foreign reserve assets[23] and the allocation of monetary income.[24] NCBs must be able to comply with their obligations under these provisions and therefore

16 See, in particular, Articles 105 and 106 of the Treaty and Articles 3 to 6 and 16 of the Statute.
17 First indent of Article 105(2) of the Treaty.
18 Third indent of Article 105(2) of the Treaty.
19 With the exception of foreign-exchange working balances, which Member State governments may retain pursuant to Article 105(3) of the Treaty.
20 Article 26 of the Statute.
21 Article 27 of the Statute.
22 Article 28 of the Statute.
23 Article 30 of the Statute.
24 Article 32 of the Statute.

any incompatible national provisions must be repealed.

2.2.6.4 EXCHANGE RATE POLICY

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

2.2.6.5 INTERNATIONAL COOPERATION

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

2.2.6.6 MISCELLANEOUS

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

3 COUNTRY SUMMARIES

3.1 CYPRUS

Over the reference period, the 12-month average rate of HICP inflation in Cyprus was 2.0%, which is well below the reference value of 3.0% as stipulated by the Treaty. On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to fall slightly in the coming months.

Looking back over a longer period, HICP inflation in Cyprus has been contained, with only occasional periods of relatively high inflation. Between 1997 and 2006 it fluctuated mostly between 2% and 3%, but in 2000 and 2003 it rose to 4.9% and 4.0% respectively, largely reflecting strong increases in energy and food prices, as well as the EU harmonisation-related gradual increases in energy excise taxes and in the VAT rate from 10% to 15% in the period 2002-03. This long-term inflation performance reflects a number of important policy choices, most notably the long-standing tradition of pegged exchange rate regimes, which dates back to 1960. From 1992 the Cyprus pound was pegged to the ECU and later the euro, and on 2 May 2005, Cyprus joined ERM II with the standard fluctuation band of ±15%. The relatively contained levels of inflation have been supported by the liberalisation of product markets and network industries. By contrast, fiscal policy has, on the whole, not been fully supportive of price stability since 1996, although it has become more supportive in recent years. Between 1998 and 2001, the overall relatively contained inflation development should be seen against a background of solid economic growth, which was for the most part around 5% in real terms. It moderated to around 2% in 2002 and 2003 but picked up again to almost 4% in 2004-06. The unemployment rate has remained relatively low, although rising somewhat since 2002, and the labour market in Cyprus is relatively flexible. Following very high wage growth in 2002 and 2003, especially in the public sector, wage pressures declined significantly in the subsequent two years, leading to moderate increases in unit labour costs. Import prices have at times been volatile, rising somewhat since 2003 in response to higher oil prices. Looking at recent developments, HICP inflation increased gradually in early 2006, reaching 2.7% in August, before decelerating to 1.4% in March 2007 on the back of moderating energy prices.

Looking ahead, the latest available inflation forecasts from major international institutions range from 1.3% to 2.1% for 2007 and from 1.9% to 2.1% for 2008. Risks to inflation projections are tilted to the upside and are associated with the planned EU harmonisation-related increase in the lower VAT rate on certain goods and services, which is expected to add around 1 percentage point to inflation, potential second-round effects of past and expected future increases in inflation, future adverse oil price developments and wage developments against the background of the rapid expansion in domestic demand and credit. Downward convergence of interest rates on loans in domestic currency towards the euro area level and reductions in reserve requirements for monetary financial institutions constitute additional upside risks to inflation. Downside risks are associated with the continued effects of liberalisation in sectors such as telecommunications and energy, wage restraint in the public sector, increased labour inflows which may exert downward pressure on wage growth and favourable oil price developments. Moreover, a possible weakening in international demand and the effect it would have on tourism exports constitute an additional downside risk.

Cyprus is at present not subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2006 it recorded a fiscal deficit of 1.5% of GDP, i.e. well below the reference value. A deficit of 1.4% of GDP is forecast by the European Commission for 2007. The general government debt-to-GDP ratio declined to 65.3% in 2006 and is forecast to decline further in 2007, to 61.5%, thus remaining above the 60% reference value. Further consolidation is required if Cyprus is to comply with the medium-term objective specified in the Stability and Growth Pact, which is quantified in the convergence programme of December 2006 as a cyclically adjusted deficit net of temporary measures of 0.5% of GDP. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment expenditure to GDP in 2006.

According to the projections by the EU's Economic Policy Committee and the European Commission, Cyprus is expected to experience a substantial increase in age-related public expenditure, amounting to 11.8 percentage points of GDP between 2004 and 2050, the highest among the EU Member States. Coping with the burden will be facilitated if sufficient room for manoeuvre is created in public finances before the demographic situation worsens.

The Cyprus pound has been participating in ERM II with effect from 2 May 2005, i.e. for the two-year reference period between May 2005 and April 2007. The central rate for the currency was set at 0.585274 pound per euro – also the rate at which the pound was linked unilaterally to the euro at the beginning of 1999 – with a standard fluctuation band of ±15%. The agreement on participation in ERM II was based on firm commitments by the Cypriot authorities in various policy areas. Since joining ERM II, Cyprus has continued to pursue a stable exchange rate policy against the euro. The pound has remained close to its central rate on the strong side of the standard fluctuation band, showing also very low volatility. Short-term interest rate differentials against the three-month EURIBOR gradually closed towards the end of the period under review. Both bilaterally against the euro and in effective terms, the real exchange rate of the Cyprus pound was in March 2007 close to historical averages as calculated from January 1996 and since the launch of the euro in 1999. As regards other external developments, Cyprus has almost consistently reported deficits in the combined current and capital account of the balance of payments that have, at times, been large. In recent years these deficits have increased – from 2.0% of GDP in 2003 to 5.9% of GDP in 2006 – owing mainly to a widening goods deficit, whereas the trade surplus in services has remained almost unchanged. Much of the financing of these deficits has come from net inflows of direct investment (in part reinvested earnings) and capital inflows in the form of "other investment", comprising mainly non-resident deposits and loans. Since capital inflows exceeded the current and capital account deficit between 2004 and 2006, Cyprus experienced an accumulation of official reserve assets in this period.

The level of long-term interest rates in Cyprus was 4.2% over the reference period and thus stood well below the 6.4% reference value for the interest rate criterion. Long-term interest

Cyprus – Economic indicators of convergence

(excluding the exchange rate criterion)

	HICP inflation 1)	Long-term interest rate 2)	General government surplus (+) or deficit (-) 3)	General government gross debt 3)
2005	2.0	5.2	-2.3	69.2
2006	2.2	4.1	-1.5	65.3
2007	4) 2.0	4) 4.2	-1.4	61.5
Reference value	4), 5) 3.0	4), 5) 6.4	-3.0	60.0

Sources: ESCB and European Commission.
1) Average annual percentage changes.
2) Percentages, annual average.
3) As a percentage of GDP. Projections for 2007 provided by the European Commission.
4) Referring to the period April 2006 to March 2007.
5) The best performing countries in terms of price stability are Finland, Poland and Sweden.

rates and their differential with government bond yields in the euro area have generally declined in recent years.

Overall, looking ahead, it will be important for Cyprus to continue on a sustainable and credible path of fiscal consolidation based on structural measures and to improve its fiscal performance by tangibly reducing its high debt ratio. It will be important, particularly in the public sector, to maintain moderate wage developments that take into account labour productivity growth, labour market conditions and developments in competitor countries. Moreover, it will be essential to proceed with structural reforms of the product and labour markets. For example, the indexation mechanism for salaries and some social benefits (cost-of-living allowances) should be overhauled in order to reduce risks associated with inflation inertia. Such structural reforms will not only make the economy more resilient to shocks but also create the best conditions for sustainable economic expansion and growth in employment. Finally, a possible reunification of Cyprus could entail additional structural and fiscal challenges depending on the specific economic and fiscal arrangements.

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

3.2 MALTA

Over the reference period, Malta achieved a 12-month average rate of HICP inflation of 2.2%, which is well below the reference value of 3.0% as stipulated by the Treaty. On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to decline further in the coming months.

Looking back over a longer period, HICP inflation in Malta has been relatively stable, fluctuating mostly between 2% and 3% during the years 1999-2006. The fact that inflation has remained relatively stable over a long period reflects a number of important policy choices, most notably the decision to maintain a pegged exchange rate arrangement since Malta became independent in 1964, for most of the period against a basket of currencies. Since 2 May 2005, the Maltese lira has been participating in ERM II and has thereby been pegged to the euro. Fiscal policy has become more supportive of the achievement of price stability over the past few years. Following a period of strong economic growth in the 1990s, output growth, on average, was sluggish from 2001 onwards, with two years of output contraction being recorded. This economic stagnation reflected a combination of external weakness, partly associated with increased competition in Malta's main export markets, and domestic factors, such as the temporary effects of restructuring operations in the manufacturing sector. Looking at recent developments, a gradual economic recovery started in 2005 and continued in 2006, but price pressures from the demand side of the economy have remained limited. The annual rate of HICP inflation declined notably towards the end of 2006 and remained subdued in early 2007. After reaching a peak of around 3.5% in mid-2006, it declined to less than 1% in the last two months of that year, to stand at 0.5% in March 2007. The decline in inflation in late 2006 was largely due to the unwinding of the impact of the earlier energy price increase, which had affected inflation in Malta relatively strongly.

Looking ahead, the latest available inflation forecasts from major international institutions range from 1.4% to 2.4% for 2007 and from 2.1% to 2.3% for 2008. Upside risks to inflation prospects are mainly associated with a potential renewed increase in world energy prices. In addition, although it is not as strong as in other countries with less developed financial markets, the ongoing rapid rise in the growth of credit needs to be carefully monitored. Downside risks to the inflation projections are related to the effects of increasing competition in some product markets, such as the food retailing and the airline industry, and ongoing efforts to streamline regulatory and administrative procedures in the public sector.

Malta is at present subject to an EU Council decision on the existence of an excessive deficit. However, in the reference year 2006 it recorded a fiscal deficit of 2.6% of GDP, i.e. below the reference value. Temporary fiscal policy measures had a deficit-reducing effect of 0.7% of GDP in 2006. Without these measures, the 2006 deficit would have amounted to 3.3% of GDP. A decrease in the deficit to 2.1% of GDP is forecast by the European Commission for 2007. The general government debt-to-GDP ratio declined to 66.5% in 2006 and is forecast to be 65.9% in 2007, thus remaining above the 60% reference value. Further consolidation is required if Malta is to comply with the medium-term objective specified in the Stability and Growth Pact, which is quantified in the convergence programme of December 2006 as a balanced budget in cyclically adjusted terms and net of temporary measures. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment expenditure to GDP in 2006.

According to the projections by the EU's Economic Policy Committee and the European Commission, Malta is expected to experience an increase of 2.2 percentage points of GDP in age-related public expenditure in the years to 2020, which then declines to an increase of 0.3 percentage point by 2050. While these projections do not take into account the public pension reform adopted by the House of Representatives in December 2006, a preliminary assessment by the European Commission suggests that the reform has not improved the prospects for the long-term sustainability of public finances. Coping with the burden will be facilitated if sufficient room for manoeuvre is created in public finances before the demographic situation worsens.

The Maltese lira has been participating in ERM II with effect from 2 May 2005, i.e. for the two-year reference period between May 2005 and April 2007. The central rate for the currency was set at 0.429300 lira per euro – the market rate at the time of entry – with a standard fluctuation band of ±15%. Upon entry into the mechanism, the Maltese lira was re-pegged to the euro from its previous basket arrangement (involving the euro, the pound sterling and the US dollar). The agreement on participation in ERM II was based on firm commitments by the Maltese authorities in various policy areas. As initially declared, since ERM II entry the Maltese authorities have maintained the exchange rate of the Maltese lira at the central rate against the euro. Short-term interest rate differentials against the three-month EURIBOR narrowed in 2006 and stood at 0.2 percentage point in the three-month period ending in March 2007. Both bilaterally against the euro and in effective terms, the real exchange rate of the Maltese lira was in March 2007 close to historical averages as calculated from January 1996 and since the launch of the euro in 1999. As regards other external developments, Malta has, since 1997, reported deficits in the combined current and capital account of the balance of payments that have, at times, been large. In 2004 and 2005 this deficit stood at 4.9% of GDP, before declining to 3.3% in 2006. Since 2003 direct investment flows have more than offset this deficit and capital inflows in the form of "other investments" have been largely offset by strong net portfolio outflows. In both 2005 and 2006 Malta experienced an accumulation of official reserve assets.

The level of long-term interest rates in Malta was 4.3% over the reference period and thus stood well below the 6.4% reference value for the interest rate criterion. In recent years, Maltese long-term interest rates and their differential with government bond yields in the euro area have generally declined.

Overall, looking ahead, it will be important for Malta to continue on a sustainable and credible path of fiscal consolidation and to improve its fiscal performance by tangibly reducing its high debt ratio. It will be important, in both the public and the private sector, to maintain moderate wage developments that take into

Malta – Economic indicators of convergence

(excluding the exchange rate criterion)

	HICP inflation [1]	Long-term interest rate [2]	General government surplus (+) or deficit (-) [3]	General government gross debt [3]
2005	2.5	4.6	-3.1	72.4
2006	2.6	4.3	-2.6	66.5
2007	[4] 2.0	[4] 4.3	-2.1	65.9
Reference value	[4], [5] 3.0	[4], [5] 6.4	-3.0	60.0

Sources: ESCB and European Commission.
1) Average annual percentage changes.
2) Percentages, annual average.
3) As a percentage of GDP. Projections for 2007 provided by the European Commission.
4) Referring to the period April 2006 to March 2007.
5) The best performing countries in terms of price stability are Finland, Poland and Sweden.

account labour productivity growth, labour market conditions and developments in competitor countries. Attention must also focus on overcoming the structural constraints on economic growth and job creation, notably by fostering labour participation. The strengthening of competition in product markets and improvements in the functioning of the labour market are key elements in this regard. Such measures will also help to make these markets more flexible, thereby facilitating adjustment in the face of possible country or industry-specific shocks. The ability to absorb such shocks is particularly important in view of the economy's relatively high degree of specialisation. These measures will help to achieve an environment conducive to price stability, as well as to promote competitiveness and employment growth.

Following the recent amendments to the Central Bank of Malta Act, the Central Bank of Malta's statutes are compatible with Treaty and Statute requirements for Stage Three of Economic and Monetary Union.

4 EXAMINATION OF ECONOMIC CONVERGENCE

4.1 CYPRUS

4.1.1 PRICE DEVELOPMENTS

Over the reference period from April 2006 to March 2007, the 12-month average rate of HICP inflation in Cyprus was 2.0%, i.e. well below the reference value of 3.0% for the criterion on price stability (see Table 1). On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to fall slightly in the coming months.

Looking back over a longer period, HICP inflation in Cyprus has been contained, with only occasional periods of relatively high inflation (see Chart 1). Between 1997 and 2006 it was mostly between 2% and 3%, but in 2000 and 2003 it rose to 4.9% and 4.0% respectively, largely reflecting strong increases in energy and food prices, as well as the EU harmonisation-related gradual increases in energy excise taxes and in the VAT rate from 10% to 15% in the period 2002-03.

The long-term inflation performance of Cyprus reflects a number of important policy choices, most notably the long-standing tradition of pegged exchange rate regimes, which dates back to 1960. The Cyprus pound was pegged to the ECU in 1992, and in 1999 to the euro, with a fluctuation band of ±2.25%. The band was widened to ±15% in 2001 in the context of an ongoing gradual liberalisation of capital movements. However, the Central Bank of Cyprus did not make use of the wider band, and the exchange rate moved within a narrow range. On 2 May 2005, Cyprus joined ERM II with the standard fluctuation band of ±15%. Price stability is the primary objective of monetary policy in Cyprus and was enshrined in the 2002 Central Bank of Cyprus Law. The relatively contained levels of inflation have also been supported by the liberalisation of product markets and network industries, particularly in the communication sector. By contrast, fiscal policy has, on the whole, not been fully supportive of price stability since 1996, although it has become more supportive in recent years.

The overall relatively contained inflation developments between 1998 and 2001 should be seen against a background of solid economic growth, which for the most part was around 5% in real terms. It moderated to around 2% in 2002 and 2003, due mainly to a weakening in the tourism sector, but picked up again to around 4% in 2004-06 (see Table 2). Output growth in 2004-06 was driven mainly by private consumption and investment. The unemployment rate has increased somewhat since 2002 but has been relatively stable at around 5% in recent years. In general, the labour market in Cyprus is relatively flexible, with significant flows of foreign workers, including seasonal workers, weakening the relationship between economic activity and the unemployment rate. Following very high wage growth in 2002 and 2003, especially in the public sector, wage pressures declined significantly in the subsequent two years, leading to moderate increases in unit labour costs despite very weak labour productivity growth. Import prices, driven largely by fluctuations in oil prices and the Cyprus pound-US dollar exchange rate, have at times been volatile, rising somewhat since 2003 in response to higher oil prices. The general pattern of relatively moderate price pressures is also apparent from other relevant price indices, such as the HICP excluding unprocessed food and energy (see Table 2).

Looking at recent developments, HICP inflation increased gradually in early 2006, reaching 2.7% in August, before decelerating to 1.4% in March 2007 on the back of moderating energy prices (see Table 3a). Upward pressures on inflation in 2006 were due mainly to rising prices for services and food. Energy prices made the largest contribution to inflation until August, but moderated significantly in the autumn. Changes in administered prices added around 0.6 percentage point to HICP inflation in 2006. The share of administered prices in the HICP basket stands at 11.0% in 2007, i.e. broadly in line with the euro area. The current inflation picture should be viewed against a background of dynamic economic conditions. In the third and fourth quarters of 2006, real

GDP grew by an annual rate of 3.6% and 3.5% respectively, leading to an average annual growth rate of 3.8% for the year as a whole, supported by robust growth in private consumption. The growth of the money supply and credit to the private sector have also accelerated, and credit appears to be oriented largely towards consumption, housing and construction.

Looking ahead, the latest available inflation forecasts from major international institutions range from 1.3% to 2.1% for 2007 and from 1.9% to 2.1% for 2008 (see Table 3b). Risks to inflation projections are tilted to the upside and are associated with the planned EU harmonisation-related increase in the lower VAT rate on certain goods and services,[1] which is expected to add around 1 percentage point to inflation, potential second-round effects of past (relating to oil prices) and expected future increases in inflation, future adverse oil price developments and wage developments against the background of the rapid expansion in domestic demand and credit. Downward convergence of interest rates on loans in domestic currency towards the euro area level and associated reductions in reserve requirements for monetary financial institutions constitute additional upside risks to inflation. Downside risks are associated with the continued effects of liberalisation in sectors such as telecommunications and energy, wage restraint in the public sector, increased labour inflows which may exert downward pressure on wage growth and favourable oil price developments. Moreover, a possible weakening in international demand and the effect it would have on tourism exports constitute an additional downside risk.

An environment conducive to sustainable price stability in Cyprus will be dependent on, inter alia, the achievement of a sustainable improvement in the country's fiscal performance. It will be equally important, particularly in the public sector, to sustain moderate wage developments that take into account labour productivity growth, labour market conditions and developments in competitor countries. Moreover, it will be essential to further strengthen national policies aimed at enhancing competition in product markets and utilities. For example, the indexation mechanism for salaries and some social benefits (cost-of-living allowances) should be overhauled in order to reduce risks associated with inflation inertia. Such structural reforms will not only make the economy more resilient to shocks but will also create the best conditions for sustainable economic expansion and growth in employment.

4.1.2 FISCAL DEVELOPMENTS

Cyprus is at present not subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2006 the general government budget balance showed a deficit of 1.5% of GDP, i.e. well below the 3% reference value. The deficit ratio did not exceed the ratio of public investment expenditure to GDP. The general government debt-to-GDP ratio was 65.3%, i.e. above the 60% reference value (see Table 4). Compared with the previous year, the deficit ratio decreased by 0.8 percentage point and the public debt ratio decreased by 3.9 percentage points. In 2007, the deficit ratio is forecast by the European Commission to decrease to 1.4% and the public debt ratio is projected to decrease to 61.5%.

Looking back over the years 1997 to 2006, the public debt-to-GDP ratio increased steeply until 2004 but moved on a declining path in the last two years (see Chart 2a and Table 5). As shown in greater detail in Chart 2b, deficit-debt adjustments represented the strongest factor underlying the increase in the government debt ratio – although they subsequently declined – and reinforced the debt-increasing effects stemming from primary deficits. A significant part of the debt-increasing deficit-debt

1 The adjustment is legally required by 1 January 2008, but the exact date of the implementation of this measure has not yet been decided. VAT rates will rise on bread, milk and other food from 0% to 5%, on restaurant services from 8% to 15%, and on medicine and land plots from 0% to 15%.

adjustments reflects the accumulation of deposits by the government with the Central Bank of Cyprus (sinking fund) to fund the repayment of government debt from 2006 onwards (see Table 6). The growth/interest-rate differential had on average a debt-decreasing impact. The primary surpluses recorded in 2005 and 2006 were the main factor behind the decline in the debt ratio in recent years. The patterns observed may be seen as indicative of the close link between primary balances and debt dynamics. In this context, it may be noted that, at 5.7% of the total, the share of public debt with a short-term maturity is low, having consistently decreased from comparatively high levels (see Table 5). Taking into account the level of the debt ratio, fiscal balances are relatively insensitive to changes in interest rates. While foreign currency-denominated government debt accounts for a relatively large proportion of Cyprus's government debt stock, it is for the greater part denominated in euro. Fiscal balances are therefore also relatively insensitive to changes in exchange rates other than that of the Cyprus pound vis-à-vis the euro.

Since 1997 a pattern of volatile but recently improving outturns has been observed in the deficit-to-GDP ratio, which was below the 3% reference value in 2005 for the first time since 2001 (see Chart 3a and Table 7). Starting from a level of 5.0% in 1997, the deficit ratio improved to 2.2% in 2001. It then rose again rapidly to 6.3% in 2003 before falling to 2.3% in 2005 and 1.5% in 2006. While the government outperformed its 2006 deficit target as set in the previous convergence programme, expenditure is estimated to have been much higher than initially anticipated. In particular social transfers other than in kind were higher than originally planned (by an amount equivalent to 0.9% of GDP). This was compensated by higher than expected revenues. As is shown in greater detail in Chart 3b, European Commission estimates indicate that cyclical factors have had only a relatively small impact on the change in the fiscal balance in recent years. In 2005 and 2006 they contributed only marginally to the fiscal balance. The change in the fiscal balance, which was sizeable in some years, was therefore driven mainly by non-cyclical factors. Non-cyclical changes in the government budget balance could reflect either a lasting structural change or the effect of temporary measures. Available evidence suggests that temporary measures reduced the deficit ratio by 0.9 percentage point in 2005, mainly through higher revenue related to a tax amnesty, but had no impact in 2006. Without these measures the deficit would have amounted to 3.2% of GDP in 2005.

Moving on to examine trends in other fiscal indicators, Chart 4 and Table 7 show that the general government total expenditure-to-GDP ratio displayed a rising trend over the period under review, reaching 43.9% of GDP at the end of the period. The 2003 jump in the expenditure ratio can be attributed in part to a sharp increase in public wages for this and the preceding two years, as well as higher expenditure on social benefits. On balance, the expenditure ratio was 7.7 percentage points higher in 2006 than in 1997 and is high in comparison with other countries with a similar level of per capita income. Government revenue in relation to GDP also increased steadily between 1997 and 2006, by 11.2 percentage points overall, reaching 42.4% at the end of the period. The underlying shift in the structure of taxation towards indirect taxes reflects in part the impact of tax harmonisation requirements under EU membership.

Cyprus's medium-term fiscal strategy, as presented in the convergence programme for 2006-10, dated December 2006 and preceding the European Commission forecasts shown in Table 4, foresees a further gradual reduction in the deficit ratio to 0.1% by 2010 and a declining expenditure ratio, while the revenue ratio is projected to remain broadly constant. The government debt ratio is also expected to decline further, to 46.1% by 2010, in part reflecting repayments of government debt from the sinking fund. For 2007, according to the convergence programme, the government plans a moderate further reduction in the deficit ratio by 0.3 percentage point, which matches the decline in interest expenditure. Estimates suggest there will be no deficit-reducing temporary effects in 2007. For 2008, the programme foresees a larger decline in the deficit ratio on the basis of broad expenditure restraint, but concrete expenditure-reducing measures are not specified. According to the programme, Cyprus aims to attain the medium-term objective specified in the Stability and Growth Pact, which it has quantified as a cyclically adjusted budget deficit net of temporary measures of 0.5% of GDP, in 2008.

With regard to the prospects of countries with a public debt ratio clearly above 60% of GDP achieving a reduction to the reference value, calculations are presented in Chart 5. On the assumption that Cyprus achieves the overall fiscal position and public debt ratio projected by the European Commission for 2007, the public debt ratio would decline to only just below 60% of GDP by 2008 if the overall or primary balance ratio were to remain at their respective 2007 levels of -1.4% and 1.7% in 2008. Such calculations are based on the assumption of a constant nominal rate of interest of 6% (an average real cost of public debt outstanding of 4% plus 2% inflation). The real GDP growth rate underlying these calculations is as projected by the European Commission in its spring 2007 forecast for 2008 and as assumed by the EU's Economic Policy Committee and the European Commission for 2009 and beyond. Deficit-debt adjustments are not taken into account. While these calculations are purely illustrative and can by no means be regarded as forecasts, the indication that maintaining the overall or primary budget balance ratio at 2007 levels would result in the debt ratio declining to only just below the reference value by 2008 highlights the need for further progress in consolidation.

As highlighted in Table 8, from around 2010 onwards a marked ageing of the population is expected. According to the projections by the EU's Economic Policy Committee and the European Commission,[2] Cyprus is expected to experience a substantial increase in the ratio of age-related public expenditure to GDP, amounting to 11.8 percentage points between 2004 and 2050, the highest among the EU Member States. While Cyprus's convergence programme discusses some reform options in the areas of pensions and health care, even the full implementation of such measures may not suffice to ensure long-term fiscal sustainability. Coping with the overall ageing-induced fiscal burden will be facilitated if sufficient room for manoeuvre is created in public finances before the demographic situation worsens. Strengthening economic growth potential by raising employment and productivity growth would also help to ensure fiscal sustainability.

Turning to further fiscal challenges, shortcomings in budget implementation in the past call for a thorough and comprehensive application of the recently introduced tools for public expenditure management. In addition to facilitating a better control of expenditure developments, these will help to lower the degree of budgetary rigidity. Prudent policies are also warranted in light of the large external imbalance. According to information from the European Commission dated end-2004, explicit contingent fiscal liabilities amounted to some 10% of GDP.[3] In addition, the establishment of a proper legal framework for the fiscal management of public-private partnerships in Cyprus is a matter of urgency. Finally, a possible reunification of Cyprus could impose substantial fiscal costs depending on the specific economic and fiscal arrangements.

4.1.3 EXCHANGE RATE DEVELOPMENTS

The Cyprus pound has been participating in ERM II with effect from 2 May 2005, i.e. for the two-year reference period between May

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

3 However, there exists no agreed method for estimating the full scale of contingent fiscal liabilities, and estimates may vary widely.

2005 and April 2007 (see Table 9a). The central rate for the currency in ERM II was set at 0.585274 pound per euro – also the rate at which the pound was linked unilaterally to the euro at the beginning of 1999 – with a standard fluctuation band of ±15%. The agreement on participation in ERM II was based on a number of policy commitments by the Cypriot authorities, relating, inter alia, to pursuing sound fiscal policies, promoting wage moderation, ensuring effective financial supervision and implementing further structural reforms.

Since joining ERM II, Cyprus has continued to pursue a stable exchange rate policy against the euro. The pound has remained close to its central rate on the strong side of the standard fluctuation band (see Chart 6 and Table 9a). As a result, in the reference period the maximum upward deviation of the exchange rate from its ERM II central rate amounted to 2.1%. Within ERM II, Cyprus has not devalued its currency's central rate against the euro on its own initiative. Over the period, the Central Bank of Cyprus provided and absorbed liquidity in foreign exchange markets, thereby helping to keep the exchange rate stable. On a net basis, these interventions were purchases of foreign currency. Throughout the period under review, the exchange rate of the Cyprus pound against the euro showed a very low degree of volatility, as measured by annualised standard deviations of daily percentage changes (see Table 9b). At the same time, short-term interest rate differentials against the three-month EURIBOR showed a sizeable spread until the end of 2005, before gradually closing towards the end of the period under review.

In a longer-term context, both bilaterally against the euro and in effective terms, the real exchange rate of the Cyprus pound was in March 2007 close to historical averages as calculated from January 1996 and since the launch of the euro in 1999 (see Table 10).

As regards other external developments, Cyprus has almost consistently reported deficits in the combined current and capital account of the balance of payments that have, at times, been large. In recent years, these deficits have increased – from 2.0% of GDP in 2003 to 5.9% of GDP in 2006 – owing mainly to a widening goods deficit (from 23.9% to 27.5% of GDP, largely related to oil developments), whereas the trade surplus in services has remained almost unchanged (at just over 23% of GDP). At the same time, while net inflows of direct investment (in part reinvested earnings) have been significant, net portfolio flows have been more volatile. Much of the financing of the deficits in the combined current and capital account over the past two years has also come from capital inflows in the form of "other investment", comprising non-resident deposits and loans. Other investment inflows amounted to a sizeable 11.3% of GDP in 2006. Since capital inflows exceeded the current and capital account deficit between 2004 and 2006, Cyprus experienced an accumulation of official reserve assets in this period. The country's net international investment position is positive and amounted to 10.3% of GDP in 2006 (see Table 11).

It may be recalled that Cyprus is a small, open economy with, in 2006, a ratio of foreign trade in goods and services to GDP of 47.5% for exports and 51.7% for imports. In the same year, exports of goods to the euro area and to the EU as a share of total exports amounted to 50.5% and 68.5% respectively. The corresponding figures for imports as a percentage of total imports in 2006 were 55.3% and 67.1%.

With regard to the fulfilment of the commitments undertaken upon ERM II entry, the following observations can be made. Since ERM II entry, the fiscal situation in Cyprus has improved, reflecting, to some extent, temporary measures in particular in 2005. Overall, wage growth has been above labour productivity growth, whereas public sector basic wage growth has remained contained. A number of prudential measures were implemented against the background of strong credit growth. Finally, some progress has been made with the implementation of structural reforms, but further efforts aiming to enhance the economy's flexibility and adaptability – including progress with the de-indexation of wage mechanisms – are required.

4.1.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from April 2006 to March 2007, long-term interest rates in Cyprus were 4.2% on average and thus stood well below the 6.4% reference value for the interest rate criterion (see Table 12).

Long-term interest rates have followed a declining, although somewhat volatile, trend since January 2001 (see Chart 7a).[4] Accompanied by reductions in the Central Bank of Cyprus's key interest rate, long-term interest rates decreased from around 7.7% at the beginning of 2001 to around 4.6% in early 2003 and were stable in the following period. In April 2004 the Central Bank of Cyprus reversed its policy stance and raised its official interest rates by 1 percentage point in the context of political uncertainties in relation to reunification negotiations, devaluation rumours accompanied by capital outflows, and large fiscal deficits. The decision contributed to an upward movement in long-term interest rates, which reached 6.6% in September 2004. Since October 2004, long-term interest rates have declined significantly and in March 2007 they stood at 4.5%. This development reflected a fall in the rate of inflation, improving fiscal balances and several reductions in official interest rates. The downward trend in long-term interest rates was reinforced by the Cyprus pound joining ERM II in May 2005, which was followed by increased capital inflows and a strengthening of the exchange rate vis-à-vis the euro. Expectations of Cyprus adopting the euro may also have played a favourable role. Furthermore, in the light of these developments, the spread between long-term interest rates in Cyprus and average government bond yields in the euro area declined significantly in 2005 and has hovered around zero in recent quarters, indicating a strong degree of interest rate convergence (see Chart 7b).

4 2001 is the first year for which data are available on the reference long-term interest rate for Cyprus.

LIST OF TABLES AND CHARTS

CYPRUS

1 PRICE DEVELOPMENTS

Table 1: HICP inflation 40
Chart 1: Price developments 40
Table 2: Measures of inflation and related indicators 40
Table 3: Recent inflation trends and forecasts
(a) Recent trends in the HICP
(b) Inflation forecasts 41

2 FISCAL DEVELOPMENTS

Table 4: General government fiscal position 42
Chart 2: General government gross debt
(a) Levels
(b) Annual change and underlying factors 42
Table 5: General government gross debt – structural features 42
Chart 3: General government surplus (+)/deficit (-)
(a) Levels
(b) Annual change and underlying factors 43
Table 6: General government deficit-debt adjustment 43
Chart 4: General government expenditure and revenue 44
Chart 5: Potential future debt ratios under alternative assumptions for fiscal balance ratios 44
Table 7: General government budgetary position 44
Table 8: Projections of the ageing-induced fiscal burden 45

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability
(b) Key indicators of exchange rate pressure for the Cyprus pound 46
Chart 6: Cyprus pound: deviation from ERM II central rate 46
Table 10: Cyprus pound: real exchange rate developments 47
Table 11: External developments 47

4 LONG-TERM INTEREST RATE DEVELOPMENTS

Table 12: Long-term interest rates (LTIRs) 48
Chart 7: (a) Long-term interest rate (LTIR)
(b) LTIR and HICP inflation differentials vis-à-vis the euro area 48

1 PRICE DEVELOPMENTS

Table 1 HICP inflation

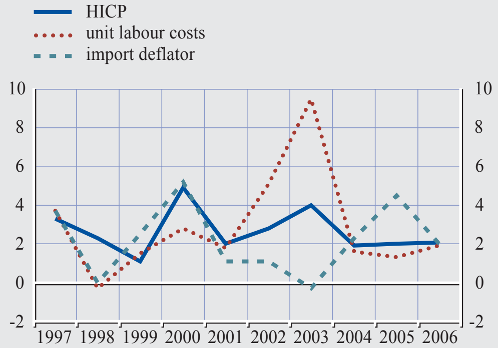
(annual percentage changes)

	2006 Dec.	2007 Jan.	Feb.	Mar.	Apr. 2006 to Mar. 2007
HICP inflation	1.5	1.4	1.2	1.4	**2.0**
Reference value [1]					***3.0***
Euro area [2]	*1.9*	*1.8*	*1.8*	*1.9*	***2.1***

Source: European Commission (Eurostat).
1) The basis of the calculation for the period April 2006 - March 2007 is the unweighted arithmetic average of the annual percentage changes in the HICP for Finland, Poland and Sweden plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(average annual percentage changes)



Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Measures of inflation										
HICP	3.3	2.3	1.1	4.9	2.0	2.8	4.0	1.9	2.0	2.2
HICP excluding unprocessed food and energy	2.5	3.1	1.5	2.8	1.6	2.1	3.1	0.8	0.8	0.8
CPI	3.6	2.2	1.7	4.1	2.0	2.8	4.1	2.3	2.5	2.5
CPI excluding changes in indirect taxes	-	-	-	-	-	-	-	-	-	-
Private consumption deflator	2.0	1.6	2.1	3.7	2.4	2.4	4.0	1.9	2.7	2.6
GDP deflator	2.4	2.9	2.3	3.8	3.4	1.2	5.1	3.3	2.4	2.5
Producer prices [1]	2.7	-0.1	2.7	7.6	1.1	2.4	3.8	5.9	5.1	3.9
Related indicators										
Real GDP growth	2.3	5.0	4.8	5.0	4.0	2.0	1.8	4.2	3.9	3.8
GDP per capita in PPS [2] (euro area = 100)	72.8	73.8	74.6	75.6	77.8	76.7	79.5	82.3	83.9	-
Comparative price levels (euro area = 100)	87.7	88.4	89.1	91.4	91.6	89.9	87.8	87.2	87.7	-
Output gap [3]	-2.2	-0.9	0.5	2.1	2.9	1.4	-0.5	-0.7	-1.2	-1.0
Unemployment rate (%) [4]	4.4	4.3	4.6	4.9	3.8	3.6	4.1	4.6	5.2	4.7
Unit labour costs, whole economy	3.7	-0.3	1.5	2.8	1.8	5.1	9.5	1.6	1.3	1.9
Compensation per employee, whole economy	5.5	3.1	4.5	6.3	3.6	4.9	7.4	2.0	1.6	4.2
Labour productivity, whole economy	1.7	3.4	2.9	3.4	1.8	-0.1	-1.9	0.4	0.3	2.3
Imports of goods and services deflator	3.7	0.0	2.5	5.2	1.1	1.1	-0.3	2.3	4.5	2.0
Nominal effective exchange rate [5]	2.4	2.3	-2.6	-4.2	0.6	1.7	3.6	1.9	0.8	0.5
Money supply (M3) [6]	10.7	9.9	16.0	9.1	13.2	11.0	3.9	6.0	9.8	14.9
Lending from banks [6]	12.4	14.7	14.6	12.2	12.0	7.9	4.8	6.3	5.8	15.8
Stock prices (CSE General Index) [7]	-6.0	17.2	688.1	-65.8	-47.2	-26.8	-14.7	-10.0	51.6	128.8
Residential property prices	-	-	-	-	-	-	-	-	-	-

Sources: European Commission (Eurostat), national data (CPI, money supply and lending from banks) and European Commission (output gap).
1) Total industry excluding construction, domestic sales.
2) PPS stands for purchasing power standards.
3) Percentage of potential GDP. A positive (negative) sign indicates that actual GDP is above (below) potential GDP.
4) The definition conforms to ILO guidelines. The data for 1997-99 are based on the national definition.
5) A positive (negative) sign indicates an appreciation (depreciation).
6) Annual end-of-period growth rates based on national definition, as compiled by the Central Bank of Cyprus.
7) The CSE General Index, which was launched in March 1996, was discontinued at the end of 2005. Data from January 2006 refer to the new CSE General Index.

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2006		2007		
	Nov.	**Dec.**	**Jan.**	**Feb.**	**Mar.**
HICP					
Annual percentage change	1.3	1.5	1.4	1.2	1.4
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	0.2	-0.4	-0.1	0.8	1.8
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	1.7	1.4	1.1	0.8	0.7

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2007	**2008**
HICP, European Commission (spring 2007)	1.3	2.0
CPI, OECD [1)]	-	-
CPI, IMF (April 2007)	2.1	2.1
CPI, Consensus Economics (March 2007)	2.0	1.9

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

2 FISCAL DEVELOPMENTS

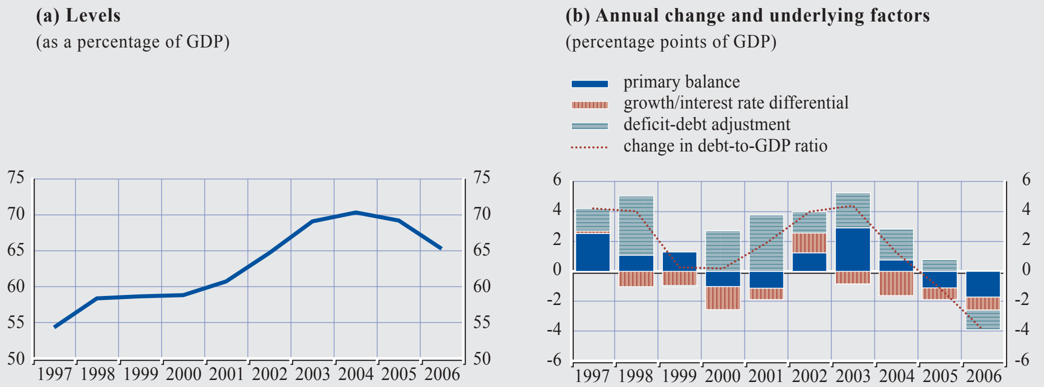
Table 4 General government fiscal position

(as a percentage of GDP)

	2005	2006	2007 [1]
General government surplus (+)/deficit (-)	-2.3	-1.5	-1.4
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure [2]	0.8	1.8	1.9
General government gross debt	69.2	65.3	61.5
Reference value	*60.0*	*60.0*	*60.0*

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

Chart 2 General government gross debt



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

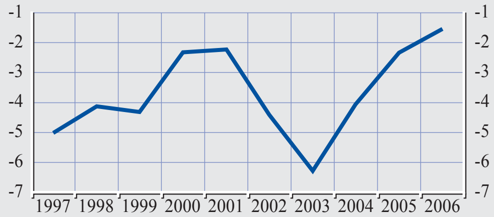
Table 5 General government gross debt – structural features

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Total debt (as a percentage of GDP)	54.4	58.4	58.7	58.8	60.7	64.7	69.1	70.3	69.2	65.3
Composition by currency (% of total)										
In domestic currency	79.3	77.0	72.7	75.9	79.9	79.7	77.7	72.8	75.4	78.1
In foreign currencies	20.7	23.0	27.3	24.1	20.1	20.3	22.3	27.2	24.6	21.9
Euro [1]	11.2	15.4	20.2	16.8	15.4	16.7	16.6	20.9	17.7	14.8
Other foreign currencies	9.5	7.7	7.2	7.3	4.8	3.7	5.8	6.2	6.9	7.0
Domestic ownership (% of total)	79.3	77.0	72.7	75.9	79.9	79.7	77.7	72.8	75.4	78.1
Average residual maturity (in years)	3.0	4.0	3.0	3.0	2.0	7.0	6.3	6.2	6.2	6.2
Composition by maturity [2] (% of total)										
Short-term (up to and including one year)	57.0	49.6	43.7	43.0	39.7	14.7	13.6	10.0	6.8	5.7
Medium and long-term (over one year)	43.0	50.4	56.3	57.0	60.3	85.3	86.4	90.0	93.2	94.3

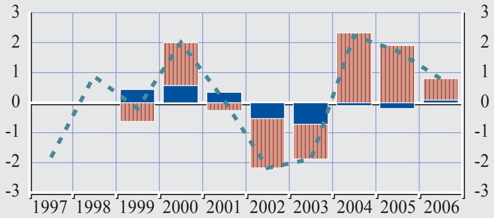
Sources: ESCB and European Commission.
Note: Year-end data. Differences between totals and the sum of their components are due to rounding.
1) Comprises debt denominated in euro and, before 1999, in ECU or in one of the currencies of the Member States that have adopted the euro.
2) Original maturity.

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

(a) Levels
(as a percentage of GDP)



(b) Annual change and underlying factors
(percentage points of GDP)



Sources: European Commission and ECB calculations.
Note: In Chart 3(b) a negative value indicates a contribution to an increase in a deficit, while a positive value indicates a contribution to its reduction.

Table 6 General government deficit-debt adjustment

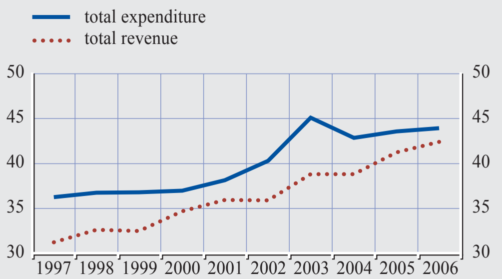
(as a percentage of GDP)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Change in general government debt[1]	6.5	8.1	4.3	5.0	6.0	5.9	8.6	6.1	3.1	0.2
General government surplus (+)/deficit (-)	-5.0	-4.1	-4.3	-2.3	-2.2	-4.4	-6.3	-4.1	-2.3	-1.5
Deficit-debt adjustment	1.5	4.0	-0.1	2.7	3.8	1.4	2.3	2.1	0.8	-1.3
Net acquisitions (+)/net sales (-) of financial assets	1.4	3.8	0.1	2.2	3.8	1.4	2.4	1.7	0.8	-1.2
Currency and deposits	1.2	3.7	0.0	2.3	3.6	0.8	1.5	1.2	0.3	-0.5
Loans and securities other than shares	0.0	0.0	0.0	0.0	0.0	0.2	0.2	0.1	0.2	-0.6
Shares and other equity	0.0	0.0	0.0	-0.6	0.0	0.0	0.0	0.0	0.0	0.0
Privatisations	0.0	0.0	0.0	-0.6	0.0	0.0	0.0	0.0	0.0	0.0
Equity injections	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other financial assets	0.2	0.1	0.1	0.5	0.2	0.4	0.7	0.3	0.3	-0.1
Valuation changes of general government debt	-0.2	0.1	-0.4	0.1	0.0	0.2	0.0	0.2	0.1	-0.1
Foreign exchange holding gains (-)/losses (+)	0.0	0.0	0.0	0.0	0.0	0.2	0.1	0.1	0.1	0.1
Other valuation effects[2]	-0.2	0.1	-0.4	0.1	0.0	-0.1	0.0	0.1	-0.1	-0.2
Other changes in general government debt[3]	0.3	0.0	0.2	0.4	0.0	-0.1	-0.1	0.1	-0.1	0.0

Sources: ESCB and European Commission.
Note: Differences between totals and the sum of their components are due to rounding.
1) Annual change in debt in period t as a percentage of GDP in period t, i.e. [debt(t) - debt(t-1)]/GDP(t).
2) Includes the difference between the nominal and market valuation of general government debt in issue.
3) Transactions in other accounts payable (government liabilities), sector reclassifications and statistical discrepancies. This item may also cover certain cases of debt assumption.

Chart 4 General government expenditure and revenue

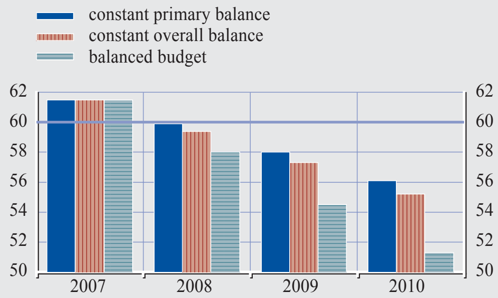
(as a percentage of GDP)



Source: ESCB.

Chart 5 Potential future debt ratios under alternative assumptions for fiscal balance ratios

(as a percentage of GDP)



Sources: European Commission projections and ECB calculations.
Note: The three scenarios assume that the debt ratio for 2007 is 61.5% of GDP as forecast and that the overall balance of -1.4% of GDP or the primary balance of 1.7% of GDP for 2007 will be kept constant over the period considered (as a percentage of GDP), or, alternatively, that a balanced budget is maintained from 2008 onwards. The nominal rate of interest is assumed to be at 6% (an average real cost of public debt outstanding of 4% plus 2% inflation). The real GDP growth rate is as projected by the European Commission in its spring 2007 forecast for 2008 and as assumed by the EU's Economic Policy Committee and the European Commission for 2009 and 2010. Deficit-debt adjustments are assumed to be equal to zero.

Table 7 General government budgetary position

(as a percentage of GDP)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Total revenue	31.2	32.6	32.5	34.7	35.9	35.9	38.8	38.8	41.2	42.4
Current revenue	31.2	32.5	32.4	34.6	35.9	35.9	38.7	38.0	40.2	42.3
Direct taxes	8.6	9.7	10.6	10.9	11.1	11.2	9.6	8.0	9.3	10.9
Indirect taxes	10.1	11.1	10.7	12.4	13.0	13.3	16.4	16.9	16.9	17.8
Social security contributions	7.0	6.9	6.6	6.5	6.8	6.7	7.0	7.7	8.3	8.0
Other current revenue	5.5	4.9	4.5	4.7	5.0	4.6	5.7	5.5	5.8	5.6
Capital revenue	0.0	0.1	0.1	0.1	0.1	0.0	0.1	0.8	1.0	0.1
Total expenditure	36.2	36.7	36.8	37.0	38.2	40.3	45.1	42.9	43.6	43.9
Current expenditure	32.7	33.3	33.6	33.5	34.8	36.7	41.1	38.7	40.0	40.0
Compensation of employees	13.7	13.5	13.5	13.5	13.2	13.8	15.6	14.8	14.8	14.8
Social benefits other than in kind	7.8	8.7	8.9	9.0	9.2	10.2	11.3	12.0	12.7	12.3
Interest payable	2.5	3.1	3.0	3.4	3.4	3.2	3.4	3.3	3.4	3.3
of which: impact of swaps and FRAs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other current expenditure	8.8	8.0	8.2	7.7	9.0	9.5	10.8	8.5	9.1	9.7
Capital expenditure	3.5	3.4	3.2	3.5	3.4	3.6	4.0	4.2	3.6	3.9
Surplus (+)/deficit (-)	-5.0	-4.1	-4.3	-2.3	-2.2	-4.4	-6.3	-4.1	-2.3	-1.5
Primary balance	-2.5	-1.1	-1.3	1.0	1.1	-1.2	-2.9	-0.8	1.1	1.7
Surplus/deficit, net of government investment expenditure	-2.0	-1.3	-1.9	0.6	0.7	-1.4	-2.9	0.0	0.8	1.8

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

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2004	2010	2020	2030	2040	2050
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	17.5	19.1	25.5	32.9	36.1	43.2
Change in age-related government expenditure (percentage points of GDP) compared with 2004	-	0.1	1.2	4.1	7.0	11.8

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

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

Membership of the exchange rate mechanism (ERM II)	Yes
Membership since	2 May 2005
ERM II central rate in CYP/EUR	0.585274
ERM II fluctuation band	± 15%
Devaluation of bilateral central rate on country's own initiative	No
Maximum upward deviation [1]	2.1
Maximum downward deviation [1]	0.0

Source: ECB.
1) Maximum percentage deviations from ERM II central rate over the period 2 May 2005 to 26 April 2007, based on daily data at business frequency. An upward/downward deviation implies that the currency is on the strong/weak side of the band.

(b) Key indicators of exchange rate pressure for the Cyprus pound

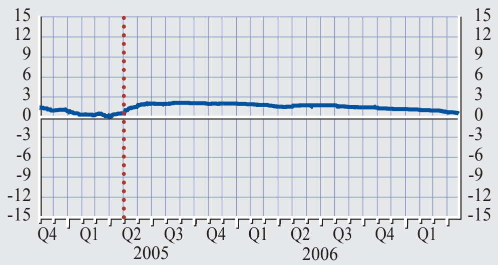
(average of three-month period ending in specified month)

	2005			2006				2007
	June	Sep.	Dec.	Mar.	June	Sep.	Dec.	Mar.
Exchange rate volatility [1]	0.9	0.2	0.2	0.2	0.4	0.2	0.2	0.2
Short-term interest rate differential [2]	2.4	1.7	1.2	0.7	0.3	0.0	0.1	0.1

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

Chart 6 Cyprus pound: deviation from ERM II central rate

(daily data; percentage deviation; 2 May 2005 to 26 April 2007)



Source: ECB.
Note: The vertical line indicates the date of entry into ERM II (2 May 2005). A positive/negative deviation from the central rate implies that the currency is at the strong/weak side of the band. For the Cyprus pound, the fluctuation band is ± 15%. Deviations prior to 2 May 2005 refer to the Cyprus pound's central rate as established upon ERM II entry.

Table 10 Cyprus pound: real exchange rate developments

(monthly data; percentage deviations; March 2007 compared with different benchmark periods)

	Average Jan. 1996 to Mar. 2007	Average Jan. 1999 to Mar. 2007
Real bilateral exchange rate against the euro [1]	2.0	0.5
Memo items:		
Nominal effective exchange rate [2]	4.7	4.6
Real effective exchange rate [1], [2]	7.2	6.3

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

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Balance of payments										
Current account and capital account balance [1]	-4.7	3.1	-1.7	-5.2	-3.2	-3.5	-2.0	-4.1	-5.1	-5.9
Current account balance	-4.7	3.1	-1.7	-5.3	-3.3	-3.7	-2.2	-5.0	-5.6	-5.9
Capital account balance	0.0	0.0	0.0	0.1	0.1	0.2	0.3	0.9	0.5	0.0
Goods balance	-23.3	-25.4	-23.6	-28.0	-26.7	-27.3	-23.9	-25.6	-25.0	-27.5
Services balance	21.4	22.0	24.4	26.7	28.3	26.2	23.4	22.9	22.3	23.4
Income balance	-3.2	6.0	-3.6	-5.8	-5.4	-3.7	-2.8	-3.3	-3.5	-2.8
Current transfers balance	0.4	0.5	1.1	1.9	0.6	1.1	1.1	1.1	0.5	1.1
Combined direct and portfolio investment balance [1]	7.1	4.9	4.0	4.3	10.0	0.0	4.3	9.7	3.5	0.9
Direct investment balance	5.8	2.9	6.5	7.3	7.2	5.1	2.4	2.5	4.3	4.2
Portfolio investment balance	1.2	2.0	-2.5	-3.1	2.8	-5.1	1.9	7.2	-0.8	-3.3
Other investment balance	-1.0	-9.3	4.7	1.4	-0.1	8.5	-4.2	-3.7	5.2	11.3
Reserve assets	0.5	0.9	-6.5	0.1	-6.3	-3.8	1.6	-2.4	-4.2	-5.5
Exports of goods and services	51.2	48.8	50.6	54.0	55.1	50.7	47.2	47.0	47.4	47.5
Imports of goods and services	53.1	52.3	49.8	55.3	53.5	51.9	47.7	49.8	50.1	51.7
Net international investment position [2]	-	-	-	.	.	10.5	4.2	14.0	19.0	10.3
External trade										
Exports of goods to the euro area [3]	16.9	22.3	33.7	34.2	33.5	35.1	38.5	37.6	52.5	50.5
Imports of goods from the euro area [3]	33.8	40.9	43.5	44.4	44.5	44.8	47.1	55.6	55.3	55.3
Exports of goods to the EU [4]	28.3	39.8	57.0	58.8	53.5	55.9	59.6	65.3	71.7	68.5
Imports of goods from the EU [4]	48.3	55.8	58.3	58.2	58.3	56.9	59.4	68.0	68.3	67.1

Sources: ESCB and Eurostat.
1) Differences between the total and the sum of the components are due to rounding.
2) A full international investment position statement was produced for the first time for the reference year 2002. In previous years only partial statements were produced.
3) As a percentage of total exports/imports. The data refers to the euro area excluding Slovenia.
4) As a percentage of total exports/imports. The data refers to the EU excluding Bulgaria and Romania.

4 LONG-TERM INTEREST RATE DEVELOPMENTS

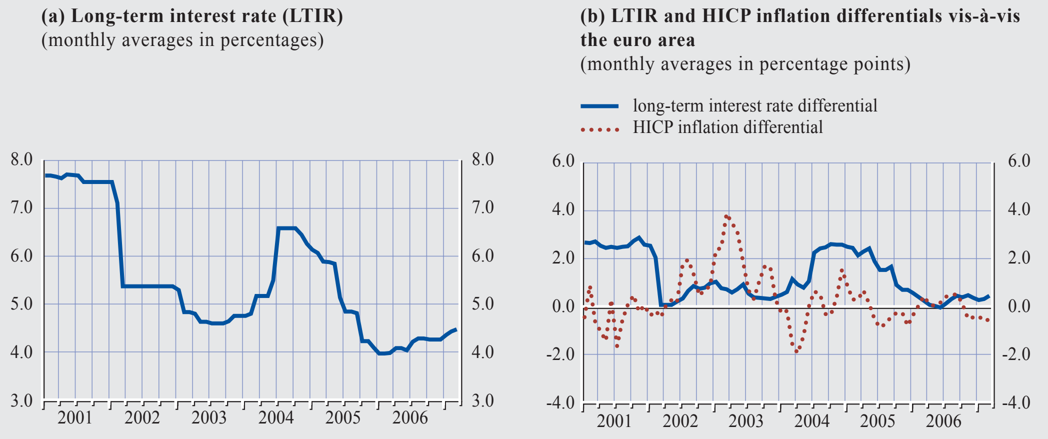
Table 12 Long-term interest rates (LTIRs)

(percentages; average of observations through period)

	2006	2007			Apr. 2006 to
	Dec.	Jan.	Feb.	Mar.	Mar. 2007
Long-term interest rate [1]	4.3	4.4	4.4	4.5	**4.2**
Reference value [2]					***6.4***
Euro area [3]	*3.9*	*4.1*	*4.1*	*4.0*	***4.0***

Sources: ECB and European Commission.
1) The long-term interest rate is based on primary market yields.
2) The basis of the calculation for the period April 2006 - March 2007 is the unweighted arithmetic average of the interest rate levels in Poland, Finland and Sweden plus 2 percentage points.
3) The euro area average is included for information only.

Chart 7 Long-term interest rate (LTIR)



Sources: ECB and European Commission.

4.2 MALTA

4.2.1 PRICE DEVELOPMENTS

Over the reference period from April 2006 to March 2007, the 12-month average rate of HICP inflation in Malta was 2.2%, i.e. well below the reference value of 3.0% for the criterion on price stability (see Table 1). On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to decline further in the coming months.

Looking back over a longer period, HICP inflation in Malta has been relatively stable, fluctuating mostly between 2% and 3% during the years 1999-2006 (see Chart 1). Somewhat higher HICP inflation rates were recorded in 1997 and 1998, largely due to relatively strong increases in hotel, restaurant and transport prices.

The fact that inflation has remained relatively stable over a long period reflects a number of important policy choices, most notably the decision to maintain a pegged exchange rate arrangement since Malta became independent in 1964. For most of this period, the Maltese lira was pegged to a basket of currencies, with large weights being assigned to the ECU/euro, pound sterling and US dollar. Since 2 May 2005, the lira has been participating in ERM II and has thereby been pegged to the euro. The maintenance of price stability as the primary objective of monetary policy was enshrined in the Central Bank of Malta Act in 2002. Relatively contained inflation has also been helped by the liberalisation of foreign trade and regulatory reforms in some network industries. Furthermore, fiscal policy has become more supportive of the achievement of price stability over the past few years.

Following a period of solid economic growth until 2000, output growth slowed significantly, but this did not have a marked impact on inflation, in part because inflation was already at a relatively low level at the start of this decade. In recent years, inflation developments were also driven by a number of special factors, such as an increase in the VAT rate, which took effect from 1 January 2004, and, more recently, measures that led to a more frequent adjustment of domestic energy prices to world market prices. From 2001 onwards real GDP growth was sluggish on average, with two years of output contraction being recorded (see Table 2). This period of economic stagnation reflected a combination of external weakness, partly associated with increased competition in Malta's most important export markets (tourism and electronics), and domestic factors, such as the temporary effects of restructuring operations in the manufacturing sector. These restructuring efforts left their mark on the labour market, with job losses in certain manufacturing industries and employment gains in some service sectors and in the newly established pharmaceutical industry. On balance, unemployment remained broadly stable during this period, with the unemployment rate standing at 7.4% in 2006. Developments in wages and unit labour costs were rather volatile but, more recently, restrained by soft labour market conditions. Import prices, which tend to be driven largely by the prices of intermediate products (in particular electronic components), fluctuations in oil prices and the Maltese lira-US dollar exchange rate, were volatile, especially in 2001. In 2002, the authorities amended the mechanism of price controls for the main types of fuel by increasing the frequency of price adjustments so as to reflect global trends more closely and by gradually dismantling subsidies on diesel fuel. The general pattern of inflation is also apparent from other relevant price indices, such as the HICP excluding unprocessed food and energy (see Table 2).

Looking at recent developments, the annual rate of HICP inflation declined notably towards the end of 2006 and remained subdued in early 2007. After reaching a peak of around 3.5% in mid-2006, it declined to less than 1% in the last two months of that year, to stand at 0.5% in March 2007 (see Table 3a). The decline in inflation in late 2006 was largely due to the unwinding of the impact of the earlier energy price increase, which had affected inflation in

Malta relatively strongly. This impact was also associated with a number of changes that the Maltese authorities introduced in the setting of electricity and water prices. More specifically, a surcharge on electricity and water consumption was introduced in early 2005 in order to strengthen the link between these prices and world energy prices. Since November 2005, this surcharge has been adjusted every two months; prior to this it was to be adjusted only every six months. Due to this slow adjustment before November 2005, the global energy price increase affected inflation in Malta relatively late (mainly in 2006). Changes in administered prices (including the surcharge on electricity and water consumption) accounted for around 0.6 percentage point of total HICP inflation in 2006. The share of administered prices in the HICP basket is 7.7% in 2007, i.e. somewhat lower than in most euro area countries. The economic recovery which started in 2005 continued in the course of 2006, with real GDP growing at an annual average rate of 2.9% in 2006. Despite this pick-up, price pressures from the demand side of the economy have remained limited.

Looking ahead, the latest available inflation forecasts from major international institutions range from 1.4% to 2.4% for 2007 and from 2.1% to 2.3% for 2008 (see Table 3b). Upside risks to inflation prospects are mainly associated with a potential renewed increase in world energy prices. Given the closer alignment of domestic energy prices with market prices, oil price shocks may pass through more rapidly to domestic inflation in the future. In addition, although it is not as strong as in other countries with less developed financial markets, the ongoing rapid rise in the growth of credit, especially to the construction sector, needs to be carefully monitored in view of its potential to generate domestic price pressures. Downside risks to the inflation projections are related to the effects of increasing competition in some product markets, such as the food retailing and the airline industry, and ongoing efforts to streamline regulatory and administrative procedures in the public sector. Looking further ahead, the catching-up process may also have a bearing on inflation, given that GDP per capita and price levels are still lower in Malta than in the euro area (see Table 2). However, it is difficult to assess the exact size of the inflation effect resulting from this process.

An environment conducive to sustainable price stability in Malta will be dependent on, inter alia, the implementation of a sound and credible medium-term fiscal strategy. It will be important, in the public as well as the private sector, to maintain moderate wage developments that take into account labour productivity growth, labour market conditions and developments in competitor countries. It will also be essential to focus on overcoming the structural constraints on economic growth and job creation, notably by fostering labour participation. Further enhancing competition in product markets and improving the functioning of the labour market are key elements in this regard. Such measures will also help to make these markets more flexible, thereby facilitating adjustment to possible country or industry-specific shocks. The ability to absorb such shocks is particularly important in view of the economy's relatively high degree of specialisation. These measures will help to achieve an environment conducive to price stability, as well as promote competitiveness and employment growth.

4.2.2 FISCAL DEVELOPMENTS

Malta is at present subject to an EU Council decision on the existence of an excessive deficit; the deadline for correction of the excessive deficit is 2006. In the reference year 2006 the general government budget balance showed a deficit of 2.6% of GDP, i.e. below the 3% reference value (see Table 4). The deficit ratio did not exceed the ratio of public investment expenditure to GDP. The general government debt-to-GDP ratio was 66.5%, i.e. above the 60% reference value. Compared with the previous year, the deficit ratio decreased by 0.5 percentage point and the public debt ratio decreased by 5.9 percentage points. The strong decline in the debt ratio was mainly due to large privatisation proceeds. In 2007, the deficit ratio is forecast by the European Commission to decrease to 2.1% and the general government debt ratio is projected to decline slightly to 65.9%.

Looking back over the years 1997 to 2006, the public debt-to-GDP ratio increased cumulatively by 26.9 percentage points until 2004, before declining in the last two years (see Chart 2a and Table 5). As shown in greater detail in Chart 2b, the primary deficit was the strongest factor behind the rising debt ratio, with the change to a primary surplus more recently supporting the subsequent decrease in the debt ratio. Reflecting low real GDP growth rates, the growth/interest-rate differential had a debt-augmenting effect in several years. Deficit-debt adjustments, by contrast, had a debt-reducing impact in several years, most notably in 2006 due to large privatisation proceeds. The patterns observed may be seen as indicative of the close link between the primary balance and debt dynamics. In this context, it may be noted that the share of public debt with a short-term maturity is noticeable at 12.2% of total public debt (see Table 5). Taking into account the level of the debt ratio, fiscal balances are relatively sensitive to changes in interest rates. Foreign currency-denominated debt accounts for only a small proportion of Malta's public debt stock, and most of it is denominated in euro. Fiscal balances are therefore relatively insensitive to changes in exchange rates.

Since 1997 a pattern of volatile but gradually improving outturns has been observed in the deficit-to-GDP ratio (see Chart 3a and Table 7). The deficit ratio moved from 7.9% of GDP in 1997 to 2.6% in 2006, after having reached very high levels of around 10% in 1998 and 2003. The 2006 deficit was slightly lower than anticipated in the previous convergence programme on account of much stronger than expected economic growth. As is shown in greater detail in Chart 3b, European Commission estimates indicate that, on balance in the period under review, cyclical factors had only a relatively small impact on the change in the fiscal balance. Non-cyclical changes in the government budget balance could reflect either a lasting structural change or the effect of temporary measures. In the case of Malta temporary measures have been sizeable in the recent past. Such measures had a deficit-increasing impact of around 3% of GDP in 2003, when the government assumed the liabilities of the Maltese ship repair and shipbuilding industries. Available evidence suggests that temporary measures had a deficit-reducing effect of 1.7% of GDP in 2005 and 0.7% of GDP in 2006, in part reflecting the sale of land. Without these measures, the 2006 deficit would have amounted to 3.3% of GDP.

Moving on to examine trends in other fiscal indicators, Chart 4 and Table 7 show that the general government total expenditure-to-GDP ratio increased in the period under review, reaching 45.2% at the end of the period. From 2000 to 2003 the expenditure ratio rose steeply, reflecting higher spending on compensation of public employees, social transfers and public investment. Since then the expenditure ratio has been declining gradually. In 2004 this reflected a decline in capital spending as a percentage of GDP, whereas in 2005 it was due to a fall in current spending. In 2006, both current and capital expenditure declined as a percentage of GDP. On balance, the expenditure ratio was 2.2 percentage points higher in 2006 than in 1997. The expenditure ratio is high in comparison with other countries with a similar level of per capita income. Government revenue in relation to GDP also increased between 1997 and 2006, by 7.6 percentage points overall to 42.7% at the end of the period, reflecting higher direct and indirect taxes.

According to Malta's medium-term fiscal strategy, as presented in the convergence programme for 2006-09, dated December 2006 and preceding the European Commission forecasts shown in Table 4, the government intends to proceed with its consolidation course, targeting a fiscal surplus of 0.1% of GDP and a debt-to-GDP ratio of 59.4% in 2009. The strategy is based on significant expenditure reduction, particularly in the areas of capital spending and social transfers but also public consumption. This would also allow a reduction in the revenue ratio. The government intends to reduce significantly the reliance on temporary fiscal policy measures. For 2007, the convergence programme foresees a reduction in the deficit ratio of 0.3 percentage point, which matches the decline in interest expenditure. The government plans to cover the impact of lower deficit-reducing temporary measures with structural consolidation measures such as lower spending on public wages, reflecting its strategy of limiting wage increases and public employment levels. There are several risks related to the implementation of the fiscal strategy. The underlying macroeconomic scenario is very favourable and the fiscal adjustment is back-loaded, with consolidation measures for 2008 and 2009 not spelled out in sufficient detail. Moreover, even if fiscal targets are met, further consolidation is required if Malta is to attain the medium-term objective specified in the Stability and Growth Pact. The convergence programme quantifies this objective as a balanced budget in cyclically adjusted terms and net of temporary measures but does not foresee its achievement within the programme horizon.

With regard to the prospects of countries with a public debt ratio clearly above 60% of GDP achieving a reduction to the reference value, calculations are presented in Chart 5. On the assumption that Malta achieves the overall fiscal position and public debt ratio projected by the European Commission for 2007, maintaining a balanced budget from 2008 onwards would ensure a decline in the public debt ratio to below 60% of GDP by 2010. However, maintaining either the overall or primary budget balance ratio at their respective 2007 levels of -2.1% and 1.2% would not appear to be sufficient to reduce the debt ratio to below the reference value before 2016. Such calculations are based on the assumption of a constant nominal rate of interest of 6% (an average real cost of public debt outstanding of 4% plus 2% inflation). The real GDP growth rate underlying these calculations is as projected by the European Commission in its spring 2007 forecast for 2008 and as assumed by the EU's Economic Policy Committee and the European Commission for 2009 and beyond. Deficit-debt adjustments are not taken into account. While these calculations are purely illustrative and can by no means be regarded as forecasts, the indication that maintaining the overall or primary budget balance ratio at 2007 levels would not enable the public debt ratio to be reduced to the 60% reference value in the next few years highlights the need for further progress in consolidation.

As highlighted in Table 8, from around 2010 onwards a marked ageing of the population is expected. According to the projections by the EU's Economic Policy Committee and the European Commission,[1] Malta is expected to experience an increase of 2.2 percentage points in the ratio of age-related public expenditure to GDP in the years to 2020, which then declines to an increase of 0.3 percentage point by 2050. These projections do not take into account the public pension reform adopted by the House of Representatives in December 2006. The pension reform includes measures aimed at increasing the effective retirement age and the level of pensions compared with previous legislation. A preliminary assessment of the reform by the European Commission[2] suggests that, compared with a no-reform scenario, public pension expenditure as a percentage of GDP would be 1.3 percentage points lower in 2020 but 3.5 percentage points higher in 2050. The reform is assessed not to have improved the prospects for the long-term sustainability of public finances. Against this background, and in view of the high level of public debt, further reforms in the areas of pensions and health care would seem necessary to contain sustainability risks. Coping with the burden will be facilitated if sufficient room for manoeuvre is created in public finances before the demographic situation worsens. Implementing

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

2 "Economic assessment of the convergence programme of Malta (Update of December 2006)", European Commission (2007).

measures to achieve an increase in the employment ratio by strengthening incentives to work and efforts to increase productivity growth would also make a significant contribution to fiscal sustainability.

Turning to further fiscal challenges, prudent fiscal policies are warranted in light of Malta's relatively large external imbalance. Implementing measures to achieve an increase in the employment ratio by strengthening incentives to work could make a significant contribution to fiscal consolidation. According to information from the European Commission dated end-2004, explicit contingent fiscal liabilities amounted to about 17% of GDP.[3] According to more recent information, the ratio was 13.3% in 2006.

4.2.3 EXCHANGE RATE DEVELOPMENTS

The Maltese lira has been participating in ERM II with effect from 2 May 2005, i.e. for the two-year reference period between May 2005 and April 2007 (see Table 9a). The central rate for the currency in ERM II was set at 0.429300 lira per euro – the market rate at the time of entry – with a standard fluctuation band of ±15%. Upon entry into the mechanism, the Maltese lira was re-pegged to the euro from its previous basket arrangement. The agreement on participation in ERM II was based on a number of policy commitments by the Maltese authorities, relating, inter alia, to pursuing sound fiscal policies, promoting wage moderation, ensuring effective financial supervision and implementing further structural reforms. At the time of ERM II entry, the Maltese authorities stated their intention to maintain the exchange rate of the Maltese lira at the central rate against the euro as a unilateral commitment, thus placing no additional obligations on the ECB.

Prior to the lira joining ERM II, the evolution of the Maltese currency against the euro reflected its peg to a basket of three currencies, consisting of the euro, the pound sterling and the US dollar. Given that the euro was the most important currency in the basket, MTL/EUR exchange rate fluctuations were rather limited over the period. Since joining ERM II, in keeping with the Maltese authorities' policy statement, the lira has remained at its central rate (see Chart 6 and Tables 9a and 9b). Moreover, within ERM II, Malta has not devalued its currency's central rate against the euro on its own initiative. The modest short-term interest rate differentials against the three-month EURIBOR widened temporarily in the course of 2005. In 2006, however, they narrowed again as monetary policy rates in Malta were raised by less than in the euro area. The differential stood at 0.2 percentage point in the three-month period ending in March 2007 (see Table 9b).

In a longer-term context, both bilaterally against the euro and in effective terms, the real exchange rate of the Maltese lira was in March 2007 close to historical averages as calculated from January 1996 and since the launch of the euro in 1999 (see Table 10).

As regards other external developments, since 1997, Malta has reported deficits in the combined current and capital account of the balance of payments that have, at times, been large and also rather volatile. Although the deficit steadily contracted until 1999, it widened rather sharply to reach 12.0% of GDP in 2000. In 2002 the deficit receded and turned into a surplus of 2.6% of GDP, partly reflecting high export receipts associated with aircraft sales by the national airline. Subsequently, the current and capital account again recorded a relatively large deficit of 4.9% of GDP in 2004 and 2005. The widening of the deficit in these years was mainly associated with a rise in the oil bill in response to higher oil prices and with a widening goods deficit (19.6% of GDP in 2005), while the services surplus declined (to 7.9% of GDP in 2005) (see Table 11). The combined current and capital account deficit contracted to 3.3% of GDP in 2006, mainly on account of higher transfers and net income receipts on the current account. From a financing perspective, since 2003

3 However, there exists no agreed method for estimating the full scale of contingent fiscal liabilities, and estimates may vary widely.

portfolio investment has shown strong net outflows driven by the banking system, which includes a number of institutions that deal almost exclusively with non-residents. Portfolio outflows reflected increased holdings of foreign debt securities by the banking sector and were financed by inflows to "other investments". Between 2005 and 2006 capital inflows exceeded the current and capital account deficit and, as a result, Malta experienced an accumulation of official reserve assets over the same period. Financial inflows partly reflected net inflows of direct investment related mainly to equity contributions for the establishment of two foreign-owned banks, although reinvested earnings and payments received by resident firms from their foreign parents to settle outstanding debts also played a role. The volatility in external accounts should be seen in the context of a very small, open economy, where a single transaction can have a large effect on the balance of payments. At the same time, sizeable credits are typically recorded under "errors and omissions", which suggest that either the current and capital account deficit or net financial outflows are overstated. The country's net international investment position remained positive and amounted to 37.5% of GDP in 2006 (see Table 11).

It may be recalled that Malta is a very small, open economy with, in 2006, a ratio of foreign trade in goods and services to GDP of 76.8% for exports and 90.3% for imports. In 2006, exports of goods to the euro area and to the EU as a share of total exports amounted to 37.5% and 50.2% respectively. The corresponding figures for imports as a percentage of total imports in 2006 were 55.0% and 67.6%.

With regard to the fulfilment of the commitments undertaken upon ERM II entry, the following observations can be made. Malta's fiscal deficit has been on a declining path, reflecting, to some extent, temporary measures. Overall, wage growth has been moderate – especially in the public sector – and below labour productivity growth. Some enhancements have been made in the area of financial supervision. Progress has been made with the implementation of structural reforms, in particular by reducing the size of the public sector and increasing domestic competition in a number of sectors.

4.2.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from April 2006 to March 2007, long-term interest rates in Malta were 4.3% on average and thus stood well below the 6.4% reference value for the interest rate criterion (see Table 12).

Long-term interest rates broadly followed a downward trend between the end of 2001 and the end of 2003 (see Chart 7a).[4] In the same period, the Central Bank of Malta gradually reduced its key interest rate, against a background of contained inflationary pressures and modest economic growth. After hovering around a level of 4.7% during 2003 and 2004, supported by the Maltese lira joining ERM II on 2 May 2005, long-term interest rates declined further, to below 4.5%, in 2005 and 2006. Expectations concerning the adoption of the euro may also have played a favourable role in this development. In May 2006 the Central Bank of Malta raised its key interest rate by 25 basis points to 3.5% to counter an underlying downward trend in its external reserves. This contributed to a slight increase in long-term interest rates in subsequent months. Between May 2006 and January 2007, the Central Bank of Malta twice raised the central intervention rate by 25 basis points to leave it standing at 4.0%. Reflecting the slow, but steady, decline in Maltese long-term interest rates over recent years, and the corresponding developments in euro area long-term interest rates, the long-term interest rate differential with average government bond yields in the euro area widened somewhat in the course of 2005, although subsequently it declined to 0.4 percentage point in March 2007 (see Chart 7b).

4 2001 is the first year for which data are available on the reference long-term interest rate for Malta.

LIST OF TABLES AND CHARTS

MALTA

1 PRICE DEVELOPMENTS
Table 1 HICP inflation 56
Chart 1 Price developments 56
Table 2 Measures of inflation and related indicators 56
Table 3 Recent inflation trends and forecasts
(a) Recent trends in the HICP
(b) Inflation forecasts 57

2 FISCAL DEVELOPMENTS
Table 4 General government fiscal position 58
Chart 2 General government gross debt
(a) Levels
(b) Annual change and underlying factors 58
Table 5 General government gross debt – structural features 58
Chart 3 General government surplus (+)/deficit (-)
(a) Levels
(b) Annual change and underlying factors 59
Table 6 General government deficit-debt adjustment 59
Chart 4 General government expenditure and revenue 60
Chart 5 Potential future debt ratios under alternative assumptions for fiscal balance ratios 60
Table 7 General government budgetary position 60
Table 8 Projections of the ageing-induced fiscal burden 61

3 EXCHANGE RATE DEVELOPMENTS
Table 9 (a) Exchange rate stability
(b) Key indicators of exchange rate pressure for the Maltese lira 62
Chart 6 Maltese lira: deviation from ERM II central rate 62
Table 10 Maltese lira: real exchange rate developments 63
Table 11 External developments 63

4 LONG-TERM INTEREST RATE DEVELOPMENTS
Table 12 Long-term interest rates (LTIRs) 64
Chart 7 (a) Long-term interest rate (LTIR)
(b) LTIR and HICP inflation differentials vis-à-vis the euro area 64

1 PRICE DEVELOPMENTS

Table 1 HICP inflation

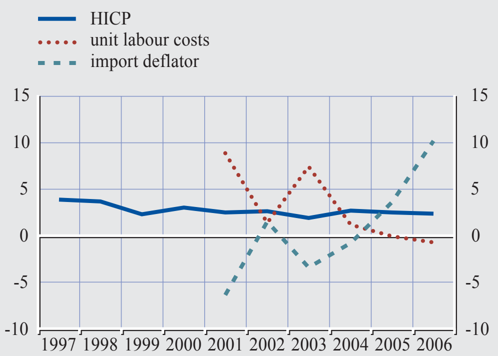
(annual percentage changes)

	2006 Dec.	2007 Jan.	Feb.	Mar.	Apr. 2006 to Mar. 2007
HICP inflation	0.8	1.2	0.8	0.5	2.2
Reference value [1]					*3.0*
Euro area [2]	*1.9*	*1.8*	*1.8*	*1.9*	*2.1*

Source: European Commission (Eurostat).
1) The basis of the calculation for the period April 2006 - March 2007 is the unweighted arithmetic average of the annual percentage changes in the HICP for Finland, Poland and Sweden plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(average annual percentage changes)



Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Measures of inflation										
HICP	3.9	3.7	2.3	3.0	2.5	2.6	1.9	2.7	2.5	2.6
HICP excluding unprocessed food and energy	4.0	4.0	2.4	2.9	2.3	2.7	1.9	2.8	2.0	1.6
CPI	3.1	2.4	2.1	2.4	2.9	2.2	1.3	2.8	3.0	2.8
CPI excluding changes in indirect taxes	-	1.8	1.9	1.2	2.9	2.0	1.0	0.5	2.8	2.6
Private consumption deflator	-	-	-	-	2.4	2.1	0.6	2.4	2.6	2.0
GDP deflator	-	-	-	-	2.9	2.7	4.6	1.4	2.4	2.6
Producer prices [1]	-	-	-	-	-	-	-	-	-	-
Related indicators										
Real GDP growth	-	-	-	-	-1.1	1.9	-2.3	0.4	3.0	2.9
GDP per capita in PPS [2] (euro area = 100)	-	71.2	70.7	71.7	68.0	69.5	69.3	67.8	67.6	-
Comparative price levels (euro area = 100)	-	-	70.4	74.9	75.3	72.9	69.1	69.7	70.5	-
Output gap [3]	0.8	1.4	2.8	5.5	1.4	2.0	-2.1	-3.4	-2.5	-1.5
Unemployment rate (%) [4]	-	-	-	6.7	7.6	7.5	7.6	7.4	7.3	7.4
Unit labour costs, whole economy	-	-	-	-	8.9	1.4	7.4	1.2	-0.1	-0.7
Compensation per employee, whole economy	-	-	-	-	5.8	2.8	3.9	2.5	1.1	1.2
Labour productivity, whole economy	-	-	-	-	-2.8	1.4	-3.3	1.2	1.2	2.0
Imports of goods and services deflator	-	-	-	-	-6.4	1.5	-3.4	-0.8	3.6	10.2
Nominal effective exchange rate [5]	1.8	2.2	-1.7	-1.5	0.6	0.8	3.3	2.4	-0.8	0.1
Money supply (M3) [6]	9.6	8.6	9.9	4.0	10.0	12.1	2.4	2.4	4.2	5.2
Lending from banks [6]	11.0	8.7	10.5	8.0	4.7	2.6	2.6	8.6	7.1	14.9
Stock prices (Maltex Index)	4.6	15.3	170.8	3.0	-34.8	-15.0	13.6	44.4	62.3	-2.2
Residential property prices	8.5	4.9	3.2	8.4	5.1	8.7	13.3	20.3	9.8	3.5

Sources: European Commission (Eurostat), national data (CPI, residential property prices, CPI excluding changes in indirect taxes, money supply and lending from banks) and European Commission (output gap).
1) Total industry excluding construction, domestic sales.
2) PPS stands for purchasing power standards.
3) Percentage of potential GDP. A positive (negative) sign indicates that actual GDP is above (below) potential GDP.
4) The definition conforms to ILO guidelines.
5) A positive (negative) sign indicates an appreciation (depreciation).
6) Annual end-of-period growth rates based on national definition, as compiled by the Central Bank of Malta.

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2006		2007		
	Nov.	Dec.	Jan.	Feb.	Mar.
HICP					
Annual percentage change	0.9	0.8	1.2	0.8	0.5
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	0.2	-0.5	-0.7	-1.0	-0.6
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	1.5	1.2	0.6	0.1	-0.2

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2007	2008
HICP, European Commission (spring 2007)	1.4	2.1
CPI, OECD [1]	-	-
CPI, IMF (April 2007)	2.4	2.3
CPI, Consensus Economics	-	-

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

2 FISCAL DEVELOPMENTS

Table 4 General government fiscal position

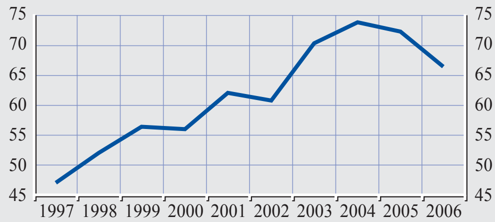
(as a percentage of GDP)

	2005	2006	2007 [1]
General government surplus (+)/deficit (-)	-3.1	-2.6	-2.1
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure [2]	2.2	2.1	3.0
General government gross debt	72.4	66.5	65.9
Reference value	*60.0*	*60.0*	*60.0*

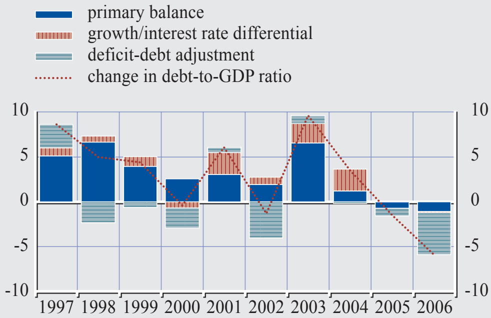
Sources: European Commission and ECB calculations.
1) European Commission projections.
2) A positive (negative) sign indicates that the government deficit is lower (higher) than investment expenditure.

Chart 2 General government gross debt

(a) Levels
(as a percentage of GDP)



(b) Annual change and underlying factors
(percentage points of GDP)



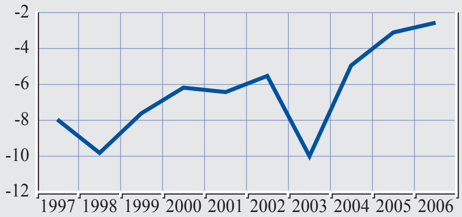
Sources: European Commission and ECB.
Note: In Chart 2(b) a negative value indicates a contribution of the respective factor to a decrease in the debt ratio, while a positive value indicates a contribution to its increase.

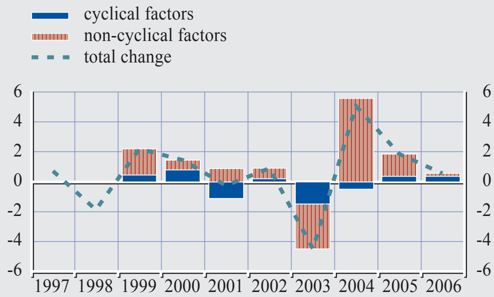
Table 5 General government gross debt – structural features

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Total debt (as a percentage of GDP)	47.0	52.0	56.4	56.0	62.1	60.8	70.4	73.9	72.4	66.5
Composition by currency (% of total)										
In domestic currency	90.5	90.7	91.8	92.6	93.9	93.7	93.4	94.3	94.9	95.6
In foreign currencies	9.5	9.3	8.2	7.4	6.1	6.3	6.6	5.7	5.1	4.4
Euro [1]	3.5	4.5	4.1	3.9	3.7	4.3	5.9	5.2	4.7	4.1
Other foreign currencies	6.0	4.7	4.1	3.6	2.4	2.0	0.7	0.4	0.4	0.2
Domestic ownership (% of total)	89.7	90.0	91.2	92.0	93.5	93.3	93.3	94.2	94.8	95.5
Average residual maturity (in years)	4.8	6.0	6.4	6.3	6.6	6.3	6.9	6.9	7.1	6.8
Composition by maturity [2] (% of total)										
Short-term (up to and including one year)	11.4	9.8	11.2	16.9	16.7	19.4	22.1	20.5	15.5	12.2
Medium and long-term (over one year)	88.6	90.2	88.8	83.1	83.3	80.6	77.9	79.5	84.5	87.8

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

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





Sources: European Commission and ECB calculations.
Note: In Chart 3(b) a negative value indicates a contribution to an increase in a deficit, while a positive value indicates a contribution to its reduction.

Table 6 General government deficit-debt adjustment

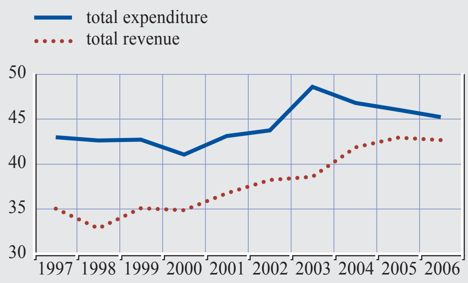
(as a percentage of GDP)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Change in general government debt [1]	10.5	7.5	7.0	3.9	7.0	1.5	10.9	4.8	2.3	-2.2
General government surplus (+)/deficit (-)	-7.9	-9.8	-7.6	-6.2	-6.4	-5.5	-10.0	-4.9	-3.1	-2.6
Deficit-debt adjustment	2.6	-2.3	-0.6	-2.3	0.6	-4.0	0.9	-0.2	-0.8	-4.7
Net acquisitions (+)/net sales (-) of financial assets	.	-1.5	-0.2	-1.1	0.4	-2.1	3.0	-0.2	1.5	-4.2
Currency and deposits	.	-0.2	3.7	-2.4	0.4	-1.1	3.6	0.0	1.5	0.6
Loans and securities other than shares	.	-0.2	-0.3	0.9	-0.4	0.4	-1.2	-0.2	0.0	-0.1
Shares and other equity	.	-2.2	-2.9	-0.6	0.3	-2.1	0.0	0.0	-1.3	-4.5
Privatisations	.	-2.4	-4.7	-0.7	0.0	-2.1	0.0	0.0	-1.4	-4.5
Equity injections	.	0.2	1.8	0.1	0.3	0.0	0.0	0.0	0.0	0.0
Other	.	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other financial assets	.	1.1	-0.7	1.0	0.1	0.7	0.6	0.0	1.2	-0.3
Valuation changes of general government debt	.	.	.	.	.	.	0.0	-0.3	-0.6	0.0
Foreign exchange holding gains (-)/losses (+)	.	.	.	.	.	.	0.0	0.0	0.0	0.0
Other valuation effects [2]	.	.	.	.	.	.	0.0	-0.3	-0.6	0.0
Other changes in general government debt [3]	.	.	.	.	.	.	-2.1	0.3	-1.7	-0.5

Sources: ESCB and European Commission.
Note: Differences between totals and the sum of their components are due to rounding.
1) Annual change in debt in period t as a percentage of GDP in period t, i.e. [debt(t) - debt(t-1)]/GDP(t).
2) Includes the difference between the nominal and market valuation of general government debt in issue.
3) Transactions in other accounts payable (government liabilities), sector reclassifications and statistical discrepancies. This item may also cover certain cases of debt assumption.

Chart 4 General government expenditure and revenue

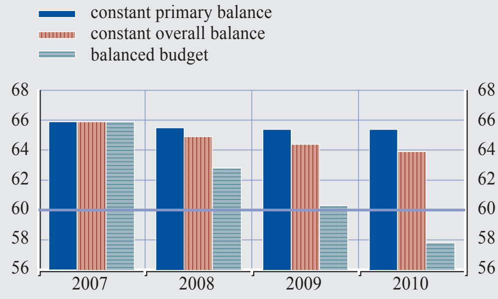
(as a percentage of GDP)



Source: ESCB.

Chart 5 Potential future debt ratios under alternative assumptions for fiscal balance ratios

(as a percentage of GDP)



Sources: European Commission projections and ECB calculations.
Note: The three scenarios assume that the debt ratio for 2007 is 65.9% of GDP as forecast and that the overall balance of -2.1% of GDP or the primary balance of 1.2% of GDP for 2007 will be kept constant over the period considered (as a percentage of GDP), or, alternatively, that a balanced budget is maintained from 2008 onwards. The nominal rate of interest is assumed to be at 6% (an average real cost of public debt outstanding of 4% plus 2% inflation). The real GDP growth rate is as projected by the European Commission in its spring 2007 forecast for 2008 and as assumed by the EU's Economic Policy Committee and the European Commission for 2009 and 2010. Deficit-debt adjustments are assumed to be equal to zero.

Table 7 General government budgetary position

(as a percentage of GDP)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Total revenue	35.0	32.8	35.1	34.9	36.7	38.2	38.6	41.9	42.9	42.7
Current revenue	33.9	31.9	34.0	33.7	36.4	37.7	38.0	40.0	39.2	39.6
Direct taxes	8.1	7.8	8.6	9.1	10.1	11.4	12.0	11.8	11.6	12.3
Indirect taxes	12.3	11.3	12.3	12.6	13.3	13.8	13.1	14.8	15.0	15.5
Social security contributions	8.0	7.4	7.4	7.5	8.4	8.1	8.1	8.2	8.6	8.0
Other current revenue	5.5	5.4	5.7	4.5	4.7	4.5	4.9	5.2	4.0	3.8
Capital revenue	1.2	0.9	1.1	1.1	0.3	0.5	0.5	1.9	3.8	3.1
Total expenditure	43.0	42.7	42.7	41.0	43.1	43.8	48.6	46.8	46.0	45.2
Current expenditure	37.7	37.3	37.1	36.1	38.6	38.9	40.1	41.8	40.8	40.4
Compensation of employees	14.0	14.3	13.7	13.0	14.9	14.6	15.0	15.0	14.5	13.8
Social benefits other than in kind	12.4	12.5	12.6	11.9	12.5	12.7	13.0	13.1	13.0	13.0
Interest payable	2.8	3.2	3.7	3.6	3.4	3.6	3.5	3.7	3.8	3.7
of which: impact of swaps and FRAs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other current expenditure	8.4	7.4	7.2	7.6	7.8	8.0	8.7	10.0	9.5	9.9
Capital expenditure	5.3	5.4	5.6	5.0	4.6	4.8	8.4	5.0	5.3	4.8
Surplus (+)/deficit (-)	-7.9	-9.8	-7.6	-6.2	-6.4	-5.5	-10.0	-4.9	-3.1	-2.6
Primary balance	-5.1	-6.6	-4.0	-2.5	-3.1	-1.9	-6.5	-1.2	0.7	1.1
Surplus/deficit, net of government investment expenditure	-3.3	-4.9	-2.8	-2.0	-2.7	-1.1	-4.9	-2.9	2.2	2.1

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

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2004	2010	2020	2030	2040	2050
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	19.0	20.4	30.0	36.0	35.9	40.6
Change in age-related government expenditure (percentage points of GDP) compared with 2004	-	0.9	2.2	1.8	1.0	0.3

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

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

Membership of the exchange rate mechanism (ERM II)	Yes
Membership since	2 May 2005
ERM II central rate in MTL/EUR	0.429300
ERM II fluctuation band	± 15%
Devaluation of bilateral central rate on country's own initiative	No
Maximum upward deviation [1]	0.0
Maximum downward deviation [1]	0.0

Source: ECB.
1) Maximum percentage deviations from ERM II central rate over the period 2 May 2005 to 26 April 2007, based on daily data at business frequency. An upward/downward deviation implies that the currency is on the strong/weak side of the band.

(b) Key indicators of exchange rate pressure for the Maltese lira

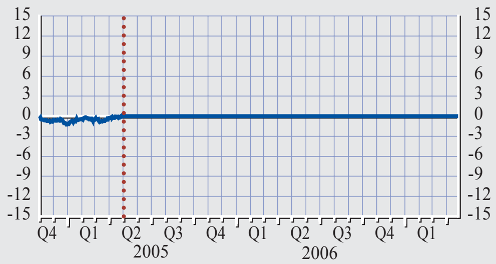
(average of three-month period ending in specified month)

	2005			2006				2007
	June	Sep.	Dec.	Mar.	June	Sep.	Dec.	Mar.
Exchange rate volatility [1]	0.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Short-term interest rate differential [2]	1.1	1.1	0.9	0.6	0.4	0.4	0.2	0.2

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

Chart 6 Maltese lira: deviation from ERM II central rate

(daily data; percentage deviation; 2 May 2005 to 26 April 2007)



Source: ECB.
Note: The vertical line indicates the date of entry into ERM II (2 May 2005). A positive/negative deviation from the central rate implies that the currency is at the strong/weak side of the band. For the Maltese lira, the fluctuation band is ± 15%. Deviations prior to 2 May 2005 refer to the Maltese lira's central rate as established upon ERM II entry.

Table 10 Maltese lira: real exchange rate developments

(monthly data; percentage deviations; March 2007 compared with different benchmark periods)

	Average Jan. 1996 to Mar. 2007	Average Jan. 1999 to Mar. 2007
Real bilateral exchange rate against the euro 1)	0.6	-2.0
Memo items:		
Nominal effective exchange rate 2)	5.2	4.5
Real effective exchange rate 1), 2)	7.8	5.5

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

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Balance of payments										
Current account and capital account balance 1)	-5.8	-5.2	-2.8	-12.0	-3.8	2.6	-2.8	-4.9	-4.9	-3.3
Current account balance	-6.1	-6.0	-3.4	-12.5	-3.8	2.5	-3.2	-6.4	-8.3	-6.3
Capital account balance	0.2	0.7	0.7	0.5	0.0	0.2	0.4	1.5	3.4	3.1
Goods balance	-19.6	-17.4	-16.9	-19.4	-14.3	-8.1	-13.1	-16.0	-19.6	-19.8
Services balance	11.8	12.0	11.6	8.6	8.9	9.5	9.9	9.8	7.9	6.2
Income balance	0.2	-1.7	1.0	-2.6	1.0	0.7	-0.5	-1.2	-2.8	-1.6
Current transfers balance	1.5	1.1	0.8	0.8	0.6	0.5	0.6	1.0	6.2	8.8
Combined direct and portfolio investment balance 1)	4.3	6.0	7.6	-3.7	-6.4	-18.7	-23.8	-30.8	-35.5	-12.2
Direct investment balance	1.3	6.6	20.4	15.4	6.3	-9.9	8.5	7.4	10.5	27.4
Portfolio investment balance	3.0	-0.7	-12.8	-19.1	-12.7	-8.8	-32.3	-38.2	-46.1	-39.6
Other investment balance	-0.9	1.7	3.4	9.6	10.1	24.2	28.5	31.1	44.9	24.4
Reserve assets	-0.2	-4.9	-6.1	5.7	-6.7	-6.7	-3.0	3.7	-4.0	-1.7
Exports of goods and services	75.5	78.0	82.1	92.0	81.1	84.3	80.7	78.4	72.6	76.8
Imports of goods and services	83.4	83.5	87.3	102.8	86.6	82.9	83.9	84.7	84.3	90.3
Net international investment position	21.8	19.9	17.9	6.0	13.8	35.5	41.3	40.4	44.1	37.5
External trade										
Exports of goods to the euro area 2)	45.8	44.6	39.0	25.7	41.5	34.4	34.5	35.6	37.3	37.5
Imports of goods from the euro area 2)	55.6	55.7	53.5	51.1	52.0	55.3	56.4	58.5	61.3	55.0
Exports of goods to the EU 3)	54.8	54.9	49.0	34.0	52.5	47.4	48.7	50.3	51.6	50.2
Imports of goods from the EU 3)	72.0	70.1	66.1	60.5	64.6	68.1	68.0	72.6	75.0	67.6

Sources: ESCB and Eurostat.
1) Differences between the total and the sum of the components are due to rounding.
2) As a percentage of total exports/imports. The data refers to the euro area excluding Slovenia.
3) As a percentage of total exports/imports. The data refers to the EU excluding Bulgaria and Romania.

4 LONG-TERM INTEREST RATE DEVELOPMENTS

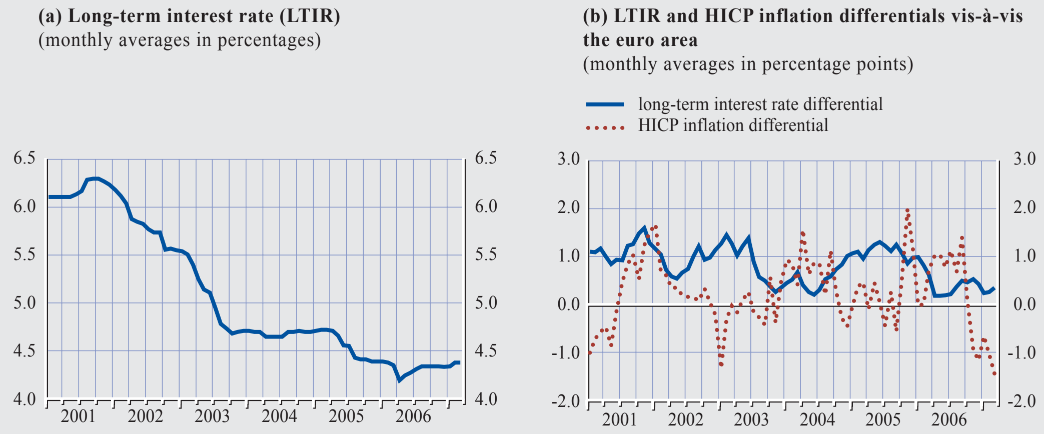
Table 12 Long-term interest rates (LTIRs)

(percentages; average of observations through period)

	2006 Dec.	2007 Jan.	Feb.	Mar.	Apr. 2006 to Mar. 2007
Long-term interest rate	4.3	4.3	4.4	4.4	**4.3**
Reference value [1]					***6.4***
Euro area [2]	*3.9*	*4.1*	*4.1*	*4.0*	***4.0***

Sources: ECB and European Commission.
1) The basis of the calculation for the period April 2006 - March 2007 is the unweighted arithmetic average of the interest rate levels in Poland, Finland and Sweden plus 2 percentage points.
2) The euro area average is included for information only.

Chart 7 Long-term interest rate (LTIR)



Sources: ECB and European Commission.

ANNEX

STATISTICAL METHODOLOGY OF CONVERGENCE INDICATORS

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

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

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

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

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

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

2 HICP INFLATION

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

Article 1 of Protocol No 21 on the convergence criteria referred to in Article 121 of the Treaty

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

2 The principles referring to statistical processes include sound methodology, appropriate statistical procedures, non-excessive burden on respondents and cost-effectiveness. Principles linked to the statistical output correspond to the data quality dimensions as indicated by Eurostat. These include relevance, accuracy and reliability, timeliness and punctuality, coherence and comparability, and accessibility and clarity. See http://epp.eurostat.cec.eu.int (April 2007).

3 Information on the institutional set-up of NSIs has been taken from their websites (April 2007).

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

Table 1 Quality and integrity of primary convergence indicators

	Cyprus	Malta
Institutional features relating to the quality and integrity of the statistics assessing the convergence process		
Legal independence of the national statistical institute	According to Section 12 of the Statistics Law, statistics are governed by suitability, impartiality, reliability, transparency and statistical confidentiality. The Head of the NSI is appointed by the Public Service Commission. The appointment is permanent.	According to Section 10 of the Malta Statistics Authority Act, statistics are based on reliability, objectivity, relevance, statistical confidentiality, transparency, specificity, proportionality and impartiality. The Head of the NSI is appointed by the Statistics Authority Board after having consulted the Ministry of Finance. The term of office is fixed (three years; reappointment is possible).
Administrative supervision and budget autonomy	The NSI is a government office under the supervision of the Ministry of Finance. It has a degree of budget autonomy on the basis of an annual amount assigned from the state budget.	The NSI is a central agency within the public administration, which reports to the Minister of Finance through the Statistics Authority Board.
Legal mandate for data collection	The Statistics Law determines the main principles of data collection.	The Statistics Authority Act determines the main principles of data collection.
Legal provisions regarding statistical confidentiality	According to Section 13 of the Statistics Law, the confidentiality of the statistical data is secured.	According to Sections 17, 40, 41 and 44 of the Statistics Authority Act, the confidentiality of statistical data is secured.
HICP inflation		
Compliance with legal minimum standards	Confirmed by Eurostat in 2004 and 2006.	For the most part, confirmed by Eurostat in 2004 and 2006. Instances of non-compliance are limited and likely to have a relatively minor impact in practice on the HICP annual average rates of change.
Other issues	No other issues identified.	No other issues identified.
Government finance statistics		
Data coverage	Revenue, expenditure, deficit and debt data are provided for the period 1997-2006.	Revenue, expenditure, deficit and debt data are provided for the period 1997-2006.
Outstanding statistical issues	No outstanding statistical issues identified.	No outstanding statistical issues identified.
Consistency of government finance statistics	No inconsistencies identified.	Reconciliation between financial and non-financial accounts is needed for the years before 2003.
Deficit-debt adjustment	High and mostly positive figures (on average 1.7% of GDP for the period 1997-2006), mainly due to the acquisition of currency and deposits.	Data coverage for the DDA, whose components must be completely broken down for better assessment, is low for the years before 2003.
Institution responsible for the compilation of EDP data	The NSI, in cooperation with the Ministry of Finance, compiles the actual EDP data, and the Ministry of Finance provides the forecasts. The NCB is not directly involved in the compilation of these statistics.	A working group composed of the NSI, the Ministry of Finance and the NCB compiles the actual EDP data, and the Ministry of Finance provides the forecasts.

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

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

Estimates of the effect of administered prices on the HICP refer to prices which are directly set or significantly influenced by the government, including national regulators. They are based on a common definition and compilation agreed by the ESCB.

COMPLIANCE WITH LEGAL MINIMUM STANDARDS

In March 2004 and in 2006, Eurostat validated and confirmed the compliance of all Member States under consideration with the legal minimum standards for the HICP. However, as the HICPs have been harmonised in stages, HICP data before 2001 are not fully comparable with the most recent data. In the case of Malta, Eurostat's most recent compliance monitoring report concluded that the "methodological basis for compiling the Maltese HICP for the most part conforms to HICP requirements" and that the "instances of non-compliance with the HICP methodology are limited and would seem likely to have a relatively minor impact in practice on the HICP annual average rates of change".[5]

3 GOVERNMENT FINANCE STATISTICS

This section assesses the methodology and quality of the statistics used to measure fiscal developments. Government finance statistics (GFS) are based mainly on national accounts concepts and should comply with the European system of national and regional accounts in the Community (ESA 95)[6] and Council Regulation (EC) No 3605/93 of 22 November 1993, amended by Council Regulation (EC) No 2103/2005 of 12 December 2005, for debt. Protocol No 20 on the excessive deficit procedure (EDP), together with Council Regulation (EC) No 3605/93 on the application of the Protocol on the excessive deficit procedure as amended, define concepts such as "government", "surplus/deficit", "interest expenditure", "investment", "debt" and "gross domestic product (GDP)" with reference to the ESA 95. The ESA 95 is consistent with other international statistical standards, such as the System of National Accounts 1993 (SNA 93). EDP statistics refer to the ESA 95 sector "general government". This comprises central government, state government (in Member States with a federal structure), regional or local government and social security funds. It typically does not include public corporations.

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

The EDP general government debt is the sum of the outstanding gross liabilities at nominal value (face value) as classified in the ESA 95 categories "currency and deposits", "securities other than shares excluding financial derivatives" (e.g. government bills, notes and bonds) and "loans". It excludes financial derivatives, such as swaps, as well as trade credits and other liabilities not represented by

5 See "HICP compliance monitoring – information note on the HICP for Malta", European Commission (Eurostat) (October 2006).
6 Council Regulation (EC) No 2223/96 of 25 June 1996 on the European system of national and regional accounts in the Community, OJ L 310, 30.11.1996, pp. 1-469.

a financial document, such as overpaid tax advances. It also excludes contingent liabilities, such as government guarantees and pension commitments. Estimates of such items have to be based on far-reaching assumptions and may vary widely. While government debt is a gross concept in the sense that neither financial nor non-financial assets are deducted from liabilities, it is consolidated within the general government sector and therefore does not include government debt held by other government units.

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

3.1 DATA COVERAGE

In April 2007 the European Commission transmitted to the ECB data on general government financial positions (general government deficit/surplus and debt) for the period 1997 to 2006 and forecasts for 2007.

The national central banks (NCBs) of the Eurosystem provide the ECB with detailed government finance statistics (GFS) data under the ECB's GFS Guideline (ECB/2005/5).[7] Although the Guideline is legally binding only on the euro area NCBs, the non-euro area NCBs transmit these GFS data to the ECB by the same deadlines and using the same procedures as the euro area NCBs. The GFS Guideline lays down the transmission of annual data with detailed breakdowns of annual revenue and expenditure, debt and deficit-debt adjustment. In addition, it requests figures on general government debt with breakdowns by instrument, by initial and residual maturity and by holder.

As regards compliance with the legal requirement for Member States to transmit government financial positions to the European Commission, annual revenue, expenditure, deficit/surplus and debt data for the period 1997-2006 have been transmitted by the Member States under consideration.

3.2 OUTSTANDING STATISTICAL ISSUES

The statistics for the EDP must reflect decisions taken by Eurostat in line with the ESA 95 for specific cases involving the general government sector. A detailed explanation of the application of the decisions taken by Eurostat is provided in Eurostat's ESA 95 manual on government deficit and debt. Currently, no outstanding issues are identified for Cyprus and Malta.

3.3 CONSISTENCY OF GOVERNMENT FINANCE STATISTICS

One of the principles of the Code linked to statistical output focuses on the coherence and comparability of the data, stating that European statistics should be consistent internally, consistent over time and comparable between countries, and that it should be possible to combine different sources and make joint use of the related data. In other words, arithmetic and accounting identities should be observed, and statistics should be consistent or at least coherent over a reasonable period of time, as well as compiled on the basis of common statistical standards with respect to their scope, definitions, units and classifications in the different surveys and sources.

In its fiscal data for the years before 2003, Malta should make further efforts to reconcile the non-financial and financial transactions of general government.

3.4 DEFICIT-DEBT ADJUSTMENT

The change in government debt outstanding at the end of two consecutive years may diverge from the government deficit/surplus for the respective year. For example, government debt may be reduced by using the receipts from privatising public corporations or by selling other financial assets without any (immediate)

7 Guideline of the ECB of 17 February 2005 on the statistical reporting requirements of the ECB and the procedures for exchanging statistical information within the European System of Central Banks in the field of government finance statistics (ECB/2005/5); amended by Guideline ECB/2006/27.

impact on the government deficit. The explanation of the sum of the deficit (-)/surplus (+) and the increase (+)/decrease (-) in government debt, the deficit-debt adjustment (DDA), is also used in the assessment of the quality and consistency of government finance statistics.[8] A large or volatile DDA does not necessarily indicate a quality issue, as long as its components are fully explained. The components of this difference are net acquisitions/net sales of financial assets, valuation changes of general government debt, and other changes in general government debt. To compile these components a fully-fledged system of ESA 95 financial accounts for the government sector has to be available (transactions, other flows and stocks) and reconciled with nominal debt.

For Cyprus, the DDA has been volatile, reaching relatively high levels in 1998 (4.0% of GDP) and in 2001 (3.8% of GDP). This is mainly determined by an accumulation of deposits held by the government. For Malta, a rather low data coverage for the DDA has been identified prior to 2003. Moreover, the DDA is relatively large in the years 2002 and 2006, (-4.0% and -4.7% of GDP respectively). However, the DDA in these two years largely reflects the effect of privatisation receipts. A more complete breakdown of the DDA before 2003 would facilitate a better assessment of the data.

4 EXCHANGE RATES

Article 3 of Protocol No 21 on the convergence criteria referred to in Article 121 of the Treaty specifies what is meant by the criterion on participation in the exchange rate mechanism of the European Monetary System. In a policy position dated 18 December 2003, the Governing Council of the ECB clarified that the criterion refers to participation in the exchange rate mechanism (ERM II) for a period of at least two years prior to the convergence assessment without severe tensions, in particular without devaluing against the euro.

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

5 LONG-TERM INTEREST RATES

Article 4 of Protocol No 21 on the convergence criteria referred to in Article 121 of the Treaty requires interest rates to be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions. While Article 5 assigns the responsibility for providing the statistical data for the application of the Protocol to the European Commission, the ECB, given its expertise in the area, assists in this process by defining representative long-term interest rates and collecting the data from

8 See "Stock-flow adjustment (SFA) for the Member States, the euro area and the EU 27 for the period 2003-2006, as reported in the April 2007 EDP notification", Eurostat, 23 April 2007, http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/STOCK_FLOW_2007/EN/STOCK_FLOW_2007-EN.PDF

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

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

the NCBs for transmission to the Commission. This is a continuation of the work carried out by the EMI as part of the preparations for Stage Three of EMU in close liaison with the Commission.

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

6 OTHER FACTORS

The last paragraph of Article 121(1) of the Treaty states that the reports of the European Commission and the ECB shall take account of, in addition to the four main criteria, the development of the ECU, the results of the integration of markets, the situation and development of the national balance of payments on current account and an examination of the development of unit labour costs and other price indices. Whereas for the four main criteria Protocol No 21 stipulates that the Commission will provide the data to be used for the assessment of compliance and describes those statistics in more detail, it makes no reference to the provision of statistics for these "other factors".

With regard to the national balance of payments (b.o.p.) and the international investment position (i.i.p.), the statistics are compiled by the NCBs in accordance with the concepts and definitions laid down in the fifth edition of the IMF Balance of Payments Manual (BPM5) and following methodological standards set out by the ECB and Eurostat. However, high priority should continue to be given to a review of the residency criterion, treating corporations without a physical presence in a country as resident institutional units if they are registered in that country. This report examines the sum of the current account balance and the balance on the capital account, which corresponds to the net lending/net borrowing of the total economy. In addition, it is worth noting that the distinction between current and capital transfers is not always straightforward in practice, as it depends on the recipient's use of the transfer. In particular, this applies to the classification of the current and capital components of transfers between EU institutions and Member States.[9]

With regard to producer price indices, these refer to domestic sales of total industry excluding construction. The statistics are collected on a harmonised basis under the EU Short-Term Statistics (STS) Regulation.[10]

Statistics on unit labour costs (calculated as compensation per employee divided by GDP

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

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

chain-linked volumes per person employed) are derived from data provided under the ESA 95 transmission programme. For Malta, chain-linked national accounts volume data are not yet available for the years before 2000.

5 EXAMINATION OF COMPATIBILITY OF NATIONAL LEGISLATION WITH THE TREATY

COUNTRY ASSESSMENTS

The following country assessments report only on those provisions of national legislation in Cyprus and Malta which the ECB considered to be problematic either from the perspective of their NCBs' independence within the ESCB or from the perspective of their NCBs' subsequent integration into the Eurosystem.

5.1 CYPRUS

5.1.1 COMPATIBILITY OF NATIONAL LEGISLATION

The following legislation forms the legal basis for the Central Bank of Cyprus and its operations:

– Articles 118 to 121 of the Cypriot Constitution,[1] and

– the Law on the Central Bank of Cyprus of 2002[2] (hereinafter the "Law").

The Law and the Constitution have already been adapted to remove incompatibilities with the Treaty and the Statute with regard to central bank independence.

In the light of the ECB's Convergence Reports of 2004 and December 2006 and of the ECB's opinions on amendments to the Law,[3] the Law was further adapted in March 2007, pursuant to Article 109 of the Treaty, by means of the Central Bank of Cyprus Law of 2007 (hereinafter the "amending law").[4] The amending law removed all remaining incompatibilities between the Law and the requirements of the Treaty and the Statute.

As far as other legislation is concerned, the ECB is not aware of any other statutory provisions which need to be adapted pursuant to Article 109 of the Treaty.

Cyprus submitted a request for a country examination on 13 February 2007.[5]

5.1.2 INDEPENDENCE OF THE NCB

With regard to the Central Bank of Cyprus's independence, the Law was adapted in the respects set out below.

INSTITUTIONAL INDEPENDENCE

The ECB's Convergence Report of December 2006 noted that the Law on public procurement procedures coordination[6] was incompatible with the Treaty and Statute requirements on central bank independence to the extent that it made decisions of the Central Bank of Cyprus to award contracts subject to review by the Procurement Review Authority[7] and it was unclear to what extent the Central Bank of Cyprus was subject, within the context of its public procurement activities, to the instructions of the Cypriot Treasury.

A Regulation issued by the Accountant General in accordance with Section 91 of the Law on public procurement procedures coordination removes this incompatibility by replacing Annex III of the Law on public procurement procedures coordination with a new Annex III which does not include the Central Bank of

1 Constitution of the Republic of Cyprus of 16 August 1960, as amended in particular by the Law on the fourth amendment of the Constitution of 2002.

2 As amended by the Central Bank of Cyprus (Amending) Law of 31 October 2003.

3 ECB Opinions: CON/2006/4 of 27 January 2006 at the request of the Central Bank of Cyprus on a draft law amending the Central Bank of Cyprus Laws of 2002 and 2003; CON/2006/33 of 28 June 2006 at the request of the Cypriot Ministry of Finance on a draft provision amending the draft law amending the Central Bank of Cyprus Laws of 2002 and 2003; and CON/2006/50 of 26 October 2006 at the request of the Cypriot Ministry of Finance on a draft provision amending the draft law amending the Central Bank of Cyprus Laws of 2002 and 2003.

4 The Central Bank of Cyprus (Amending) Law of 2007, 34(I)/2007.

5 The request for the preparation of a Convergence Report in accordance with Article 122(2) of the Treaty was filed by Dr Michalis Sarris, the Cypriot Minister for Finance, and Dr Christodoulos Christodoulou, Governor of the Central Bank of Cyprus.

6 Law 12(I) of 2006. Public procurement procedures, as specified under the Law on public procurement procedures coordination, are applicable to the Central Bank of Cyprus even in cases where the contract relates to and/or is connected with the Central Bank of Cyprus's performance of ESCB-related tasks.

7 It is noted that the members of this authority are appointed and may be dismissed by the Council of Ministers, and that its budget is included in the Government's annual budget.

Cyprus in the list of bodies that fulfil the definition of a "body governed by public law".[8]

Article 55(1) of the Law, on the statutory reporting of the Governor of the Central Bank of Cyprus to the President of the Republic and to the Cypriot Parliament, would, in a future revision of the Law, benefit from a clarification that such reporting will be without prejudice to Article 108 of the Treaty and Article 38 of the Statute.

PERSONAL INDEPENDENCE

The ECB's Convergence Report of December 2006 noted that Article 13(3) of the Law, which gives the Ministerial Council the right to appoint a Board member for a term of less than five years, needs to be adapted to comply with Article 14.2 of the Statute. The amending law removes this incompatibility by amending Article 13(3) of the Law.

5.1.3 PROHIBITION ON MONETARY FINANCING AND PRIVILEGED ACCESS

The ECB's Convergence Report of December 2006 noted that Article 46(3) of the Law, providing that the Central Bank of Cyprus may grant advances against collateral security to banks for fixed periods and for purposes which the Central Bank of Cyprus may designate, did not contain sufficient safeguards to prevent such lending from potentially breaching the monetary financing prohibition contained in Article 101 of the Treaty.

The amending law removes this incompatibility by introducing sufficient safeguards against a potential breach of the monetary financing prohibition in the form of an explicit proviso subordinating the powers of the Central Bank of Cyprus to the performance of its obligations under the Treaty and the Statute, in particular Article 21 of the Statute.

The ECB's Convergence Report of December 2006 also noted that the range of public sector entities referred to in Article 49(1) of the Law (which prohibits the Central Bank of Cyprus from granting overdraft facilities or any other type of credit facility with the Central Bank of Cyprus in favour of the Cypriot Government, local authorities, public corporations or public undertakings and the purchase directly from them by the Central Bank of Cyprus of debt instruments when they are issued) needed to be extended to be consistent with the Treaty and fully mirror Article 101 of the Treaty to avoid any confusion as to which entities are covered by the monetary financing prohibition.

The amending law removes this incompatibility by means of an explicit reference to Article 101 of the Treaty.

5.1.4 LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

5.1.4.1 ECONOMIC POLICY OBJECTIVES

The Central Bank of Cyprus's economic policy objectives were previously incompatible with the Treaty and the Statute. The amending law makes Article 5 of the Law (entitled "Objectives of the Bank") compatible with the Treaty and the Statute, subordinating the Central Bank of Cyprus's support for the general economic policy of the State not only to the achievement of its primary objective of ensuring price stability, but also to the fulfilment of the Central Bank of Cyprus's obligations under Article 105(1) of the Treaty.

8 Regulation 470/2006, Official Gazette of the Republic No 4158, III(I), 20.12.2006. The related Contracts Award (Supplies, Works and Services) Directive of the Central Bank of Cyprus, which incorporates, subject to the necessary adjustments, the provisions of Directive 2004/18/EC of the European Parliament and of the Council of 31 March 2004 on the coordination of procedures for the award of public works contracts, public supply contracts and public service contracts (OJ L 134, 30.4.2004, p. 114) was also published in the Official Gazette of the Republic (Regulation 469/2006, Official Gazette of the Republic No 4158, III(I), 20.12.2006).

5.1.4.2 TASKS

MONETARY POLICY

The ECB's Convergence Report of December 2006 noted that Article 6(2)(a) and Articles 10 and 11 of the Law, providing for the Central Bank of Cyprus's powers in the field of monetary policy, were incompatible with the Treaty and the Statute.

The amending law removes this incompatibility by expressly referring to the Central Bank of Cyprus as an integral part of the ESCB, with an obligation to act in accordance with the ECB's guidelines and instructions. The amending law acknowledges the primacy of the Treaty and the Statute when the Central Bank of Cyprus carries out its tasks and abolishes, with effect from the date the euro is adopted, the Monetary Policy Committee. Concerning Article 72A of the Law, providing that directives, acts and decisions of the Monetary Policy Committee continue to be in force until they are amended or repealed, the ECB understands that this provision also covers non-monetary policy-related legal acts issued by the Monetary Policy Committee, as well as acts and decisions on the implementation of the Eurosystem's monetary policy framework. Therefore, the ECB expects that all directives, acts and decisions of the Monetary Policy Committee which are not fully consistent with the Eurosystem's framework will be repealed or adapted at the time of effective application of the Law, in line with the Treaty.

ISSUING BANKNOTES

The ECB's Convergence Report of December 2006 noted that Articles 27 to 31 of the Law, establishing the Central Bank of Cyprus's exclusive right to issue banknotes and coins in Cyprus, were incompatible with the Treaty and the Statute.

Articles 21 to 25 of the amending law remove this incompatibility by expressly subordinating the Central Bank of Cyprus's right to issue banknotes and coins to the provisions of Article 106 of the Treaty.

FOREIGN RESERVE MANAGEMENT

The ECB's Convergence Report of December 2006 noted that Article 6(2)(c) and Articles 33 to 36 of the Law, empowering the Central Bank of Cyprus in relation to foreign reserve management, were incompatible with the Treaty and the Statute.

Articles 6 and 27 to 30 of the amending law remove this incompatibility by recognising the ECB's powers in this field. The ECB notes that Article 33(2) of the Law (on the powers of the Board of Directors of the Central Bank of Cyprus to determine, subject to the provisions of the Treaty and the Statute, the foreign exchange which the Central Bank of Cyprus keeps as part of its assets) vests an ESCB-related task with the Board of Directors, whilst under Article 20(3)(a) of the Law ESCB-related tasks are vested with the Governor and Deputy Governor. A clarification of such inconsistency would be appropriate in a further revision of the Law.

5.1.4.3 INSTRUMENTS

The ECB's Convergence Report of December 2006 noted that Articles 39, 40 and 44 of the Law, which provide for the Central Bank of Cyprus's powers in relation to monetary policy instruments, were incompatible with the Treaty and the Statute.

Article 34(b) and Articles 36 and 43 of the amending law remove this incompatibility by recognising the ECB's powers in this field.

The ECB's Convergence Report of December 2006 noted that Article 41 and Article 46(2) of the Law, which impose minimum reserve requirements on banks, were incompatible with the Treaty and the Statute.

Article 38 of the amending law removes this incompatibility by recognising the ECB's powers in this field. However, as regards Article 46(2) of the Law, providing that the Central Bank of Cyprus may, at its discretion, pay interest on specified deposits by banks, the

ECB understands that this provision refers to foreign currency accounts, or if referring to euro-denominated accounts it must be read in conjunction with Article 41 of the Law, which makes reference to Article 19 of the Statute. Thus, their terms and conditions will always correspond to those of the ECB. A clarification of that provision, in a further revision of the Law, would be welcome.

The ECB's Convergence Report of December 2006 noted that Article 65 of the Law, which establishes offences for anyone infringing any of the provisions of the Law, was incompatible with the Treaty and the Statute.

Article 59 of the amending law removes this incompatibility by recognising the ECB's powers in this field.

5.1.4.4 FINANCIAL PROVISIONS

APPOINTMENT OF INDEPENDENT EXTERNAL AUDITORS

The ECB's Convergence Report of December 2006 noted that Article 60(1) of the Law provides that the Central Bank of Cyprus's annual financial statements are audited by approved independent auditors appointed by the Board of Directors, after consultation with the Minister for Finance.

Article 55 of the amending law removes this incompatibility by stating that, with effect from the date the euro is adopted, the Central Bank of Cyprus's annual financial statements will be audited in accordance with Article 27 of the Statute.[9]

FINANCIAL REPORTING

The ECB's Convergence Report of December 2006 noted that Part IX of the Law, which deals inter alia with the Central Bank of Cyprus's annual financial statements, does not currently reflect the Central Bank of Cyprus's obligation to comply with the Eurosystem's regime for financial reporting of NCB operations pursuant to Article 26 of the Statute.

Article 54 of the amending law addresses this issue by providing that, with effect from the date the euro is adopted, the Central Bank of Cyprus will determine its net profit or net loss for each financial year according to the approved accounting standards that apply to the ESCB, as adopted by the ECB.

5.1.4.5 EXCHANGE RATE POLICY

The ECB's Convergence Report of December 2006 noted that Article 6(2)(b) and Article 37 of the Law, empowering the Central Bank of Cyprus to set exchange rates for the Cyprus pound, were incompatible with the Treaty.

Articles 6 and 31 of the amending law address these issues by deleting the conduct of exchange rate policy from the list of the Central Bank of Cyprus's tasks and deleting Article 37 of the Law, covering the determination of rates for transactions in foreign currencies. Both provisions take effect from the date the euro is adopted.

5.1.4.6 INTERNATIONAL COOPERATION

The ECB's Convergence Report of December 2006 noted that Article 6(2)(g) of the Law, on the Central Bank of Cyprus's participation in international monetary and economic

9 See Opinions CON/2006/33 and CON/2006/50, reaffirming the view that the Auditor General is not an external auditor within the meaning of Article 27.1 of the Statute. The ECB made this point previously in Opinion CON/2006/4, where it also observed that the appointment of an independent external auditor, in accordance with Article 27.1 of the Statute, to audit the Central Bank of Cyprus's annual financial statements once Cyprus has adopted the single currency, "will not prevent the Audit Office from continuing to perform a control function, provided that its auditing activities: (i) do not interfere with the review of European System of Central Banks (ESCB) related tasks of the CBC [Central Bank of Cyprus] to be undertaken by the CBC's independent external auditors to be approved by the Council of the European Union in accordance with Article 27 of the Statute; and (ii) do not jeopardise the CBC's independence". Paragraph 2.2 of Opinion CON/2006/50 concluded: "Subsection 1(b) of the draft provision provides that the Auditor General may carry out financial and management audits of those activities of the CBC that are not related to its ESCB tasks and competences, provided that his reports and audit activities do not impinge on the CBC's independence. The ECB also welcomes subsection 1(b) and the draft provision's definition of management audit, which preclude any interference with the audit to be carried out by the CBC's independent external auditors."

organisations, was inconsistent with the Statute as it did not make such participation conditional on the ECB's approval.

Article 6 of the amending law removes this incompatibility by bringing the Central Bank of Cyprus's participation in international monetary institutions into line with Article 6.2 of the Statute.

For the concluding summary on Cyprus please see the Country Summaries.

5.2 MALTA

5.2.1 COMPATIBILITY OF NATIONAL LEGISLATION

The legal basis for the Central Bank of Malta and its operations is the Central Bank of Malta Act[10] (hereinafter the "Act").

Prior to 2007, there were various amendments to the Act. These amendments, in particular those passed in 2005, were adopted with the aim of providing for central bank independence as required by the Treaty and the Statute, and for further convergence with the Statute.[11]

Since then the Act has been further amended,[12] following the two consultations of the ECB in 2006.[13] Given that the Maltese Parliament adopted the amendments in the form in which they were submitted to the ECB, thereby implementing Opinions CON/2006/23 and CON/2006/58, the Act now complies with the Treaty and the Statute. One further amendment to rectify one imperfection which was still outstanding has also been enacted.[14] As far as other legislation is concerned, the ECB is not aware of any other statutory provisions which need to be adapted pursuant to Article 109 of the Treaty.

Malta submitted a request for a country examination on 27 February 2007.[15]

5.2.2 INDEPENDENCE OF THE NCB

INSTITUTIONAL INDEPENDENCE

The Public Contracts Regulations (Subsidiary Legislation 174.04)[16] were previously incompatible with the Treaty and the Statute requirements on central bank independence to the extent that the Central Bank of Malta had to seek approval from the Ministry of Finance for restricted and negotiated tender procedures, even where these procurement procedures were directly connected to ESCB-related tasks.

The ECB's Convergence Report of December 2006 noted that Legal Notice 177 of 2005 exempted the Central Bank of Malta from the scope of application of the Public Contracts Regulations.

As regards Article 8(6) of the Act, concerning the Central Bank of Malta's reporting obligations to the House of Representatives, a clarification of this provision by means of an explicit reference to Article 29(a) to (c) of the Act would be welcome, in a further revision of the Act, to clarify that such reporting is without prejudice to both the Central Bank of Malta's independence and respect for the ESCB's confidentiality regime.

10 Chapter 204 of the Laws of Malta, as last amended.

11 Despite the obligation on national authorities to consult the ECB regarding draft legislative provisions under Article 2(1) of Decision 98/415/EC, the Maltese authorities did not consult the ECB in relation to Act IX of 2005.

12 Act I of 2007, which was enacted on 2 March 2007.

13 See ECB Opinions: CON/2006/23 of 22 May 2006 at the request of the Central Bank of Malta concerning a draft law amending the Central Bank of Malta Act; and CON/2006/58 of 15 December 2006 at the request of the Central Bank of Malta concerning amendments to the Central Bank of Malta Act.

14 This amendment in Part III of bill 81 (the bill in which the amendment was included) passed through all three readings in Parliament before the cut-off date of 15 March and was given presidential assent and published on 16 March. The bill was enacted on 16 March as Act IV of 2007.

15 This request was made in writing by Mr Lawrence Gonzi, the Maltese Prime Minister and Minister for Finance, and Mr Michael C. Bonello, Governor of the Central Bank of Malta, to the Commissioner for Economic and Monetary Affairs and the ECB's President, during the EU Council meeting in Brussels on 27 February 2007.

16 Legal Notice 299 of 2003.

PERSONAL INDEPENDENCE

The ECB's Convergence Report of December 2006 noted that Article 11(1) of the Act, which regulated disqualification, resignation and filling of vacancies, had to be aligned with the wording of Article 14.2 of the Statute, as far as the Governor, Deputy Governor and other members of the Board of Directors involved in the performance of ESCB-related tasks were concerned.

The latest amendments remove this incompatibility by adding a new Article 8(5) in the Act aligning the grounds for relieving the Governor and the Deputy Governor from office with those set out in Article 14.2 of the Statute. Furthermore Article 9(1) of the Act has been amended to exclude the Governor and the Deputy Governor from being subject to the grounds for disqualification and resignation that apply to the other Directors.

CONFIDENTIALITY

Article 37 of the Act provides for information exchange between the Central Bank of Malta and the competent authority in the exercise of the latter's duties under any law, and such information is subject to the duty of professional secrecy pursuant to Article 38 of the Act. The ECB understands that such information exchange is without prejudice to the ESCB's confidentiality regime. A clarification of this provision, by means of an explicit reference to Article 38 of the Statute, would be welcome in a further revision of the Act.

5.2.3 MONETARY FINANCING AND PRIVILEGED ACCESS

The ECB's Convergence Report of December 2006 noted that the range of public sector entities referred to in Article 27(1) of the Act, which prohibited the Central Bank of Malta from granting overdrafts or any other type of credit facility to the Maltese Government or to any public undertaking, public authority or Government-owned corporation, or from purchasing their debt instruments, needed to be extended to be consistent with the Treaty and fully mirror Article 101 of the Treaty, to avoid any confusion as to which entities are covered by the monetary financing prohibition.

The latest amendments remove this incompatibility by amending Article 27(1) of the Act to include "bodies governed by public law" among the public sector entities covered by the monetary financing prohibition.

5.2.4 LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

The ECB's Convergence Report of December 2006 noted that Article 3 of the Act did not make any reference to the Central Bank of Malta as an integral part of the ESCB or to its obligation to act in accordance with the ECB's legal acts and instruments.

The latest amendments remove this incompatibility by referring to these aspects, as well as consequential rights and obligations, in Article 3(1) of the Act.

5.2.4.1 ECONOMIC POLICY OBJECTIVES

The ECB's Convergence Report of December 2006 noted that Article 4(1) of the Act stated that the Central Bank of Malta's primary objective was to maintain price stability, but went on to state that, without prejudice to this objective, the Central Bank of Malta had to promote orderly and balanced economic development.

The latest amendments remove this incompatibility by amending Article 4 of the Act to make reference to the relevant provisions of the Treaty and Statute.

Moreover, Article 4(2) contained a list of further objectives which relate to the Central Bank of Malta's principal business and powers.

The latest amendments remove this incompatibility by ensuring that the list of the

Central Bank of Malta's tasks is contained in the new Article 5 of the Act, in accordance with the Statute.

5.2.4.2 TASKS

MONETARY POLICY

The ECB's Convergence Report of December 2006 noted that Article 4(2)(a) of the Act, which stated that one of the Central Bank of Malta's objectives is to influence the volume and conditions of supply of credit, did not recognise the ECB's powers in the field of monetary policy.

The latest amendments remove this incompatibility by stating in the new Article 5(1)(a) that the Central Bank of Malta has the power to implement monetary policy in accordance with the Treaty and the Statute.

The ECB's Convergence Report of December 2006 noted that Article 17A(1) of the Act, which empowered the Central Bank of Malta in the field of monetary policy, did not recognise the ECB's powers in this field.

The latest amendments provide that the Governor's exercise of powers must be in accordance with the Statute.

The ECB's Convergence Report of December 2006 noted that Article 17A(4) and (5) of the Act did not recognise the ECB's powers in relation to monetary policy decisions.

The latest amendments remove this incompatibility by deleting these provisions.

The ECB's Convergence Report of December 2006 noted that Article 17D(1) to (3) of the Act, which provided for the publication of statements on monetary policy decisions, was incompatible with the Statute.

The latest amendments remove this incompatibility by deleting these provisions.

ISSUING BANKNOTES

The ECB's Convergence Report of December 2006 noted that Part VII of the Act empowered the Central Bank of Malta to issue currency, but did not recognise the ECB's exclusive right to authorise the issue of banknotes within the Community.

The latest amendments remove this incompatibility by making reference to the ECB's exclusive powers in the new Part X of the Act.

FOREIGN RESERVE MANAGEMENT

The ECB's Convergence Report of December 2006 noted that Articles 15(2) and 19 of the Act empowered the Central Bank of Malta, inter alia, to manage its foreign reserves. These provisions did not recognise the ECB's powers in this field.

The latest amendments include the deletion of Article 19 and amend other provisions of the Act. Article 15(2) of the Act, renumbered as Article 17(2), provides that the Central Bank of Malta manages and maintains the reserve assets in accordance with the ECB's guidelines and instructions.

5.2.4.3 INSTRUMENTS

The ECB's Convergence Report of December 2006 noted that Article 15(1) of the Act, which listed the Central Bank of Malta's principal business and powers, and Articles 37(1) to (3) and 52A of the Act, all concerning reserve deposits, did not recognise the ECB's powers in this field.

The latest amendments recognise the ECB's powers in this field by explicitly referring to the Treaty and the Statute in Article 17(1) and amend Article 56 of the Act.

The ECB's Convergence Report of December 2006 noted that Article 36(5) of the Act, which authorised the Central Bank of Malta to issue directives relating to clearing and payment systems, did not recognise the ECB's powers in this field.

The latest amendments remove this incompatibility by making reference to the Treaty and the Statute. They also add a new proviso to Article 34(5) of the Act ensuring that the Central Bank of Malta's power to issue directives under Article 34(5) is exercised in accordance with the Treaty, the Statute and any regulations issued thereunder.

The ECB's Convergence Report of December 2006 noted that Article 52A of the Act, which sets out the possible sanctions against third parties which fail to comply with their statistical obligations, did not recognise the ECB's and the Community's powers in this field.

The latest amendments recognise the ECB's and the Community's powers in this field. Article 56(1) is amended to ensure that the Minister for Finance is not permitted to issue regulations providing for penalties and/or sanctions where the ECB has adopted similar regulations.

Furthermore, with reference to Article 9.2 of the Statute, the ECB understands that Article 31 of the Act (when read in conjunction with Article 3 of the Act), which authorises the Central Bank of Malta in exceptional circumstances to appoint, for practical implementation activities, any credit institution in Malta to act as its agent on a public function, is subject to the following conditions: (i) the Central Bank of Malta retains legal responsibility and liability for the public task; (ii) such outsourcing does not jeopardise the implementation of the Eurosystem framework for the provision of the relevant services; and (iii) such outsourcing does not endanger the correct implementation of the Eurosystem's policy decisions.

5.2.4.4 FINANCIAL PROVISIONS

APPOINTMENT OF INDEPENDENT EXTERNAL AUDITORS

The ECB's Convergence Report of December 2006 noted that Part III of the Act, dealing with financial provisions (including Article 22, on the appointment of auditors by the Central Bank of Malta's Board of Directors with the Minister's approval), did not recognise the ECB's and the EU Council's powers in this field.

The latest amendments remove this incompatibility by establishing, in line with Article 27.1 of the Statute, that the independent external auditors must be recommended by the ECB and approved by the EU Council.

FINANCIAL REPORTING

The ECB's Convergence Report of December 2006 noted that the provisions dealing with the preparation and transmission of the annual accounts in Part III of the Act did not recognise the Eurosystem's regime for financial reporting of NCB operations pursuant to Article 26 of the Statute.

The new Article 21(5) of the Act, provided for in the latest amendments, recognises the Eurosystem's regime in the financial reporting of the Central Bank of Malta's operations.

5.2.4.5 EXCHANGE RATE POLICY

The ECB's Convergence Report of December 2006 noted that Part VII of the Act empowered the Central Bank of Malta in respect of exchange rate policy and did not recognise the Community's or the ECB's powers in this field.

The latest amendments remove this incompatibility by repealing the references to the external value of the Maltese lira in Part X, as renumbered.

5.2.4.6 INTERNATIONAL COOPERATION

The ECB's Convergence Report of December 2006 noted that Article 38G of the Act, which stated that the Central Bank of Malta could own shares and undertake other participations in international and national organisations and could further participate in international monetary agreements to the extent necessary to carry out its tasks and duties under the law and to fulfil its international obligations, did not recognise the ECB's powers in this field.

The latest amendments remove this incompatibility by making reference to the Statute in Article 39, as renumbered.

For the concluding summary on Malta please see the Country Summaries.

GLOSSARY

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

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

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

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

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

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

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

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

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

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

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

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

ECOFIN Council: see **EU Council**.

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

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

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

ERM II (exchange rate mechanism II): the exchange rate mechanism which provides the framework for exchange rate policy cooperation between the **euro area** countries and the non-euro area EU Member States. ERM II is a multilateral arrangement with fixed, but adjustable, **central rates** and a standard fluctuation band of ±15%. Decisions concerning central rates and, possibly, narrower fluctuation bands are taken by mutual agreement between the EU Member State concerned, the euro area countries, the **ECB** and the other EU Member States participating in the mechanism. All participants in ERM II, including the ECB, have the right to initiate a confidential procedure aimed at changing the central rates (see also **realignment**).

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

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

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

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

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

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

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

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

European Parliament: an institution of the European Union. It comprises 785 representatives of the citizens of the Member States (as of January 2007). The Parliament plays a role in the EU's legislative process, although with differing prerogatives that depend on the procedures through which the respective EU legislation is to be enacted. Where monetary policy and the **ESCB** are concerned, the Parliament has mainly consultative powers. However, the **Treaty** establishes certain procedures with respect to the democratic accountability of the **ECB** to the Parliament (presentation of the ECB's Annual Report, including a general debate on monetary policy, and testimonies before the competent parliamentary committees).

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

European System of Central Banks (ESCB): the central banking system of the European Union. Composed of the **ECB** and the NCBs of all 27 EU Member States, i.e. it includes, in addition to the members of the **Eurosystem**, the NCBs of those Member States that have not yet adopted the euro. The ESCB is governed by the **Governing Council** and the **Executive Board** of the ECB, and, as a third decision-making body of the ECB, by the **General Council**.

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

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

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

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

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

Funded and unfunded pension schemes: funded pension schemes are those schemes that finance pension payments by drawing down on segregated and earmarked assets. These schemes can be exactly funded, under-funded or over-funded, depending on the size of the accumulated assets in relation to the pension entitlements. Unfunded pension schemes are those schemes that finance current pension payments with the ongoing contributions paid by future pensioners and/or other ongoing revenue such as taxes or transfers; unfunded schemes may hold sizeable assets (for example for liquidity reasons or as buffer funds).

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

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

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

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

Harmonised Index of Consumer Prices (HICP): a measure of consumer prices which is compiled by **Eurostat** and harmonised for all EU Member States. Administered prices refer to prices which are directly set by the government (e.g. fees for services provided by government) or which are significantly influenced by the government (e.g. prices requiring approval by government or regulators).

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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