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From:	Mr Mario DRAGHI, President of the European Central Bank
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To:	Mr Jeroen Dijsselbloem, President of the ECOFIN Council
Subject:	ECB Convergence report 2016 - Part 3

Delegations will find attached the third part of the European Central Bank's Convergence report 2016.

Encl.:

ECB Convergence Report June 2016 - Part 3

5.3 Croatia

5.3.1 Price developments

In April 2016 the 12-month average rate of HICP inflation in Croatia was -0.4%, i.e. well below the reference value of 0.7% for the criterion on price stability (see Chart 5.3.1). This rate is expected to remain broadly unchanged over the coming months.

Over the past ten years the 12-month average rate of HICP inflation has fluctuated within a relatively wide range, from -0.4% to 6.0%, and the average for that period was moderate, standing at 2.3%. Towards the end of 2007 this rate of inflation accelerated significantly, peaking at levels close to 6% in 2008. This mainly reflected a surge in food, energy and administered prices, alongside a build-up of domestic price pressures during a period of robust economic expansion. Rapid credit growth, fuelled partly by cross-border lending by foreign parent banks, led to a significant accumulation of private sector debt. The boom in domestic demand was accompanied by soaring trade deficits and accelerating growth in unit labour costs. The global financial crisis led to an unwinding of the credit and housing boom. Inflation decreased rapidly as the economy moved into recession and global commodity prices declined. Following a cumulative decline in real GDP of more than 12% over the period 2009-14, economic activity started to recover in 2015 (see Table 5.3.1). Owing to increases in energy and food prices, inflation picked up in 2011 and 2012, before falling to historically low levels in 2014 and 2015 on the back of lower commodity prices in conjunction with weak internal demand. The unemployment rate, which rose sharply during the recession, decreased slightly in 2015, albeit remaining at a high level. Growth in unit labour costs has been very weak or even negative over the past few years.

For the first four months of 2016, the average annual rate of HICP inflation stood at -0.6%. This negative inflation rate mainly reflected declines in the prices of crude oil and food, as well as a reduction in administered gas prices for households.

Policy choices have played an important role in shaping inflation dynamics in Croatia over the past decade, most notably the orientation of monetary policy towards price stability. Hrvatska narodna banka aims to achieve price stability through a tightly managed floating exchange rate regime vis-à-vis the euro. During the period of robust economic expansion, Croatia's monetary policy was constrained by the tightly managed floating exchange rate regime, and the overall policy stance (including fiscal policy) was not tight enough to counter the build-up of macroeconomic imbalances. Owing to the growing financial vulnerabilities and macroeconomic imbalances prior to the economic downturn, Hrvatska narodna banka introduced a series of administrative and prudential measures to curb credit growth funded by banks' borrowing abroad. However, several of these measures were later abolished or loosened under counter-cyclical policies. In addition, the government introduced a number of growth-enhancing credit schemes, but domestic credit growth to the private sector remained fairly weak. At the same time,

corporations with access to international markets partly made up for the reduction in their borrowing from domestic credit institutions by obtaining funding from other sources, primarily those abroad. At the beginning of 2016 Hrvatska narodna banka introduced a structural repo operation allowing banks to increase lending in local currency at more favourable financing conditions. This welcome move, aimed at fostering the use of the kuna in the banking system, was facilitated by favourable balance of payments developments and the stronger external positions of banks.

Inflation is expected to increase in the coming years, albeit remaining at a moderate level; over the longer term there are concerns regarding the sustainability of inflation convergence in Croatia. According to the European Commission's Spring 2016 Economic Forecast, average annual HICP inflation will remain in negative territory, at -0.6%, in 2016, before increasing to 0.7% in 2017. Inflationary pressures are expected to be contained given the weak economic growth. Risks to the inflation outlook are broadly balanced. On the upside, the risks relate to developments in administered prices, while on the downside, they relate to the heightened uncertainty regarding developments in the global economy, which could reduce external price pressures. Looking further ahead, the catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area, given that GDP per capita and price levels are still significantly lower in Croatia than in the euro area. In order to prevent the build-up of excessive price pressures and macroeconomic imbalances, the catching-up process must be supported by appropriate policies.

Achieving an environment that is conducive to sustainable convergence in Croatia requires stability-oriented economic policies and wide-ranging structural reforms. Given monetary policy's limited room for manoeuvre owing to the tightly managed floating exchange rate regime and the high level of euroisation, it is imperative that other policy areas provide the economy with the wherewithal to cope with country-specific shocks in order to ensure the correction of macroeconomic imbalances and to prevent their recurrence in the future. More specifically, structural reforms are needed to increase overall productivity and raise the potential growth of the economy, to enhance the quantity and quality of the labour supply, and to align the education system with the needs of the market. This is particularly important in view of the high levels of structural and youth unemployment. Notwithstanding the labour market reforms in 2013 and 2014 that have significantly reduced the gap with other EU economies in terms of employment protection legislation, and the recent measures in support of youth employment, there is scope and a need for further measures. In particular, further progress is required in the review of social benefits in order to push up the very low participation rate. It is also crucial to achieve sufficient flexibility in wages, strengthen national policies aimed at enhancing competition in product markets and proceed with the liberalisation of regulated sectors. Priority should be given to improving the quality of the business and regulatory environment, with a particular focus on fighting corruption. In addition, it is essential to improve the effectiveness of the public administration and the judicial system. Modernising the country's infrastructure (in particular its rail network) would boost potential output and support a more efficient allocation of resources. Against this background, significant efforts should be made

to ensure that Croatia improves its very weak absorption of EU funds. Recent government intervention in existing loan agreements to allow the conversion of loans denominated in, or linked to, Swiss francs into loans denominated in, or linked to, euro, highlights the need for a more predictable legal system. Moreover, when the recent Swiss franc loan conversion was designed, due consideration should have been given to fair burden sharing among all stakeholders in order to avoid moral hazard.¹¹⁵ With regard to macroeconomic imbalances, the European Commission selected Croatia for an in-depth review in its Alert Mechanism Report 2016 and concluded that Croatia is experiencing excessive macroeconomic imbalances.

Financial sector policies should be geared to safeguarding financial stability and ensuring that the financial sector makes a sound contribution to sustainable economic growth.

In view of the high level of private sector debt, it is important to ensure that the necessary conditions are in place for an orderly deleveraging process. The resolution framework for non-performing loans should be further strengthened, particularly in order to improve the efficiency of court practice. Given that the legislative changes allowing the conversion of loans denominated in Swiss francs had a negative impact on banks' profitability, it is important to preserve the resilience of the banking system and its ability to support the real economy. In order to minimise the potential risks to financial stability associated with a high proportion of foreign currency loans, Croatia should continue to apply the Recommendation of the European Systemic Risk Board of 21 September 2011 on lending in foreign currencies (ESRB/2011/1). Close cooperation between the home and host country supervisory authorities is important to ensure the effective implementation of these measures.

5.3.2 Fiscal developments

The deficit and debt do not comply with the Maastricht criteria. In 2015 the general government budget balance of Croatia recorded a deficit of 3.2% of GDP, i.e. above the 3% reference value. The general government gross debt-to-GDP ratio was 86.7%, well above the 60% reference value (see Table 5.3.2). Compared with the previous year, the deficit ratio decreased by 2.3 percentage points, while the debt ratio increased by 0.2 percentage points of GDP. The deficit ratio is forecast by the European Commission to decline to 2.7% in 2016, while the government debt ratio is projected to increase to 87.6% of GDP. With regard to other fiscal factors, the deficit ratio exceeded the ratio of public investment to GDP over the 2011-14 interval and is expected to do so again in 2015.

Croatia has been subject to the corrective arm of the Stability and Growth Pact since 2014. The European Council, following Croatia's accession to the EU in June 2013 and taking into account the level of the 2013 deficit, as well as the planned 2014 deficit – both of which breach the 3% deficit reference value – decided on 21 January 2014 to open an excessive deficit procedure (EDP), with the deadline for

¹¹⁵ See Opinion of the European Central Bank of 18 September 2015 on the conversion of Swiss franc loans (CON/2015/32).

correcting the excessive deficit being 2016. The European Commission's Spring 2016 Economic Forecast, while projecting a budget balance below the 3% reference value in 2016, also points to risks of deviation from the structural balance adjustment requirements.

Both cyclical and non-cyclical factors have contributed to the deficit changes over recent years. The deficit peaked in 2011 at 7.8% of GDP, driven by non-cyclical factors (presented in Table 5.3.2). In 2012 the deficit improved markedly (by 2.5 percentage points of GDP) on account of a large structural adjustment, which was partly offset by unfavourable cyclical factors. On average, during 2012-15, the deficit remained high, standing well above the 3% reference value, owing to positive structural and negative cyclical factors.

The debt-to-GDP ratio, currently well above the 60% reference value, has almost doubled since the 2009 crisis as a result of unfavourable economic conditions and large primary deficits. The debt ratio increased rapidly and continuously from 49% of GDP in 2009 to 86.7% of GDP in 2015. This sharp increase was driven by persistently high primary deficits, rising interest growth differentials due to unfavourable economic conditions, and significant deficit-debt adjustments (see Chart 5.3.2). The particularly strong deficit-debt adjustment in 2013 mainly reflected pre-financing for the first half of 2014. The government did not report contingent liabilities related to the financial sector.

The level and structure of government debt protects Croatia, to some extent, from interest rate shocks while the high share of foreign currency-denominated debt implies that the fiscal balances would be highly sensitive to the exchange rate movements. The share of government debt with a short-term maturity is low (6.7% in 2015 – see Table 5.3.2). Taking into account the fact that long-term debt is entirely based on fixed rates, fiscal balances are relatively insensitive to interest rate changes. However, a high share of public debt is denominated in foreign currency (78.6% in 2015), mainly euro (74.4% of the total debt). Taking the government debt share of GDP into account, this implies that the fiscal balances are highly sensitive to exchange rate changes. The tightly managed float (designed to reduce the exchange rate's volatility against the euro) followed by Hrvatska narodna banka means that the high sensitivity of fiscal balances to the euro-kuna exchange rate changes should be somewhat mitigated. Both the foreign currency-denominated part of public debt and long-term maturity debt are close to their medium-term trends, although the euro share is on a slightly upward trend.

The European Commission's Spring 2016 Economic Forecast foresees a timely correction of the excessive deficit but points to a risk that Croatia will not comply with the Stability and Growth Pact. According to the European Commission's latest forecast, the headline deficit is projected to return to below the 3% reference value by the 2016 EDP deadline. The improvement in the structural balance in 2017 (under the assumption of unchanged policies) is expected to fall short of the fiscal requirements with respect to both the medium-term objective and the debt reduction benchmark. In contrast, the medium-term fiscal policy strategy of Croatia, as presented in the 2016 Convergence Programme, forecasts the structural deficit to be 1.2% of GDP in 2016, 1.1% of GDP in 2017 and 0.8% of GDP in 2018,

thus already below the minimum medium-term objective (1.75% of GDP structural deficit from 2017 onwards). Therefore, there is scope for additional measures to ensure compliance with the Stability and Growth Pact in 2017.

Croatia needs to improve its national fiscal framework. The fiscal strategy has to focus on compositional issues so that public spending becomes more growth and employment-friendly. Only modest progress has been made in implementing the 2014 country-specific recommendations on fiscal governance, as the measures announced have not been adopted. Challenges in the Croatian fiscal framework relate to the operationalisation and independence of the Fiscal Policy Commission and the revision of the Fiscal Responsibility Act. Moreover, the full adoption of numerical fiscal rules, control of expenditure by means of spending reviews and effective budgetary planning are essential for the improvement of the Croatian fiscal framework.

The Commission's 2015 Fiscal Sustainability Report suggests that Croatia faces a high debt sustainability risk over the medium term. The European Commission's 2015 Fiscal Sustainability Report foresees no significant short-term risks of fiscal stress, although some variables (namely the primary deficit; the net international investment position; and the level of, and change in, the share of non-performing loans) point to significant short-term challenges. Over the medium term, the risk level is high, underpinned by the high stock of debt and high sensitivity of the projections to macro shocks. Over the long term, while Croatia appears to be at low risk because of the projected decrease in age-related spending, the low level of, and projected further decline in, the benefit ratio raise concerns about the adequacy of the pension system. Croatia has taken steps to tackle ageing costs, including (i) streamlining social benefits, (ii) tightening the regime for special pensions, and (iii) increasing penalties for early retirement. The projected decrease in public expenditure is largely the result of the low valorisation of pension rights and the anticipated decrease in the level of new public pensions. This, in turn, would entail a reduced level of current and future spending on public pensions. This largely explains the projected savings in demography-sensitive public expenditure and, thus, the low fiscal stress in the long term. These projected developments also imply a risk regarding the future adequacy of the pension system in the form of the upcoming increased social payments that may be needed to support the elderly population that will be below the poverty line or socially excluded. According to the 2015 projections by the European Commission and the EU's Economic Policy Committee¹¹⁶, Croatia is likely to experience a decrease in age-related public expenditure amounting to 2.5 percentage points of GDP by 2060 in the AWG reference scenario from a level of 20.7% of GDP in 2013. In the AWG risk scenario, the reduction in the cost of ageing is 0.4 percentage points. This is mainly due to significant savings in gross pensions, which are projected to fall from 10.8% of GDP to 6.9% of GDP for the period 2013-60, while healthcare and long-term care spending are expected to increase by 2.7% and 1.1% of GDP respectively during the same period.

¹¹⁶ European Commission and Economic Policy Committee, "The 2015 Ageing Report: Economic and budgetary projections for the EU-28 Member States (2013-2060)", prepared by the AWG.

A prudent and credible fiscal policy based on further fiscal consolidation, along with renewed determination in pursuing fiscal reforms, are needed for public finances to return to a more sustainable footing over the medium term.

Despite the fact that the budget balance is projected to be below the 3% reference value in 2016, possible fiscal risks in 2016 and additional required adjustment in 2017 may point to additional consolidation measures. These need to be implemented in a growth-friendly framework in order to mitigate the effect on economic conditions, which remain weak. In the light of the significant medium-term risks to debt sustainability, Croatia needs to set up a credible medium-term consolidation plan. Moreover, fiscal risks related to the inefficiency of public spending and of state-owned enterprises need to be addressed. The Croatian fiscal governance framework needs to be strengthened further, particularly as regards the independence of the Fiscal Policy Commission, the revision of the Fiscal Responsibility Act, the improvement to numerical fiscal rules, the introduction of effective expenditure control and budgetary planning.

5.3.3 Exchange rate developments

In the two-year reference period from 19 May 2014 to 18 May 2016, the Croatian kuna did not participate in ERM II, but traded under a flexible exchange rate regime involving a tightly managed floating of the currency's exchange rate.

The Croatian kuna was stable over the reference period and traded close to its May 2014 average exchange rate against the euro of 7.595 kuna per euro, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate (see Chart 5.3.3). On 18 May 2016 the exchange rate stood at 7.488 kuna per euro, i.e. 1.4% stronger than its average level in May 2014. Over the reference period the maximum upward deviation from this benchmark was 1.7%, while the maximum downward deviation amounted to 1.7%. Looking back over a longer period the exchange rate of the Croatian kuna against the euro has depreciated by 3.0% over the past ten years.

The exchange rate of the Croatian kuna against the euro exhibited, on average, a low degree of volatility over the reference period. This reflected the strategy of Hrvatska narodna banka to limit exchange rate fluctuations by means of occasional market interventions. Hrvatska narodna banka conducted two foreign exchange interventions at the beginning of 2015 by selling euro for domestic currency. The purpose was to alleviate depreciation pressures caused by banks adjusting their foreign exchange position against the background of the government's decision to freeze the exchange rate vis-à-vis the Swiss franc for loan repayments at the exchange rate level applicable before the decision of the Swiss National Bank to discontinue its minimum exchange rate target vis-à-vis the euro. Moreover, as of September 2015 Hrvatska narodna banka undertook a series of measures to alleviate the pressures on the foreign exchange and money markets caused by legislative changes regulating the conversion of loans in Swiss francs. Over the reference period short-term interest rate differentials against the three-month EURIBOR stood, on average, at a low level. The spreads increased late in the third quarter of 2015 amid the above-mentioned legislative changes and decreased

thereafter as the measures by Hrvatska narodna banka reduced the pressures on money markets.

The real effective exchange rate of the Croatian kuna has depreciated overall over the past ten years (see Chart 5.3.4). However, this indicator should be interpreted with caution, as during this period Croatia was subject to a process of economic convergence, which complicates any historical assessment of real exchange rate developments.

Croatia's current and capital account has improved over the past decade, while the country's net foreign liabilities remain high (see Table 5.3.3). After a progressive increase in the external deficit in the period up to 2008, the combined current and capital account improved steadily and turned into a small surplus in 2012, stabilising at around 1% in 2013 and 2014. This improvement primarily reflected a sharp decline in the goods deficit, driven largely by the contraction in domestic demand. The surplus widened notably in 2015 to 5.6% of GDP, mainly reflecting a temporary reduction in the deficit of the balance of primary income owing to foreign-owned banks' losses following the regulatory amendments allowing for the conversion of loans in Swiss francs, as well as improvements in the balance on trade in services owing to an exceptionally good tourist season. In addition, the balance of secondary income and capital accounts improved as a result of the intensified allocation of EU funds to end-beneficiaries. Gross external debt increased substantially from 73.9% of GDP in 2006 to 105.6% in 2013 and 108.4% in 2014. At the same time the country's net international investment position, which had deteriorated substantially from -76.1% of GDP in 2006 to -95.9% in 2010, improved to reach -88.0% in 2014 and -78.7% in 2015. However, the country's net foreign liabilities are still very high. Fiscal and structural policies therefore continue to be important for supporting external sustainability and the competitiveness of the economy.

The Croatian economy is well integrated with the euro area through trade linkages.¹¹⁷ In 2015 exports of goods and services to the euro area constituted 58.9% of total exports, while the corresponding figure for imports was higher, at 59.3%.

5.3.4 Long-term interest rate developments

Over the reference period from May 2015 to April 2016, long-term interest rates in Croatia were 3.7% on average and thus below the 4.0% reference value for the interest rate convergence criterion (see Chart 5.3.5).

Long-term interest rates in Croatia have decreased from above 8% in 2009 to 3.6% in 2016, with the reduction having been interrupted by three episodes of long-term rate rises. The first rise could be observed in 2011 and lasted until 2012,

¹¹⁷ Data on Croatia's investment position with the euro area are available only for portfolio investment liabilities.

with long-term interest rates increasing from around 6% to close to 8%. A second period of rate rises could be observed in 2013 on the back of credit ratings being downgraded. Since early 2014 long-term interest rates have continued to decline, interrupted by an increase in yields in 2015. This rise can partly be attributed to the weak economic environment and legislative changes concerning the conversion of Swiss franc loans, as well as heightened political uncertainty following the election. Rating agencies gave Croatia a negative credit rating outlook in the course of 2014 and 2015.

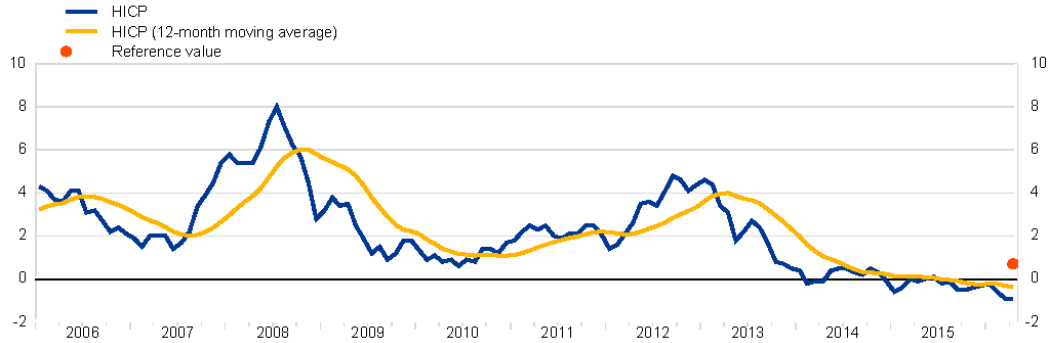
Croatia's long-term interest rate differential vis-à-vis the euro area has widened since the start of 2013, to stand at 2.7 percentage points at the end of the review period. The interest rate differential, which had increased during the 2008-09 financial crisis, decreased from 2009 onwards. The latest widening was in excess of what could be observed in the euro area, and largely reflected long-term structural issues and weak economic growth, despite a relatively resilient financial sector (see Chart 5.3.6). The long-term interest rate differential vis-à-vis the AAA euro area yield stood at 3.4 percentage points at the end of the review period.

Capital markets in Croatia are smaller and much less developed than those in the euro area (see Table 5.3.4), but among the most developed in central and eastern Europe. The non-banking financial sector is relatively large compared with those of peer countries, with non-banking institutions also playing a more important role in financial intermediation. Since the financial crisis, pension funds in particular have gained importance. Stock market capitalisation as a share of GDP is higher than for many peer countries and stood at 38.7% in 2015. Contrary to overall developments in the euro area, stock market capitalisation has remained more or less constant over the last decade. Despite this, the share of debt securities issued by financial and non-financial institutions as a percentage of GDP remains very low, at 0.4% and 5.3% respectively at the end of 2015. Integration of Croatia's financial sector with the euro area, as measured by the claims of euro area banks on Croatian banks, has reached a considerable level. The Croatian financial sector is largely bank-based, with its banking sector being largely foreign-owned and highly integrated with the EU financial sector. The degree of financial intermediation is somewhat lower than the euro area average. During the recession of the last few years, which followed a period of strong credit expansion prior to the crisis, the claims of euro area MFIs on resident MFIs decreased from 16.4% in 2012 to 8.2% in 2015, while MFI credit to non-government residents in 2015 stood at 66.8% of GDP – slightly below pre-crisis levels (see Table 5.3.4). The share of foreign currency-denominated loans remains high, with most loans denominated in euro, whereas the share of loans denominated in Swiss francs dropped to very low levels after the recent Swiss franc loan conversion.

Croatia - Price developments

Chart 5.3.1 HICP inflation and reference value ¹⁾

(annual percentage changes)



Sources: European Commission (Eurostat) and ECB calculations.

¹⁾ The basis of the calculation of the reference value for the period from May 2015 to April 2016 is the unweighted arithmetic average of the annual percentage changes in the HICP for Bulgaria, Slovenia and Spain plus 1.5 percentage points. The reference value is 0.7%.

Table 5.3.1 Measures of inflation and related indicators

(annual percentage changes, unless otherwise indicated)

	2006-2015 ¹⁾	2006-2010 ¹⁾	2011-2015 ¹⁾	2011	2012	2013	2014	2015	2016 ²⁾	2017 ²⁾
Measures of inflation										
HICP	2.3	3.0	1.6	2.2	3.4	2.3	0.2	-0.3	-0.6	0.7
HICP excluding unprocessed food and energy	2.1	3.0	1.3	1.5	1.6	2.1	0.6	0.8	0.1	0.8
HICP at constant tax rates ³⁾	1.9	2.8	1.1	2.1	2.5	1.9	-0.6	-0.6	-	-
CPI	2.3	3.1	1.4	2.3	3.4	2.2	-0.2	-0.5	-	-
Private consumption deflator	2.3	3.3	1.3	2.4	3.3	1.9	-0.4	-0.5	-0.5	0.7
GDP deflator	2.1	3.5	0.8	1.7	1.6	0.8	0.0	0.1	0.3	1.0
Producer prices ⁴⁾	2.5	3.6	1.3	6.4	7.0	0.4	-2.7	-3.8	-	-
Related indicators										
Real GDP growth	0.0	0.5	-0.5	-0.3	-2.2	-1.1	-0.4	1.6	1.8	2.1
GDP per capita in PPS ⁵⁾ (euro area = 100)	55.6	55.9	55.3	55.0	55.8	55.3	55.0	-	-	-
Comparative price levels (euro area = 100)	70.1	72.1	67.6	70.5	67.6	67.0	65.2	-	-	-
Output gap ⁶⁾	0.1	3.2	-3.0	-1.3	-2.8	-3.7	-4.0	-2.9	-1.7	-0.3
Unemployment rate (%) ⁷⁾	13.2	10.2	16.1	13.7	16.0	17.3	17.3	16.3	15.5	14.7
Unit labour costs, whole economy	2.1	5.5	-1.2	0.6	-1.3	-2.2	-2.4	-0.5	0.4	0.9
Compensation per employee, whole economy	1.5	3.5	-0.4	4.3	0.2	-0.7	-5.3	-0.3	1.1	1.6
Labour productivity, whole economy	-0.6	-1.9	0.8	3.7	1.5	1.6	-3.0	0.1	0.7	0.7
Imports of goods and services deflator	1.7	1.9	1.4	5.9	3.0	0.2	-0.7	-1.2	-0.7	0.4
Nominal effective exchange rate ⁸⁾	-0.5	0.2	-1.3	-1.6	-3.3	1.2	0.6	-3.1	-	-
Money supply (M3) ⁹⁾	2.7	6.8	1.3	1.0	2.9	2.8	0.1	4.2	-	-
Lending from banks ¹⁰⁾	-2.6	-	-2.6	4.4	-6.2	-0.1	-1.7	-2.4	-	-
Stock prices (CROBEX) ¹¹⁾	-15.4	5.7	-20.0	-17.6	0.0	3.1	-2.7	-3.2	-	-
Residential property prices ¹²⁾	-3.0	-5.7	-2.0	0.2	-1.6	-4.0	-1.6	-2.9	-	-

Sources: European Commission (Eurostat, DG ECFIN), national data for CPI, money supply, lending from banks and residential property prices, and ECB calculations based on Thomson Reuters data for stock prices.

¹⁾ Multi-annual averages calculated using the geometric mean, except for GDP per capita in PPS, comparative price levels, output gap and unemployment rate, for which the arithmetic mean is used.

²⁾ Data from the European Commission's Spring 2016 Economic Forecast.

³⁾ The difference between the HICP and the HICP at constant tax rates shows the theoretical impact of changes in indirect taxes (e.g. VAT and excise duties) on the overall rate of inflation. This impact assumes a full and instantaneous pass-through of tax rate changes to the price paid by the consumer.

⁴⁾ Domestic sales, total industry excluding construction.

⁵⁾ PPS stands for purchasing power standards.

⁶⁾ Percentage difference of potential GDP: a positive (negative) sign indicates that actual GDP is above (below) potential GDP.

⁷⁾ Definition conforms to International Labour Organization guidelines.

⁸⁾ EER-38 group of trading partners. A positive (negative) sign indicates an appreciation (depreciation).

⁹⁾ The series includes repurchase agreements with central counterparties.

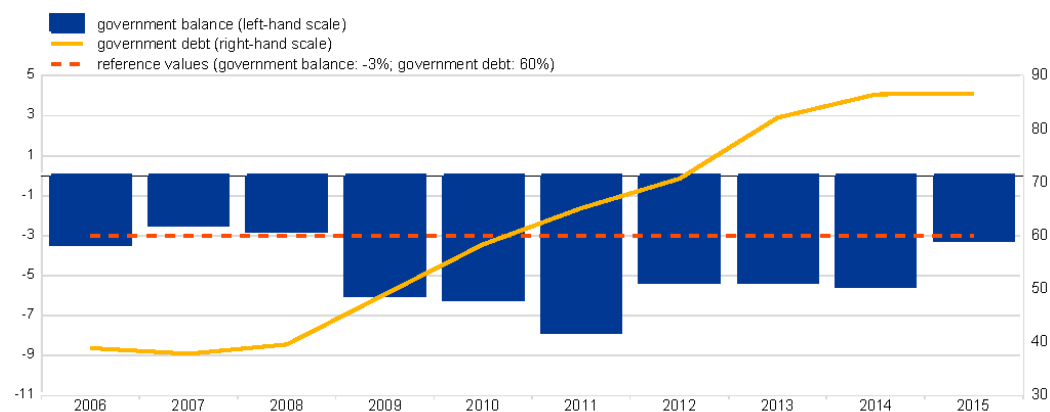
¹⁰⁾ Data available since 2011. Not adjusted for the derecognition of loans from the MFI statistical balance sheet due to their sale or securitisation.

¹¹⁾ Multi-annual and annual figures represent the percentage change between the end of the given period and the end of the previous period.

¹²⁾ Data available since 2006.

Croatia - Fiscal developments

Chart 5.3.2 General government balance and debt
(as a percentage of GDP)



Sources: European System of Central Banks and European Commission (Eurostat).

Table 5.3.2 Government budgetary developments and projections
(as a percentage of GDP, unless otherwise indicated)

	2006-2015 ¹⁾	2006-2010 ²⁾	2011-2015 ²⁾	2011	2012	2013	2014	2015	2016 ³⁾	2017 ³⁾	2018	2019
Government balance	-4.8	-4.2	-5.4	-7.8	-5.3	-5.3	-5.5	-3.2	-2.7	-2.3		
Total revenue	42.1	41.8	42.3	41.0	41.7	42.5	42.6	43.7	44.1	44.4		
Current revenue	41.8	41.7	41.8	40.6	40.9	42.2	42.3	43.0	43.3	43.5		
Direct taxes	6.5	6.9	6.1	6.2	6.1	6.3	6.1	5.9	5.8	6.1		
Indirect taxes	18.3	18.0	18.6	17.5	18.3	19.0	18.7	19.5	19.5	19.5		
Net social contributions	11.7	11.7	11.6	11.6	11.5	11.3	11.8	11.9	11.9	12.0		
Other current revenue ⁴⁾	5.3	5.1	5.5	5.4	4.9	5.7	5.7	5.7	5.9	6.0		
Capital revenue	0.3	0.1	0.5	0.3	0.9	0.3	0.3	0.7	0.8	0.9		
Total expenditure	46.9	46.0	47.7	48.8	47.0	47.8	48.1	46.9	46.8	46.6		
Current expenditure	40.9	39.1	42.7	42.1	42.2	42.9	43.1	43.1	42.8	42.4		
Compensation of employees	11.8	11.6	12.0	12.4	12.3	12.1	11.8	11.4	11.4	11.3		
Social benefits	15.7	15.1	16.2	16.1	16.3	15.9	16.6	16.4	16.3	16.1		
Interest payable	2.8	2.1	3.4	3.0	3.4	3.5	3.5	3.6	3.6	3.6		
Other current expenditure ⁵⁾	10.6	10.2	11.0	10.6	10.3	11.4	11.3	11.7	11.5	11.5		
Capital expenditure	6.0	6.9	5.0	6.7	4.8	4.9	5.0	3.9	4.0	4.2		
of which: Investment	4.4	5.4	3.5	3.6	3.5	3.7	3.7	2.8	3.1	3.3		
Cyclically adjusted balance	-4.8	-5.6	-4.0	-7.3	-4.0	-3.6	-3.6	-1.8	-1.9	-2.1		
One-off and temporary measures	-	-	-0.1	0.0	0.0	-0.2	-0.1	-0.1	0.0	0.0		
Structural balance ⁶⁾	-	-	-4.0	-7.3	-4.0	-3.3	-3.5	-1.7	-1.9	-2.1		
Government debt	61.5	44.7	78.2	65.2	70.7	82.2	86.5	86.7	87.6	87.3		
Average residual maturity (in years)	-	-	5.3	5.8	5.3	5.1	5.0	5.3				
In foreign currencies (% of total)	-	-	77.8	77.3	76.4	78.0	78.8	78.6				
of which: Euro	-	-	73.2	71.5	71.3	74.1	74.7	74.4				
Domestic ownership (% of total)	55.8	53.0	58.5	58.9	58.5	57.7	58.4	59.2				
Medium and long-term maturity (% of total) ⁶⁾	89.4	88.0	90.9	89.7	90.4	90.2	90.8	93.3				
of which: Variable interest rate (% of total)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0				
Deficit-debt adjustment	0.6	0.7	0.5	-0.2	-0.2	6.0	-1.4	-1.6				
Net acquisitions of main financial assets	0.4	0.6	0.2	-1.4	0.6	3.8	-0.5	-1.5				
Currency and deposits	0.4	0.9	-0.1	-1.5	0.3	3.2	-0.7	-1.7				
Debt securities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.1				
Loans	0.2	0.1	0.3	0.2	0.2	0.5	0.3	0.2				
Equity and investment fund shares or units	-0.2	-0.4	0.0	0.0	0.1	0.1	-0.1	0.0				
Revaluation effects on debt	0.6	0.4	0.7	1.1	0.5	1.0	0.7	0.4				
of which: Foreign exchange holding gains/losses	0.3	0.1	0.5	0.8	0.1	0.6	0.6	0.1				
Other ⁷⁾	-0.4	-0.3	-0.4	0.1	-1.3	1.3	-1.6	-0.5				
Convergence programme: government balance	-	-	-	-	-	-	-	-	-2.6	-2.0	-1.6	-1.0
Convergence programme: structural balance	-	-	-	-	-	-	-	-	-1.5	-1.7	-1.8	-1.7
Convergence programme: government debt	-	-	-	-	-	-	-	-	85.9	84.7	82.8	80.0

Sources: European System of Central Banks and European Commission (Eurostat, DG ECFIN).

1) Multi-annual averages.

2) Data from the European Commission's Spring 2016 Economic Forecast, except for convergence programme data.

3) Sales and other current revenue.

4) Intermediate consumption, subsidies payable and other current expenditure.

5) Cyclically-adjusted balance excluding one-off and other temporary measures.

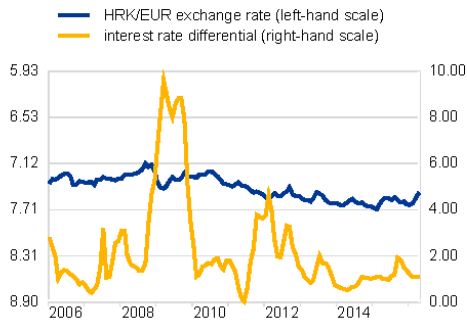
6) Original maturity of more than one year.

7) Time of recording differences and other discrepancies (sector reclassifications and statistical discrepancies).

Croatia - Exchange rate and external developments

Chart 5.3.3 Bilateral exchange rate and short-term interest rate differential

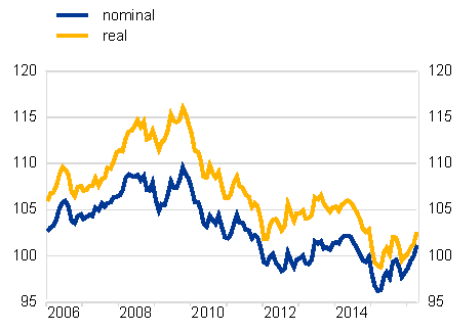
(HRK/EUR exchange rate: monthly averages; difference between three-month interbank interest rates and three-month EURIBOR: basis points, monthly values)



Sources: National data and ECB calculations.

Chart 5.3.4 Effective exchange rates ¹⁾

(EER-38 group of trading partners; monthly averages; base index: Q1 1999 = 100)



Source: ECB.

1) The real EER-38 is CPI deflated. An increase (decrease) in the EER indicates an appreciation (depreciation).

Table 5.3.3 External developments

(as a percentage of GDP, unless otherwise indicated)

	2008-2015 ⁵⁾	2008-2010 ⁵⁾	2011-2015 ⁵⁾	2011	2012	2013	2014	2015	2016 ³⁾	2017 ³⁾
Balance of payments										
Current account and capital account balance ⁴⁾	-1.0	-4.9	1.4	-0.7	0.0	1.1	1.0	5.6	5.0	4.7
Current account balance	-1.1	-5.0	1.2	-0.8	-0.1	1.0	0.8	5.2	4.4	4.0
Goods	.	.	-14.7	-14.3	-14.3	-15.1	-14.8	-15.1	.	.
Services	.	.	15.8	13.8	14.8	15.5	16.8	17.9	.	.
Primary income	.	.	-2.5	-3.0	-3.4	-2.0	-3.3	-0.7	.	.
Secondary income	2.5	2.3	2.6	2.7	2.8	2.6	2.1	3.1	.	.
Capital account balance	0.2	0.1	0.2	0.1	0.1	0.1	0.2	0.4	.	.
Combined direct and portfolio investment balance ⁴⁾	-3.7	-3.6	-3.8	-4.0	-6.7	-6.3	-1.4	-0.5	.	.
Direct investment	-2.6	-3.5	-2.1	-2.5	-2.7	-1.9	-3.1	-0.3	.	.
Portfolio investment	-1.1	-0.1	-1.7	-1.5	-4.0	-4.4	1.7	-0.2	.	.
Other investment balance	-0.2	-4.7	2.5	-0.3	5.8	1.1	2.3	3.4	.	.
Reserve assets	1.0	0.7	1.1	0.9	0.1	4.2	-1.2	1.7	.	.
Exports of goods and services	41.6	36.9	44.3	40.5	41.7	43.1	46.4	50.1	.	.
Imports of goods and services	42.4	40.9	43.3	40.9	41.2	42.6	44.4	47.3	.	.
Net international investment position ⁴⁾	-86.5	-85.3	-87.3	-90.6	-90.5	-88.7	-88.0	-78.7	.	.
Gross external debt ⁴⁾	.	.	.	103.7	103.0	105.6	108.4	.	.	.
Internal trade with the euro area ⁴⁾										
Exports of goods and services	.	.	55.7	51.9	52.5	57.2	58.0	58.9	.	.
Imports of goods and services	.	.	53.5	46.0	47.4	56.2	58.8	59.3	.	.
Investment position with the euro area ⁴⁾										
Direct investment assets ⁴⁾
Direct investment liabilities ⁴⁾
Portfolio investment assets ⁴⁾
Portfolio investment liabilities ⁴⁾	49.2	55.2	45.6	41.6	45.3	44.2	48.9	48.2	.	.

Sources: European System of Central Banks and European Commission (Eurostat, DG ECFIN).

Note: Backdata are available from 2008.

1) Multi-annual averages.

2) Data from the European Commission's Spring 2016 Economic Forecast.

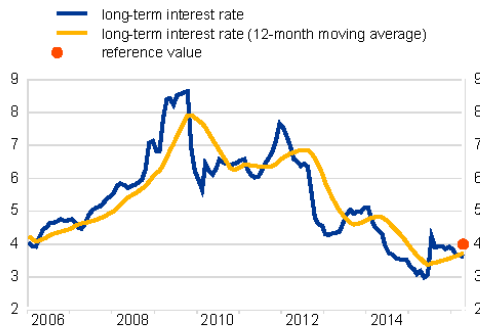
3) Differences between totals and sum of their components are due to rounding.

4) End-of-period outstanding amounts.

5) As a percentage of the total.

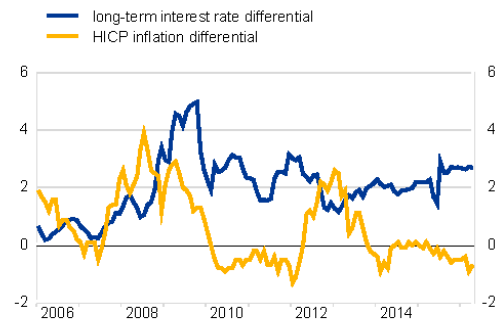
Croatia - Long-term interest rate developments

Chart 5.3.5 Long-term interest rate ¹⁾
(monthly averages in percentages)



Sources: European System of Central Banks and ECB calculations.
1) The basis of the calculation of the reference value for the period from May 2015 to April 2016 is the unweighted arithmetic average of the interest rate levels in Bulgaria, Slovenia and Spain plus 2 percentage points. The reference value is 4.0%.

Chart 5.3.6 Long-term interest rate and HICP inflation differentials vis-à-vis the euro area
(monthly averages in percentage points)



Sources: European System of Central Banks, ECB calculations and European Commission (Eurostat).

Table 5.3.4 Long-term interest rates and indicators of financial development and integration
(as a percentage of GDP, unless otherwise indicated)

	2006-2015 ¹⁾	2006-2010 ²⁾	2011-2015 ³⁾	2012	2013	2014	2015	May 2015 to Apr. 2016	Memo item: euro area 2015
Long-term interest rates									
Croatia ⁴⁾	5.4	5.9	5.0	6.1	4.7	4.1	3.6	3.7	-
Euro area ⁵⁾	3.4	4.0	2.9	3.9	3.0	2.0	1.2	1.2	-
Euro area AAA par curve, ten-year residual maturity ⁶⁾	2.8	3.8	1.8	2.1	1.9	1.4	0.6	0.6	-
Indicators of financial development and integration									
Debt securities issued by financial corporations ⁷⁾	0.4	-	0.4	-	0.4	0.4	0.4	-	73.6
Debt securities issued by non-financial corporations ⁸⁾	5.3	-	5.3	-	5.9	4.8	5.3	-	10.8
Stock market capitalisation ⁹⁾	38.0	-	38.0	-	36.5	38.9	38.7	-	60.4
MFI credit to non-government residents ¹⁰⁾	66.2	-	71.0	71.5	71.0	70.1	66.8	-	114.7
Claims of euro area MFIs on resident MFIs ¹¹⁾	15.5	-	14.7	16.4	15.3	12.5	8.2	-	27.4

Sources: European System of Central Banks and ECB calculations.

1) Multi-annual averages calculated using the arithmetic average.

2) Average interest rate.

3) Included for information only.

4) Outstanding amount of debt securities issued by resident MFIs and other financial corporations. Data available since 2013.

5) Outstanding amount of debt securities issued by resident non-financial corporations. Data available since 2013.

6) Outstanding amount of listed shares issued by residents at the end of the period at market values. Data available since 2013.

7) MFI (excluding NCB) credit to domestic non-MFI residents other than general government. Credit includes outstanding amounts of loans and debt securities. Data available since 2011.

8) Outstanding amount of deposits and debt securities issued by domestic MFIs (excluding the NCB) held by euro area MFIs as a percentage of total liabilities of domestic MFIs (excluding the NCB). Total liabilities exclude capital and reserves and remaining liabilities. Data available since 2011.

5.4 Hungary

5.4.1 Price developments

In April 2016 the 12-month average rate of HICP inflation in Hungary was 0.4%, i.e. below the reference value of 0.7% for the criterion on price stability (see Chart 5.4.1). This rate is expected to increase over the coming months.

Over the past ten years the 12-month average rate of HICP inflation has fluctuated within a relatively wide range, from -0.3% to 7.9%, and the average for that period was elevated, standing at 3.8%. In 2007 the average annual rate of HICP inflation accelerated to 7.9%, owing partly to hikes in administered prices and indirect taxes. As a result of the sharp economic slowdown that started in 2007, inflation receded gradually, but successive commodity price shocks and frequent changes to indirect taxes and administered prices meant that consumer price inflation in Hungary was relatively volatile during the period under review. In 2010 and 2011 Hungary experienced a weak economic recovery driven by external demand (see Table 5.4.1). While domestic demand remained subdued amid wage restraint, hikes in indirect taxes and the depreciation of the forint kept consumer price inflation at an elevated level. In 2012 economic activity declined again, while inflation increased as a result of, among other things, a hike in the value added tax rate. The ensuing economic recovery was to a large extent supported by government intervention in an environment characterised by a contraction in bank lending to the private sector. In recent years inflation expectations have become increasingly better anchored. As inflation receded, the Magyar Nemzeti Bank continued to loosen its monetary policy stance. In 2014 and 2015 the average annual rate of HICP inflation was close to zero owing to a combination of factors, including global commodity price developments, utility price cuts, relatively muted wage growth and subdued external price pressures. The delayed recovery in residential house prices can partly be explained by the high share of non-performing loans in the household sector and the ongoing contraction in lending.

For the first four months of 2016, the average annual rate of HICP inflation stood at 0.3%. Strong domestic demand, supported by a sharply declining unemployment rate, robust wage growth and an accommodative monetary policy stance, made an increasing contribution to domestically generated inflation. However, this was partly offset by developments in global commodity prices and subdued inflation in Hungary's key trading partners.

Policy choices have played an important role in shaping inflation dynamics in Hungary over the past decade, most notably the orientation of monetary policy towards price stability. The Magyar Nemzeti Bank defines its inflation target as an annual rate of consumer price inflation of 3%. This was adopted in August 2005. In addition, in March 2015 the Magyar Nemzeti Bank adopted an ex-ante tolerance band of ± 1 percentage point around this inflation target. Successive cuts in administrative prices, which constitute a large share of Hungary's HICP basket of goods and services (17% in 2016), helped to contain consumer price inflation. In late

2008 Hungary's large external financing needs necessitated an EU-IMF financial assistance programme, which, owing to a change of government, went off track in June 2010. In November 2011 Hungary requested further precautionary financial assistance from the EU and the IMF, but negotiations were limited to one official round in July 2012, as Hungary did not request any further assistance.

Inflation is expected to increase in the coming years; over the longer term there are concerns regarding the sustainability of inflation convergence in Hungary. According to the European Commission's Spring 2016 Economic Forecast, the rate of inflation will accelerate in 2016 and reach 2.3% in 2017. The inflation outlook is based on expectations of moderate economic growth, with robust job creation and dynamic compensation per employee growth projected to contribute to pushing up inflation. The risks to the inflation outlook are broadly balanced. The main upside risks relate to further depreciation pressure being exerted on the forint, owing to the heightened uncertainty regarding domestic policy. A key downside risk relates to the greater uncertainty about developments in the global economy, which could reduce external price pressures. Looking further ahead, the catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area, since GDP per capita and price levels are still significantly lower in Hungary than in the euro area. In order to prevent the build-up of excessive price pressures and macroeconomic imbalances, the catching-up process must be supported by appropriate policies.

Achieving an environment that is conducive to sustainable convergence in Hungary requires stability-oriented economic policies and wide-ranging structural reforms. More specifically, economic policies promoting private sector-led growth in order to drive up the currently low level of potential growth are essential. Improving the quality of public institutions and ensuring that they are free from undue political intervention are prerequisites for private sector-led economic growth. The red tape for businesses should be reduced further and the excessive tax burden on the private sector, specifically related to special taxes and levies at the sectoral level, needs to be reconsidered. Enhanced governance, stronger institutions and a better functioning administration at the national level should, among other things, help to improve the absorption of EU funds. With regard to macroeconomic imbalances, the European Commission selected Hungary for an in-depth review in its Alert Mechanism Report 2016 and concluded that Hungary is not experiencing macroeconomic imbalances.

Financial sector policies should be geared to safeguarding financial stability and ensuring that the financial sector makes a sound contribution to sustainable economic growth. Policies should aim at reviving lending to the private sector in a sustainable manner. The reduction in the banking tax should be implemented as originally envisaged in the Memorandum of Understanding between the Government of Hungary and the European Bank for Reconstruction and Development. The resolution framework for non-performing loans should be further strengthened and the existing bottlenecks in the collateral enforcement process need to be removed.

5.4.2 Fiscal developments

The deficit-to-GDP ratio complies with the Maastricht criteria, whereas the debt-to-GDP ratio exceeds the reference value. In the reference year 2015 the general government budget balance recorded a deficit of 2.0% of GDP, i.e. below the 3% reference value. The general government gross debt-to-GDP ratio was 75.3%, i.e. above the 60% reference value (see Table 5.4.2). Compared with the previous year, the deficit and debt ratios decreased by 0.3 and 0.9 percentage points of GDP respectively. The deficit ratio is forecast by the European Commission to remain at 2.0% in 2016, while the government debt ratio is projected to decrease further to 74.3%. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2015, nor is it expected to do so in 2016.

Hungary has been subject to the preventive arm of the Stability and Growth Pact since 2013. It had recorded deficits in excess of 3% of GDP each year up to 2012. Hungary's excessive deficit procedure ended on 21 June 2013, nine years after the European Council first assessed that it had an excessive deficit. Hungary is currently subject to the debt rule, as well as the preventive arm of the Stability and Growth Pact. The European Commission's Spring 2016 Economic Forecast projects the structural deficit to be above the medium-term objective, pointing to a high risk of a significant deviation from the preventive arm's requirements in both 2016 and 2017, unless further measures are taken.

Cyclical factors explain most of the deficit reduction over recent years. The deficit ratio reached its peak in 2006 at 9.3% of GDP and has been on a downward trend ever since, with a subsequent peak in 2011, when it was 5.5% of GDP. European Commission estimates (presented in Table 5.4.2) indicate that cyclical factors improved the budget balance by about 1.7 percentage points of GDP between 2010 and 2015, while the structural balance did so by almost the same amount (1.6 percentage points of GDP). The structural deficit path also points to periods of consolidation efforts (e.g. between 2006 and 2009, as well as in 2012 and, to a lesser extent, 2015), but also to intervals of fiscal loosening (e.g. between 2009 and 2011, and between 2012 and 2014).

The debt-to-GDP ratio increased sharply during the crisis, but has been on a downward path since 2011, albeit at levels above the 60% reference value. The debt ratio increased rapidly, from 65.6% of GDP in 2007 to 80.8% of GDP in 2011, driven by an unfavourable interest growth differential and high deficit-debt adjustments (see Chart 5.4.2), which were partly related to the support granted to the financial sector and partly to the debt revaluation effects stemming from exchange rate dynamics. Since 2012 the debt ratio has been on a downward path, underpinned by primary surpluses, favourable deficit-debt adjustments and an almost neutral effect of the interest-growth differential (see Table 5.4.2). These favourable deficit-debt adjustments stem from the sizeable capital transfer that resulted from the state takeover of mandatory second-pillar private pension assets. Hungary has not incurred contingent liabilities resulting from government interventions to support financial institutions or markets during the crisis.

The level and structure of government debt indicate a high sensitivity with respect to exchange rate movements and fiscal balances that are relatively sensitive to interest rate variations. The share of government debt with a short-term maturity is noticeable (15.1% in 2015 – see Table 5.4.2). Taking into account the level of the debt ratio, fiscal balances are relatively sensitive to changes in interest rates. At the same time, the proportion of foreign currency-denominated government debt, mainly in euro, is high (35.3% in 2015). This leaves fiscal balances sensitive to changes in the exchange rate vis-à-vis the euro. Despite some fluctuations, the share of debt denominated in euro and other foreign currency has been on a decreasing path since 2011, pointing to a decline in debt-related vulnerabilities.

The European Commission's Spring 2016 Economic Forecast points to a high risk of a significant deviation from the adjustment path towards the medium-term objective over the forecast horizon. According to the European Commission's latest forecast, the structural deficit is projected to increase from a level of 2.0% of GDP in 2015 to 2.9% of GDP in 2016, returning to 2.5% of GDP in 2017, thereby deviating from the medium-term objective of -1.7% of GDP (and of -1.5% of GDP from 2017 onwards) and pointing to a high risk of a significant deviation from the preventive arm's provisions. Hungary's medium-term fiscal policy strategy, as presented in the 2016 Convergence Programme update, although indicating compliance with the preventive's arm requirements in 2015, points to partial compliance over the forecast horizon, with the structural deficit projections deviating from the target over 2016-2018 (a widening deviation in 2017 also as a result of the new, tighter medium-term objective) and a return to compliance with the revised medium-term objective as of 2019.

The national fiscal governance framework has recently been strengthened, but there is scope for further improvement. Hungary began the process of reforming its national fiscal governance framework in 2010 (also establishing a strong constitutional basis for the new set-up) and subsequently implemented several changes, ranging from allocating optional tasks and resources to the fiscal council to assigning veto competence to the council over the annual budget bill. However, the fiscal council's analytical capacities and competencies should be improved and its independence needs to be strengthened in order to match its uniquely strong veto powers. Moreover, positive provisions, such as the government's obligation to fully justify the differences between the medium-term budgetary framework and the actual draft budgetary plan by factors outside the government influence have not been implemented. This suggests that the current framework has still not passed an effectiveness test. There is scope for improving the fiscal governance framework with (i) a better medium-term budget programming process, (ii) an enhanced fiscal council with a broader mandatory remit that will further increase the transparency of public finances, (iii) a more growth and environmentally-friendly taxation system and less reliance on sector-specific distortionary taxation, and (iv) further improvements in the efficiency of tax administration that will address the existing compliance gaps. This could be complemented by (v) tackling the high expenditure ratio and (vi) recognising existing contingent liabilities at the level of state-owned enterprises. Implementing these fiscal framework improvements should increase the efficiency,

transparency and credibility of the fiscal sector, thus fostering a sustainable adjustment towards an already favourable medium-term objective.

Hungary is at no risk of fiscal stress over the long term, but medium risk over the medium term and an ageing population pose a challenge to public finances.

In the 2015 Fiscal Sustainability Report published by the European Commission, the assessment for Hungary points to no risk over the short and long term and medium risk over the medium term. This medium-term risk is underpinned by the high stock of debt, the sensitivity to possible shocks to nominal growth, interest rates and the government primary balance. It is partly mitigated by the low adjustment implied by the cost of ageing in the baseline scenario. Hungary has taken steps to tackle the costs of ageing. Notably, the authorities have made successive parametric changes to the existing pension system pertaining to: (i) the level of the benefit (including changes in indexation) and (ii) the number of recipients (raising the retirement age and the effective retirement age), (iii) changes to the tax system to incentivise favourable demographic developments and (iv) labour market reforms aimed at increasing the participation rate in the workforce. These reforms imply a reduced level of current and future spending on public pensions which, in turn, largely explains the projected savings in demography-sensitive public expenditure. However, such developments raise concerns regarding the future adequacy of the pension system in Hungary. In the 2015 Ageing Report¹¹⁸ projections, Hungary is likely to experience an increase in strictly age-related public expenditure of 0.9 percentage points of GDP by 2060 in the AWG reference scenario, rising from a level of 20.5% of GDP in 2013. In the same time span, Hungary is projected to incur higher ageing costs amounting to 5.4 percentage points of GDP (mostly from increases of 4.2% and 1.5% of GDP in long-term care and health care respectively) in the AWG risk scenario, significantly above the EU average. All these factors suggest that further pension reform is needed in order to enhance the long-term sustainability of public finances.

Further reforms of the fiscal governance framework and a prudent fiscal policy are necessary in order to safeguard the sustainability of public finances over the medium term.

Hungary should take the necessary measures to ensure compliance with its medium-term objective in 2016 and beyond. Fiscal risks related to low tax compliance, contingent liabilities stemming from state-owned enterprises and deficiencies in the medium-term budget programming process need to be addressed. Determined progress towards the medium-term objective in line with preventive-arm requirements, as well as reforms of the fiscal governance framework, are necessary in order to safeguard the sustainability of public finances over the medium term.

¹¹⁸ European Commission and Economic Policy Committee, "The 2015 Ageing Report: Economic and budgetary projections for the EU-28 Member States (2013-2060)", prepared by the AWG.

5.4.3 Exchange rate developments

Over the reference period from 19 May 2014 to 18 May 2016, the Hungarian forint did not participate in ERM II, but traded under a flexible exchange rate regime. In the two-year reference period the Hungarian forint traded close to its May 2014 average exchange rate against the euro of 304.58 forints per euro, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate (see Chart 5.4.3). On 18 May 2016 the exchange rate stood at 316.05 forints per euro, i.e. 3.8% weaker than its average level in May 2014. Over the reference period the maximum upward deviation from this benchmark was 2.6%, while the maximum downward deviation amounted to 5.8%. Looking back over a longer period the exchange rate of the Hungarian forint against the euro has depreciated by 20.5% over the past ten years.

The exchange rate of the Hungarian forint against the euro exhibited, on average, a relatively high degree of volatility over the reference period. It is likely that the existing macroeconomic vulnerabilities in Hungary, albeit declining, together with a non-investment sovereign credit rating and a gradually declining short-term interest rate differential against the three-month EURIBOR, have made the forint susceptible to relatively high volatility. Between November 2014 and January 2015 the Hungarian forint depreciated against the euro amid a deteriorating outlook in the country's key trading partners and elevated geopolitical risks. This period was followed by a rather dynamic appreciation between January 2015 and April 2015, which coincided with monetary policy decisions in the country's key trading partners and their subsequent impact on financial markets. By July 2015 the Hungarian forint had depreciated markedly again, erasing most of the gains it had recorded against the euro during the previous period. Since then the forint exchange rate volatility has declined somewhat.

The real effective exchange rate of the Hungarian forint has been subject to some volatility over the past ten years (see Chart 5.4.4). However, this indicator should be interpreted with caution, as during this period Hungary was subject to a process of economic convergence, which complicates any historical assessment of real exchange rate developments.

Over the past decade Hungary's current and capital account has improved markedly and contributed to a reduction in the country's net foreign liabilities, which remain high (see Table 5.4.3). After reporting a large deficit of, on average, 6.3% of GDP between 2006 and 2008, the combined current and capital account balance turned into a slight surplus in 2009, which widened gradually thereafter to 5.7% in 2014 and 8.7% in 2015. This is largely explained by a substantial adjustment in the goods and services balance owing to robust export growth supported by expanded capacities of export-oriented sectors and, until recently, to relatively subdued domestic demand. An increasing capital account surplus reflecting larger transfers from the EU budget to Hungary also contributed to this rebalancing in the more recent past. The sharp adjustment in Hungary's external position was coupled with a significant reshuffling of its financing capital flows. While the portfolio investment balance turned into net outflows, which were later reversed, the balance

on other investment continued to record net outflows until recently. Moreover, Hungary has been, on average, a recipient of net inflows of foreign direct investment. Against this background, gross external debt decreased from 161.5% in 2011 to 145.0% of GDP in 2014 and 133.8% of GDP in 2015. Hungary's net international investment position improved somewhat less dynamically, from -94.5% of GDP in 2011 to -73.9% of GDP in 2014 and -68.6% of GDP in 2015. However, the country's net foreign liabilities are still very high. Fiscal and structural policies therefore continue to be important for supporting external sustainability and the competitiveness of the economy.

The Hungarian economy is well integrated with the euro area through trade and investment linkages. In 2015 exports of goods and services to the euro area constituted 55.6% of total exports, while the corresponding figure for imports was similar, at 57.8%. The share of the euro area in Hungary's stock of inward direct investment stood at 59.0% in 2015 and its share in the country's stock of portfolio investment liabilities was 38.1% in 2015. The share of Hungary's stock of foreign assets invested in the euro area amounted to 32.7% in the case of direct investment and 65.2% in the case of portfolio investment in 2015.

5.4.4 Long-term interest rate developments

Over the reference period from May 2015 to April 2016, long-term interest rates in Hungary were 3.4% on average and thus below the 4.0% reference value for the interest rate convergence criterion (see Chart 5.4.5).

Long-term interest rates in Hungary have decreased since 2009. After an initial steep decline in 2009, there was a temporary increase in long-term interest rates in 2011-12, which was accompanied by a significant increase in credit default swap prices to levels above those observed during the financial crisis. The reasons for the temporary increase in long-term interest rates included uncertainty related to the prospects of a possible IMF/EU programme, contracting economic activity in the midst of increasing inflation and the rise in global risk aversion due to the euro area debt crisis. In 2013 the long-term interest rate hovered around 6%, before falling to below 4% at the end of 2014 (see Chart 5.4.5). A decrease in global risk aversion, coupled with an improvement in the country-specific risk perception, and a number of consecutive monetary policy rate cuts may all have contributed to this decline in bond yields. During the reference period interest rates remained below 4% and the increase in euro area sovereign yields during the summer of 2015 was also evident in Hungarian sovereign yield developments.

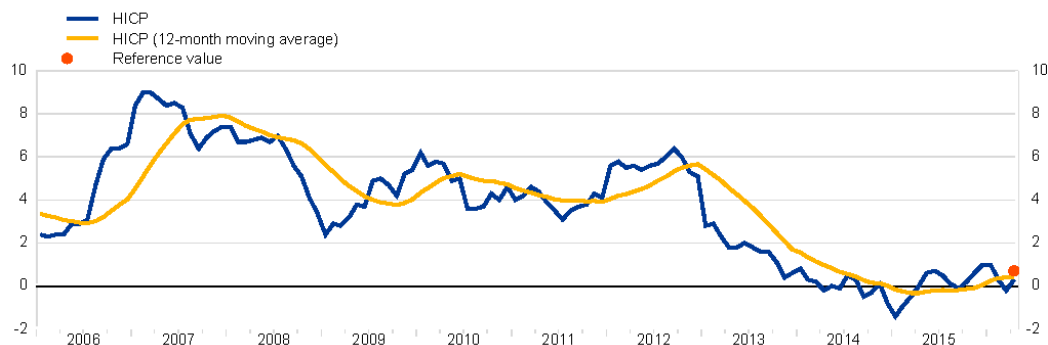
Hungary's long-term interest rate differential vis-à-vis the euro area average has narrowed over recent years to stand at 2.1 percentage points at the end of the reference period. The interest rate differential, which had increased during the 2008-09 financial crisis, decreased from 2009 onwards, with the exception of some widening in 2011 and 2012 (see Chart 5.4.6). Since 2012 gradual but continuous reductions of the base rate (measured by the three-month fixed rate deposit since 23 September 2015, replacing the two-week central bank deposit rate), from 7%

down to currently 1.05%, have contributed to the decline in the differential. As a result of this and given improving euro area financial market confidence since mid-2012, the long-term interest rate differential with respect to the AAA euro area yield stood at 2.8 percentage points at the end of the reference period.

Hungarian capital markets are much smaller than in the euro area and still underdeveloped (see Table 5.4.4). Stock market capitalisation, as a share of GDP, has declined in recent years, from above 20% of GDP before the crisis to 15% in 2015. Overall, equities do not play an important role in the financing of the Hungarian economy. Outstanding debt securities issued by non-financial institutions (a measure of market-based indebtedness) amounted to only 1.1% of GDP in 2015. The decline in debt securities issued by financial corporations also reflects continued deleveraging efforts in an environment characterised by a still relatively high level of non-performing loans. Integration of Hungary's financial sector with the euro area, as measured by the claims of euro area banks on Hungarian banks, is moderate, particularly following the deleveraging observed since 2008. However, the share of foreign ownership of the Hungarian banking system is significant. In addition, foreign participation in the Budapest Stock Exchange remains high. The degree of financial intermediation is low compared with the euro area average, despite Hungary's financial sector being well developed in comparison with its peers. A significant rebound in the financial intermediation capacity of Hungarian banks is being hampered by continued deleveraging and a number of policy measures weighing on banks' profits. MFI credit to non-government residents in 2015 stood at 39.0% of GDP, approximately 15 percentage points down from its 2012 level (see Table 5.4.4). The level of claims of euro area MFIs on resident MFIs has also decreased significantly, standing at 5.7% in 2015 compared with a euro area average of 27.4%.

Hungary - Price developments

Chart 5.4.1 HICP inflation and reference value ¹⁾
(annual percentage changes)



Sources: European Commission (Eurostat) and ECB calculations.

¹⁾ The basis of the calculation of the reference value for the period from May 2015 to April 2016 is the unweighted arithmetic average of the annual percentage changes in the HICP for Bulgaria, Slovenia and Spain plus 1.5 percentage points. The reference value is 0.7%.

Table 5.4.1 Measures of inflation and related indicators

(annual percentage changes, unless otherwise indicated)

	2006-2015 ¹⁾	2006-2010 ¹⁾	2011-2015 ¹⁾	2011	2012	2013	2014	2015	2016 ²⁾	2017 ²⁾
Measures of inflation										
HICP	3.8	5.3	2.3	3.9	5.7	1.7	0.0	0.1	0.4	2.3
HICP excluding unprocessed food and energy	3.5	4.3	2.8	3.0	5.0	3.0	1.6	1.3	1.5	2.4
HICP at constant tax rates ³⁾	3.1	4.5	1.6	3.7	3.5	1.2	0.0	0.0	-	-
CPI	3.8	5.4	2.2	3.9	5.7	1.7	-0.2	-0.1	0.4	2.3
Private consumption deflator	3.6	4.7	2.6	3.7	6.3	2.1	1.0	0.1	0.8	2.3
GDP deflator	3.4	4.0	2.8	2.2	3.5	3.1	3.2	1.8	2.4	2.5
Producer prices ⁴⁾	4.0	7.0	1.1	6.1	5.3	-0.5	-2.1	-3.0	-	-
Related indicators										
Real GDP growth	0.7	-0.2	1.7	1.8	-1.7	1.9	3.7	2.9	2.5	2.8
GDP per capita in PPS ⁵⁾ (euro area = 100)	59.6	58.1	61.6	60.4	60.2	62.0	63.7	-	-	-
Comparative price levels (euro area = 100)	61.1	62.9	58.8	60.0	59.9	58.5	56.7	-	-	-
Output gap ⁶⁾	-0.6	0.4	-1.5	-1.5	-3.3	-2.4	-0.7	0.1	0.5	1.0
Unemployment rate (%) ⁷⁾	9.1	8.8	9.4	11.0	11.0	10.2	7.7	6.8	6.4	6.1
Unit labour costs, whole economy	2.4	2.6	2.3	1.4	4.0	0.9	2.0	3.2	2.9	1.5
Compensation per employee, whole economy	2.7	3.3	2.2	3.1	2.1	1.8	0.9	3.3	4.6	4.3
Labour productivity, whole economy	0.3	0.6	0.0	1.7	-1.8	0.9	-1.1	0.1	1.6	2.7
Imports of goods and services deflator	1.6	1.7	1.5	4.9	4.1	-0.5	0.3	-1.0	-0.5	0.3
Nominal effective exchange rate ⁸⁾	-2.4	-2.0	-2.8	-0.8	-5.8	-0.8	-2.7	-3.7	-	-
Money supply (M3) ⁹⁾	5.5	7.5	3.6	2.1	0.1	6.2	2.9	6.8	-	-
Lending from banks ¹⁰⁾	-0.5	6.4	-6.9	-13.1	-5.5	-4.1	-3.5	-8.1	-	-
Stock prices (BUX) ¹¹⁾	15.1	2.6	12.2	-20.4	7.1	2.2	-10.4	43.8	-	-
Residential property prices ¹²⁾	0.0	-1.8	1.0	-3.4	-3.8	-2.6	4.3	11.5	-	-

Sources: European Commission (Eurostat, DG ECFIN), national data for CPI, money supply, lending from banks and residential property prices, and ECB calculations based on Thomson Reuters data for stock prices.

¹⁾ Multi-annual averages calculated using the geometric mean, except for GDP per capita in PPS, comparative price levels, output gap and unemployment rate, for which the arithmetic mean is used.

²⁾ Data from the European Commission's Spring 2016 Economic Forecast.

³⁾ The difference between the HICP and the HICP at constant tax rates shows the theoretical impact of changes in indirect taxes (e.g. VAT and excise duties) on the overall rate of inflation. This impact assumes a full and instantaneous pass-through of tax rate changes to the price paid by the consumer.

⁴⁾ Domestic sales, total industry excluding construction.

⁵⁾ PPS stands for purchasing power standards.

⁶⁾ Percentage difference of potential GDP: a positive (negative) sign indicates that actual GDP is above (below) potential GDP.

⁷⁾ Definition conforms to International Labour Organization guidelines.

⁸⁾ EER-38 group of trading partners. A positive (negative) sign indicates an appreciation (depreciation).

⁹⁾ The series includes repurchase agreements with central counterparties.

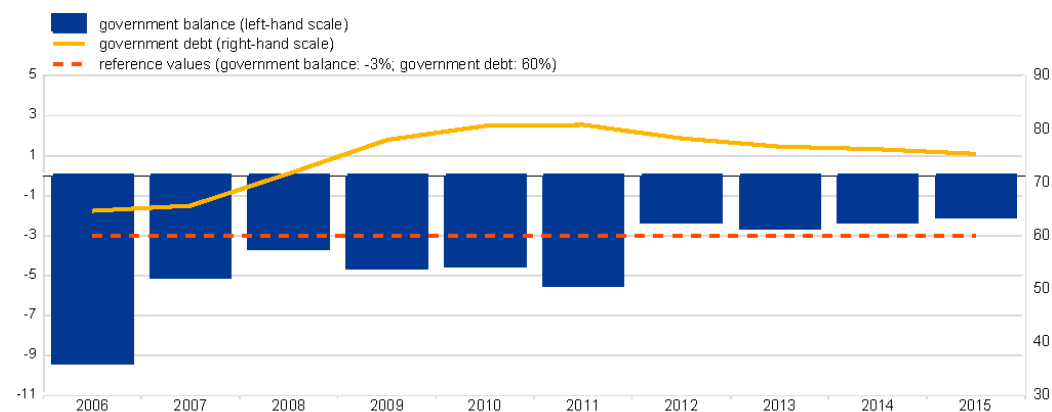
¹⁰⁾ Not adjusted for the derecognition of loans from the MFI statistical balance sheet due to their sale or securitisation.

¹¹⁾ Multi-annual and annual figures represent the percentage change between the end of the given period and the end of the previous period.

¹²⁾ Data available since 2007.

Hungary - Fiscal developments

Chart 5.4.2 General government balance and debt
(as a percentage of GDP)



Sources: European System of Central Banks and European Commission (Eurostat).

Table 5.4.2 Government budgetary developments and projections
(as a percentage of GDP, unless otherwise indicated)

	2006-2015 ¹⁾	2006-2010 ²⁾	2011-2015 ³⁾	2011	2012	2013	2014	2015	2016 ⁴⁾	2017 ⁵⁾	2018	2019
Government balance	-4.2	-5.4	-2.9	-5.5	-2.3	-2.6	-2.3	-2.0	-2.0	-2.0		
Total revenue	45.8	44.7	46.8	44.3	46.3	47.0	47.5	48.7	48.4	46.1		
Current revenue	43.8	43.6	44.0	42.1	44.2	44.4	44.6	44.7	44.3	43.9		
Direct taxes	8.1	9.4	6.7	6.3	6.8	6.6	6.8	6.9	7.2	7.0		
Indirect taxes	17.2	16.0	18.4	17.3	18.6	18.5	18.5	19.0	18.1	17.8		
Net social contributions	13.0	12.9	13.1	13.1	13.0	13.0	13.1	13.3	13.4	13.4		
Other current revenue ⁶⁾	5.5	5.3	5.8	5.3	5.8	6.4	6.1	5.5	5.6	5.6		
Capital revenue	2.0	1.1	2.8	2.2	2.1	2.6	3.0	4.0	2.1	2.2		
Total expenditure	49.9	50.2	49.7	49.7	48.6	49.6	49.8	50.7	48.4	48.1		
Current expenditure	43.8	44.7	43.0	43.5	43.3	43.8	42.9	41.3	41.3	40.5		
Compensation of employees	10.8	11.4	10.3	10.2	10.0	10.1	10.4	10.7	11.0	10.9		
Social benefits	18.5	19.2	17.8	19.0	18.5	18.2	17.1	16.4	14.8	14.3		
Interest payable	4.2	4.1	4.2	4.2	4.6	4.5	4.0	3.6	3.1	3.0		
Other current expenditure ⁶⁾	10.3	9.8	10.7	10.2	10.3	11.0	11.4	10.6	12.4	12.4		
Capital expenditure	6.1	5.5	6.7	6.3	5.3	5.9	6.9	9.4	7.1	7.5		
of which: Investment	4.3	4.0	4.7	3.4	3.7	4.4	5.5	6.7	5.5	5.3		
Cyclically adjusted balance	-3.9	-5.6	-2.2	-4.7	-0.7	-1.4	-1.9	-2.1	-2.2	-2.5		
One-off and temporary measures	.	.	0.2	-0.2	0.7	0.1	0.3	0.0	0.7	0.0		
Structural balance ⁷⁾			-2.3	-4.5	-1.4	-1.5	-2.2	-2.0	-2.9	-2.5		
Government debt	74.8	72.1	77.5	80.8	78.3	76.8	76.2	75.3	74.3	73.0		
Average residual maturity (in years)	4.6	4.6	4.5	4.9	4.5	4.6	4.5	4.2				
In foreign currencies (% of total)	40.7	38.8	42.5	51.8	43.4	42.1	39.8	35.3				
of which: Euro	39.4	37.2	41.6	49.7	41.7	41.5	39.8	35.3				
Domestic ownership (% of total)	45.3	48.1	42.5	34.9	38.2	42.4	45.5	51.6				
Medium and long-term maturity (% of total) ⁸⁾	87.0	87.6	86.5	89.4	86.3	85.3	86.3	84.9				
of which: Variable interest rate (% of total)	5.8	4.0	7.7	4.5	4.4	5.5	11.6	12.4				
Deficit-debt adjustment	0.1	0.9	-0.6	-2.2	-3.4	-0.4	2.2	0.6				
Net acquisitions of main financial assets	0.4	0.4	0.5	4.4	-0.7	-1.6	0.8	-0.6				
Currency and deposits	0.3	0.7	-0.2	0.5	0.4	-1.4	0.7	-0.9				
Debt securities	0.0	0.0	0.0	0.2	0.1	0.3	-0.4	0.0				
Loans	-0.1	0.1	-0.2	-0.5	-0.4	0.0	0.0	0.0				
Equity and investment fund shares or units	0.2	-0.4	0.8	4.3	-0.7	-0.4	0.4	0.3				
Revaluation effects on debt	0.7	0.5	0.9	4.8	-2.4	0.7	1.3	0.2				
of which: Foreign exchange holding												
gains/losses	0.8	0.5	1.0	4.8	-2.4	0.7	1.6	0.3				
Other ⁹⁾	-1.0	0.0	-2.0	-11.4	-0.3	0.5	0.1	1.0				
Convergence programme: government balance	-	-	-	-	-	-	-	-	-1.9	-2.4	-1.8	-1.5
Convergence programme: structural balance	-	-	-	-	-	-	-	-	-2.1	-2.1	-1.7	-1.5
Convergence programme: government debt	-	-	-	-	-	-	-	-	74.5	73.6	72.4	68.4

Sources: European System of Central Banks and European Commission (Eurostat, DG ECFIN).

1) Multi-annual averages.

2) Data from the European Commission's Spring 2016 Economic Forecast, except for convergence programme data.

3) Sales and other current revenue.

4) Intermediate consumption, subsidies payable and other current expenditure.

5) Cyclically-adjusted balance excluding one-off and other temporary measures.

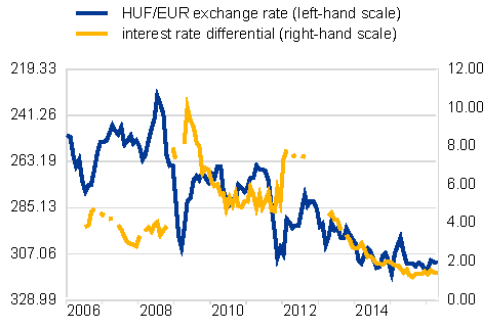
6) Original maturity of more than one year.

7) Time of recording differences and other discrepancies (sector reclassifications and statistical discrepancies).

Hungary - Exchange rate and external developments

Chart 5.4.3 Bilateral exchange rate and short-term interest rate differential

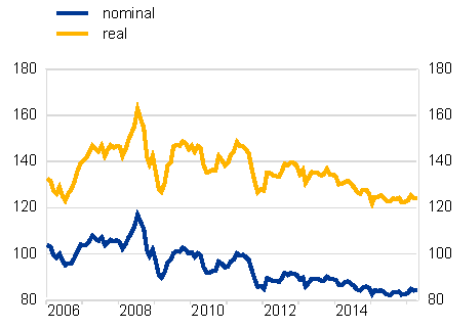
(HUF/EUR exchange rate: monthly averages; difference between three-month interbank interest rates and three-month EURIBOR: basis points, monthly values)



Sources: National data and ECB calculations.

Chart 5.4.4 Effective exchange rates ¹⁾

(EER-38 group of trading partners; monthly averages; base index: Q1 1999 = 100)



Source: ECB.

1) The real EER-38 is CPI deflated. An increase (decrease) in the EER indicates an appreciation (depreciation).

Table 5.4.3 External developments

(as a percentage of GDP, unless otherwise indicated)

	2008-2015 ⁵⁾	2008-2010 ⁵⁾	2011-2015 ⁵⁾	2011	2012	2013	2014	2015	2016 ³⁾	2017 ³⁾
Balance of payments										
Current account and capital account balance ⁴⁾	3.3	-0.9	5.9	3.1	4.3	7.6	5.7	8.7	7.7	7.7
Current account balance	0.6	-2.5	2.5	0.8	1.7	3.9	2.0	4.2	5.0	4.5
Goods	2.5	1.5	3.1	2.9	2.9	3.4	2.4	3.9	.	.
Services	3.2	1.7	4.1	3.3	3.8	3.9	4.7	4.7	.	.
Primary income	-4.4	-5.1	-4.0	-4.8	-4.2	-2.8	-4.5	-3.7	.	.
Secondary income	-0.7	-0.6	-0.7	-0.6	-0.8	-0.5	-0.7	-0.7	.	.
Capital account balance	2.7	1.6	3.3	2.3	2.5	3.6	3.7	4.5	.	.
Combined direct and portfolio investment balance ⁴⁾	-1.0	0.7	-2.0	-7.7	-3.7	-3.0	0.2	4.2	.	.
Direct investment	-1.5	-1.5	-1.5	-1.4	-2.2	-0.1	-2.8	-1.0	.	.
Portfolio investment	0.5	2.2	-0.5	-6.3	-1.5	-3.0	3.0	5.2	.	.
Other investment balance	1.3	-8.6	7.3	3.7	12.1	8.7	3.4	8.4	.	.
Reserve assets	-	-	-0.4	3.9	-3.3	1.1	0.7	-4.5	.	.
Exports of goods and services	85.0	78.9	88.7	87.3	86.7	88.0	89.5	92.1	.	.
Imports of goods and services	79.3	75.6	81.5	81.1	80.0	80.7	82.3	83.5	.	.
Net international investment position ⁴⁾	-92.2	-108.0	-82.7	-94.5	-93.0	-83.5	-73.9	-68.6	.	.
Gross external debt ⁴⁾	153.8	162.3	148.8	161.5	158.0	145.5	145.0	133.8	.	.
Internal trade with the euro area ⁴⁾										
Exports of goods and services	56.4	57.0	56.0	55.9	56.3	55.8	56.5	55.6	.	.
Imports of goods and services	55.3	53.7	56.2	54.1	55.8	55.7	57.8	57.8	.	.
Investment position with the euro area ⁴⁾										
Direct investment assets ⁴⁾	39.3	46.1	35.2	39.6	35.0	36.1	32.9	32.7	.	.
Direct investment liabilities ⁴⁾	56.0	55.7	56.1	55.1	54.4	56.3	55.7	59.0	.	.
Portfolio investment assets ⁴⁾	65.5	63.8	66.6	64.6	64.3	67.5	71.2	65.2	.	.
Portfolio investment liabilities ⁴⁾	48.8	56.4	44.2	50.4	45.3	45.2	41.9	38.1	.	.

Sources: European System of Central Banks and European Commission (Eurostat, DG ECFIN).
Note: Backdata are available from 2008.

1) Multi-annual averages.

2) Data from the European Commission's Spring 2016 Economic Forecast.

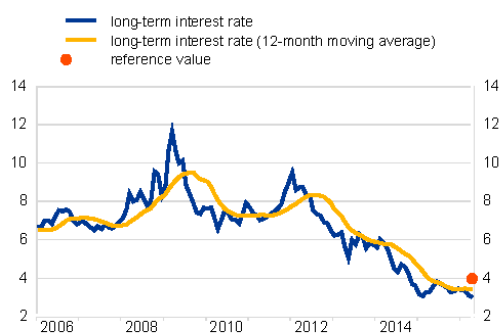
3) Differences between totals and sum of their components are due to rounding.

4) End-of-period outstanding amounts.

5) As a percentage of the total.

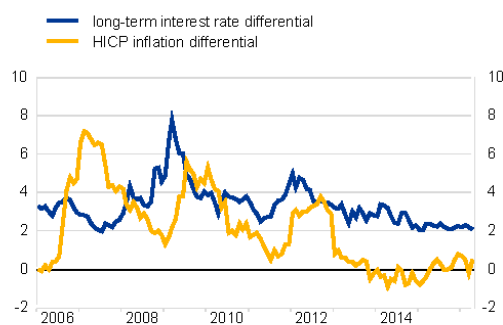
Hungary - Long-term interest rate developments

Chart 5.4.5 Long-term interest rate ¹⁾
(monthly averages in percentages)



Sources: European System of Central Banks and ECB calculations.
1) The basis of the calculation of the reference value for the period from May 2015 to April 2016 is the unweighted arithmetic average of the interest rate levels in Bulgaria, Slovenia and Spain plus 2 percentage points. The reference value is 4.0%.

Chart 5.4.6 Long-term interest rate and HICP inflation differentials vis-à-vis the euro area
(monthly averages in percentage points)



Sources: European System of Central Banks, ECB calculations and European Commission (Eurostat).

Table 5.4.4 Long-term interest rates and indicators of financial development and integration
(as a percentage of GDP, unless otherwise indicated)

	2006-2015 ¹⁾	2006-2010 ²⁾	2011-2015 ³⁾	2012	2013	2014	2015	May 2015 to Apr. 2016	Memo item: euro area 2015
Long-term interest rates									
Hungary ²⁾	6.8	7.7	5.9	7.9	5.9	4.8	3.4	3.4	-
Euro area ^{2),3)}	3.4	4.0	2.9	3.9	3.0	2.0	1.2	1.2	-
Euro area AAA par curve, ten-year residual maturity ^{2),3)}	2.8	3.8	1.8	2.1	1.9	1.4	0.6	0.6	-
Indicators of financial development and integration									
Debt securities issued by financial corporations ⁴⁾	19.0	19.0	19.0	24.0	27.3	9.3	9.7	-	73.6
Debt securities issued by non-financial corporations ⁵⁾	1.7	1.5	1.9	2.2	2.0	2.0	1.1	-	10.8
Stock market capitalisation ⁶⁾	19.3	24.1	14.6	16.0	14.2	11.8	15.0	-	60.4
MFI credit to non-government residents ⁷⁾	56.4	62.5	50.2	54.2	48.8	45.1	39.0	-	114.7
Claims of euro area MFIs on resident MFIs ⁸⁾	17.2	22.6	11.8	13.5	11.6	8.0	5.7	-	27.4

Sources: European System of Central Banks and ECB calculations.
1) Multi-annual averages calculated using the arithmetic average.
2) Average interest rate.
3) Included for information only.
4) Outstanding amount of debt securities issued by resident MFIs and other financial corporations.
5) Outstanding amount of debt securities issued by resident non-financial corporations.
6) Outstanding amount of listed shares issued by residents at the end of the period at market values.
7) MFI (excluding NCB) credit to domestic non-MFI residents other than general government. Credit includes outstanding amounts of loans and debt securities.
8) Outstanding amount of deposits and debt securities issued by domestic MFIs (excluding the NCB) held by euro area MFIs as a percentage of total liabilities of domestic MFIs (excluding the NCB). Total liabilities exclude capital and reserves and remaining liabilities.

5.5 Poland

5.5.1 Price developments

In April 2016 the 12-month average rate of HICP inflation in Poland was -0.5%, i.e. well below the reference value of 0.7% for the criterion on price stability (see Chart 5.5.1). This rate is expected to increase over the coming months.

Over the past ten years the 12-month average rate of HICP inflation has fluctuated within a relatively wide range, from -0.7% to 4.3%, and the average for that period was moderate, standing at 2.3%. During the period 2006-08 HICP inflation followed an upward trend, reaching levels of over 4%. To a large extent, this was due to stronger growth in unit labour costs and changes to administered prices, as well as the global food and energy price shock. In 2006 and 2007 real GDP expanded at an annual rate of well above 6% and the unemployment rate declined to historically low levels. A relatively short-lived economic slowdown – Poland was the only EU Member State that avoided a decline in output in 2009 – and lower global commodity prices resulted in a temporary fall in annual HICP inflation, to levels slightly below 2% in the summer of 2010. Thereafter, inflationary pressures re-emerged, supported by the robust recovery in economic activity and a hike in the value added tax rate in 2011. As a result, Narodowy Bank Polski had to increase interest rates over the period from 2011 to mid-2012. In 2012 the Polish economy slowed on account of weak domestic demand and unfavourable external conditions. The weakening of domestic economic activity, along with a significant fall in global commodity prices, contributed to a sharp decline in inflation over the period 2013-15. In 2015 the average annual rate of HICP inflation stood at -0.7% (see Table 5.5.1), despite the stronger growth in real GDP growth since mid-2013 and notwithstanding the fact that Narodowy Bank Polski cut its main policy rate to a historical low of 1.50%.

For the first four months of 2016, the average annual rate of HICP inflation stood at -0.4%. This historically low level of inflation largely reflects the decline in global commodity prices over the past year. At the same time, however, domestic price pressures remained subdued. This is reflected in the very low levels of HICP inflation excluding unprocessed food and energy.

Policy choices have played an important role in shaping inflation dynamics in Poland over the past decade, most notably the orientation of monetary policy towards price stability. Narodowy Bank Polski operates a floating exchange rate system and since 1999 has had an inflation-targeting monetary policy framework in place. The medium-term CPI inflation target has been 2.5% (± 1 percentage point) since 2004. Inflation developments have been broadly supported by a number of reforms designed to strengthen financial market stability, increase labour market flexibility and enhance product market competition.

Inflation is expected to increase in the coming years, albeit remaining at a moderate level; over the longer term, there are concerns regarding the

sustainability of inflation convergence in Poland. According to the European Commission's Spring 2016 Economic Forecast, average annual inflation is projected to increase, reaching 1.6% in 2017. Relatively strong real GDP growth and further declines in the unemployment rate are likely to support a gradual pick-up in inflation towards the lower bound of the range of the central bank's inflation target. Risks to the inflation outlook are broadly balanced. Downside risks relate to the heightened uncertainty regarding developments in the global economy, which could reduce external price pressures, while upside risks may arise from stronger than expected wage pressures on the back of tightening labour market conditions. Looking further ahead, the catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area, given that GDP per capita and price levels are still lower in Poland than in the euro area. In order to prevent the build-up of excessive price pressures and macroeconomic imbalances, the catching-up process must be supported by appropriate policies.

Achieving an environment that is conducive to sustainable convergence in Poland requires stability-oriented economic policies and targeted structural reforms. Although the Polish economy managed to weather the global financial crisis comparatively well, a number of structural issues remain unresolved. In order to enhance potential growth and resource allocation, efforts are needed to boost competition in product markets and speed up innovation, privatisation and infrastructure modernisation. Improvements in the business environment could help to attract private investment. In the labour market, a number of structural weaknesses need to be addressed, for example, by strengthening vocational education and reducing labour market mismatches, as well as by boosting the labour force participation rate. It is also essential that structural reforms are carried out to tackle disincentives to work, particularly those resulting from income taxation and pension schemes. With regard to macroeconomic imbalances, the European Commission did not select Poland for an in-depth review in its Alert Mechanism Report 2016.

Financial sector policies should be geared to safeguarding financial stability and ensuring that the financial sector makes a sound contribution to economic growth. In view of the tax on financial institutions' assets that was introduced in February 2016 and the possible regulation on the conversion of foreign exchange-denominated mortgage loans, it is essential to preserve the currently strong financial position of the banking sector. This would ensure the supply of credit to the real economy. Improvements are needed in terms of the completion of the legislation on recovery and resolution mechanisms.

5.5.2 Fiscal developments

Poland's government deficit and debt complied with the Maastricht criteria in 2015. In the reference year 2015 the general government budget balance recorded a deficit of 2.6% of GDP, i.e. below the 3% reference value. The general government gross debt-to-GDP ratio was 51.3%, i.e. below the 60% reference value (see Table 5.5.2). Compared with the previous year, the deficit ratio fell by 0.7 percentage point

of GDP. By contrast, the debt ratio increased by 0.8 percentage point. The deficit ratio is forecast by the European Commission to remain at the same level in 2016, before edging up to 3.1% in 2017 on the basis of unchanged policies. The debt-to-GDP ratio is projected to continue to increase, reaching 52.7% in 2017. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2015, nor is it expected to do so in 2016.

Poland has been subject to the preventive arm of the Stability and Growth Pact since 2015. Against the background of the rise in the budget deficit in excess of the reference value in 2008, the ECOFIN Council decided on 7 July 2009 that an excessive deficit situation existed in Poland and set 2012 as the deadline for correcting it. This was extended to 2014 on 21 June 2013 and by a further year, to 2015, on 10 December 2013. It was noted that Poland had not taken effective action in response to the Council's 21 June 2013 recommendation. The ECOFIN Council abrogated the excessive deficit procedure on 19 June 2015, one year earlier than the extended deadline. While the deficit amounted to 3.3% of GDP in 2014, i.e. above the 3% of GDP reference value, the Council found Poland to be eligible for specific provisions under the excessive deficit procedure that deal with systemic pension reforms. The European Commission's Spring 2016 Economic Forecast points to risks of a significant deviation from the adjustment path towards the medium-term objective both in 2016 and, under unchanged policies, in 2017.

The reduction in the deficit in recent years is attributable to the improvement in the structural position. The deficit ratio declined from its peak of 7.5% of GDP in 2010 to 2.6% of GDP in 2015. The structural balance according to European Commission estimates (presented in Table 5.5.2) improved even further, while the cyclical component of the deficit deteriorated slightly. The improvement in the structural balance reflects substantial expenditure-based consolidation, driven by broad-based restraint in current spending and a reduction in public investment towards its historical average. Some fiscal measures on the revenue side, such as VAT and social security contribution rate increases, as well as modifications to the pension system with a positive budgetary impact, supported the improvement. In addition, the fiscal adjustment benefited from a considerable reduction in the interest payment bill in relation to GDP.

The debt-to-GDP ratio increased to a limited degree during the early years of the crisis to move closer to the 60% reference value, but decreased more recently. The debt ratio increased by about 5 percentage points in 2010-11, reaching around 55% of GDP. This was attributable to sizeable primary deficits recorded on the back of relatively high capital expenditure related to the absorption of EU structural funds. The debt ratio fell markedly (by more than 5 percentage points) in 2014 on account of a negative deficit-debt adjustment. This reflected the impact of the changes to the pension system, which involved a one-off transfer of government debt from private pension funds to the public sector, partly reversing previous pension reforms. The government has not reported any contingent liabilities related to the financial sector.

The structure of government debt exposes Poland to changes in interest rates and exchange rate fluctuations to some extent. The share of short-term maturity

debt in total government debt is negligible (0.8% in 2015 – see Table 5.5.2). A proportion of long-term debt (around 20% in 2015) is subject to a variable interest rate. Overall, taking both characteristics and the level of the debt-to-GDP ratio into consideration, the budget balance remains relatively sensitive to changes in interest rates. The share of foreign currency-denominated government debt is significant (35% in 2015), with around 75% denominated in euro. As a result, and accounting for the debt-to-GDP ratio, the fiscal balance is relatively sensitive to exchange rate fluctuations.

The European Commission's Spring 2016 Economic Forecast points to the risk of a significant deviation from the adjustment path towards the medium-term objective. The European Commission's Spring 2016 Economic Forecast points to a deterioration in the structural balance of 0.7 percentage point of GDP in 2016. This represents a significant deviation from the improvement of 0.5 percentage point of GDP that is required under the preventive arm. Moreover, the deficit ratio projected for 2017 exceeds the reference value of 3%. The Polish government's plans that were presented in the 2016 Convergence Programme update assume that the deficit ratio will remain below 3%. However, the structural adjustment will be in line with the requirements only in the later years (i.e. 2018-19). Furthermore, according to the government's projections, Poland is not expected to achieve by 2019 its medium-term objective of a structural balance amounting to -1.0% of GDP. The fiscal strategy is not yet fully underpinned by specific measures.

The Polish fiscal framework has strong features, but its effectiveness would benefit from stronger implementation in practice. The constitutional debt rule with triggers for corrective action provides a legal safeguard against exceeding the 60% reference value. Medium-term budgetary planning is based on the Multiannual State Financial Plan, which covers four years and constitutes the basis for annual budget preparation. In addition, a permanent expenditure rule came into force in 2015. This rule limits the growth of public spending to trend GDP growth, or below if government debt is above pre-specified thresholds. However, its effectiveness remains to be seen, especially in view of recent amendments allowing a less restrictive fiscal policy in an environment of low inflation. Unlike most EU countries, Poland does not have an independent fiscal council. However, in line with the provisions of the Fiscal Compact, Poland should, before joining the euro area, put in place the role and independence of the institutions responsible at national level for monitoring compliance with EU fiscal rules.

Over the medium and long term, Poland faces medium risks to fiscal sustainability. The analysis laid out in the European Commission's 2015 Fiscal Sustainability Report points to medium risk over the medium and long term. This stems largely from an unfavourable initial budgetary position and the necessity to meet future increases in strictly age-related costs. The latter, according to the 2015 Ageing Report,¹¹⁹ are projected to rise moderately (by 1.3 percentage points) by 2060 in the AWG reference scenario, increasing from a level of 20.7% of GDP in

¹¹⁹ European Commission and Economic Policy Committee, "The 2015 Ageing Report: Economic and budgetary projections for the EU-28 Member States (2013-2060)".

2013. In the AWG risk scenario, the ageing costs increase significantly in the same time interval (by 3.3 percentage points of GDP), albeit by less than the EU average increase of 3.8 percentage points. The expected increase is entirely driven by healthcare and long-term care spending, whereas pension expenditure and education spending act as mitigating factors. These developments signal the need for reforms in order to address the expected spending pressures.

The favourable medium-term macroeconomic outlook should be used to build up fiscal buffers and introduce the necessary reforms. Poland should ensure compliance with the provisions of the preventive arm of the Pact and make adequate progress towards the medium-term objective. The role and independence of the national institutions that monitor compliance with the EU fiscal rules should be improved. There is significant room for broadening tax bases and boosting tax compliance. On the spending side, the strategy should focus on improving expenditure efficiency through spending reviews and better-targeted benefits. Finally, there is a need for reform to curb projected increases in healthcare and long-term care spending.

5.5.3 Exchange rate developments

In the two-year reference period from 19 May 2014 to 18 May 2016, the Polish zloty did not participate in ERM II, but traded under a flexible exchange rate regime. Over the reference period the Polish zloty at times traded below its May 2014 average exchange rate against the euro of 4.1800 zlotys per euro, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate (see Chart 5.5.3). On 18 May 2016 the exchange rate stood at 4.3885 zlotys per euro, i.e. 5.0% weaker than its average level in May 2014. Over the reference period the maximum upward deviation from this benchmark was 5.1%, while the maximum downward deviation amounted to 7.5%. Looking back over a longer period the exchange rate of the Polish zloty against the euro has depreciated by 12.7% over the past ten years.

The exchange rate of the Polish zloty against the euro exhibited, on average, a relatively high degree of volatility over the reference period. Volatility increased at the beginning of 2015, which coincided with monetary policy decisions in the country's key trading partners and their subsequent impact on financial markets, and it remained elevated in the first half of 2015. The Polish zloty appreciated against the euro rapidly up to mid-April 2015, a trend that was fully reversed during the following two months. Overall, since mid-2015, the Polish zloty weakened gradually against the euro, partly as the positive interest rate differential vis-à-vis euro area assets declined. The Polish currency may also have been affected by rising global financial market volatility, concerns regarding developments in emerging market economies and the increase in interest rates by the Federal Reserve System at the end of 2015. This has been in contrast to a relatively strong and resilient macroeconomic performance by the Polish economy over this period. Over the reference period short-term interest rate differentials against the three-month EURIBOR remained at relatively wide levels, on average, on account of higher monetary policy rates in

Poland than in the euro area. However, the spreads decreased from 2.4 percentage points in the three-month period ending in September 2014 to 1.9 percentage points in the three-month period ending in March 2016 amid two interest rate cuts by Narodowy Bank Polski. A Flexible Credit Line (FCL) arrangement by the IMF, which can be obtained by countries with very strong economic fundamentals and a good policy track record, has been in place since mid-2009. The latest two-year FCL arrangement was approved in January 2015 for an amount of SDR 15.51 billion, which was confirmed in January 2016, but for a lower amount of SDR 13 billion, as a way of providing adequate insurance against external risks, while sending a signal of their intention to gradually exit the FCL as conditions allow. Poland has not received any disbursements since its establishment. As this arrangement helped to reduce risks related to financial vulnerabilities, it might also have contributed to reducing the risk of exchange rate pressures.

The real effective exchange rate of the Polish zloty has depreciated overall over the past ten years (see Chart 5.5.4). However, this indicator should be interpreted with caution, as during this period Poland was subject to a process of economic convergence, which complicates any historical assessment of real exchange rate developments.

Poland's current and capital account has improved over the past decade, while the country's net foreign liabilities remain high (see Table 5.5.3). Following relatively large deficits over the period 2008-12, the current and capital account subsequently recorded a small surplus. This mostly reflected improvement in the goods and services balance on account of strengthening exports. On the financing side, Poland received net inflows in direct and portfolio investment from 2008 to 2015. Against this background, gross external debt increased over this period, reaching 70.3% of GDP in 2015. At the same time Poland's net international investment position deteriorated substantially to a very high level of -60.7% of GDP in 2015. Fiscal and structural policies therefore continue to be important for supporting external sustainability and the competitiveness of the economy.

The Polish economy is well integrated with the euro area through trade and investment linkages. In 2015 exports of goods and services to the euro area constituted 56.5% of total exports, while the corresponding figure for imports was slightly higher, at 58.2%. The share of the euro area in Poland's stock of inward direct investment stood at 77.5% in 2015 and its share in the country's stock of portfolio investment liabilities was 37.2% in 2015. The share of Poland's stock of foreign assets invested in the euro area amounted to 67.5% in the case of direct investment and 58.2% in the case of portfolio investment in 2015.

5.5.4 Long-term interest rate developments

Over the reference period from May 2015 to April 2016, long-term interest rates in Poland were 2.9% on average and thus below the 4.0% reference value for the interest rate convergence criterion (see Chart 5.5.5).

Long-term interest rates in Poland have been on a declining trend since 2011 as 12-month moving average rates more than halved from approximately 6% to under 3% at the end of the reference period. After hovering around 6% in the years between 2008 and 2011 (see Chart 5.5.5), Polish long-term interest rates declined in an environment where rates globally were also falling. In addition, in 2011 and 2012, the relative resilience of the Polish economy and a stable credit rating at the time may have contributed to the fall in Polish interest rates.

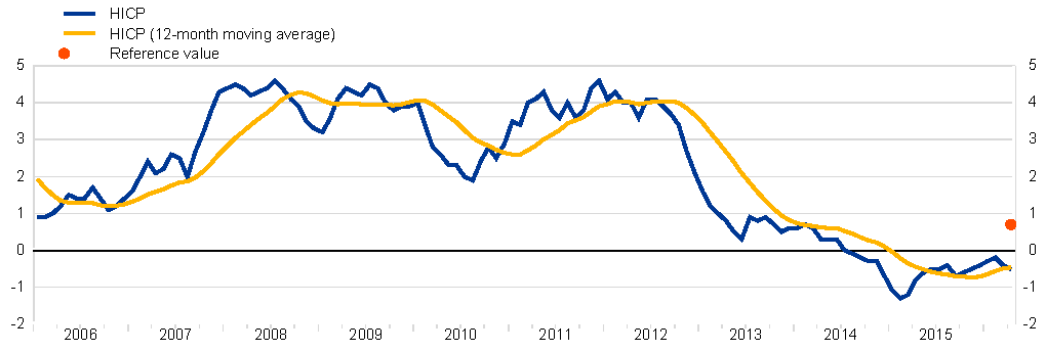
Poland's long-term interest rate differential vis-à-vis the euro area has exhibited a high degree of stability over the past decade. In fact, the rate differential has moved within a band of between approximately 1 and 2 percentage points for most of the period since 2006 (see Chart 5.5.6). It was only in 2009 and 2010 that the differential with the euro area consistently exceeded 2 percentage points, peaking at about 2.6 percentage points towards the end of 2009. With the subsequent reductions in Poland's long-term interest rates between 2011 and 2013 being somewhat more pronounced than in the euro area, the interest rate differential reached a low point of 0.6 percentage points in the spring of 2013. It has increased since then, following the end of the previous easing cycle amid expectations of a gradual economic recovery. However, at 2.0 percentage points, the differential continues to be at levels comparable to those observed over the past ten years (for comparison, the differential vis-à-vis the euro area AAA yield stood at 2.7 percentage points).

At the end of 2015 Poland's capital market was smaller and much less developed than the euro area average. While both corporate debt and equity markets were smaller relative to GDP than in the euro area, bond issuance by financial corporations was particularly low at 7.7% of GDP compared with more than 70% in the euro area (see Table 5.5.4). At the same time, the gap vis-à-vis the euro area in terms of equity market capitalisation was less pronounced (28.5% in Poland compared with 60.4% in the euro area). Integration of the Polish financial sector with the euro area, as measured by the claims of euro area banks on Polish banks, is limited. Claims of euro area MFIs accounted for 5.4% of Polish banks' liabilities at the end of 2015 (see Table 5.5.4). Poland's banking sector is smaller and less developed than that of the euro area but, at the same time, is well integrated into the EU financial system. MFIs had extended the equivalent of 57.2% of GDP in credit to the private sector by the end of 2015 (compared with 114.7% in the euro area), with European banks accounting for a major part of those loans.

Poland - Price developments

Chart 5.5.1 HICP inflation and reference value ¹⁾

(annual percentage changes)



Sources: European Commission (Eurostat) and ECB calculations.

¹⁾ The basis of the calculation of the reference value for the period from May 2015 to April 2016 is the unweighted arithmetic average of the annual percentage changes in the HICP for Bulgaria, Slovenia and Spain plus 1.5 percentage points. The reference value is 0.7%.

Table 5.5.1 Measures of inflation and related indicators

(annual percentage changes, unless otherwise indicated)

	2006-2015 ¹⁾	2006-2010 ²⁾	2011-2015 ³⁾	2011	2012	2013	2014	2015	2016 ⁴⁾	2017 ⁵⁾
Measures of inflation										
HICP	2.2	2.9	1.5	3.9	3.7	0.8	0.1	-0.7	0.0	1.6
HICP excluding unprocessed food and energy	1.9	2.3	1.5	3.1	2.8	1.0	0.6	0.3	0.6	1.6
HICP at constant tax rates ⁶⁾	1.8	2.5	1.2	3.1	3.4	0.5	-0.3	-0.7	-	-
CPI	2.3	2.9	1.7	4.3	3.7	0.9	0.0	-0.9	0.0	1.6
Private consumption deflator	2.1	2.7	1.4	4.9	3.4	0.4	-0.2	-1.2	0.0	1.6
GDP deflator	2.2	3.1	1.4	3.2	2.4	0.4	0.5	0.4	0.2	1.3
Producer prices ⁷⁾	2.5	3.8	1.2	7.6	3.6	-1.2	-1.4	-2.4	-	-
Related indicators										
Real GDP growth	3.8	4.7	2.9	5.0	1.6	1.3	3.3	3.6	3.7	3.6
GDP per capita in PPS ⁸⁾ (euro area = 100)	56.0	51.5	61.8	59.5	61.9	62.4	63.4	-	-	-
Comparative price levels (euro area = 100)	58.4	60.8	55.5	56.9	55.2	54.8	55.0	-	-	-
Output gap ⁹⁾	0.9	1.8	0.0	2.3	0.4	-1.2	-1.0	-0.5	0.0	0.4
Unemployment rate (%) ¹⁰⁾	9.5	9.7	9.3	9.7	10.1	10.3	9.0	7.5	6.8	6.3
Unit labour costs, whole economy	1.6	2.9	0.3	0.9	2.1	0.3	0.1	-1.8	0.8	1.3
Compensation per employee, whole economy	4.2	5.9	2.5	5.3	3.6	1.7	1.6	0.4	3.8	4.3
Labour productivity, whole economy	2.5	2.9	2.2	4.4	1.4	1.3	1.5	2.2	3.0	3.0
Imports of goods and services deflator	2.3	2.9	1.8	8.5	5.1	-1.1	-1.9	-1.3	0.0	1.9
Nominal effective exchange rate ¹¹⁾	-0.5	0.3	-1.2	-2.7	-3.8	1.5	1.7	-2.5	-	-
Money supply (M3) ¹²⁾	10.4	13.1	7.9	10.8	5.6	6.2	7.8	8.9	-	-
Lending from banks ¹³⁾	12.5	19.8	5.7	5.9	7.3	4.0	5.4	5.8	-	-
Stock prices (Warsaw General Index) ¹⁴⁾	30.5	33.4	-2.2	-20.8	26.2	8.1	0.3	-9.6	-	-
Residential property prices ¹⁵⁾	-1.1	-	-1.1	0.1	-3.5	-4.4	1.0	1.5	-	-

Sources: European Commission (Eurostat, DG ECFIN), national data for CPI, money supply, lending from banks and residential property prices, and ECB calculations based on Thomson Reuters data for stock prices.

¹⁾ Multi-annual averages calculated using the geometric mean, except for GDP per capita in PPS, comparative price levels, output gap and unemployment rate, for which the arithmetic mean is used.

²⁾ Data from the European Commission's Spring 2016 Economic Forecast.

³⁾ The difference between the HICP and the HICP at constant tax rates shows the theoretical impact of changes in indirect taxes (e.g. VAT and excise duties) on the overall rate of inflation. This impact assumes a full and instantaneous pass-through of tax rate changes to the price paid by the consumer.

⁴⁾ Domestic sales, total industry excluding construction.

⁵⁾ PPS stands for purchasing power standards.

⁶⁾ Percentage difference of potential GDP: a positive (negative) sign indicates that actual GDP is above (below) potential GDP.

⁷⁾ Definition conforms to International Labour Organization guidelines.

⁸⁾ EER-38 group of trading partners. A positive (negative) sign indicates an appreciation (depreciation).

⁹⁾ The series includes repurchase agreements with central counterparties.

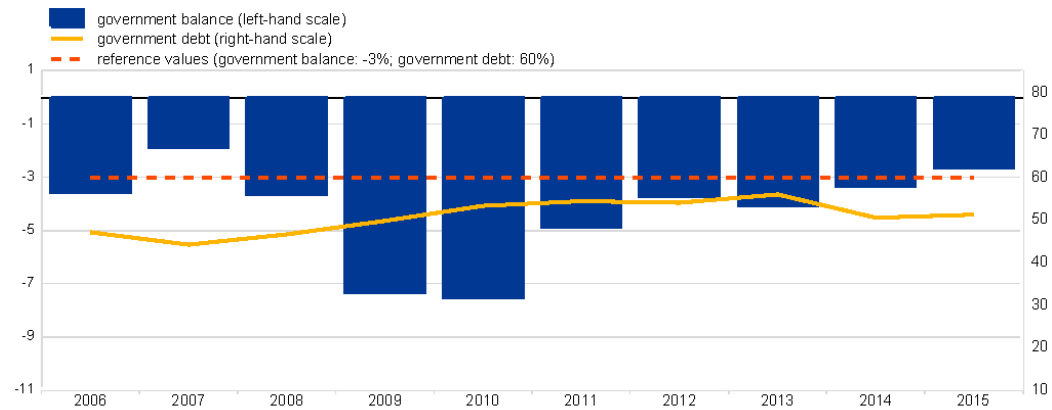
¹⁰⁾ Not adjusted for the derecognition of loans from the MFI statistical balance sheet due to their sale or securitisation.

¹¹⁾ Multi-annual and annual figures represent the percentage change between the end of the given period and the end of the previous period.

¹²⁾ Data available since 2010.

Poland - Fiscal developments

Chart 5.5.2 General government balance and debt
(as a percentage of GDP)



Sources: European System of Central Banks and European Commission (Eurostat).

Table 5.5.2 Government budgetary developments and projections

(as a percentage of GDP, unless otherwise indicated)

	2006-2015 *	2006-2010 *	2011-2015 *	2011	2012	2013	2014	2015	2016 ²	2017 ²	2018	2019
Government balance	-4.2	-4.8	-3.7	-4.9	-3.7	-4.0	-3.3	-2.6	-2.6	-3.1		
Total revenue	39.3	39.9	39.7	38.8	38.9	38.4	38.9	38.9	39.1	39.1		
Current revenue	38.4	39.2	37.5	37.0	37.6	37.4	37.7	37.8	38.1	37.8		
Direct taxes	7.2	7.6	6.9	6.7	6.9	6.8	6.9	6.9	7.1	7.2		
Indirect taxes	13.5	13.9	13.0	13.7	12.9	12.8	12.8	12.9	13.0	12.7		
Net social contributions	12.7	12.4	13.0	12.1	12.9	13.3	13.2	13.6	13.7	13.7		
Other current revenue ³	5.0	5.3	4.6	4.6	4.8	4.6	4.7	4.4	4.4	4.3		
Capital revenue	1.0	0.7	1.3	1.7	1.3	1.0	1.2	1.1	1.0	1.3		
Total expenditure	43.6	44.7	42.4	43.6	42.6	42.4	42.2	41.5	41.7	42.2		
Current expenditure	38.3	39.1	37.5	37.3	37.6	38.1	37.4	36.8	37.6	37.4		
Compensation of employees	10.6	10.8	10.4	10.5	10.3	10.4	10.4	10.2	10.1	10.1		
Social benefits	16.2	16.4	16.0	15.5	15.8	16.3	16.2	16.3	17.1	17.2		
Interest payable	2.3	2.3	2.3	2.5	2.7	2.5	1.9	1.8	1.7	1.5		
Other current expenditure ⁴	9.1	9.5	8.8	8.7	8.8	8.9	8.9	8.5	8.6	8.5		
Capital expenditure	5.3	5.6	5.0	6.3	5.0	4.3	4.7	4.7	4.1	4.8		
of which: Investment	4.8	4.8	4.7	5.8	4.7	4.1	4.5	4.4	4.3	4.5		
Cyclically adjusted balance	-4.7	-5.7	-3.7	-6.0	-3.9	-3.4	-2.8	-2.4	-2.6	-3.3		
One-off and temporary measures	.	.	0.0	0.0	0.1	0.0	-0.2	0.0	0.4	0.0		
Structural balance ⁵	.	.	-3.7	-6.0	-4.0	-3.4	-2.8	-2.3	-3.0	-3.3		
Government debt	50.7	48.2	53.2	54.4	54.0	56.0	50.5	51.3	52.0	52.7		
Average residual maturity (in years)	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0				
In foreign currencies (% of total)	29.2	26.1	32.3	31.1	30.7	29.6	35.1	35.0				
of which: Euro	21.2	19.0	23.5	21.5	21.9	21.7	25.9	26.5				
Domestic ownership (% of total)	54.0	61.5	46.5	51.2	47.5	49.5	42.3	42.0				
Medium and long-term maturity (% of total) ⁶	96.8	94.3	99.3	98.5	99.3	99.9	99.7	99.2				
of which: Variable interest rate (% of total)	14.4	12.0	16.8	11.3	15.4	17.6	18.8	21.0				
Deficit-debt adjustment	-0.9	0.0	-1.9	0.3	-2.0	-1.1	-6.8	0.2				
Net acquisitions of main financial assets	-0.4	0.0	-0.7	-1.8	-0.3	-1.5	0.9	-0.9				
Currency and deposits	0.1	0.4	-0.2	-0.6	0.8	-1.0	0.6	-0.9				
Debt securities	0.0	0.0	0.0	0.0	0.0	0.1	-0.1	0.0				
Loans	0.1	0.1	0.0	0.1	0.0	0.0	0.2	0.0				
Equity and investment fund shares or units	-0.5	-0.5	-0.5	-1.3	-1.0	-0.6	0.2	0.0				
Revaluation effects on debt	0.3	0.2	0.4	1.9	-1.5	0.0	1.2	0.5				
of which: Foreign exchange holding gains/losses	0.2	0.1	0.4	1.9	-1.4	-0.1	0.9	0.5				
Other ⁷	-0.9	-0.2	-1.6	0.3	-0.2	0.3	-8.8	0.6				
Convergence programme: government balance	-	-	-	-	-	-	-	-	-2.6	-2.9	-2.0	-1.3
Convergence programme: structural balance	-	-	-	-	-	-	-	-	-3.1	-2.8	-2.1	-1.3
Convergence programme: government debt	-	-	-	-	-	-	-	-	52.0	52.5	52.0	50.4

Sources: European System of Central Banks and European Commission (Eurostat, DG ECFIN).

1) Multi-annual averages.

2) Data from the European Commission's Spring 2016 Economic Forecast, except for convergence programme data.

3) Sales and other current revenue.

4) Intermediate consumption, subsidies payable and other current expenditure.

5) Cyclically-adjusted balance excluding one-off and other temporary measures.

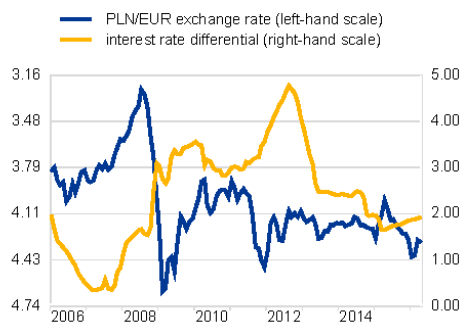
6) Original maturity of more than one year.

7) Time of recording differences and other discrepancies (sector reclassifications and statistical discrepancies).

Poland - Exchange rate and external developments

Chart 5.5.3 Bilateral exchange rate and short-term interest rate differential

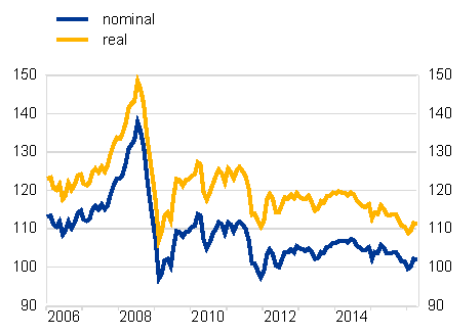
(PLN/EUR exchange rate: monthly averages; difference between three-month interbank interest rates and three-month EURIBOR: basis points, monthly values)



Sources: National data and ECB calculations.

Chart 5.5.4 Effective exchange rates ¹⁾

(EER-38 group of trading partners; monthly averages; base index: Q1 1999 = 100)



Source: ECB.

1) The real EER-38 is CPI deflated. An increase (decrease) in the EER indicates an appreciation (depreciation).

Table 5.5.3 External developments

(as a percentage of GDP, unless otherwise indicated)

	2008-2015 ⁵⁾	2008-2010 ⁵⁾	2011-2015 ⁵⁾	2011	2012	2013	2014	2015	2016 ³⁾	2017 ³⁾
Balance of payments										
Current account and capital account balance ⁴⁾	-1.6	-3.9	-0.2	-3.3	-1.5	1.0	0.4	2.1	0.9	0.4
Current account balance	-3.6	-5.4	-2.5	-5.2	-3.7	-1.3	-2.0	-0.2	-0.3	-0.9
Goods	-2.2	-4.0	-1.2	-3.5	-2.1	-0.1	-0.8	0.5	.	.
Services	1.6	1.3	1.8	1.4	1.5	1.9	2.1	2.3	.	.
Primary income	-2.9	-2.7	-3.1	-3.2	-3.1	-3.0	-3.2	-2.8	.	.
Secondary income	0.0	0.0	0.0	0.2	0.0	-0.1	-0.1	-0.2	.	.
Capital account balance	2.0	1.5	2.2	1.9	2.2	2.3	2.4	2.4	.	.
Combined direct and portfolio investment balance ⁴⁾	-3.5	-4.8	-2.7	-5.8	-5.1	-0.8	-1.6	0.0	.	.
Direct investment	-1.6	-1.8	-1.5	-2.6	-1.2	-0.8	-2.0	-0.7	.	.
Portfolio investment	-1.9	-2.9	-1.2	-3.2	-3.9	0.0	0.4	0.7	.	.
Other investment balance	-1.0	-3.7	0.5	-0.6	1.2	-0.4	0.7	1.8	.	.
Reserve assets	1.2	1.9	0.8	1.2	2.2	0.2	0.1	0.2	.	.
Exports of goods and services	43.2	38.5	46.0	42.6	44.4	46.3	47.5	49.4	.	.
Imports of goods and services	43.8	41.2	45.4	44.7	44.9	44.4	46.2	46.6	.	.
Net international investment position ⁴⁾	-62.0	-57.8	-64.5	-57.8	-67.1	-69.7	-67.1	-60.7	.	.
Gross external debt ⁴⁾	65.6	58.5	69.9	65.5	72.1	70.6	71.1	70.3	.	.
Internal trade with the euro area ⁴⁾										
Exports of goods and services	.	.	55.2	56.1	54.3	53.8	55.4	56.5	.	.
Imports of goods and services	.	.	57.3	57.5	56.1	57.1	57.4	58.2	.	.
Investment position with the euro area ⁴⁾										
Direct investment assets ⁴⁾	.	.	64.1	59.6	62.5	65.6	65.0	67.5	.	.
Direct investment liabilities ⁴⁾	.	.	76.8	75.0	75.5	77.4	78.5	77.5	.	.
Portfolio investment assets ⁴⁾	.	.	56.2	53.7	50.9	59.3	58.8	58.2	.	.
Portfolio investment liabilities ⁴⁾	43.7	47.4	41.5	44.4	42.8	42.6	40.4	37.2	.	.

Sources: European System of Central Banks and European Commission (Eurostat, DG ECFIN).
Note: Backdata are available from 2008.

1) Multi-annual averages.

2) Data from the European Commission's Spring 2016 Economic Forecast.

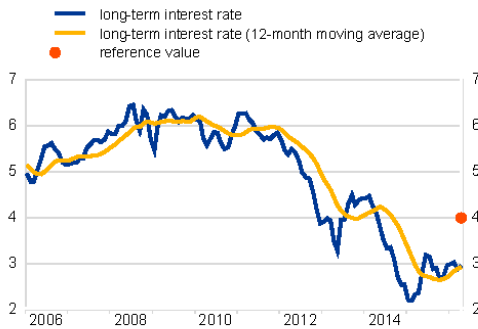
3) Differences between totals and sum of their components are due to rounding.

4) End-of-period outstanding amounts.

5) As a percentage of the total.

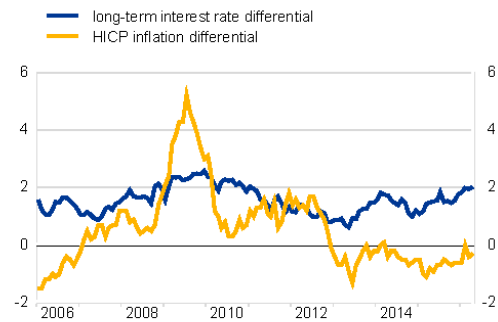
Poland - Long-term interest rate developments

Chart 5.5.5 Long-term interest rate ¹⁾
(monthly averages in percentages)



Sources: European System of Central Banks and ECB calculations.
1) The basis of the calculation of the reference value for the period from May 2015 to April 2016 is the unweighted arithmetic average of the interest rate levels in Bulgaria, Slovenia and Spain plus 2 percentage points. The reference value is 4.0%.

Chart 5.5.6 Long-term interest rate and HICP inflation differentials vis-à-vis the euro area
(monthly averages in percentage points)



Sources: European System of Central Banks, ECB calculations and European Commission (Eurostat).

Table 5.5.4 Long-term interest rates and indicators of financial development and integration
(as a percentage of GDP, unless otherwise indicated)

	2006-2015 ¹⁾	2006-2010 ²⁾	2011-2015 ³⁾	2012	2013	2014	2015	May 2015 to Apr. 2016	Memo item: euro area 2015
Long-term interest rates									
Poland ⁴⁾	5.0	5.7	4.2	5.0	4.0	3.5	2.7	2.9	-
Euro area ⁵⁾	3.4	4.0	2.9	3.9	3.0	2.0	1.2	1.2	-
Euro area AAA par curve, ten-year residual maturity ⁶⁾	2.8	3.8	1.8	2.1	1.9	1.4	0.6	0.6	-
Indicators of financial development and integration									
Debt securities issued by financial corporations ⁷⁾	6.8	4.5	9.1	9.6	10.6	8.5	7.7	-	73.6
Debt securities issued by non-financial corporations ⁸⁾	3.5	2.6	4.5	4.2	4.3	4.9	5.0	-	10.8
Stock market capitalisation ⁹⁾	32.7	33.9	31.4	31.9	34.8	33.6	28.5	-	60.4
MFI credit to non-government residents ¹⁰⁾	49.2	44.1	54.2	52.1	53.5	55.4	57.2	-	114.7
Claims of euro area MFIs on resident MFIs ¹¹⁾	9.0	9.9	8.0	8.9	8.1	5.8	5.4	-	27.4

Sources: European System of Central Banks and ECB calculations.
1) Multi-annual averages calculated using the arithmetic average.
2) Average interest rate.
3) Included for information only.
4) Outstanding amount of debt securities issued by resident MFIs and other financial corporations.
5) Outstanding amount of debt securities issued by resident non-financial corporations.
6) Outstanding amount of listed shares issued by residents at the end of the period at market values.
7) MFI (excluding NCB) credit to domestic non-MFI residents other than general government. Credit includes outstanding amounts of loans and debt securities.
8) Outstanding amount of deposits and debt securities issued by domestic MFIs (excluding the NCB) held by euro area MFIs as a percentage of total liabilities of domestic MFIs (excluding the NCB). Total liabilities exclude capital and reserves and remaining liabilities.

5.6 Romania

5.6.1 Price developments

In April 2016 the 12-month average rate of HICP inflation in Romania was -1.3%, i.e. well below the reference value of 0.7% (see Chart 5.6.1). This rate is expected to increase over the coming months.

Over the past ten years the 12-month average rate of HICP inflation has fluctuated within a relatively wide range, from -1.3% to 8.5%, and the average for that period was elevated, standing at 4.5%. In the years leading up to the global financial crisis in 2008, inflation stood at elevated levels amid signs of overheating in the Romanian economy. At the same time, unemployment declined and wage growth significantly outpaced productivity growth, which, in turn, drove up unit labour cost growth to double-digit levels. Following sharp increases in energy and food prices, as well as the depreciation of the leu, the average annual rate of HICP inflation peaked at 7.9% in 2008. Thereafter, it decelerated alongside the sharp contraction in economic activity in 2009 and 2010, which was followed by a rather moderate recovery (see Table 5.6.1). Following three years of wage cuts, mainly in the public sector, from 2009 to 2011, including a 25% cut in public sector wages in 2010, compensation per employee rose again as of 2012, albeit at a somewhat lower rate than before. In 2014 and, in particular, in 2015 inflation declined to historically low levels, closely reflecting developments in energy and food prices, which together represent around 50% of Romania's HICP basket of goods and services. The fall in HICP inflation was also driven by successive cuts in indirect taxes. In particular, on the back of a reduction in the value added tax (VAT) rate on food items, non-alcoholic beverages and food services from 24% to 9% in June 2015, HICP inflation declined sharply and entered into negative territory. Given the latest developments in inflation and the inflation outlook in particular, the key policy interest rate has been kept unchanged since May 2015 at the historically low level of 1.75%.

For the first four months of 2016, the average annual rate of HICP inflation stood at -2.2%. To a large extent, the negative rate of inflation reflects exceptional country-specific factors, in particular the broadening of the scope of the reduced VAT rate (9%) to all food items, non-alcoholic beverages and food services in June 2015 and the reduction in the standard VAT rate from 24% to 20% in January 2016. The significant impact of these tax cuts is evidenced by the gap between headline inflation and the annual rate of growth in the HICP at constant tax rates. The steep fall in HICP inflation has occurred in an environment of very low levels of inflation across the globe, robust growth in real GDP and a closing output gap.

Policy choices have played an important role in shaping inflation dynamics in Romania over the past decade, most notably the orientation of monetary policy towards price stability. In 2005 Banca Națională a României shifted to an inflation-targeting framework combined with a managed floating exchange rate regime. The annual CPI inflation target was initially set at 7.5% and was reduced

gradually to stand at 2.5% from 2013, with a 1 percentage point variation band around the central target.

Inflation is expected to increase in the coming years; over the longer term there are concerns regarding the sustainability of inflation convergence in Romania. According to the European Commission's Spring 2016 Economic Forecast, average annual HICP inflation will remain in negative territory, at -0.6%, in 2016 on account of substantial VAT cuts and generally low oil and commodity prices. Thereafter, inflation is projected to move into the inflation targeting band, reaching 2.5% in 2017. The balance of risks surrounding the forecast is on the upside. Upside risks are associated with increasing wage pressure on the back of wage hikes in the public sector and a series of minimum wage increases, as well as the faster than expected closing of the output gap. Moreover, there are risks stemming from the persistent uncertainty regarding the progress on structural reforms and from potential fiscal slippages in the context of an unstable political environment, which could, in turn, lead to depreciation pressure on the leu. Downside risks to the inflation outlook are related to the heightened uncertainty regarding developments in the global economy, which could reduce external price pressures. Looking further ahead, the catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area, given that GDP per capita and price levels are still significantly lower in Romania than in the euro area. In order to prevent the build-up of excessive price pressures and macroeconomic imbalances, the catching-up process must be supported by appropriate policies.

Achieving an environment that is conducive to sustainable convergence in Romania requires stability-oriented economic policies and wide-ranging structural reforms. More specifically, the government should continue with product market reforms to boost private investment and competition. The deregulation of gas prices should be completed and reforms aimed at enhancing the corporate governance of state-owned enterprises need to be stepped up. Improving Romania's very weak absorption of EU funds warrants attention, in particular with a view to improving the quality of the infrastructure in the energy and transport sector. In order to enhance growth prospects and competitiveness, it is essential to advance structural reforms (including the fight against corruption), as well as the quality and efficiency of public institutions. In terms of the labour market, measures aimed at reducing youth and long-term unemployment should be implemented more broadly and participation in lifelong learning should be promoted. With regard to macroeconomic imbalances, the European Commission selected Romania for an in-depth review in its Alert Mechanism Report 2016 and concluded that Romania is not experiencing macroeconomic imbalances.

Financial sector policies should be geared to continuing to safeguard financial stability and ensuring that the financial sector makes a sound contribution to economic growth. In order to safeguard financial sector stability in the future, it is of utmost importance to continue the clean-up of bank balance sheets and to support a sustainable recovery in lending, in particular to non-financial corporations. The impact on the banking sector of recent legal initiatives warrants special attention,

particularly with regard to the potential negative spillover effects on the economy as a whole.

5.6.2 Fiscal developments

Romania's government deficit and debt complied with the Maastricht criteria in 2015. In the reference year 2015 the general government budget balance recorded a deficit of 0.7% of GDP, well below the 3% reference value. The general government gross debt-to-GDP ratio was 38.4%, well below the 60% reference value (see Table 5.6.2). Compared with the previous year, the deficit and debt ratios decreased by 0.1 and 1.4 percentage points of GDP respectively. The European Commission's Spring 2016 Economic Forecast expects the deficit to deteriorate markedly to 2.8% of GDP in 2016 as a result of cuts in VAT and personal income taxation, as well as sharp increases in public wages. On a no-policy-change basis, the Commission expects the deficit to worsen further to 3.4% of GDP in 2017. Government debt is projected to increase to 40.1% of GDP in 2017. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2015, nor is it expected to do so in 2016.

Romania has been subject to the preventive arm of the Stability and Growth Pact since 2013. Against the background of the rise in the budget deficit above the reference value in 2008, the ECOFIN Council decided on 7 July 2009 that an excessive deficit situation existed in Romania and set 2011 as the deadline for correcting it. Its recommendation of 12 February 2010 extended this deadline to 2012. The ECOFIN Council abrogated the excessive deficit procedure on 21 June 2013. Romania achieved its medium-term objective of a structural deficit of 1% of GDP over the period 2013-15.

Sizeable consolidation efforts contributed to the deficit reduction between 2009 and 2015. The deficit ratio peaked in 2009 at 9.1% of GDP and declined steadily afterwards, reaching 0.7% of GDP in 2015. European Commission estimates (presented in Table 5.6.2) indicate that cyclical factors contributed only marginally to the changes in the budget balance in the period 2010-15, whereas the structural balance improved by 8.7 percentage points over the same period, reflecting the significant consolidation measures adopted by the government in the period 2010-12. Fiscal consolidation packages were agreed under the EU/IMF financial assistance programme and mainly included an increase in indirect taxes, wage cuts in the public sector and other spending cuts to contain public expenditure in general. Consolidation continued at a slower pace in 2013-14, while the fiscal stance turned slightly expansionary in 2015.

The debt-to-GDP ratio more than tripled during the crisis, reaching 39.9% of GDP in 2014, but remained well below the 60% reference value. The debt-to-GDP ratio increased rapidly from 13.2% of GDP in 2008 to 37.4% of GDP in 2012, driven by high primary deficits and the impact of the recession (see Chart 5.6.2). After 2012 the increase in the debt ratio slowed on the back of a gradually improving primary balance and a recovery in real GDP growth. Debt increased in 2012 and

2014, mainly on account of the build-up of a foreign currency-denominated cash buffer. In 2015 debt decreased for the first time since the crisis. European Commission estimates point to a risk of adverse debt dynamics in the years to come (see Table 5.6.2). The Romanian government has not incurred contingent liabilities resulting from government interventions to support financial institutions and financial markets during the crisis.

The level and structure of government debt indicate that Romania's fiscal balances are protected from sudden changes in interest rates; however, the balances are sensitive to exchange rate fluctuations. The share of government debt with a short-term maturity is low (6.7% of overall debt in 2014 – see Table 5.6.2). Taking into account the share of long-term debt with a variable interest rate as a percentage of GDP, fiscal balances appear relatively insensitive to interest rate changes. The proportion of foreign currency-denominated government debt is high (57.0% in 2014). Taking the size of the debt as a share of GDP into consideration, it can therefore be concluded that the fiscal balances are sensitive to exchange rate movements, mainly the EUR/RON exchange rate, as a large part of the debt is denominated in euro (81% of foreign denominated debt in 2014). Despite some fluctuations, the share of debt denominated in euro and other foreign currency has remained relatively stable since 2009. After decreasing during the financial crisis, the share of debt with a long-term maturity reached a peak of 93.8% in 2013.

There are risks of a significant deviation from the SGP preventive arm requirements in 2016 and, under unchanged policies, also in 2017. According to the European Commission's Spring 2016 Economic Forecast, the structural deficit is projected to increase to 2.8% of GDP in 2016 and 3.4% in 2017 on account of expansionary fiscal measures, such as further indirect tax cuts and higher spending on public wages. Net expenditure growth is projected to be well above the benchmark rate, pointing to a significant deviation from the SGP's provisions. This procyclical fiscal stance is expected to push the deficit above the 3% of GDP reference rate in 2017 and put the debt-to-GDP ratio on an upward path. Romania's medium-term fiscal policy strategy, as presented in the April 2016 Convergence Programme update, also projects a significant deterioration of both the headline and structural deficits in 2016 that brings the headline deficit just below the 3% threshold in 2016 and 2017. Despite a smaller projected deterioration in the structural deficit in 2017 compared with the European Commission's latest forecast, the structural deficit is projected to deviate significantly from the medium-term objective in both 2016 and 2017. Therefore, further consolidation measures are needed in 2016 and 2017 in order to ensure compliance with the Stability and Growth Pact's provisions.

Romania has strengthened its national fiscal governance framework significantly in recent years, but it has not always been applied effectively. Romania's fiscal governance framework has been strengthened following the adoption of the Fiscal Compact (through the implementation of a structural budget balance rule, debt rule and a correction mechanism), the creation of an independent fiscal council in 2010 and reform of the tax collection agency (ANAF). Romanian authorities should fully support the fiscal council by means of a more timely submission of the budget and by increasing the transparency of macroeconomic and

fiscal forecasts and the budget documentation. The government should also increase efforts to improve its public finance management, to reform the public administration, to make the tax policy and administration more efficient, to improve tax collection and to combat tax evasion. Privatisations and governance reforms of state-owned enterprises should continue.

The Commission's analysis points to high sustainability risks in the medium term and the need to address the projected increase in healthcare and long-term care spending. Its 2015 Fiscal Sustainability Report points to there being no risks over the short term, but high and medium risks over the medium and long term respectively. This assessment is primarily underpinned by the unfavourable initial budgetary position and is compounded by the projected impact of age-related public spending. In respect of the latter, Romania has taken steps to tackle the costs of ageing. Notably, the authorities (i) implemented the comprehensive pension reform that was passed in 2010 and (ii) introduced a basic package of health policies in 2014 to improve the efficiency of health care. Nevertheless, according to the 2015 projections by the European Commission and the EU's Economic Policy Committee¹²⁰, Romania is likely to experience a notable increase in strictly age-related public expenditure from a level of 15.3% of GDP in 2013 to 17.4% of GDP by the year 2060 in the AWG reference scenario. In the risk scenario, the increase in the cost of ageing amounts to 5.2 percentage points of GDP, significantly above the average for the 28 EU Member States. All these developments suggest that further reforms are needed to enhance the long-term sustainability of public finances, in particular to improve the effectiveness and efficiency of the healthcare system. The Romanian government's decision to partially re-establish the special pensions abolished in 2010 goes in the opposite direction and further hampers the sustainability of the pension system.

Further reforms and a sound fiscal position in line with the provisions of the SGP are warranted in order to safeguard the sustainability of public finances over the medium term. Romania needs to ensure compliance with the SGP requirements in 2016 and beyond. The authorities should avoid the significant deviation from the medium-term objective that is planned. Additional government investment should be financed by better absorption of EU funds, with a view to improving the quality of public infrastructure. The Romanian government should make further efforts to improve the tax collection system, to fight tax evasion, to advance structural fiscal reforms (including the corporate governance of state-owned enterprises) and to tackle the projected increase in healthcare and long-term care spending.

5.6.3 Exchange rate developments

Over the reference period from 19 May 2014 to 18 May 2016, the Romanian leu did not participate in ERM II, but traded under a flexible exchange rate regime

¹²⁰ Published in "The 2015 Ageing Report: Economic and budgetary projections for the EU-28 Member States (2013-2060)", prepared by the AWG.

involving a managed floating of the currency's exchange rate. In the two-year reference period the Romanian leu traded close to its May 2014 average exchange rate against the euro of 4.4237 lei per euro, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate (see Chart 5.6.3). On 18 May 2016 the exchange rate stood at 4.4990 lei per euro, i.e. 1.7% weaker than its average level in May 2014. Over the reference period the maximum upward deviation from this benchmark was 0.9%, while the maximum downward deviation amounted to 2.6%. Looking back over a longer period the exchange rate of the Romanian leu against the euro has depreciated by 28.3% over the past ten years.

The exchange rate of the Romanian leu against the euro exhibited, on average, a relatively high degree of volatility over the reference period. Between November 2014 and January 2015 the Romanian leu depreciated against the euro amid a deteriorating economic outlook in the country's key trading partners and elevated geopolitical risks. Thereafter, in the period up to mid-April 2015, the Romanian leu appreciated, recovering its previous losses, which coincided with the monetary policy decisions in the country's key trading partners and their subsequent impact on financial markets. However, it then came under renewed pressure during a period of increased international financial market volatility in mid-2015. After a period of relative exchange rate stability up to late November 2015, the Romanian leu depreciated until the end of 2015 on the back of global financial market developments associated with the monetary policy decisions adopted by major central banks. Thereafter, the leu strengthened against the euro until the end of the reference period, reflecting the relatively strong macroeconomic performance of the Romanian economy. Over the reference period short-term interest rate differentials against the three-month EURIBOR remained at somewhat wide but, on average, decreasing levels on account of higher monetary policy rates in Romania than in the euro area. The spreads decreased from 2.2 percentage points in the three-month period ending in June 2014 to 0.8 percentage point in the three-month period ending in March 2016 amid seven interest rate cuts by Banca Națională a României.

In 2009 an international financial assistance package led by the EU and the IMF was agreed for Romania. This was followed by two precautionary financial assistance programmes, totalling €4 billion each, which ran from 2011 to 2013 and from 2013 to 2015 respectively. The latest programme expired in September 2015. Romania did not draw on the resources of the precautionary arrangements. As these three consecutive agreements helped to reduce financial vulnerabilities, they might also have contributed to reducing exchange rate pressures over the reference period.

The real effective exchange rate of the Romanian leu has depreciated overall over the past ten years (see Chart 5.6.4). However, this indicator should be interpreted with caution, as during this period Romania was subject to a process of economic convergence, which complicates any historical assessment of real exchange rate developments.

Romania's current and capital account has improved substantially over the past decade, while the country's net foreign liabilities, although declining gradually, remain high (see Table 5.6.3). After reaching double-digit levels from

2006 to 2008, the combined current and capital account deficit declined to 3.4% of GDP in 2012 and turned into a surplus of 1.0% of GDP in 2013, 2.2% and 1.3% in 2014 and 2015 respectively. The improvement in the current and capital account balance primarily reflected the sharp decline in the goods deficit, which was driven mainly by a strong export performance and moderate domestic demand. The external deficit has been financed mainly by net inflows in direct and portfolio investment since 2012 and by official borrowing in the period 2009-11. Against this background, gross external debt increased substantially to 75.5% of GDP in 2012 and decreased thereafter to 56.2% in 2015. At the same time the country's net international investment position deteriorated up to 2012, but improved thereafter, to -50.2% of GDP in 2015. However, the country's net foreign liabilities are still high. Fiscal and structural policies therefore continue to be important for supporting external sustainability and the competitiveness of the economy.

The Romanian economy is well integrated with the euro area through trade and investment linkages. In 2015 exports of goods and services to the euro area constituted 54.9% of total exports, while the corresponding figure for imports amounted to 54.3%. The share of the euro area in Romania's stock of inward direct investment stood at 83.8% and its share in the country's stock of portfolio investment liabilities was 49.1% in 2015. The share of Romania's stock of foreign assets invested in the euro area amounted to 81.9% in the case of direct investment and 63.1% in the case of portfolio investment in 2015.

5.6.4 Long-term interest rate developments

Over the reference period from May 2015 to April 2016, long-term interest rates in Romania were 3.6% on average and thus below the 4.0% reference value for the interest rate convergence criterion (see Chart 5.6.5).

Long-term interest rates in Romania have declined steadily since early 2012, with 12-month moving average rates approximately halving from over 7% to a near-historical low of 3.6% at the end of the reference period. Volatility around this trend has been very low, especially if compared with developments in 2008 and 2009 when a combination of global financial tensions, a deteriorating domestic outlook and liquidity strains raised Romanian long-term rates to almost 12% (see Chart 5.6.5). Recently, the only substantial increase in Romania's long-term interest rates was in the first half of 2015, but this was in line with the increases observed in the euro area.

Romania's long-term interest rate differential vis-à-vis the euro area has recently been both stable and low relative to the past decade. More precisely, long-term interest rates in Romania have stayed within 3 percentage points of those in the euro area since 2013, and the differential hit a low of 1.8 percentage points in early 2015, before reaching 2.6 percentage points at the end of the reference period (see Chart 5.6.6). The differential vis-à-vis the euro area AAA yield was slightly higher, at 3.3 percentage points. However, this compares favourably with the peak reached in mid-2009. Moreover, the volatility of the differential has been more muted

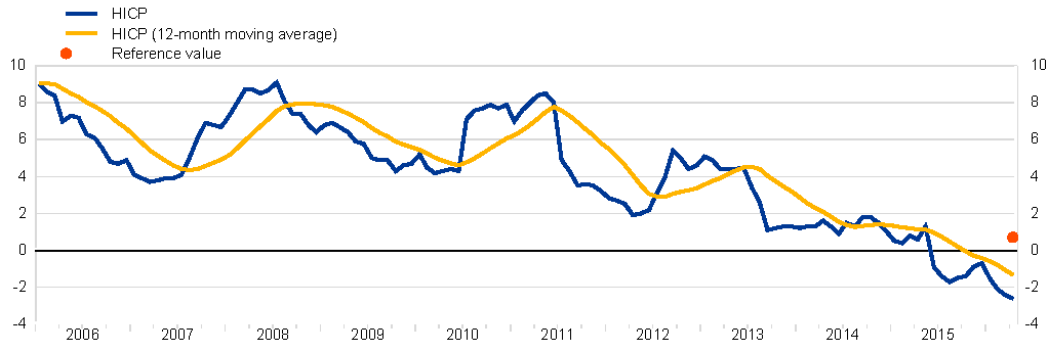
in recent years than was the case from 2006 to 2008 and from 2010 to 2012, periods in which the differential fluctuated in a corridor of around 2 to 4 percentage points.

At the end of 2015 Romania's capital market was much smaller than the euro area average and still underdeveloped. This was particularly true for the corporate debt segment, as both financial and non-financial corporations were issuing securities amounting to less than 1% of GDP (see Table 5.6.4). Romania's equity market was also less developed but, at 9.5% of GDP, the difference with the euro area (60.4% of GDP) was lower than in the case of corporate debt markets. Integration of the Romanian financial sector with the euro area, as measured by the claims of euro area banks on Romanian banks, has reached a considerable level. Claims of euro area MFIs accounted for 13.1% of Romanian banks' liabilities at the end of 2015 (see Table 5.6.4). Moreover, the Romanian banking system is highly integrated into the EU financial system, as institutions controlled by euro area banks account for a substantial amount of credit to the private sector. However, overall Romania's banking sector is relatively small, with private sector credit, for example, standing at only 30.4% of GDP in 2015 (the corresponding euro area figure being 114.7% of GDP).

Romania - Price developments

Chart 5.6.1 HICP inflation and reference value ¹⁾

(annual percentage changes)



Sources: European Commission (Eurostat) and ECB calculations.

¹⁾ The basis of the calculation of the reference value for the period from May 2015 to April 2016 is the unweighted arithmetic average of the annual percentage changes in the HICP for Bulgaria, Slovenia and Spain plus 1.5 percentage points. The reference value is 0.7%.

Table 5.6.1 Measures of inflation and related indicators

(annual percentage changes, unless otherwise indicated)

	2006-2015 ¹⁾	2006-2010 ¹⁾	2011-2015 ¹⁾	2011	2012	2013	2014	2015	2016 ²⁾	2017 ²⁾
Measures of inflation										
HICP	4.4	6.2	2.7	5.8	3.4	3.2	1.4	-0.4	-0.6	2.5
HICP excluding unprocessed food and energy	4.5	6.4	2.6	5.0	3.3	2.3	1.7	0.7	0.3	2.7
HICP at constant tax rates ³⁾	3.5	4.5	2.5	3.8	3.2	3.0	1.1	1.2	-	-
CPI	4.4	6.2	2.7	5.8	3.3	4.0	1.1	-0.6	-0.6	2.5
Private consumption deflator	4.4	6.1	2.7	4.2	4.5	2.6	1.2	1.2	0.2	1.8
GDP deflator	6.6	9.7	3.5	4.7	4.7	3.4	1.7	2.9	2.0	2.4
Producer prices ⁴⁾	4.5	6.4	2.7	6.6	4.8	3.7	0.2	-1.8	-	-
Related indicators										
Real GDP growth	2.6	2.9	2.4	1.1	0.6	3.5	3.0	3.8	4.2	3.7
GDP per capita in PPS ⁵⁾ (euro area = 100)	45.4	41.8	49.9	47.1	50.2	50.5	51.7	-	-	-
Comparative price levels (euro area = 100)	55.7	58.3	52.3	53.6	50.9	52.5	52.4	-	-	-
Output gap ⁶⁾	-0.2	2.6	-3.0	-3.8	-4.9	-3.1	-2.1	-1.1	0.0	0.3
Unemployment rate (%) ⁷⁾	6.7	6.5	6.9	7.2	6.8	7.1	6.8	6.8	6.8	6.7
Unit labour costs, whole economy	3.8	8.0	-0.3	-5.8	3.4	-0.6	3.1	-1.3	2.5	2.3
Compensation per employee, whole economy	7.4	11.4	3.4	-4.1	9.4	3.8	5.3	3.2	6.9	6.2
Labour productivity, whole economy	3.5	3.2	3.8	1.9	5.7	4.5	2.1	4.7	4.2	3.8
Imports of goods and services deflator	1.8	3.1	0.6	6.0	7.3	-6.0	-1.5	-2.0	-2.9	1.2
Nominal effective exchange rate ⁸⁾	-1.9	-2.7	-1.1	0.1	-6.4	2.7	0.9	-2.4	-	-
Money supply (M3) ⁹⁾	9.4	11.9	6.9	6.1	3.8	8.7	7.8	8.4	-	-
Lending from banks ¹⁰⁾	13.1	26.4	1.2	7.6	-0.7	-3.5	-1.3	4.5	-	-
Stock prices (BET) ¹¹⁾	6.3	-20.0	32.9	-17.7	18.7	26.1	9.1	-1.1	-	-
Residential property prices ¹²⁾	-4.7	-7.8	-4.1	-14.2	-6.5	-0.2	-2.3	3.7	-	-

Sources: European Commission (Eurostat, DG ECFIN), national data for CPI, money supply, lending from banks and residential property prices, and ECB calculations based on Thomson Reuters data for stock prices.

¹⁾ Multi-annual averages calculated using the geometric mean, except for GDP per capita in PPS, comparative price levels, output gap and unemployment rate, for which the arithmetic mean is used.

²⁾ Data from the European Commission's Spring 2016 Economic Forecast.

³⁾ The difference between the HICP and the HICP at constant tax rates shows the theoretical impact of changes in indirect taxes (e.g. VAT and excise duties) on the overall rate of inflation. This impact assumes a full and instantaneous pass-through of tax rate changes to the price paid by the consumer.

⁴⁾ Domestic sales, total industry excluding construction.

⁵⁾ PPS stands for purchasing power standards.

⁶⁾ Percentage difference of potential GDP: a positive (negative) sign indicates that actual GDP is above (below) potential GDP.

⁷⁾ Definition conforms to International Labour Organization guidelines.

⁸⁾ EER-38 group of trading partners. A positive (negative) sign indicates an appreciation (depreciation).

⁹⁾ The series includes repurchase agreements with central counterparties.

¹⁰⁾ Not adjusted for the derecognition of loans from the MFI statistical balance sheet due to their sale or securitisation.

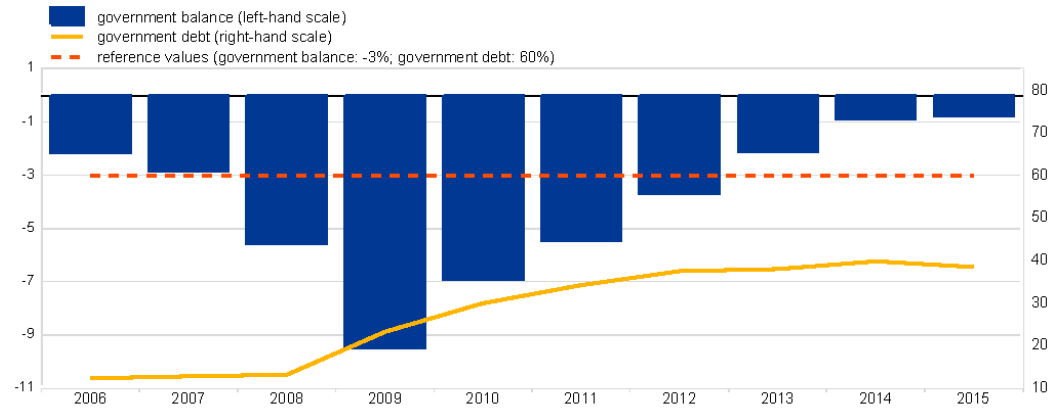
¹¹⁾ Multi-annual and annual figures represent the percentage change between the end of the given period and the end of the previous period.

¹²⁾ Data available since 2009.

Romania - Fiscal developments

Chart 5.6.2 General government balance and debt

(as a percentage of GDP)



Sources: European System of Central Banks and European Commission (Eurostat).

Table 5.6.2 Government budgetary developments and projections

(as a percentage of GDP, unless otherwise indicated)

	2006-2015 *	2006-2010 *	2011-2015 *	2011	2012	2013	2014	2015	2016*	2017*	2018	2019
Government balance	-4.0	-5.4	-2.6	-5.4	-3.7	-2.1	-0.9	-0.7	-2.8	-3.4		
Total revenue	33.4	33.2	33.7	33.7	33.4	33.1	33.5	34.8	31.8	31.5		
Current revenue	32.3	32.5	32.0	33.0	32.0	31.6	31.4	32.2	30.5	29.7		
Direct taxes	6.2	6.2	6.2	6.0	5.9	6.0	6.3	6.7	6.4	6.5		
Indirect taxes	12.4	11.8	13.0	13.0	13.2	12.8	12.8	13.2	11.9	11.2		
Net social contributions	9.3	10.0	8.6	9.0	8.8	8.7	8.6	8.1	8.2	8.1		
Other current revenue ²⁾	4.4	4.5	4.2	5.0	4.1	4.2	3.8	4.1	3.9	3.9		
Capital revenue	1.2	0.6	1.7	0.7	1.5	1.5	2.1	2.6	1.4	1.8		
Total expenditure	37.4	38.5	36.3	39.1	37.1	35.2	34.3	35.5	34.6	34.9		
Current expenditure	30.8	31.5	30.1	31.3	30.8	29.7	29.3	29.3	29.7	29.7		
Compensation of employees	8.8	9.9	7.8	7.8	7.8	8.1	7.7	7.6	8.3	8.4		
Social benefits	11.7	11.5	12.0	13.1	12.1	11.7	11.5	11.5	11.4	11.2		
Interest payable	1.4	1.0	1.7	1.6	1.8	1.7	1.7	1.6	1.7	1.7		
Other current expenditure ⁴⁾	8.8	9.1	8.6	8.7	9.2	8.1	8.4	8.5	8.3	8.3		
Capital expenditure	6.6	7.0	6.2	7.9	6.3	5.6	5.0	6.2	4.9	5.2		
of which: Investment	5.4	6.0	4.8	5.4	4.8	4.5	4.3	5.1	3.8	4.1		
Cyclically adjusted balance	-3.9	-6.2	-1.8	-4.1	-2.0	-1.1	-0.2	-0.4	-2.8	-3.4		
One-off and temporary measures	-	-	-0.1	-1.1	0.5	0.0	0.0	0.3	0.1	0.0		
Structural balance ⁵⁾			-1.5	-3.0	-2.6	-1.1	-0.2	-0.6	-2.8	-3.4		
Government debt	27.9	18.3	37.6	34.2	37.4	38.0	39.8	38.4	38.7	40.1		
Average residual maturity (in years)	5.3	5.8	4.8	5.0	4.1	4.4	5.3	5.4				
In foreign currencies (% of total)	60.4	64.0	56.8	57.7	58.8	56.5	57.0	53.8				
of which: Euro	46.6	46.9	46.2	47.6	47.4	46.7	46.3	43.1				
Domestic ownership (% of total)	44.3	39.8	48.8	50.8	49.1	45.5	48.0	50.3				
Medium and long-term maturity (% of total) ⁶⁾	85.4	82.3	88.5	77.1	84.8	93.8	93.3	93.5				
of which: Variable interest rate (% of total)	22.7	31.1	14.3	20.0	16.5	12.7	11.2	11.3				
Deficit-debt adjustment	0.1	-0.9	1.2	0.5	1.3	0.9	2.6	0.4				
Net acquisitions of main financial assets	0.3	-0.2	0.9	1.2	1.5	0.6	1.6	-0.6				
Currency and deposits	0.6	0.3	1.0	1.0	1.8	0.9	1.7	-0.5				
Debt securities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0				
Loans	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0				
Equity and investment fund shares or units	-0.3	-0.6	-0.1	0.1	-0.3	-0.3	0.0	0.0				
Revaluation effects on debt	0.0	0.1	0.0	0.2	0.4	-0.2	-0.3	-0.2				
of which: Foreign exchange holding												
gains/losses	0.2	0.1	0.2	0.1	0.6	0.3	0.0	0.2				
Other ⁷⁾	-0.3	-0.8	0.3	-0.8	-0.6	0.5	1.4	1.1				
Convergence programme: government balance	-	-	-	-	-	-	-	-	-2.9	-2.9	-2.3	-1.6
Convergence programme: structural balance	-	-	-	-	-	-	-	-	-2.7	-2.9	-2.4	-1.9
Convergence programme: government debt	-	-	-	-	-	-	-	-	39.1	39.8	39.9	39.3

Sources: European System of Central Banks and European Commission (Eurostat, DG ECFIN).

1) Multi-annual averages.

2) Data from the European Commission's Spring 2016 Economic Forecast, except for convergence programme data.

3) Sales and other current revenue.

4) Intermediate consumption, subsidies payable and other current expenditure.

5) Cyclically-adjusted balance excluding one-off and other temporary measures.

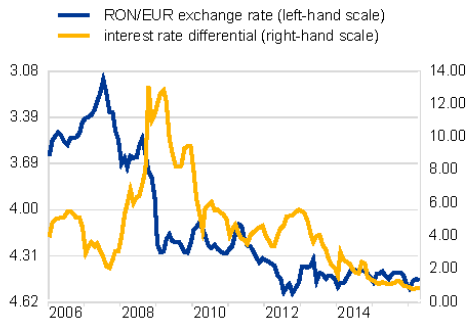
6) Original maturity of more than one year.

7) Time of recording differences and other discrepancies (sector reclassifications and statistical discrepancies).

Romania - Exchange rate and external developments

Chart 5.6.3 Bilateral exchange rate and short-term interest rate differential

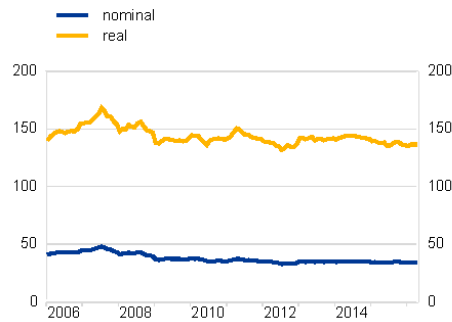
(RON/EUR exchange rate: monthly averages; difference between three-month interbank interest rates and three-month EURIBOR: basis points, monthly values)



Sources: National data and ECB calculations.

Chart 5.6.4 Effective exchange rates ¹⁾

(EER-38 group of trading partners; monthly averages; base index: Q1 1999 = 100)



Source: ECB.

1) The real EER-38 is CPI deflated. An increase (decrease) in the EER indicates an appreciation (depreciation).

Table 5.6.3 External developments

(as a percentage of GDP, unless otherwise indicated)

	2008-2015 ¹⁾	2008-2010 ²⁾	2011-2015 ³⁾	2011	2012	2013	2014	2015	2016 ⁴⁾	2017 ⁵⁾
Balance of payments										
Current account and capital account balance ⁴⁾	-3.0	-6.9	-0.7	-4.4	-3.4	1.0	2.2	1.3	0.1	-0.7
Current account balance	-4.3	-7.3	-2.5	-5.0	-4.8	-1.1	-0.5	-1.1	-2.1	-2.8
Goods	-7.2	-10.2	-5.4	-7.0	-7.0	-4.0	-4.2	-4.8	.	.
Services	2.3	1.3	2.9	1.2	1.9	3.3	3.9	4.3	.	.
Primary income	-1.7	-1.6	-1.8	-1.3	-1.7	-2.2	-1.3	-2.4	.	.
Secondary income	2.3	3.2	1.8	2.1	2.0	1.9	1.1	1.8	.	.
Capital account balance	1.3	0.3	1.8	0.5	1.4	2.1	2.6	2.4	.	.
Combined direct and portfolio investment balance ⁴⁾	-3.7	-3.9	-3.6	-2.5	-4.6	-5.8	-3.7	-1.2	.	.
Direct investment	-2.5	-3.7	-1.7	-1.3	-1.9	-2.0	-1.8	-1.7	.	.
Portfolio investment	-1.2	-0.2	-1.8	-1.3	-2.6	-3.8	-1.9	0.5	.	.
Other investment balance	0.3	-4.8	3.3	-1.8	3.0	5.5	6.6	3.4	.	.
Reserve assets	.	.	.	.	.	1.4	-0.9	-0.4	.	.
Exports of goods and services	35.2	28.7	39.2	36.7	37.3	39.8	41.2	41.1	.	.
Imports of goods and services	40.1	37.5	41.7	42.4	42.4	40.5	41.5	41.6	.	.
Net international investment position ⁴⁾	-59.2	-57.6	-60.2	-64.2	-67.8	-61.9	-56.8	-50.2	.	.
Gross external debt ⁴⁾	66.4	64.4	67.8	75.0	75.5	68.3	63.0	56.2	.	.
Internal trade with the euro area ⁴⁾										
Exports of goods and services	.	.	.	.	.	52.2	53.1	54.9	.	.
Imports of goods and services	.	.	.	.	.	53.6	52.9	54.3	.	.
Investment position with the euro area ⁴⁾										
Direct investment assets ⁴⁾	56.6	81.7	81.9	.	.
Direct investment liabilities ⁴⁾	83.1	82.9	83.8	.	.
Portfolio investment assets ⁴⁾	57.3	53.7	63.1	.	.
Portfolio investment liabilities ⁴⁾	61.6	75.3	53.3	68.5	49.8	48.9	50.2	49.1	.	.

Sources: European System of Central Banks and European Commission (Eurostat, DG ECFIN). Note: Backdata are available from 2008.

1) Multi-annual averages.

2) Data from the European Commission's Spring 2016 Economic Forecast.

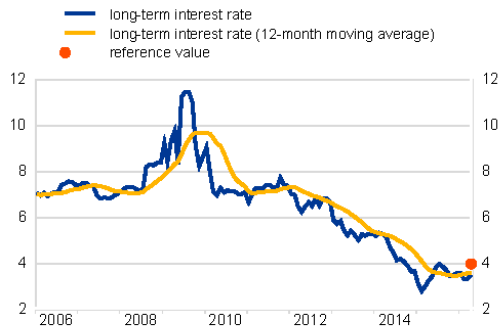
3) Differences between totals and sum of their components are due to rounding.

4) End-of-period outstanding amounts.

5) As a percentage of the total.

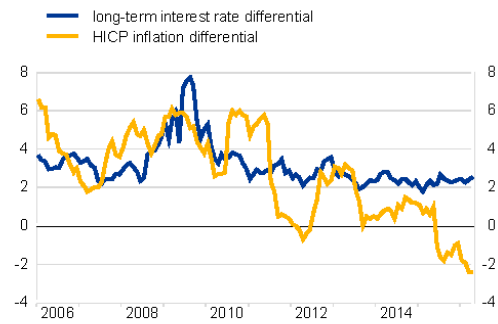
Romania - Long-term interest rate developments

Chart 5.6.5 Long-term interest rate ¹⁾
(monthly averages in percentages)



Sources: European System of Central Banks and ECB calculations.
1) The basis of the calculation of the reference value for the period from May 2015 to April 2016 is the unweighted arithmetic average of the interest rate levels in Bulgaria, Slovenia and Spain plus 2 percentage points. The reference value is 4.0%.

Chart 5.6.6 Long-term interest rate and HICP inflation differentials vis-à-vis the euro area
(monthly averages in percentage points)



Sources: European System of Central Banks, ECB calculations and European Commission (Eurostat).

Table 5.6.4 Long-term interest rates and indicators of financial development and integration
(as a percentage of GDP, unless otherwise indicated)

	2006-2015 ¹⁾	2006-2010 ²⁾	2011-2015 ³⁾	2012	2013	2014	2015	May 2015 to Apr. 2016	Memo item: euro area 2015
Long-term interest rates									
Romania ⁴⁾	6.6	7.8	5.5	6.7	5.4	4.5	3.5	3.6	-
Euro area ^{4,5)}	3.4	4.0	2.9	3.9	3.0	2.0	1.2	1.2	-
Euro area AAA par curve, ten-year residual maturity ^{4,5)}	2.8	3.8	1.8	2.1	1.9	1.4	0.6	0.6	-
Indicators of financial development and integration									
Debt securities issued by financial corporations ⁶⁾	0.4	0.5	0.3	0.2	0.3	0.3	0.3	-	73.6
Debt securities issued by non-financial corporations ⁶⁾	0.0	0.0	0.0	0.0	0.0	0.1	0.1	-	10.8
Stock market capitalisation ⁶⁾	11.5	13.0	10.0	8.8	11.4	11.3	9.5	-	60.4
MFI credit to non-government residents ⁷⁾	35.2	35.7	34.8	37.9	34.3	31.6	30.4	-	114.7
Claims of euro area MFIs on resident MFIs ⁸⁾	24.0	29.0	20.1	23.5	20.1	16.6	13.1	-	27.4

Sources: European System of Central Banks and ECB calculations.
1) Multi-annual averages calculated using the arithmetic average.
2) Average interest rate.
3) Included for information only.
4) Outstanding amount of debt securities issued by resident MFIs and other financial corporations.
5) Outstanding amount of debt securities issued by resident non-financial corporations.
6) Outstanding amount of listed shares issued by residents at the end of the period at market values.
7) MFI (excluding NCB) credit to domestic non-MFI residents other than general government. Credit includes outstanding amounts of loans and debt securities.
8) Outstanding amount of deposits and debt securities issued by domestic MFIs (excluding the NCB) held by euro area MFIs as a percentage of total liabilities of domestic MFIs (excluding the NCB). Total liabilities exclude capital and reserves and remaining liabilities. Data available since 2007.

5.7 Sweden

5.7.1 Price developments

In April 2016 the 12-month average rate of HICP inflation in Sweden was 0.9%, i.e. above the reference value of 0.7% for the criterion on price stability (see Chart 5.7.1). This rate is expected to increase over the coming months.

Over the past ten years the 12-month average rate of HICP inflation has fluctuated within a range from 0.2% to 3.4%, and the average for that period was subdued, standing at 1.4%. In 2008 inflation picked up from moderate levels, driven largely by the spike in global commodity prices and the sharp depreciation of the krona. In the wake of the global financial crisis, inflation declined substantially amid plummeting commodity prices and ample spare capacity in the Swedish economy. The unemployment rate increased and the growth in unit labour costs declined. Despite the subsequent recovery in economic activity, spare capacity persisted for some time. In that environment, companies found it difficult to pass on cost pressures to consumer prices. The steady appreciation of the krona in nominal effective terms from 2009 to 2013, along with low external price pressures, also kept a lid on consumer price inflation over that period. In 2015 inflation picked up from very low levels, supported by the lagged effects of the krona's depreciation in 2014 and strong economic growth (see Table 5.7.1). The upward trend in inflation was underpinned by an accommodative monetary policy stance. In particular, Sveriges Riksbank reduced its main policy rate into negative territory and launched a programme of government bond purchases. Amid historically low interest rates and supply-side frictions in the housing market, house prices have increased substantially over recent years, together with household indebtedness.

In the first four months of 2016 consumer price developments in Sweden were rather subdued, albeit slightly more dynamic than in the majority of EU Member States. The average annual rate of HICP inflation during that period was 1.1%. The strong underlying growth momentum and the past weakening of the krona continued to exert upward pressure on prices, underpinned by an accommodative monetary policy stance. Tax increases in the form of lower tax deductions for certain construction-related services also had a positive, albeit temporary, effect on inflation. At the same time, the decline in global commodity prices over the past year, lower electricity prices and subdued external price pressures weighed on headline inflation.

Policy choices have played an important role in shaping inflation dynamics in Sweden over the past decade, most notably the orientation of monetary policy towards price stability. Since 1995 Sveriges Riksbank has had an inflation target that is quantified as an annual rise of 2% in the CPI. In June 2010 the tolerance margin of ± 1 percentage point was removed from the policy objective. Sweden's institutional framework, which fosters prudent fiscal policy and wage formation, has generally lent support to the achievement of price stability. In recent years Sweden has consistently been among the top-performing EU Member States in terms of the international rankings of institutional environments.

Inflation in Sweden is expected to increase in the coming years, albeit remaining below 2%. According to the European Commission's Spring 2016 Economic Forecast, average annual HICP inflation is set to increase in 2016 and reach 1.2% in 2017. The outlook is based on expectations of relatively strong economic growth, which will drive up underlying cost pressures and facilitate their pass-through to consumer prices. However, low external price pressures are likely to weigh on inflation and the positive effects of the past depreciation of the krona will gradually wane. The risks to the inflation outlook are broadly balanced. A key upside risk relates to the build-up of stronger than expected domestic price pressures amid very robust economic growth. Downside risks relate to the heightened uncertainty regarding developments in the global economy, which could reduce external price pressures. Exchange rate developments are an additional source of uncertainty surrounding the inflation outlook. Looking further ahead, monetary policy and the stability-oriented institutional framework should continue to support the achievement of price stability in Sweden. Furthermore, price level convergence would require lower inflation rates than in the euro area over the medium term, since the price level in Sweden is comparatively high.

Maintaining an environment that is conducive to sustainable convergence in Sweden requires the continuation of stability-oriented economic policies and targeted structural reforms. In particular, decisive efforts are needed to address the risks to macroeconomic stability arising from the ongoing housing boom and the elevated level of private debt. A disorderly correction of house prices in Sweden could dampen consumption and, in turn, trigger an economic downturn. Therefore, it is essential that structural reforms alleviate supply-side bottlenecks and other inefficiencies in the housing market, such as planning and zoning restrictions, as well as rigid rental regulations. Against this backdrop, the European Commission selected Sweden for an in-depth review in its Alert Mechanism Report 2016 and concluded that Sweden is experiencing macroeconomic imbalances.

Financial sector policies should be geared to continuing to safeguard financial stability and ensuring that the financial sector makes a sound contribution to economic growth. Given the credit-financed housing boom, financial sector policies should first and foremost aim to prepare the ground for a "soft landing" in Sweden. This requires measures to curb mortgage demand, such as a gradual reduction in mortgage interest rate deductibility from the income tax or increases in recurrent property taxes. In order to further improve the resilience of the large banking sector, the Swedish authorities could consider additional measures, such as a minimum leverage ratio requirement.

5.7.2 Fiscal developments

The deficit and debt complied with the Maastricht criteria in 2015. In 2015 the general government recorded a balanced budget, thus standing well below the 3% reference value. The general government gross debt-to-GDP ratio was 43.4%, i.e. below the 60% reference value (see Table 5.7.2). Compared with the previous year, the deficit and debt ratios decreased by 1.6 and 1.3 percentage points of GDP

respectively. According to the European Commission's Spring 2016 Economic Forecast, the deficit ratio is projected to increase to 0.4% in 2016, whereas the government debt ratio is projected to decrease to 41.3%. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2015, nor is it expected to do so in 2016.

Sweden is currently subject to the preventive arm of the Stability and Growth Pact. Sweden has never been subject to a European Council decision on the existence of an excessive deficit. According to the information provided in the 2016 Convergence Programme on 28 April 2016, Sweden is expected to comply with its medium-term objective (a structural deficit of 1% of GDP at most) over the programme horizon. The European Commission's Spring 2016 Economic Forecast projects the structural deficit to remain below the medium-term objective from 2015 to 2017. It therefore assesses the country to be compliant with the preventive arm requirements throughout the reference period.

The deficit-to-GDP ratio stayed at levels well below the 3% reference value during the crisis. The deficit ratio reached its trough in 2015 at 0.0% of GDP, after improving by 0.7 percentage points since 2009. The European Commission's estimates (presented in Table 5.7.2) indicate that cyclical factors improved the budget balance by 2.9 percentage points of GDP between 2009 and 2015, following their large deficit-increasing impact in 2008 and 2009 (5.3 percentage points) as the Swedish government let automatic stabilisers operate freely. The structural balance deteriorated by 2.2 percentage points between 2009 and 2015, while no substantial temporary or one-off measures occurred in the same period.

The debt-to-GDP ratio increased progressively after the crisis, while staying at levels well below the 60% reference value. The debt ratio increased steadily from its post-crisis trough of 36.9% of GDP in 2011 to its peak of 44.8% of GDP in 2014, mainly driven by large deficit-debt adjustments (see Table 5.7.2). The latter increased the debt ratio by 7.0 percentage points over 2013 and 2014, mainly reflecting loans to strengthen the currency reserves of Sveriges Riksbank and a redefinition of statistics. Primary deficits more than offset a debt-reducing growth-interest rate differential in the same period. Contingent liability risks remain low, as the banking sector is fully capitalised and public provisions related to the support given to financial institutions are negligible.

Sweden's government debt structure shows that fiscal balances are relatively sensitive to interest rate and exchange rate fluctuations. The share of government debt with a short-term maturity is relatively high (27.2% in 2015 – see Table 5.7.2). Taking into account the level of the debt ratio, fiscal balances are relatively sensitive to changes in interest rates. At the same time, the proportion of government debt denominated in foreign currency is relatively high (25.8% in 2015). Taking the size of the debt as a share of GDP into consideration, this leaves fiscal balances relatively sensitive to the exchange rate movements of foreign currencies. Moreover, potential short-term risks in terms of maturity structure emerge as a result of a significant increase (5.5 percentage points) in the share of short-term debt between 2013 and 2015.

The European Commission's Spring 2016 Economic Forecast points to compliance under the preventive arm of the Stability and Growth Pact.

According to the Commission's latest forecast, a structural surplus of 0.3% of GDP in 2015 is projected to turn into a structural deficit of 0.5% and 0.9% of GDP in 2016 and, under unchanged policies, in 2017 respectively. It therefore sees no risk of deviation from the medium-term objective (i.e. a structural deficit of 1% of GDP at most).

Sweden has further strengthened its already strong national fiscal governance framework over recent years.

Sweden has a strong rule-based fiscal framework consisting of three key components: (i) a general government surplus target of 1% of GDP over the business cycle, (ii) a three-year rolling nominal expenditure ceiling for central government and the pension system, and (iii) a balanced budget requirement for local governments. Over recent years, the Swedish government has introduced a number of changes aimed at increasing the scope of budget bills under the new European Semester, including regular evaluations to improve the accuracy of forecasts and provisions to enhance the control of revenue. A parliamentary committee is investigating whether to change the level of the surplus target. Any change in the national target should ensure the medium-term sustainability of public finances under the requirements of the Stability and Growth Pact.

Sweden faces low risks to the long-term sustainability of public finances, but expenditure on long-term care raises some concerns.

The detailed examination performed for the European Commission's 2015 Fiscal Sustainability Report points to there being no risks over the short term, low risks over the medium term and medium risks in the long term. The long-term risks stem from both the relatively unfavourable initial budgetary position and the projected impact of age-related public spending. In respect of the latter, according to the estimates by the European Commission and the Economic Policy Committee reported in the 2015 Ageing Report,¹²¹ an ageing population poses some challenges to Swedish public finances, especially in the area of long-term care. According to the AWG reference scenario, strictly age-related expenditure is projected to rise by 0.7 percentage points of GDP by the year 2060 from a level of 25.1% of GDP in 2013, mainly driven by long-term care costs. In the AWG risk scenario, the increase in the cost of ageing amounts to 3.8 percentage points of GDP, a figure that was partly determined by long-term care costs. Reforms aimed at increasing the availability of substitutes for publicly financed formal care are needed, thus enhancing the long-term sustainability of public finances.

Sweden should build on its strong track record so as to ensure the continued compliance of its public finances with the requirements under the preventive arm of the Stability and Growth Pact. Sweden should continue to anchor sound public finances in its rule-based fiscal framework, thus ensuring compliance with its medium-term objective in the years to come. In the short-to-medium term, risks are low and mainly relate to the composition of government debt as a result of its

¹²¹ "The 2015 Ageing Report: Economic and budgetary projections for the EU-28 Member States (2013-2060)", prepared by the AWG.

sensitivity to interest rate and exchange rate movements. However, Sweden should focus on minimising debt-financed expenditure linked to the recent influx of asylum seekers, which is expected to continue over the coming years. In the long term, fiscal risks arise from age-related expenditure, particularly in the area of long-term care. Therefore, the Swedish government should adhere to its commitment to diversify its liability structure towards safer components, such as long-term and krona-denominated debt. Most importantly, the government should contain the growth in age-related expenditure in order to stave off long-term risks to the sustainability of public finances.

5.7.3 Exchange rate developments

In the two-year reference period from 19 May 2014 to 18 May 2016, the Swedish krona did not participate in ERM II, but traded under a flexible exchange rate regime. Over the reference period the Swedish currency often traded substantially below its May 2014 average exchange rate against the euro of 9.0298 kronor per euro, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate (see Chart 5.7.3). On 18 May 2016 the exchange rate stood at 9.3525 kronor per euro, i.e. 3.6% weaker than its average level in May 2014. Over the reference period the maximum upward deviation from this benchmark was 0.4%, while the maximum downward deviation amounted to 6.9%. Looking back over a longer period the exchange rate of the Swedish krona against the euro has depreciated by 0.2% over the past ten years. On 4 January 2016 Sveriges Riksbank announced its intention to intervene on the foreign exchange market if necessary to ensure that developments in the krona exchange rate do not comprise a serious risk to the uptum in inflation. Furthermore, Sveriges Riksbank maintained a swap agreement with the ECB for borrowing up to €10 billion in exchange for Swedish kronor, which had been in place since 20 December 2007 with the aim of facilitating the functioning of financial markets and providing euro liquidity to the latter if needed. As this agreement has helped to reduce financial vulnerabilities, it might also have had an impact on the exchange rate of the Swedish krona against the euro.

The exchange rate of the Swedish krona against the euro exhibited, on average, a relatively high degree of volatility over the two-year reference period. The currency depreciated by around 5% against the euro between May 2014 and August 2015, while the interest rate differential vis-à-vis euro area assets turned negative. Thereafter, the krona strengthened by around 3% against the euro up to the end of 2015 on account of a narrowing interest rate differential and the strong performance of the Swedish economy. In the first two months of 2016, following the above-mentioned announcement by Sveriges Riksbank regarding possible exchange rate interventions, the Swedish currency depreciated again vis-à-vis the euro. More recently, the krona appreciated somewhat. Over the reference period short-term interest rate differentials against the three-month EURIBOR were overall very small and stood at -0.2 percentage point in the three-month period ending in March 2016.

The real effective exchange rate of the Swedish krona has depreciated overall over the past ten years (see Chart 5.7.4).

Over the past ten years Sweden has recorded large current account surpluses, usually coupled with a relatively small negative net international investment position (see Table 5.7.3). In 2015 the surplus in the combined current and capital account of the balance of payments stood at 5.7% of GDP, reflecting surpluses in the goods, services and primary income balances. The corresponding net capital outflows in the financial account were mainly in direct investment and other investment. Gross external debt, which is concentrated in monetary financial institutions, stood at 181.4% of GDP in 2015. Over the past ten years Sweden has usually recorded a relatively small negative net international investment position, which stood at -1.6% in 2015.

The Swedish economy is well integrated with the euro area through trade and investment linkages. In 2015 exports of goods and services to the euro area constituted 39.3% of total exports, while the corresponding figure for imports was higher, at 47.9%. The share of the euro area in Sweden's stock of inward direct investment stood at 57.2% in 2015, and its share in the country's stock of portfolio investment liabilities was 31.9%. The share of Sweden's stock of foreign assets invested in the euro area amounted to 47.7% in the case of direct investment and 37.1% in the case of portfolio investment in 2015.

5.7.4 Long-term interest rate developments

Over the reference period from May 2015 to April 2016, long-term interest rates in Sweden were 0.8% on average and thus well below the 4.0% reference value for the interest rate convergence criterion (see Chart 5.7.5).

Long-term interest rates in Sweden have been on a declining trend since 2008, with some volatility, as 12-month moving averages fell from over 4% to only 0.8% at the end of the reference period. Substantial decreases in Swedish long-term interest rates were recorded between 2011 and 2012, and then from late 2013 until early 2015 (see Chart 5.7.5). In the first episode, the decline partly reflected safe-haven flows into Swedish sovereign debt. At the time, Swedish sovereign debt continued to hold the highest possible credit rating from the major credit rating agencies while several euro area sovereigns were coming under stress. After safe-haven flows had lessened as tensions in euro area financial markets eased, long-term interest rates in Sweden increased. However, from late 2013 onwards long-term interest rates in Sweden began to experience a protracted decline, partly on the back of the government bond purchase programme launched by Sveriges Riksbank.

Sweden's long-term interest rate differential vis-à-vis the euro area had almost disappeared at the end of the reference period, following sizeable moves over the past ten years. These moves reflect to a large extent the build-up and subsequent reversal of safe-haven flows to Sweden, as the differential dropped rapidly to its low point of -3 percentage points in late 2011. The differential dropped amid sovereign tensions in the euro area, before starting to converge back towards zero in mid-2012 as those tensions abated (see Chart 5.7.6). Ever since 2013, Swedish long-term rates have traded below, but within 1 percentage point of, their

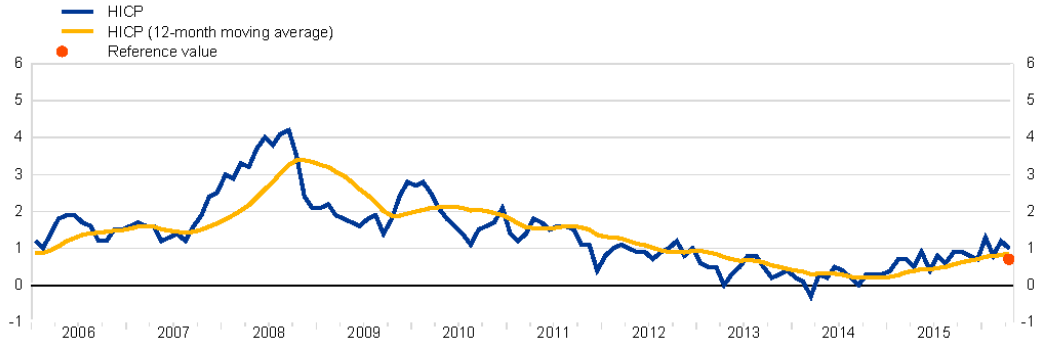
euro area average equivalents, as rates in both jurisdictions declined in comparable fashion. At the end of the reference period, the differential reached -0.1 percentage points (0.6 percentage points as compared with the AAA euro area yield).

At the end of 2015 the Swedish capital market was highly developed, with corporate bond issuance and equity market capitalisation accounting for a higher share of GDP than in the euro area (see Table 5.7.4). In particular, relative to economic activity, non-financial corporations in Sweden finance themselves about one and a half times as intensively through bonds as their euro area counterparts, while the relative size of the stock market is approximately twice the size of that of the euro area. Integration of the Swedish financial sector with the euro area, as measured by the claims of euro area banks on Swedish banks, is moderate. Claims of euro area MFIs accounted for 8.3% of Swedish banks' liabilities in 2015 (see Table 5.7.4). Sweden's financial sector is highly developed. This is evident, among other indicators, in the provision of bank loans to the private sector. At the end of 2015, these stood at a level of 130.5% of GDP and, thus, somewhat higher than the corresponding figure in the euro area of 114.7%. Even though foreign-owned banks in general do not play a particularly prominent role in Sweden, the Swedish banking sector is well integrated into the EU financial system. Unlike in many peer countries, integration exists in the form of ownership by Swedish banks of euro area MFIs, rather than vice versa. Moreover, Swedish banks are particularly active in the Nordic-Baltic euro area countries.

Sweden - Price developments

Chart 5.7.1 HICP inflation and reference value ¹⁾

(annual percentage changes)



Sources: European Commission (Eurostat) and ECB calculations.

¹⁾ The basis of the calculation of the reference value for the period from May 2015 to April 2016 is the unweighted arithmetic average of the annual percentage changes in the HICP for Bulgaria, Slovenia and Spain plus 1.5 percentage points. The reference value is 0.7%.

Table 5.7.1 Measures of inflation and related indicators

(annual percentage changes, unless otherwise indicated)

	2006-2015 ¹⁾	2006-2010 ¹⁾	2011-2015 ¹⁾	2011	2012	2013	2014	2015	2016 ²⁾	2017 ²⁾
Measures of inflation										
HICP	1.4	2.1	0.7	1.4	0.9	0.4	0.2	0.7	0.9	1.2
HICP excluding unprocessed food and energy	1.3	1.7	0.9	1.1	1.0	0.5	0.5	1.1	1.2	1.3
HICP at constant tax rates ³⁾	1.3	1.8	0.7	1.4	1.3	0.4	0.2	0.5	-	-
CPI	1.1	1.5	0.7	3.0	0.9	0.0	-0.2	0.0	-	-
Private consumption deflator	1.4	1.9	0.9	1.7	0.5	0.7	0.7	1.0	1.1	1.3
GDP deflator	1.8	2.3	1.4	1.2	1.1	1.1	1.6	1.9	2.7	1.8
Producer prices ⁴⁾	1.7	3.7	-0.2	0.9	-0.3	-0.7	0.1	-1.1	-	-
Related indicators										
Real GDP growth	1.8	1.6	2.0	2.7	-0.3	1.2	2.3	4.1	3.4	2.9
GDP per capita in PPS ⁵⁾ (euro area = 100)	116.0	115.6	116.5	116.8	117.9	118.3	115.1	-	-	-
Comparative price levels (euro area = 100)	117.7	111.9	124.9	122.2	124.3	129.3	123.9	-	-	-
Output gap ⁶⁾	-0.7	0.0	-1.4	-0.2	-1.9	-2.4	-2.1	-0.5	0.2	0.4
Unemployment rate (%) ⁷⁾	7.5	7.2	7.8	7.8	8.0	8.0	7.9	7.4	6.8	6.3
Unit labour costs, whole economy	2.3	2.5	2.1	2.6	4.1	1.7	1.3	1.0	1.3	1.8
Compensation per employee, whole economy	3.1	3.4	2.8	3.2	3.1	2.0	2.2	3.6	3.1	3.2
Labour productivity, whole economy	0.8	0.9	0.6	0.5	-1.0	0.3	0.9	2.6	1.8	1.4
Imports of goods and services deflator	0.7	1.7	-0.3	-0.2	-1.1	-2.8	1.7	0.9	-2.4	1.2
Nominal effective exchange rate ⁸⁾	-0.2	-0.4	0.0	6.1	1.0	3.2	-3.5	-6.1	-	-
Money supply (M3) ⁹⁾	6.6	8.6	4.7	6.5	3.8	3.1	4.2	6.1	-	-
Lending from banks ¹⁰⁾	6.5	8.7	4.3	5.5	3.6	3.0	5.1	4.4	-	-
Stock prices (OMXS30) ¹¹⁾	50.7	20.4	25.2	-14.5	11.8	20.7	9.9	-1.2	-	-
Residential property prices	6.8	7.3	6.2	2.5	1.2	5.5	9.4	13.1	-	-

Sources: European Commission (Eurostat, DG ECFIN), national data for CPI, money supply, lending from banks and residential property prices, and ECB calculations based on Thomson Reuters data for stock prices.

¹⁾ Multi-annual averages calculated using the geometric mean, except for GDP per capita in PPS, comparative price levels, output gap and unemployment rate, for which the arithmetic mean is used.

²⁾ Data from the European Commission's Spring 2016 Economic Forecast.

³⁾ The difference between the HICP and the HICP at constant tax rates shows the theoretical impact of changes in indirect taxes (e.g. VAT and excise duties) on the overall rate of inflation. This impact assumes a full and instantaneous pass-through of tax rate changes to the price paid by the consumer.

⁴⁾ Domestic sales, total industry excluding construction.

⁵⁾ PPS stands for purchasing power standards.

⁶⁾ Percentage difference of potential GDP: a positive (negative) sign indicates that actual GDP is above (below) potential GDP.

⁷⁾ Definition conforms to International Labour Organization guidelines.

⁸⁾ EER-38 group of trading partners. A positive (negative) sign indicates an appreciation (depreciation).

⁹⁾ The series includes repurchase agreements with central counterparties.

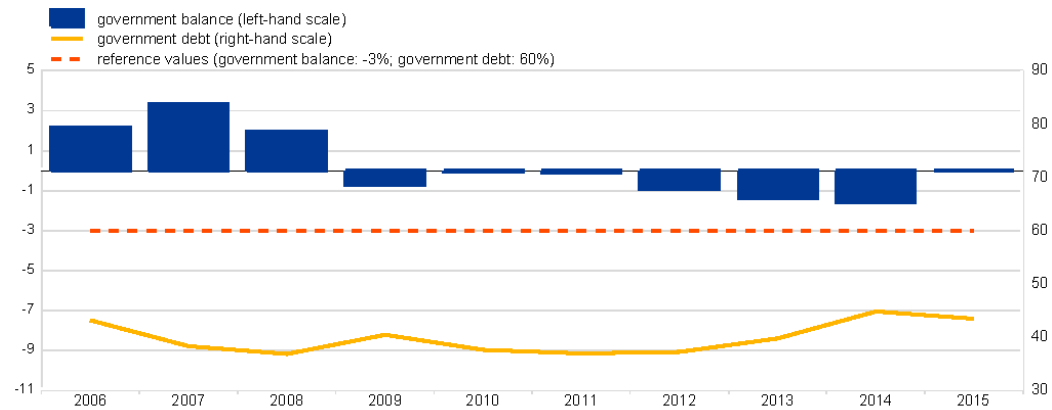
¹⁰⁾ Not adjusted for the derecognition of loans from the MFI statistical balance sheet due to their sale or securitisation.

¹¹⁾ Multi-annual and annual figures represent the percentage change between the end of the given period and the end of the previous period.

Sweden - Fiscal developments

Chart 5.7.2 General government balance and debt

(as a percentage of GDP)



Sources: European System of Central Banks and European Commission (Eurostat).

Table 5.7.2 Government budgetary developments and projections

(as a percentage of GDP, unless otherwise indicated)

	2006-2015 *	2006-2010 *	2011-2015 *	2011	2012	2013	2014	2015	2016*	2017*	2018	2019
Government balance	0.3	1.3	-0.8	-0.1	-0.9	-1.4	-1.6	0.0	-0.4	-0.7		
Total revenue	51.5	52.5	50.6	50.5	50.7	51.0	50.2	50.4	49.8	49.7		
Current revenue	51.4	52.4	50.3	50.4	50.4	50.6	50.1	50.3	49.6	49.6		
Direct taxes	18.6	19.3	17.8	17.6	17.4	17.8	17.9	18.3	18.1	18.2		
Indirect taxes	22.1	22.2	22.0	21.9	22.2	22.2	21.9	22.0	22.0	22.1		
Net social contributions	3.7	3.6	3.7	3.7	3.8	3.8	3.7	3.7	3.6	3.6		
Other current revenue ²⁾	7.0	7.2	6.7	7.1	7.0	6.9	6.4	6.2	5.9	5.7		
Capital revenue	0.2	0.1	0.2	0.1	0.4	0.3	0.1	0.2	0.1	0.1		
Total expenditure	51.2	51.1	51.4	50.5	51.7	52.4	51.7	50.4	50.1	50.4		
Current expenditure	46.7	46.8	46.7	45.9	46.9	47.7	47.1	45.9	45.6	45.8		
Compensation of employees	12.4	12.4	12.5	12.1	12.5	12.6	12.6	12.4	12.3	12.3		
Social benefits	18.3	18.2	18.3	17.8	18.4	18.9	18.6	18.1	16.9	16.9		
Interest payable	1.1	1.4	0.8	1.1	0.9	0.8	0.7	0.5	0.5	0.5		
Other current expenditure ³⁾	14.9	14.7	15.1	14.9	15.1	15.4	15.2	15.0	16.0	16.0		
Capital expenditure	4.5	4.4	4.6	4.6	4.8	4.7	4.6	4.5	4.5	4.6		
of which: Investment	4.4	4.3	4.4	4.4	4.6	4.5	4.5	4.3	4.4	4.4		
Cyclically adjusted balance	0.7	1.4	0.0	0.1	0.2	0.0	-0.3	0.3	-0.5	-0.9		
One-off and temporary measures	-	-	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Structural balance ⁴⁾	-	-	0.0	0.1	0.2	0.0	-0.3	0.3	-0.5	-0.9		
Government debt	39.8	39.3	40.4	36.9	37.2	39.8	44.8	43.4	41.3	40.1		
Average residual maturity (in years)	-	-	-	-	-	-	-	-	-	-		
In foreign currencies (% of total)	22.7	21.7	23.8	20.1	18.6	28.2	26.2	25.8	-	-		
of which: Euro	8.8	8.5	9.1	9.1	8.0	10.7	9.1	8.7	-	-		
Domestic ownership (% of total)	67.6	73.0	62.2	68.2	64.7	60.8	56.1	61.2	-	-		
Medium and long-term maturity (% of total) ⁵⁾	73.4	73.2	73.5	74.3	71.8	78.3	70.6	72.8	-	-		
of which: Variable interest rate (% of total)	-	-	-	-	-	-	-	-	-	-		
Deficit-debt adjustment	1.3	0.9	1.7	0.6	-0.4	2.1	4.9	1.2				
Net acquisitions of main financial assets	1.4	1.2	1.6	1.4	0.9	2.6	3.8	-0.8	-	-		
Currency and deposits	0.3	0.1	0.5	0.9	-0.2	-0.2	2.0	-0.3	-	-		
Debt securities	0.3	0.4	0.3	-0.2	-0.1	0.0	1.5	0.2	-	-		
Loans	1.1	1.0	1.2	0.8	0.5	3.4	0.8	0.7	-	-		
Equity and investment fund shares or units	-0.3	-0.3	-0.4	-0.1	0.6	-0.6	-0.5	-1.4	-	-		
Revaluation effects on debt	0.2	-0.2	0.5	0.4	-0.1	0.5	1.2	0.5	-	-		
of which: Foreign exchange holding gains/losses	-	-	0.3	-0.1	-0.4	0.1	1.4	0.6	-	-		
Other ⁷⁾	-0.3	-0.2	-0.4	-1.1	-1.2	-1.0	0.0	1.5	-	-		
Convergence programme: government balance	-	-	-	-	-	-	-	-	-0.4	-0.7	-0.4	0.1
Convergence programme: structural balance	-	-	-	-	-	-	-	-	-0.2	-0.7	-0.5	0.0
Convergence programme: government debt	-	-	-	-	-	-	-	-	42.5	41.1	40.3	39.1

Sources: European System of Central Banks and European Commission (Eurostat, DG ECFIN).

1) Multi-annual averages.

2) Data from the European Commission's Spring 2016 Economic Forecast, except for convergence programme data.

3) Sales and other current revenue.

4) Intermediate consumption, subsidies payable and other current expenditure.

5) Cyclically-adjusted balance excluding one-off and other temporary measures.

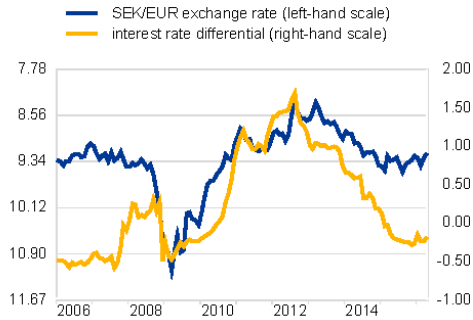
6) Original maturity of more than one year.

7) Time of recording differences and other discrepancies (sector reclassifications and statistical discrepancies).

Sweden - Exchange rate and external developments

Chart 5.7.3 Bilateral exchange rate and short-term interest rate differential

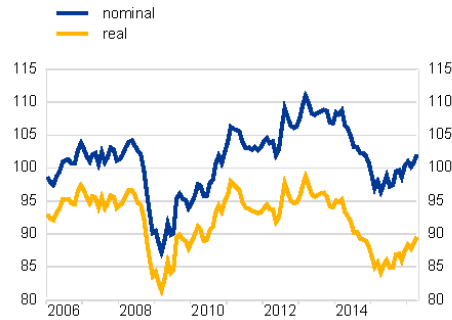
(SEK/EUR exchange rate: monthly averages; difference between three-month interbank interest rates and three-month EURIBOR: basis points, monthly values)



Sources: National data and ECB calculations.

Chart 5.7.4 Effective exchange rates ¹⁾

(EER-38 group of trading partners; monthly averages; base index: Q1 1999 = 100)



Source: ECB.

1) The real EER-38 is CPI deflated. An increase (decrease) in the EER indicates an appreciation (depreciation).

Table 5.7.3 External developments

(as a percentage of GDP, unless otherwise indicated)

	2008-2015 ¹⁾	2008-2010 ²⁾	2011-2015 ³⁾	2011	2012	2013	2014	2015	2016 ⁴⁾	2017 ⁵⁾
Balance of payments										
Current account and capital account balance ³⁾	6.0	6.7	5.7	5.9	5.7	5.8	5.2	5.7	5.6	5.5
Current account balance	6.2	6.8	5.9	6.1	5.9	6.0	5.4	5.9	5.8	5.7
Goods	3.8	4.5	3.4	3.6	3.7	3.6	3.3	2.9	.	.
Services	1.8	1.3	2.0	1.8	1.8	2.1	1.8	2.6	.	.
Primary income	2.2	2.4	2.0	2.0	2.2	1.9	1.9	2.1	.	.
Secondary income	-1.5	-1.3	-1.6	-1.3	-1.8	-1.7	-1.7	-1.6	.	.
Capital account balance	-0.2	-0.1	-0.2	-0.2	-0.2	-0.2	-0.1	-0.2	.	.
Combined direct and portfolio investment balance ³⁾	-1.0	-2.1	-0.3	-2.0	-0.8	-4.0	5.0	0.1	.	.
Direct investment	2.4	2.1	2.6	3.0	2.3	4.4	0.9	2.3	.	.
Portfolio investment	-3.4	-4.3	-2.9	-5.1	-3.1	-8.4	4.2	-2.1	.	.
Other investment balance	3.8	3.3	4.1	9.4	3.2	6.4	-1.3	2.9	.	.
Reserve assets	.	.	0.6	0.1	0.1	2.6	0.0	0.3	.	.
Exports of goods and services	45.6	46.2	45.3	46.6	45.9	43.9	44.8	45.3	.	.
Imports of goods and services	40.0	40.4	39.8	41.2	40.3	38.1	39.6	39.8	.	.
Net international investment position ⁴⁾	-5.4	0.8	-9.1	-10.4	-16.9	-14.3	-2.5	-1.6	.	.
Gross external debt ⁵⁾	189.0	191.9	187.3	192.9	187.0	184.6	190.6	181.4	.	.
Internal trade with the euro area ³⁾										
Exports of goods and services	.	.	39.3	38.8	38.5	39.9	40.1	39.3	.	.
Imports of goods and services	.	.	48.7	49.3	48.2	49.8	48.3	47.9	.	.
Investment position with the euro area ³⁾										
Direct investment assets ⁴⁾	.	.	48.8	49.6	48.5	49.4	48.8	47.7	.	.
Direct investment liabilities ⁴⁾	.	.	58.3	60.9	59.2	57.4	56.8	57.2	.	.
Portfolio investment assets ⁴⁾	.	.	38.6	40.1	40.2	39.5	36.0	37.1	.	.
Portfolio investment liabilities ⁴⁾	34.1	36.7	32.5	33.4	34.3	31.6	31.1	31.9	.	.

Sources: European System of Central Banks and European Commission (Eurostat, DG ECFIN).

Note: Backdata are available from 2008.

1) Multi-annual averages.

2) Data from the European Commission's Spring 2016 Economic Forecast.

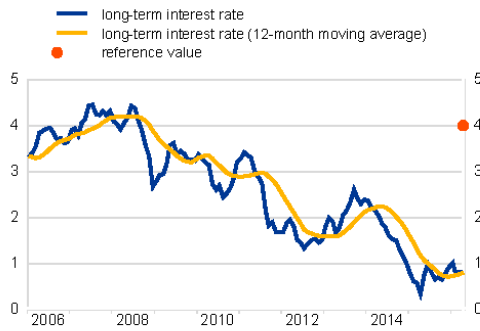
3) Differences between totals and sum of their components are due to rounding.

4) End-of-period outstanding amounts.

5) As a percentage of the total.

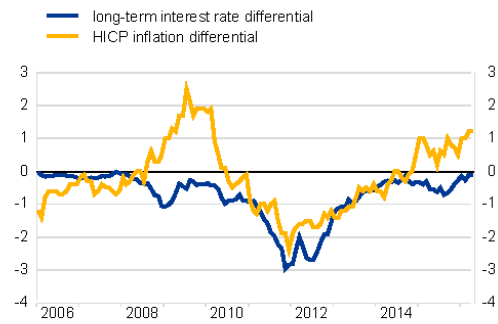
Sweden - Long-term interest rate developments

Chart 5.7.5 Long-term interest rate ¹⁾
(monthly averages in percentages)



Sources: European System of Central Banks and ECB calculations.
1) The basis of the calculation of the reference value for the period from May 2015 to April 2016 is the unweighted arithmetic average of the interest rate levels in Bulgaria, Slovenia and Spain plus 2 percentage points. The reference value is 4.0%.

Chart 5.7.6 Long-term interest rate and HICP inflation differentials vis-à-vis the euro area
(monthly averages in percentage points)



Sources: European System of Central Banks, ECB calculations and European Commission (Eurostat).

Table 5.7.4 Long-term interest rates and indicators of financial development and integration
(as a percentage of GDP, unless otherwise indicated)

	2006-2015 ¹⁾	2006-2010 ²⁾	2011-2015 ³⁾	2012	2013	2014	2015	May 2015 to Apr. 2016	Memo item: euro area 2015
Long-term interest rates									
Sweden ⁴⁾	2.7	3.6	1.8	1.6	2.1	1.7	0.7	0.8	-
Euro area ⁵⁾	3.4	4.0	2.9	3.9	3.0	2.0	1.2	1.2	-
Euro area AAA par curve, ten-year residual maturity ⁶⁾	2.8	3.8	1.8	2.1	1.9	1.4	0.6	0.6	-
Indicators of financial development and integration									
Debt securities issued by financial corporations ⁷⁾	101.4	92.1	110.7	106.9	111.8	115.6	112.0	-	73.6
Debt securities issued by non-financial corporations ⁸⁾	17.2	15.0	19.4	17.7	21.2	21.0	20.9	-	10.8
Stock market capitalisation ⁹⁾	110.1	105.2	115.0	102.4	120.3	128.0	132.9	-	60.4
MFI credit to non-government residents ¹⁰⁾	124.2	117.8	130.5	130.3	131.3	132.9	130.5	-	114.7
Claims of euro area MFIs on resident MFIs ¹¹⁾	9.3	9.9	8.6	8.0	8.4	9.0	8.3	-	27.4

Sources: European System of Central Banks and ECB calculations.
1) Multi-annual averages calculated using the arithmetic average.
2) Average interest rate.
3) Included for information only.
4) Outstanding amount of debt securities issued by resident MFIs and other financial corporations.
5) Outstanding amount of debt securities issued by resident non-financial corporations.
6) Outstanding amount of listed shares issued by residents at the end of the period at market values.
7) MFI (excluding NCB) credit to domestic non-MFI residents other than general government. Credit includes outstanding amounts of loans and debt securities.
8) Outstanding amount of deposits and debt securities issued by domestic MFIs (excluding the NCB) held by euro area MFIs as a percentage of total liabilities of domestic MFIs (excluding the NCB). Total liabilities exclude capital and reserves and remaining liabilities.