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From:	Mr Mario DRAGHI, President of the European Central Bank
date of receipt:	7 June 2016
To:	Mr Jeroen Dijsselbloem, President of the ECOFIN Council
Subject:	ECB Convergence report 2016 - Part 2

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

Encl.:

ECB Convergence Report June 2016 - Part 2

Assumption of public sector liabilities

National legislation which requires an NCB to take over the liabilities of a previously independent public body, as a result of a national reorganisation of certain tasks and duties (for example, in the context of a transfer to the NCB of certain supervisory tasks previously carried out by the state or independent public authorities or bodies), without fully insulating the NCB from all financial obligations resulting from the prior activities of such a body, would be incompatible with the monetary financing prohibition.⁶² Along the same lines, national legislation that requires an NCB to obtain approval from the government prior to taking resolution actions under a broad range of circumstances, but which does not limit the NCB's liability to its own administrative acts, would be incompatible with the monetary financing prohibition.⁶³

Financial support for credit and/or financial institutions

National legislation which provides for financing by an NCB, granted independently and at their full discretion, of credit institutions other than in connection with central banking tasks (such as monetary policy, payment systems or temporary liquidity support operations), in particular the support of insolvent credit and/or other financial institutions, would be incompatible with the monetary financing prohibition.

This applies, in particular, to the support of insolvent credit institutions. The rationale is that by financing an insolvent credit institution, an NCB would be assuming a government task.⁶⁴ The same concerns apply to the Eurosystem financing of a credit institution which has been recapitalised to restore its solvency by way of a direct placement of state-issued debt instruments where no alternative market-based funding sources exist (hereinafter 'recapitalisation bonds'), and where such bonds are to be used as collateral. In such case of a state recapitalisation of a credit institution by way of direct placement of recapitalisation bonds, the subsequent use of the recapitalisation bonds as collateral in central bank liquidity operations raises monetary financing concerns.⁶⁵ Emergency liquidity assistance, granted by an NCB independently and at its full discretion to a solvent credit institution on the basis of collateral security in the form of a State guarantee, has to meet the following criteria: (i) it must be ensured that the credit provided by the NCB is as short term as possible; (ii) there must be systemic stability aspects at stake; (iii) there must be no doubts as to the legal validity and enforceability of the State guarantee under applicable national law; and (iv) there must be no doubts as to the economic adequacy of the State guarantee, which should cover both principal and interest on the loans.⁶⁶

⁶² Opinion CON/2013/56.

⁶³ Opinion CON/2015/22.

⁶⁴ Opinion CON/2013/5.

⁶⁵ Opinions CON/2012/50, CON/2012/64, and CON/2012/71.

⁶⁶ Opinion CON/2012/4, footnote 42 referring to further relevant Opinions in this field.

To this end, inserting references to Article 123 of the Treaty in national legislation should be considered.

Financial support for resolution funds or financial arrangements and for deposit insurance or investor compensation schemes

While administrative resolution tasks are generally considered as related to those referred to in Article 127(5) of the Treaty, the financing of any resolution fund or financial arrangement is not in line with the monetary financing prohibition.⁶⁷ Where an NCB acts as resolution authority, it should not, under any circumstances, assume or finance any obligation of either a bridge institution or an asset management vehicle.⁶⁸ To this end, national legislation should clarify that the NCB will not assume or finance any of these entities' obligations.⁶⁹

The Deposit Guarantee Schemes Directive⁷⁰ and the Investor Compensation Schemes Directive⁷¹ provide that the costs of financing deposit guarantee schemes and investor compensation schemes must be borne, respectively, by credit institutions and investment firms themselves. National legislation which provides for the financing by an NCB of a national deposit insurance scheme for credit institutions or a national investor compensation scheme for investment firms would be compatible with the monetary financing prohibition only if it were short term, addressed urgent situations, systemic stability aspects were at stake, and decisions were at the NCB's discretion.⁷² To this end, inserting references to Article 123 of the Treaty in national legislation should be considered. When exercising its discretion to grant a loan, the NCB must ensure that it is not de facto taking over a government task.⁷³ In particular, central bank support for deposit guarantee schemes should not amount to a systematic pre-funding operation.⁷⁴

Fiscal agency function

Article 21.2 of the Statute establishes that the 'ECB and the national central banks may act as fiscal agents' for 'Union institutions, bodies, offices or agencies, central governments, regional local or other public authorities, other bodies governed by public law, or public undertakings of Member States.' The purpose of Article 21.2 of the Statute is, following transfer of the monetary policy competence to the Eurosystem, to enable NCBs to continue to provide the fiscal agent service

⁶⁷ Opinion CON/2015/22.

⁶⁸ Opinions CON/2011/103, CON/2012/99, CON/2015/3 and CON/2015/22.

⁶⁹ Opinions CON/2015/33 and CON/2015/35.

⁷⁰ Recital 27 of Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes (OJ L 173, 12.6.2014, p. 149).

⁷¹ Recital 23 of Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor-compensation schemes (OJ L 84, 26.3.1997, p. 22).

⁷² Opinion CON/2015/40.

⁷³ Opinions CON/2011/83 and CON/2015/52.

⁷⁴ Opinion CON/2011/84.

traditionally provided by central banks to governments and other public entities without automatically breaching the monetary financing prohibition. Regulation (EC) No 3603/93 establishes a number of explicit and narrowly drafted exemptions from the monetary financing prohibition relating to the fiscal agency function, as follows: (i) intra-day credits to the public sector are permitted provided that they remain limited to the day and that no extension is possible;⁷⁵ (ii) crediting the public sector's account with cheques issued by third parties before the drawee bank has been debited is permitted if a fixed period of time corresponding to the normal period for the collection of cheques by the NCB concerned has elapsed since receipt of the cheque, provided that any float which may arise is exceptional, is of a small amount and averages out in the short term;⁷⁶ and (iii) the holding of coins issued by and credited to the public sector is permitted where the amount of such assets remains at less than 10 % of coins in circulation.⁷⁷

National legislation on the fiscal agency function should be compatible with EU law in general, and with the monetary financing prohibition in particular.⁷⁸ Taking into account the express recognition in Article 21.2 of the Statute of the provision of fiscal agency services as a legitimate function traditionally performed by NCBs, the provision by central banks of fiscal agency services complies with the prohibition on monetary financing, provided that such services remain within the field of the fiscal agency function and do not constitute central bank financing of public sector obligations vis-à-vis third parties or central bank crediting of the public sector outside the narrowly defined exceptions specified in Regulation (EC) No 3603/93.⁷⁹ National legislation that enables an NCB to hold government deposits and to service government accounts does not raise concerns about compliance with the monetary financing prohibition as long as such provisions do not enable the extension of credit, including overnight overdrafts. However, there would be a concern about compliance with the monetary financing prohibition if, for example, national legislation were to enable the remuneration of deposits or current account balances above, rather than at or below, market rates. Remuneration that is above market rates constitutes a de facto credit, contrary to the objective of the prohibition on monetary financing, and might therefore undermine the prohibition's objectives. It is essential for any remuneration of an account to reflect market parameters and it is particularly important to correlate the remuneration rate of the deposits with their maturity.⁸⁰ Moreover, the provision without remuneration by an NCB of fiscal agent services does not raise monetary financing concerns, provided they are core fiscal agent services.⁸¹

⁷⁵ See Article 4 of Regulation (EC) No 3603/93 and Opinion CON/2013/2.

⁷⁶ See Article 5 of Regulation (EC) No 3603/93.

⁷⁷ See Article 6 of Regulation (EC) No 3603/93.

⁷⁸ Opinion CON/2013/3.

⁷⁹ Opinions CON/2009/23, CON/2009/67 and CON/2012/9.

⁸⁰ See, among others, Opinions CON/2010/54, CON/2010/55 and CON/2013/62.

⁸¹ Opinion CON/2012/9.

2.2.5.2 Prohibition on privileged access

Article 124 of the Treaty provides that '[a]ny measure, not based on prudential considerations, establishing privileged access by Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States to financial institutions, shall be prohibited.'

Under Article 1(1) of Council Regulation (EC) No 3604/93,⁸² privileged access is understood as any law, regulation or other binding legal instrument adopted in the exercise of public authority which: (a) obliges financial institutions to acquire or to hold liabilities of EU institutions or bodies, central governments, regional, local or other public authorities, other bodies governed by public law or public undertakings of Member States, or (b) confers tax advantages that only benefit financial institutions or financial advantages that do not comply with the principles of a market economy, in order to encourage those institutions to acquire or hold such liabilities.

As public authorities, NCBs may not take measures granting privileged access to financial institutions by the public sector if such measures are not based on prudential considerations. Furthermore, the rules on the mobilisation or pledging of debt instruments enacted by the NCBs must not be used as a means of circumventing the prohibition on privileged access.⁸³ Member States' legislation in this area may not establish such privileged access.

Article 2 of Regulation (EC) No 3604/93 defines 'prudential considerations' as those which underlie national laws, regulations or administrative actions based on, or consistent with, EU law and designed to promote the soundness of financial institutions so as to strengthen the stability of the financial system as a whole and the protection of the customers of those institutions. Prudential considerations seek to ensure that banks remain solvent with regard to their depositors.⁸⁴ In the area of prudential supervision, EU secondary legislation has established a number of requirements to ensure the soundness of credit institutions.⁸⁵ A 'credit institution' has been defined as an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account.⁸⁶ Additionally, credit institutions are commonly referred to as 'banks' and require an authorisation by a competent Member State authority to provide services.⁸⁷

⁸² Council Regulation (EC) No 3604/93 of 13 December 1993 specifying definitions for the application of the prohibition of privileged access referred to in Article 104a of the Treaty [establishing the European Community] (OJ L 332, 31.12.1993, p. 4). Article 104a is now Article 124 of the Treaty.

⁸³ See Article 3(2) of and recital 10 of Regulation (EC) No 3604/93.

⁸⁴ Opinion of Advocate General Elmer in Case C-222/95 *Parodi v Banque H. Albert de Bary* [1997] ECR I-3899, paragraph 24.

⁸⁵ See: (i) Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.06.2013, p. 1); and (ii) Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.06.2013, p. 338).

⁸⁶ See point (1) of Article 4(1) of Regulation (EU) No 575/2013.

⁸⁷ See Article 8 of Directive 2013/36/EU.

Although minimum reserves might be seen as a part of prudential requirements, they are usually part of an NCB's operational framework and used as a monetary policy tool in most economies, including in the euro area.⁸⁸ In this respect, paragraph 2 of Annex I to Guideline ECB/2014/60⁸⁹ states that the Eurosystem's minimum reserve system primarily pursues the aims of stabilising the money market interest rates and creating (or enlarging) a structural liquidity shortage.⁹⁰ The ECB requires credit institutions established in the euro area to hold the required minimum reserves (in the form of deposits) on account with their NCB.⁹¹

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

2.2.6 Single spelling of the euro

Article 3(4) of the Treaty on European Union lays down that the 'Union shall establish an economic and monetary union whose currency is the euro'. In the texts of the Treaties in all the authentic languages written using the Roman alphabet, the euro is consistently identified in the nominative singular case as 'euro'. In the Greek alphabet text, the euro is spelled 'ευρώ' and in the Cyrillic alphabet text the euro is spelled 'еуро'.⁹² Consistent with this, Council Regulation (EC) No 974/98 of 3 May 1998 on the introduction of the euro⁹³ makes it clear that the name of the single currency must be the same in all the official languages of the EU, taking into account the existence of different alphabets. The Treaties thus require a single spelling of the word 'euro' in the nominative singular case in all EU and national legislative provisions, taking into account the existence of different alphabets.

⁸⁸ This is supported by Article 3(2) and recital 9 of Regulation (EC) No 3604/93.

⁸⁹ Guideline (EU) 2015/510 of the European Central Bank of 19 December 2014 on the implementation of the Eurosystem monetary policy framework (General Documentation Guideline) (ECB/2014/60) (OJ L 91, 2.4.2015, p. 3).

⁹⁰ The higher the reserve requirement is set, the fewer funds banks will have to loan out, leading to lower money creation.

⁹¹ See: Article 19 of the Statute; Council Regulation (EC) No 2531/98 of 23 November 1998 concerning the application of minimum reserves by the European Central Bank (OJ L 318, 27.11.1998, p. 1); Regulation (EC) No 1745/2003 of the European Central Bank of 12 September 2003 on the application of minimum reserves (ECB/2003/9) (OJ L 250, 2.10.2003, p. 10); and Regulation (EU) No 1071/2013 of the European Central Bank of 24 September 2013 concerning the balance sheet of the monetary financial institutions sector (ECB/2013/33) (OJ L 297, 7.11.2013, p. 1).

⁹² The 'Declaration by the Republic of Latvia, the Republic of Hungary and the Republic of Malta on the spelling of the name of the single currency in the Treaties', annexed to the Treaties, states that: 'Without prejudice to the unified spelling of the name of the single currency of the European Union referred to in the Treaties as displayed on banknotes and on coins, Latvia, Hungary and Malta declare that the spelling of the name of the single currency, including its derivatives as applied throughout the Latvian, Hungarian and Maltese text of the Treaties, has no effect on the existing rules of the Latvian, Hungarian or Maltese languages'.

⁹³ OJ L 139, 11.5.1998, p. 1.

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

2.2.7 Legal integration of NCBs into the Eurosystem

Provisions in national legislation (in particular an NCB's statutes, but also other legislation) which would prevent the performance of Eurosystem-related tasks or compliance with the ECB's decisions are incompatible with the effective operation of the Eurosystem once the Member State concerned has adopted the euro. National legislation therefore has to be adapted to ensure compatibility with the Treaty and the Statute in respect of Eurosystem-related tasks. To comply with Article 131 of the Treaty, national legislation had to be adjusted to ensure its compatibility by the date of establishment of the ESCB (as regards Sweden) and by 1 May 2004, 1 January 2007 and 1 July 2013 (as regards the Member States which joined the EU on these dates). Nevertheless, statutory requirements relating to the full legal integration of an NCB into the Eurosystem need only enter into force at the moment that full integration becomes effective, i.e. the date on which the Member State with a derogation adopts the euro.

The main areas examined in this report are those in which statutory provisions may hinder an NCB's compliance with the Eurosystem's requirements. These include provisions that could prevent the NCB from taking part in implementing the single monetary policy, as defined by the ECB's decision-making bodies, or hinder a Governor from fulfilling their duties as a member of the ECB's Governing Council, or which do not respect the ECB's prerogatives. Distinctions are made between economic policy objectives, tasks, financial provisions, exchange rate policy and international cooperation. Finally, other areas where an NCB's statutes may need to be adapted are mentioned.

2.2.7.1 Economic policy objectives

The full integration of an NCB into the Eurosystem requires its statutory objectives to be compatible with the ESCB's objectives, as laid down in Article 2 of the Statute. Among other things, this means that statutory objectives with a 'national flavour' – for example, where statutory provisions refer to an obligation to conduct monetary policy within the framework of the general economic policy of the Member State concerned – need to be adapted. Furthermore, an NCB's secondary objectives must be consistent and not interfere with its obligation to support the general economic policies in the EU with a view to contributing to the achievement of the objectives of

the EU as laid down in Article 3 of the Treaty on European Union, which is itself an objective expressed to be without prejudice to maintaining price stability.⁹⁴

2.2.7.2 Tasks

The tasks of an NCB of a Member State whose currency is the euro are predominantly determined by the Treaty and the Statute, given that NCB's status as an integral part of the Eurosystem. In order to comply with Article 131 of the Treaty, provisions on tasks in an NCB's statutes therefore need to be compared with the relevant provisions of the Treaty and the Statute, and any incompatibility must be removed.⁹⁵ This applies to any provision that, after adoption of the euro and integration into the Eurosystem, constitutes an impediment to carrying out ESCB-related tasks and in particular to provisions which do not respect the ESCB's powers under Chapter IV of the Statute.

Any national legislative provisions relating to monetary policy must recognise that the EU's monetary policy is to be carried out through the Eurosystem.⁹⁶ An NCB's statutes may contain provisions on monetary policy instruments. Such provisions should be comparable to those in the Treaty and the Statute, and any incompatibility must be removed in order to comply with Article 131 of the Treaty.

Monitoring fiscal developments is a task that an NCB carries out on a regular basis to assess properly the stance to be taken in monetary policy. NCBs may also present their views on relevant fiscal developments on the basis of their monitoring activity and the independence of their advice, with a view to contributing to the proper functioning of the European Monetary Union. The monitoring of fiscal developments by an NCB for monetary policy purposes should be based on the full access to all relevant public finance data. Accordingly, the NCBs should be granted unconditional, timely and automatic access to all relevant public finance statistics. However, an NCB's role should not go beyond monitoring activities that result from or are linked – directly or indirectly – to the discharge of their monetary policy mandate.⁹⁷ A formal mandate for an NCB to assess forecasts and fiscal developments implies a function for the NCB in (and a corresponding responsibility for) fiscal policymaking which may risk undermining the discharge of the Eurosystem's monetary policy mandate and the NCB's independence.⁹⁸

In the context of the national legislative initiatives to address the turmoil in the financial markets, the ECB has emphasised that any distortion in the national segments of the euro area money market should be avoided, as this may impair the

⁹⁴ Opinions CON/2010/30 and CON/2010/48.

⁹⁵ See, in particular, Articles 127 and 128 of the Treaty and Articles 3 to 6 and 16 of the Statute.

⁹⁶ First indent of Article 127(2) of the Treaty.

⁹⁷ Opinions CON/2012/105, CON/2013/90 and CON/2013/91.

⁹⁸ For example, national legislative provisions transposing Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States (OJ L 306, 23.11.2011, p. 41). See Opinions CON/2013/90 and CON/2013/91.

implementation of the single monetary policy. In particular, this applies to the extension of State guarantees to cover interbank deposits.⁹⁹

Member States must ensure that national legislative measures addressing liquidity problems of businesses or professionals, for example their debts to financial institutions, do not have a negative impact on market liquidity. In particular, such measures may not be inconsistent with the principle of an open market economy, as reflected in Article 3 of the Treaty on European Union, as this could hinder the flow of credit, materially influence the stability of financial institutions and markets and therefore affect the performance of Eurosystem tasks.¹⁰⁰

National legislative provisions assigning the exclusive right to issue banknotes to the NCB must recognise that, once the euro is adopted, the ECB's Governing Council has the exclusive right to authorise the issue of euro banknotes, pursuant to Article 128(1) of the Treaty and Article 16 of the Statute, while the right to issue euro banknotes belongs to the ECB and the NCBs. National legislative provisions enabling the government to influence issues such as the denominations, production, volume or withdrawal of euro banknotes must also either be repealed or recognition must be given to the ECB's powers with regard to euro banknotes, as set out in the provisions of the Treaty and the Statute. Irrespective of the division of responsibilities in relation to coins between governments and NCBs, the relevant provisions must recognise the ECB's power to approve the volume of issue of euro coins once the euro is adopted. A Member State may not consider currency in circulation as its NCB's debt to the government of that Member State, as this would defeat the concept of a single currency and be incompatible with the requirements of Eurosystem legal integration.¹⁰¹

With regard to foreign reserve management,¹⁰² any Member State that has adopted the euro and which does not transfer its official foreign reserves¹⁰³ to its NCB is in breach of the Treaty. In addition, any right of a third party – for example, the government or parliament – to influence an NCB's decisions with regard to the management of the official foreign reserves would be inconsistent with the third indent of Article 127(2) of the Treaty. Furthermore, NCBs have to provide the ECB with foreign reserve assets in proportion to their shares in the ECB's subscribed capital. This means that there must be no legal obstacles to NCBs transferring foreign reserve assets to the ECB.

With regard to statistics, although regulations adopted under Article 34.1 of the Statute in the field of statistics do not confer any rights or impose any obligations on Member States that have not adopted the euro, Article 5 of the Statute, which concerns the collection of statistical information, applies to all Member States, regardless of whether they have adopted the euro. Accordingly, Member States

⁹⁹ Opinions CON/2009/99 and CON/2011/79.

¹⁰⁰ Opinion CON/2010/8.

¹⁰¹ Opinion CON/2008/34.

¹⁰² Third indent of Article 127(2) of the Treaty.

¹⁰³ With the exception of foreign-exchange working balances, which Member State governments may retain pursuant to Article 127(3) of the Treaty.

whose currency is not the euro are under an obligation to design and implement, at national level, all measures they consider appropriate to collect the statistical information needed to fulfil the ECB's statistical reporting requirements and to make timely preparations in the field of statistics in order for them to become Member States whose currency is the euro.¹⁰⁴ National legislation laying down the framework for cooperation between the NCBs and national statistical offices should guarantee the NCBs' independence in the performance of their tasks within the ESCB's statistical framework.¹⁰⁵

2.2.7.3 Financial provisions

The financial provisions in the Statute comprise rules on financial accounts,¹⁰⁶ auditing,¹⁰⁷ capital subscription,¹⁰⁸ the transfer of foreign reserve assets¹⁰⁹ and the allocation of monetary income.¹¹⁰ NCBs must be able to comply with their obligations under these provisions and therefore any incompatible national provisions must be repealed.

2.2.7.4 Exchange rate policy

A Member State with a derogation may retain national legislation which provides that the government is responsible for the exchange rate policy of that Member State, with a consultative and/or executive role being granted to the NCB. However, by the time that a Member State adopts the euro, such legislation must reflect the fact that responsibility for the euro area's exchange rate policy has been transferred to the EU level in accordance with Articles 138 and 219 of the Treaty.

2.2.7.5 International cooperation

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

¹⁰⁴ Opinion CON/2013/88.

¹⁰⁵ Opinion CON/2015/5 and CON/2015/24.

¹⁰⁶ Article 26 of the Statute.

¹⁰⁷ Article 27 of the Statute.

¹⁰⁸ Article 28 of the Statute.

¹⁰⁹ Article 30 of the Statute.

¹¹⁰ Article 32 of the Statute.

2.2.7.6 Miscellaneous

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

3 The state of economic convergence

Compliance with the convergence criteria has increased since the ECB's 2014 Convergence Report, with progress made in several countries in bringing inflation rates down towards euro area levels (see Table 3.1). Progress has also been made in all countries in reducing fiscal imbalances. However, none of the countries examined in this report participates in ERM II, and some countries' currencies have experienced sizeable fluctuations against the euro over the last few years. Finally, significant progress has been achieved in reducing long-term interest rate differentials versus the euro area.

Table 3.1
Overview table of economic indicators of convergence

		Price stability	Government budgetary developments and projections			Exchange rate		Long-term interest rate ⁶⁾
		HICP inflation ¹⁾	Country in excessive deficit ^{2) 3)}	General government surplus (+)/deficit (-) ⁴⁾	General Government debt ⁴⁾	Currency participating in ERM II ⁵⁾	Exchange rate vis-à-vis euro ^{3) 4)}	
Bulgaria	2014	-1.6	No	-5.4	27.0	No	0.0	3.3
	2015	-1.1	No	-2.1	26.7	No	0.0	2.5
	2016	-1.0	No	-2.0	28.1	No	0.0	2.5
Czech Republic	2014	0.4	No	-1.9	42.7	No	-6.0	1.6
	2015	0.3	No	-0.4	41.1	No	0.9	0.6
	2016	0.4	No	-0.7	41.3	No	0.9	0.6
Croatia	2014	0.2	Yes	-5.5	86.5	No	-0.7	4.1
	2015	-0.3	Yes	-3.2	86.7	No	0.3	3.6
	2016	-0.4	Yes	-2.7	87.6	No	0.5	3.7
Hungary	2014	0.0	No	-2.3	76.2	No	-4.0	4.8
	2015	0.1	No	-2.0	75.3	No	-0.4	3.4
	2016	0.4	No	-2.0	74.3	No	-0.7	3.4
Poland	2014	0.1	Yes	-3.3	50.5	No	0.3	3.5
	2015	-0.7	No	-2.6	51.3	No	0.0	2.7
	2016	-0.5	No	-2.6	52.0	No	-4.2	2.9
Romania	2014	1.4	No	-0.9	39.8	No	-0.6	4.5
	2015	-0.4	No	-0.7	38.4	No	0.0	3.5
	2016	-1.3	No	-2.8	38.7	No	-1.0	3.6
Sweden	2014	0.2	No	-1.6	44.8	No	-5.2	1.7
	2015	0.7	No	0.0	43.4	No	-2.8	0.7
	2016	0.9	No	-0.4	41.3	No	0.6	0.8
Reference value ⁷⁾		0.7		-3.0	60.0			4.0

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

1) Average annual percentage change. Data for 2016 refer to the period from May 2015 to April 2016.

2) Refers to whether a country was subject to an EU Council decision on the existence of an excessive deficit for at least part of the year.

3) The information for 2016 refers to the period up to the cut-off date for statistics (18 May 2016).

4) As a percentage of GDP. Data for 2016 are taken from the European Commission's Spring 2016 Economic Forecast.

5) Average annual percentage change. A positive (negative) number denotes an appreciation (depreciation) vis-à-vis the euro.

6) Average annual interest rate. Data for 2016 refer to the period from May 2015 to April 2016.

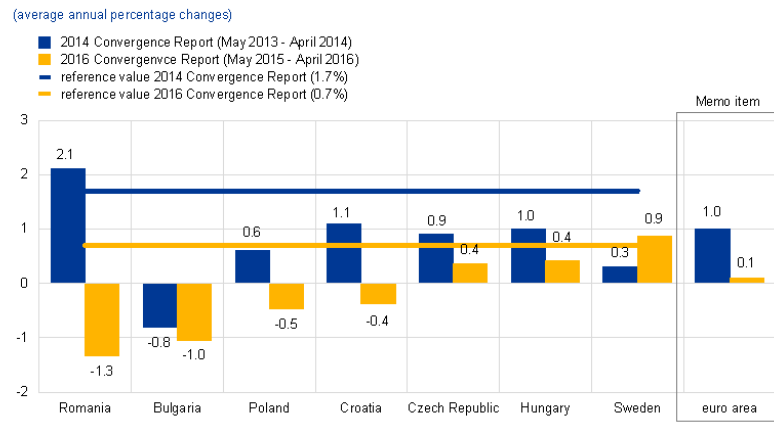
7) The reference values for HICP inflation and long-term interest rates refer to the period from May 2015 to April 2016; for the general government balance and debt, the reference values are defined in Article 126 of the Treaty on the Functioning of the European Union and the related Protocol (No 12) on the excessive deficit procedure.

The economic environment has become more favourable since the publication of the last Convergence Report. Economic activity has started to gain momentum again in most EU Member States and gradually become broader-based in the countries covered by the report. This reflects the impact of rising real disposable incomes supported by the absence of inflationary pressures in most countries, accommodative monetary policies and increasing signs of economic stabilisation in several euro area countries. The incipient recovery has led to significant improvements in the labour market in almost all countries under review; in Croatia unemployment has remained very high. In all countries further progress has been

made with regard to correcting external imbalances and reducing the dependence on external funding, particularly in the banking sector. This enhanced the resilience of most of the countries under review during the recent episodes of turmoil in emerging markets outside the EU. However, individual countries still have significant vulnerabilities of various kinds, which, if not adequately tackled, are likely to restrain the convergence process over the long term.

Regarding the price stability criterion, the 12-month average inflation rate was below – in some cases well below – the reference value of 0.7% in six of the seven countries examined in this report (see Chart 3.1). Bulgaria, Croatia, Poland and Romania recorded negative inflation rates. In Sweden inflation was above the reference value. In the 2014 Convergence Report, Romania was the only country that recorded an inflation rate above the then applicable reference value of 1.7%.

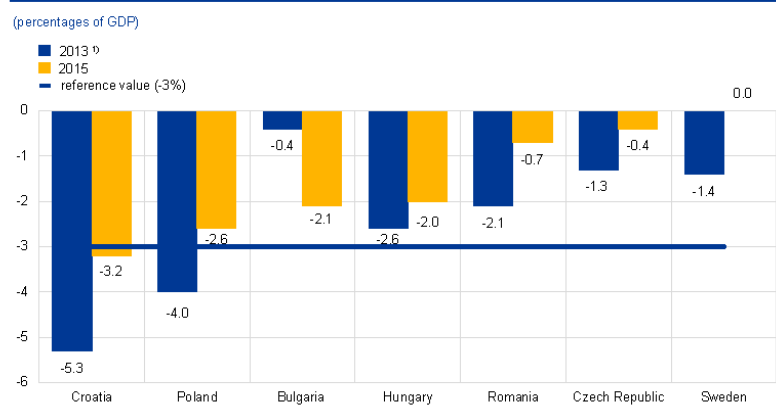
Chart 3.1
HICP inflation



As regards the fiscal criteria, among the countries under review, only Croatia is, at the time of publication of this report, subject to an EU Council decision on the existence of an excessive deficit. This is in contrast to the situation identified in the 2014 Convergence Report, when the Czech Republic and Poland were also subject to excessive deficit procedures; these procedures were abrogated in June 2014 (Czech Republic) and June 2015 (Poland). In 2015, the headline fiscal balance stood at or below the 3% of GDP reference value in all countries except Croatia, whereas in the 2014 report Croatia and Poland were reported as having posted a fiscal deficit-to-GDP ratio above 3% in 2013 (see Chart 3.2a). As in the 2014 Convergence Report, Croatia and Hungary were in 2015 the only countries with a general government debt-to-GDP ratio above the 60% reference value. In Croatia the debt ratio was notably higher compared with the 2013 data, while in Hungary it was slightly lower. Poland's debt-to-GDP ratio was above 50% in 2015. In

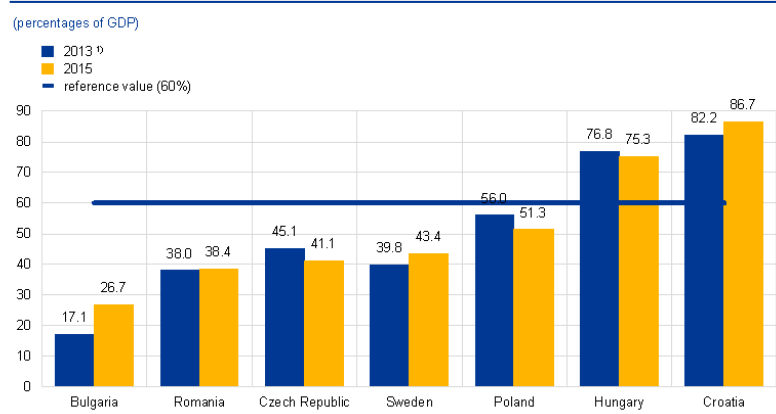
the Czech Republic and Sweden the ratio was below 50%, in Romania it was below 40%, and in Bulgaria it was below 30% (see Chart 3.2b).

Chart 3.2 a
General government surplus (+) or deficit (-)



Source: Eurostat.
1) Data have been revised slightly since the 2014 Convergence Report.

Chart 3.2 b
General government gross debt

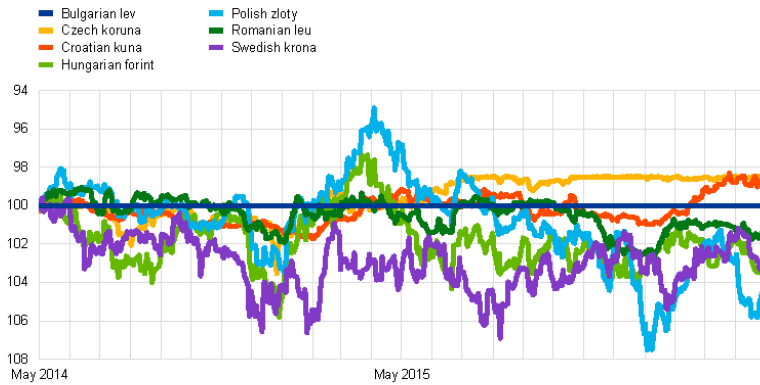


Source: Eurostat.
1) Data have been revised slightly since the 2014 Convergence Report.

As regards the exchange rate criterion, none of the countries under review participates in ERM II. In several countries the exchange rate exhibited a relatively high degree of volatility over the two-year reference period. Exceptions were the currencies of Bulgaria and Croatia; the former country has a currency board vis-à-vis the euro, while the latter operates a tightly managed float. Most other currencies under review weakened against the euro over the reference period, most notably the Polish zloty (see Chart 3.3). By contrast, the Czech koruna and the Croatian kuna strengthened modestly against the euro.

Chart 3.3
Bilateral exchange rates vis-à-vis the euro

(daily data; average of May 2014 = 100; 19 May 2014-18 May 2016)

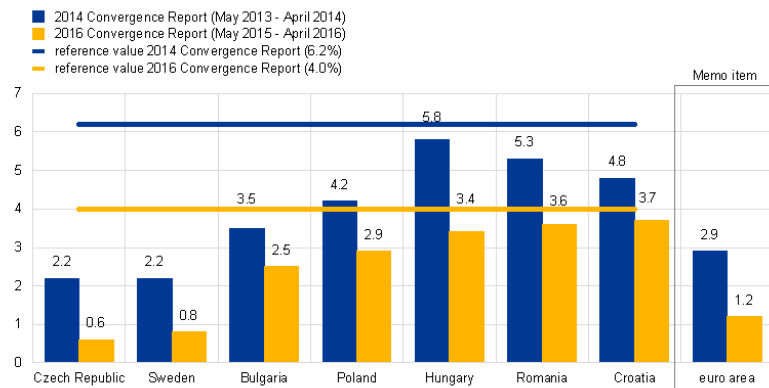


Source: ECB
Note: An upward (downward) movement indicates an appreciation (depreciation) of the local currency.

With regard to the convergence of long-term interest rates, all seven countries under review recorded, as in 2014, long-term interest rates below the reference value, which was 4% (Chart 3.4). Interest rates were lowest in the Czech Republic and Sweden.

Chart 3.4
Long-term interest rates

(percentages, annual average)



Sources: Eurostat and ECB

When considering compliance with the convergence criteria, sustainability is essential. Convergence must be achieved on a lasting basis and not just at a given point in time. The first decade of EMU showed that weak fundamentals, an excessively loose macroeconomic stance at country level and overly optimistic expectations about the convergence in real incomes pose risks not only for the

countries concerned but also for the smooth functioning of the euro area as a whole. Fulfilment of the numerical convergence criteria at a point in time is, by itself, not a guarantee of smooth membership of the euro area. Countries joining the euro area should thus demonstrate the sustainability of their convergence processes and their capacity to live up to the permanent commitments which euro adoption represents. This is in the country's own interest, as well as in the interest of the euro area as a whole.

Lasting policy adjustments are required in many of the countries under review to achieve sustainable convergence. A prerequisite for sustainable convergence is macroeconomic stability and in particular sound fiscal policy. A high degree of flexibility in product and labour markets is essential to cope with macroeconomic shocks. A stability culture needs to exist, with well-anchored inflation expectations helping to achieve an environment of price stability. Favourable conditions for an efficient use of capital and labour in the economy are needed to enhance total factor productivity and long-run economic growth. Sustainable convergence also requires sound institutions and a supportive business environment. A high degree of economic integration with the euro area is needed to achieve the synchronisation of business cycles. Moreover, appropriate macroprudential policies need to be in place to prevent the build-up of macroeconomic imbalances, such as excessive asset price increases and credit boom-bust cycles. Finally, an appropriate framework for the supervision of financial institutions needs to be in place.

3.1 The price stability criterion

In April 2016 six of the seven countries under review recorded a 12-month average inflation rate below – in several cases well below – the reference value of 0.7% for the price stability criterion. Inflation was very low in the EU over the reference period, mainly owing to the significant fall in oil prices. This was reflected in a reference value of 0.7% (see Box 1 in Chapter 2). In all the countries examined, inflation was very low by historical standards. The Czech Republic and Hungary recorded low positive inflation rates below the reference value. In Bulgaria, Croatia, Poland and Romania, inflation stood in negative territory. In Sweden inflation was above the reference value.

Over the past ten years both the average level and the volatility of inflation have varied significantly across the countries examined. Over this period Bulgaria, Hungary and Romania recorded an average HICP inflation rate well above 3%. In the Czech Republic, Croatia and Poland, the average inflation rate was closer to 2%. In Sweden inflation averaged 1.4% over the past ten years. During this period, price dynamics were particularly volatile in Bulgaria, although inflation in the Czech Republic, Croatia, Hungary, Poland and Romania also fluctuated within a relatively wide range. Sweden recorded the lowest volatility in inflation rates. The marked cross-country differences in the average level and the volatility of inflation over the longer term contrast with the small inflation differentials over the reference period from May 2015 to April 2016, indicating the progress made towards

convergence over the recent past. To some extent, the recent developments also reflect common oil price shocks.

The longer-term price developments mirrored a more volatile macroeconomic environment in many countries. In the years leading up to the global financial crisis, inflation accelerated amid robust economic growth in all countries examined. At the same time, macroeconomic imbalances were building up in some central and eastern European economies, particularly in the form of excessive credit growth and large current account deficits. In most of the countries under review, average annual inflation peaked in 2008, before declining substantially in 2009 amid an abrupt economic downturn and a fall in global commodity prices. In the following years, price developments became more heterogeneous, partly reflecting differences in the strength of the economic recovery and country-specific measures related to administered prices. In 2013 inflation embarked on a downward trend in all countries under review, reaching historical lows and often even negative levels. This broad-based movement has mainly reflected developments in global commodity prices, low imported inflationary pressures and persistent spare capacity in some countries. The developments in global commodity prices have had a particularly pronounced impact on central and eastern European economies, given the relatively large weight of energy and food in their HICP baskets. In some of the countries under review, cuts in administered prices and indirect taxes, base effects from past increases in indirect taxes or a strengthening of the nominal effective exchange rate also exerted downward pressure on inflation. Against this backdrop, monetary policy conditions have been loosened considerably over recent years.

While inflation is expected to increase moderately in the coming years, there are concerns over the longer term regarding the sustainability of inflation convergence in most of the countries examined. In 2016 and 2017 inflation is expected to gradually increase from the current very low levels in all countries under review, according to the European Commission's Spring 2016 Economic Forecast. This partly reflects base effects related to the recent decline in oil prices. However, the fragile global economic recovery, coupled with persistent spare capacity in some countries, is expected to keep underlying inflationary pressures contained. The risks to the price outlook are broadly balanced in most countries. A key downside risk relates to heightened uncertainties regarding developments in the global economy, which could reduce external price pressures. In most of the countries under review, upside risks to inflation could arise from stronger than expected domestic price and wage pressures amid strengthening economic activity and tightening labour market conditions. Looking further ahead, in many of the central and eastern European countries under review the catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area.

An environment that is conducive to sustainable price stability in the countries covered in this report requires stability-oriented economic policies, structural reforms and measures to safeguard financial stability. Achieving or maintaining an environment supportive of price stability will crucially depend on the implementation of further structural reforms. In particular, wage increases should reflect labour productivity growth at firm level and take into account labour market

conditions and developments in competitor countries. In addition, continued reform effort is needed to further improve the functioning of labour and product markets and maintain favourable conditions for economic expansion and employment growth. To that end, measures to support stronger governance and further improvements in the quality of institutions are essential in the central and eastern European economies. Given the limited room for manoeuvre for monetary policy under the tightly managed exchange rate regime in Croatia, as well as the currency board framework in Bulgaria, it is imperative that other policy areas support the capacity of these economies to cope with country-specific shocks and to avoid the build-up of macroeconomic imbalances. Financial sector and supervisory policies should be aimed at further safeguarding financial stability. In this respect, the recommendations of the European Systemic Risk Board should also be implemented.

3.2 The government budgetary position criterion

At the time of publication of this report, only Croatia is subject to an EU Council decision on the existence of an excessive deficit. The deadline for correcting the excessive deficit situation in Croatia is 2016. All the other countries under review posted a fiscal deficit-to-GDP ratio at or below the 3% reference value in 2015. Croatia recorded a deficit of 3.2% of GDP; the remaining deficits were 2.6% in Poland, 2.1% in Bulgaria, 2.0% in Hungary, 0.7% in Romania and 0.4% in the Czech Republic. Sweden recorded 0%.

Between 2013 and 2015 the fiscal balance improved in most of the countries covered by this report, with the exception of Bulgaria. In Croatia, Poland, Romania and Sweden, the improved budget balances largely reflect a better macroeconomic situation, as well as structural consolidation efforts. In the case of Hungary and the Czech Republic, the better macroeconomic developments have been partially offset by a loosening in the fiscal stance. The deficit increase in Bulgaria is mostly explained by a deterioration in the structural balance.

For 2016, the European Commission forecasts the deficit-to-GDP ratio to be below the 3% reference value in all countries. Romania, Croatia and Poland are projected to post a deficit ratio below the reference value at 2.8%, 2.7% and 2.6% of GDP respectively. The deficit ratios in Bulgaria and Hungary are forecast to reach 2.0%, and those in Czech Republic and Sweden are projected to stay well below the reference value, at 0.7% and 0.4% of GDP respectively.

In Croatia and Hungary the debt ratio was above 60% of GDP in 2015, while in the other countries under review the debt levels were below or well below this threshold (see Table 3.1). Since 2013 the government debt-to-GDP ratio has increased by 9.6 percentage points in Bulgaria, 4.5 percentage points in Croatia and 3.7 percentage points in Sweden. In Hungary and Romania the debt ratios changed only slightly. In the same period Poland and the Czech Republic posted notable reductions in their debt ratios (by 4.7 and 4.1 percentage points of GDP respectively). Taking a longer perspective, between 2006 and 2015, the government debt-to-GDP ratio increased substantially in Croatia (by 47.8 percentage points),

Romania (by 26.2 percentage points), the Czech Republic (by 13.1 percentage points) and Hungary (by 10.7 percentage points), while in the rest of the countries the changes were smaller.

For 2016, the European Commission projects a rise in the debt ratio in Bulgaria, the Czech Republic, Croatia, Poland and Romania, with opposite dynamics in Hungary and Sweden. The Commission's projections also indicate that the debt ratio will remain below the 60% reference value in all countries except Croatia and Hungary in 2016.

Looking ahead, it is essential for the countries examined to achieve and/or maintain sound and sustainable fiscal positions. Croatia – which is subject to an EU Council decision on the existence of an excessive deficit – must comply with its EDP commitments in a credible and timely manner and bring its budget deficit below the reference value in 2016. Further consolidation is also required in Bulgaria, Hungary and Poland, which have yet to attain their medium-term budgetary objectives, and also in the Czech Republic and Romania, which are projected to deviate from theirs. In this respect, particular attention should be paid to limiting expenditure growth to a rate below the medium-term potential economic growth rate, in line with the expenditure benchmark rule of the revised Stability and Growth Pact. Moreover, beyond the transition period provided for under the Pact, countries whose debt-to-GDP ratio exceeds the reference value should ensure that the ratio is declining sufficiently, in accordance with the provisions of the enhanced Pact. Further consolidation would also make it easier to deal with the budgetary challenges related to the ageing of the population and to build up buffers to allow automatic stabilisers to work. Strong national fiscal frameworks that are fully in line with EU rules and implemented effectively should support fiscal consolidation and limit slippages in public expenditure, while helping to prevent a re-emergence of macroeconomic imbalances. Overall, fiscal strategies should be consistent with comprehensive structural reforms to increase potential growth and employment.

3.3 The exchange rate criterion

None of the countries examined in this report participates in ERM II. The countries under review operate under different exchange rate regimes.

The Bulgarian lev remained fixed at 1.95583 levs per euro within the framework of a currency board in the reference period. This exchange rate regime operated amid mostly low short-term interest rate differentials vis-à-vis the euro area.

The Croatian kuna and the Romanian leu traded under flexible exchange rate regimes involving – to different degrees – a managed float vis-à-vis the euro. In the case of the Croatian kuna, this was reflected in low exchange rate volatility compared with the other flexible currencies under review, amid low short-term interest rate differentials vis-à-vis the euro area. The exchange rate of the Romanian leu against the euro showed a relatively high degree of volatility, with short-term interest rate differentials vis-à-vis the euro area remaining at relatively high levels throughout the reference period. In 2009, Romania was granted an international

financial assistance package, led by the EU and the IMF, followed by a precautionary financial assistance programme in 2011 and a successor programme in 2013. As these agreements have helped reduce financial vulnerabilities, they might also have contributed to reducing exchange rate pressures over the reference period.

All other currencies traded under a flexible exchange rate regime amid high exchange rate volatility in most countries. As regards the Czech Republic, however, this has since 2013 involved a commitment by Česká národní banka not to let the koruna appreciate above a level close to CZK 27 against the euro. Short-term interest rate differentials vis-à-vis the euro area were small in the Czech Republic and Sweden but relatively high in Hungary and Poland. In the case of Poland, a Flexible Credit Line arrangement with the IMF, designed to meet the demand for crisis-prevention and crisis-mitigation lending, was in place over the reference period. As this arrangement has helped to reduce risks related to financial vulnerabilities, it might also have contributed to reducing the risk of exchange rate pressures. In Sweden, over the reference period Sveriges Riksbank maintained a swap agreement with the ECB which, as it has helped to reduce financial vulnerabilities, might also have had an impact on exchange rate developments.

3.4 The long-term interest rate criterion

Over the reference period, all countries under examination recorded average long-term interest rates that were – to different degrees – below the 4.0% reference value. Long-term interest rates in the Czech Republic and Sweden were below 1%, while they stood between 2% and 3% in Bulgaria and Poland, and above 3% in Croatia, Hungary and Romania.

Since the 2014 Convergence Report long-term interest rate spreads vis-à-vis the euro area average have remained broadly stable in most of the countries under review. However, financial markets have continued to differentiate between countries on the basis of their external and internal vulnerabilities, including the developments in budgetary performance and the prospects for sustainable convergence.

3.5 Other relevant factors

According to the European Commission, most of the countries under review have made progress in addressing imbalances in their economies, albeit to a different degree. The European Commission's in-depth reviews, the results of which were published on 8 March 2016, concluded that Sweden was experiencing macroeconomic imbalances, and that Bulgaria and Croatia were experiencing

excessive macroeconomic imbalances¹¹¹. As regards Bulgaria, the Commission stated that the economy continues to be characterised by remaining fragilities in the financial sector and high corporate indebtedness, which need to be addressed through the full implementation of ambitious reforms. As regards Croatia, the Commission found that limited progress had been made towards the correction of macroeconomic imbalances, while the implementation of the reform agenda had suffered significant delays, partly due to parliamentary elections held in November 2015. While the European Commission classified the other countries under review as having no imbalances, various challenges also exist for these countries.

External deficits have been reduced in recent years. The MIP scoreboard shows that three-year average current account balances improved further in 2015 (see Table 3.2). In Sweden, however, the large current account surplus remained unchanged compared with 2014 (just below the 6% of GDP indicative threshold). Surpluses were also observed in Hungary, Croatia, Bulgaria and the Czech Republic, whereas deficits were reported in Poland and Romania.

The negative net international investment position as a share of GDP has diminished but stayed at high levels in almost all countries under review. On the positive side, the net foreign liabilities of the central and eastern European countries are mainly in foreign direct investment, which is assessed to constitute a stable form of financing. In 2015 the net international investment position was beyond the indicative threshold of -35% of GDP in five out of the seven countries under review. Net foreign liabilities were particularly sizeable in Croatia, where they exceeded 70% of GDP. Net foreign liabilities were smallest in the Czech Republic (31.5% of GDP) and Sweden (1.6% of GDP).

In terms of price and cost competitiveness, over the three-year period from 2013 to 2015, real effective exchange rates depreciated to different degrees in most of the examined countries, with Romania and Croatia being the only exceptions. The three-year growth rate of unit labour costs, which in the pre-crisis years stood at very high levels in almost all countries, has generally remained below the indicative threshold of 12% over recent years. Over the five-year period from 2011 to 2015, gains in export market shares were experienced in Romania and, to a lesser extent, Bulgaria, Poland and the Czech Republic. The other countries' export market shares decreased.

House prices have increased again in all countries under review except Croatia. This follows a downward correction from the high levels reached in the pre-crisis phase. Sweden has recorded particularly strong increases in house prices over recent years, partly due to supply-side bottlenecks and historically low interest rates.

¹¹¹ For countries identified as having excessive imbalances the MIP Regulation (Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances) foresees the possibility for the EU Council, upon a recommendation by the European Commission, to recommend that the Member State concerned takes corrective action. This would result in the country entering a different procedure, i.e. the excessive imbalance procedure (EIP).

Table 3.2
Scoreboard for the surveillance of macroeconomic imbalances

Table 3.2a – External imbalances and competitiveness indicators

		Current account balance ¹⁾	Net international investment position ²⁾	Real effective exchange rate, HICP-deflated ³⁾	Export market share ⁴⁾	Nominal unit labour costs ⁵⁾
Bulgaria	2013	0.3	-73.5	-1.0	0.2	15.2
	2014	0.4	-74.8	-2.8	6.0	17.0
	2015	1.2	-60.7	-4.1	14.4	10.8
Czech Republic	2013	-1.4	-39.4	-3.1	-9.4	4.2
	2014	-0.6	-36.8	-10.0	-5.7	3.8
	2015	0.2	-31.5	-8.0	0.4	0.1
Croatia	2013	0.0	-88.7	-4.0	-23.1	-2.9
	2014	0.6	-88.1	-1.0	-18.6	-5.8
	2015	2.3	-78.7	0.1	-3.1	-5.1
Hungary	2013	2.2	-83.5	-4.0	-20.9	6.3
	2014	2.6	-73.9	-7.0	-15.6	6.9
	2015	3.4	-68.6	-6.9	-7.2	6.1
Poland	2013	-3.4	-69.7	-4.3	0.1	3.3
	2014	-2.3	-67.1	-1.3	5.0	2.5
	2015	-1.2	-60.7	-1.0	9.1	-1.4
Romania	2013	-3.6	-61.9	0.3	14.2	-3.2
	2014	-2.1	-56.9	-1.1	20.8	6.0
	2015	-0.9	-50.2	2.7	21.7	1.1
Sweden	2013	6.0	-14.3	5.1	-16.5	8.6
	2014	5.8	-2.5	-3.6	-9.7	7.2
	2015	5.8	-1.6	-7.9	-9.9	4.0
Threshold		-4.0/+6.0	-35.0	+/-11.0	-6.0	+12.0

Table 3.2b – Internal imbalances and unemployment indicators

		Internal imbalances					New unemployment indicators			
		House prices, consumption-deflated ⁴⁾	Private sector credit flow, consolidated ²⁾	Private sector debt, consolidated ²⁾	Financial sector liabilities ³⁾	General government debt ²⁾	Unemployment rate ⁷⁾	Activity rate ⁸⁾	Long-term unemployment ⁵⁾	Youth unemployment ⁶⁾
Bulgaria	2013	0.4	7.3	132.2	4.3	17	12.2	1.7	2.7	6.4
	2014	1.5	-0.3	124.3	7.2	27	12.2	3.1	0.6	-1.3
	2015	3.6	.	.	.	27	11.2	2.2	-1.2	-6.4
Czech Republic	2013	-0.8	4.4	74.1	11.3	45	6.9	2.7	0.0	0.6
	2014	1.9	1.8	72.7	4.4	43	6.7	3.0	-0.1	-2.2
	2015	3.8	.	.	.	41	6.1	2.4	-0.6	-6.9
Croatia	2013	-5.7	-0.6	119.7	3.2	82	15.7	-1.4	4.4	17.6
	2014	-1.2	0.3	120.8	0.9	87	16.9	2.0	1.7	8.9
	2015	-2.4	.	.	.	87	17.0	3.0	0.1	0.9
Hungary	2013	-4.6	-1.1	95.2	-1.0	77	10.7	2.8	-0.5	0.2
	2014	3.1	-0.5	91.3	8.5	76	9.6	4.6	-1.6	-5.6
	2015	11.6	.	.	.	75	8.2	4.9	-1.9	-10.9
Poland	2013	-4.7	3.1	75.4	7.6	56	10.0	1.7	1.4	-3.6
	2014	1.1	4.8	77.9	0.6	50	9.8	2.1	0.3	-1.9
	2015	2.8	.	.	.	51	9.0	1.6	-1.1	-5.7
Romania	2013	-2.8	-1.5	66.6	1.1	38	7.0	0.0	0.8	1.6
	2014	-3.2	-2.4	62.1	1.1	40	6.9	1.6	-0.1	0.2
	2015	1.7	0.0	58.3	3.8	38	6.9	1.3	0.0	-0.9
Sweden	2013	4.7	4.7	192.4	8.8	40	7.9	2.0	-0.1	-1.2
	2014	8.6	5.9	194.0	13.4	45	8.0	1.6	0.0	0.2
	2015	12.0	.	.	.	43	7.8	1.4	0.0	-3.3
Threshold		+6.0	+14.0	133	+16.5	-60	+10.0	-0.2	0.5	2.0

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

Note: This table includes data available as of 18 May 2016, i.e. the cut-off date for this report, and therefore differs from the scoreboard published in the Alert Mechanism Report of November 2015.

1) As a percentage of GDP, three-year average.

2) As a percentage of GDP.

3) Three-year percentage change relative to 41 other industrial countries. A positive value indicates a loss of competitiveness.

4) Five-year percentage change.

5) Three-year percentage change.

6) Year-on-year percentage change.

7) Three-year average.

8) Three-year percentage point change.

A relatively long period of credit expansion prior to the financial crisis left the private non-financial sector with high levels of accumulated debt in some of the countries under review. This constitutes a key vulnerability in those countries. Strong credit growth, especially in loans for house purchase in Sweden, requires close monitoring. In 2014 Sweden recorded a particularly high level of private sector debt, exceeding 190% of GDP. In addition, the stock of foreign currency loans in several countries is very large and represents a macroeconomic and financial risk, as it exposes unhedged borrowers to exchange rate risk. Risks stemming from foreign currency mismatches – affecting households and in Croatia also the public sector – are significant in Croatia, Romania and, to a lesser extent, Poland.

Financial sector policies should be aimed at ensuring that the financial sector makes a sound contribution to economic growth and price stability in the countries under review, and supervisory policies should be geared towards stabilising the supervisory framework, which is a precondition for joining the Single Supervisory Mechanism (SSM). In order to minimise the potential risks associated with a large share of loans being denominated in foreign currency, the recommendations of the European Systemic Risk Board (ESRB) on lending in foreign currencies should be implemented. Close cooperation between supervisors across EU countries is important to ensure the effective implementation of measures.

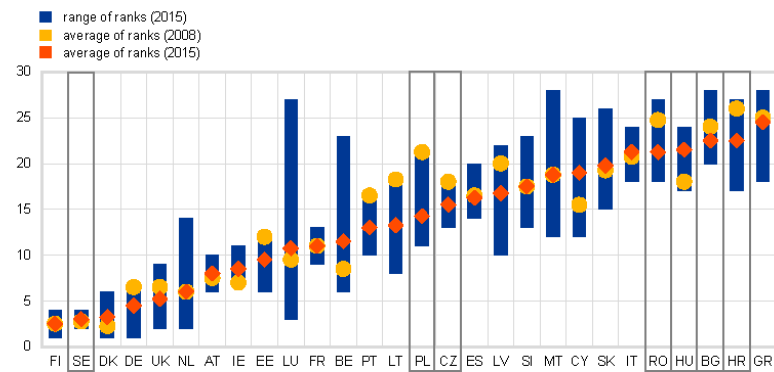
The adjustment process has resulted in a relatively high level of unemployment in some of the countries under review. Notably, in Croatia high levels of long-term and youth unemployment highlight the severity of domestic imbalances. Unemployment – which has generally been accompanied by a worsening of skill and/or cross-regional mismatches – is a vulnerability in many countries and poses a risk to the convergence of real incomes, also in view of adverse demographic trends.

The strength of the institutional environment is another important factor in the analysis of the sustainability of economic integration and convergence. In several central and eastern European countries, removing the existing rigidities and impediments to the efficient use and allocation of production factors would help to enhance economic potential. These reflect, for example, weaknesses in the business environment, the relatively low quality of institutions, weak governance and corruption. By hampering potential output growth, the institutional environment may also undermine a country's debt-servicing ability and make economic adjustments more difficult. It may also affect a country's ability to implement necessary policy measures.

The quality of institutions and governance is relatively weak in all countries under review except Sweden. Specific institutional indicators broadly confirm an overall picture of weak quality of institutions and governance in most of the countries, although with some notable differences (Chart 3.5 and 3.6). Croatia has the weakest quality of institutions and governance among the countries under review, and is ranked second to last among the EU countries, despite some improvement over the past few years. Although countries are ranked differently depending on the source

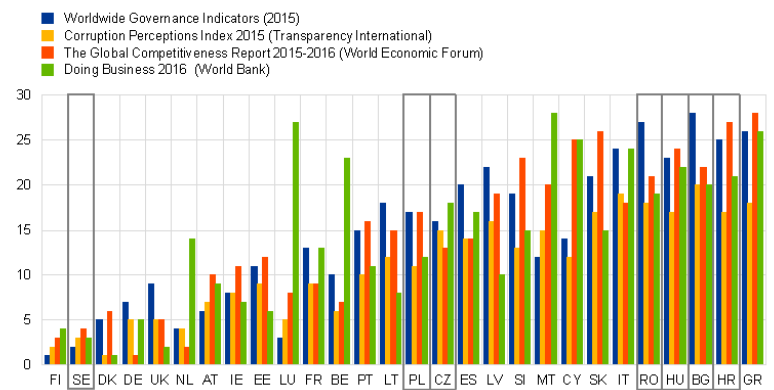
used to measure the quality of the business and institutional environment, there is clearly still significant room for improvement in this field in most of the countries.

Chart 3.5
Overview of EU country rankings in terms of institutional quality



Sources: Worldwide Governance Indicators 2015, The Global Competitiveness Report 2015-2016 (World Economic Forum), Corruption Perceptions Index 2015 (Transparency International) and Doing Business 2016 (World Bank).
Notes: Countries are ranked from one (best performer in the EU) to 28 (worst performer in the EU) and ordered according to their average position in the 2015 rankings. In the Doing Business report Malta has only been covered since the 2013 report and Cyprus only since 2010.

Chart 3.6
EU country rankings in terms of institutional quality by individual indicator



Sources: Worldwide Governance Indicators 2015, The Global Competitiveness Report 2015-2016 (World Economic Forum), Corruption Perceptions Index 2015 (Transparency International) and Doing Business 2016 (World Bank).
Note: Countries are ranked from one (best performer in the EU) to 28 (worst performer in the EU) and ordered according to their average position in the 2015 rankings.

Wide-ranging structural reforms are required in most of the countries under review to improve economic growth and competitiveness. Improving the local institutions, governance and business environment, along with further progress with the privatisation of state-owned enterprises and reinforced efforts to enhance the absorption of EU funds, would help to speed up productivity growth. This would in turn contribute to increasing competition in key regulated sectors (e.g. energy and

transport), diminishing barriers to entry and encouraging much-needed private investment.

Finally, institutional features relating to the quality of the statistics are also essential to support a smooth convergence process. This applies to, among other things, the specification of the legal independence of the national statistical authority, its administrative supervision and budget autonomy, its legal mandate for data collection and its legal provisions governing statistical confidentiality, which are described in more detail in Chapter 6.

4 Country summaries

4.1 Bulgaria

In April 2016 the 12-month average rate of HICP inflation in Bulgaria was -1.0%, i.e. well below the reference value of 0.7% for the criterion on price stability.

Over the past ten years this rate has fluctuated within a wide range, from -1.7% to 12.6%, and the average for that period was elevated, standing at 3.6%. Looking ahead, there are concerns regarding the sustainability of inflation convergence in Bulgaria over the longer term. The catching-up process is likely to result in positive inflation differentials vis-à-vis 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.

Bulgaria's general government deficit and debt complied with the Maastricht criteria in 2015. Bulgaria has been subject to the preventive arm of the Stability and Growth Pact since 2012. The deficit exceeded the 3% of GDP reference value in 2014. However, the European Commission assessed the excess deficit to be both exceptional and temporary, thereby not warranting the opening of an excessive deficit procedure. The European Commission's Spring 2016 Economic Forecast points to the risk of some deviation from the adjustment path towards the medium-term objective in both 2016 and 2017. Furthermore, Bulgaria faces medium risks to fiscal sustainability in the long run, partly as a result of the expected increase in age-related expenditure on health care and long-term care. Further reforms in these areas and further progress towards the medium-term objective in line with preventive-arm requirements are essential for ensuring sound public finances over the medium and long term.

In the two-year reference period from 19 May 2014 to 18 May 2016, the Bulgarian lev did not participate in ERM II, but its exchange rate was fixed at 1.95583 levs per euro within the framework of a currency board. Over the past decade Bulgaria's current and capital account has improved, while the country's net foreign liabilities remain high.

Over the reference period from May 2015 to April 2016, long-term interest rates in Bulgaria were 2.5% on average and thus below the 4.0% reference value for the interest rate convergence criterion. Long-term interest rates in Bulgaria have decreased since 2009, with 12-month average rates having declined from above 7% to below 3%.

Achieving an environment that is conducive to sustainable convergence in Bulgaria requires stability-oriented economic policies and wide-ranging structural reforms. With regard to macroeconomic imbalances, the European Commission selected Bulgaria for an in-depth review in its Alert Mechanism Report 2016 and concluded that Bulgaria is experiencing excessive macroeconomic imbalances. Bulgaria would benefit from wide-ranging structural reforms to enhance the institutional and business environment. In order to safeguard financial stability, it

is essential that the authorities complete the asset quality review and stress test exercises relating to the financial sector and further improve supervisory practices.

Bulgarian law does not comply with all the requirements for central bank independence, the monetary financing prohibition, and legal integration into the Eurosystem. Bulgaria is an EU Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.

4.2 Czech Republic

In April 2016 the 12-month average rate of HICP inflation in the Czech Republic was 0.4%, i.e. below the reference value of 0.7% for the criterion on price stability. Over the past ten years this rate has fluctuated within a relatively wide range, from 0.3% to 6.6%, and the overall average for that period was moderate, standing at 2.1%.

The Czech Republic's general government deficit and debt complied with the Maastricht criteria in 2015. The Czech Republic has been subject to the preventive arm of the Stability and Growth Pact since 2014. The European Commission's Spring 2016 Economic Forecast projects the structural deficit to remain below the medium-term objective over the forecast horizon and, thus, in compliance with the preventive arm's requirements. The Czech Republic is at medium risk of fiscal stress over the long term, mainly as a result of an ageing population. Broadening the scope of the current fiscal framework reforms, strictly enforcing the existing rules and making further progress towards the medium-term objective in full compliance with preventive-arm requirements are necessary in order to ensure sound public finances.

In the two-year reference period from 19 May 2014 to 18 May 2016, the Czech koruna did not participate in ERM II. The koruna traded under a flexible exchange rate regime, although since November 2013 this has entailed a commitment by Česká národní banka not to let the koruna appreciate above a level of 27 korunas per euro. The exchange rate of the Czech koruna against the euro exhibited a low degree of volatility over the reference period. On 18 May 2016 the exchange rate stood at 27.022 korunas per euro, i.e. 1.5% stronger than its average level in May 2014. The current account deficit shrank gradually and the balance turned positive from 2014, while the country's net foreign liabilities declined steadily.

Over the reference period from May 2015 to April 2016, long-term interest rates in the Czech Republic were 0.6% on average and thus well below the 4.0% reference value for the interest rate convergence criterion. Long-term interest rates in the Czech Republic have decreased since 2009, with 12-month average rates having declined from almost 5% to below 1%.

Achieving an environment that is conducive to sustainable convergence requires conducting price stability-oriented economic policies, including targeted structural reforms that are geared to ensuring macroeconomic stability. With regard to macroeconomic imbalances, the European Commission did

not select the Czech Republic for an in-depth review in its Alert Mechanism Report 2016. Nevertheless, the targeted structural reforms with regard to labour and product market policies, as well as the business environment, need to be stepped up in order to boost potential growth.

Czech law does not comply with all the requirements for central bank independence, the monetary financing prohibition and legal integration into the Eurosystem. The Czech Republic is an EU Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.

4.3 Croatia

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.

Over the past ten years this rate 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%. Looking ahead, there are concerns regarding the sustainability of inflation convergence in Croatia over the longer term. The catching-up process is likely to result in positive inflation differentials vis-à-vis 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.

Croatia's general government deficit and debt did not comply with the Maastricht criteria in 2015. Croatia has been subject to the corrective arm of the Stability and Growth Pact since 2014, with the deadline for correcting the excessive deficit being 2016. The European Commission's Spring 2016 Economic Forecast foresees a timely correction of the excessive deficit but points to the risk that Croatia will not comply with the provisions of the Stability and Growth Pact. The Commission's 2015 Fiscal Sustainability Report suggests that Croatia faces a high debt sustainability risk over the medium term. Over the long term, while Croatia appears to be at low risk owing to 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. Overall, it is essential that Croatia follows a determined, growth-friendly consolidation strategy that addresses the high risks to medium-term debt sustainability. This will need to be coupled with an overhaul of the fiscal governance framework that is geared towards improving public spending efficiency in order to create the conditions for a lasting improvement in the conduct of fiscal policies.

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 exchange rate of the Croatian kuna against the euro exhibited, on average, a low degree of volatility over the reference period. 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.

Croatia's current and capital account has improved over the past decade, while the country's net foreign liabilities remain high.

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. Long-term interest rates in Croatia have decreased since 2009, with 12-month average rates having declined from around 8% to below 4%.

Achieving an environment that is conducive to sustainable convergence in Croatia requires stability-oriented economic policies and wide-ranging structural reforms. 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. In terms of structural reforms, there is considerable scope and an urgent need for reforms aimed at improving the institutional and business environment, boosting competition in the product markets, reducing mismatches in the labour market and enhancing the efficiency of the public administration and the judicial system. Significant efforts should also be made to ensure that Croatia improves its very weak absorption of EU funds.

Croatian law does not comply with all the requirements for central bank independence. Croatia is an EU Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.

4.4 Hungary

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. Over the past ten years this rate 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%. Looking ahead, there are concerns regarding the sustainability of inflation convergence in Hungary over the longer term. The catching-up process is likely to result in positive inflation differentials vis-à-vis 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.

In 2015 Hungary's general government deficit complied with the Maastricht criteria, whereas its debt exceeded the reference value. Hungary has been subject to the preventive arm of the Stability and Growth Pact since 2013. The European Commission's Spring 2016 Economic Forecast points to the high risk of a significant deviation from the adjustment path to the medium-term objective over the 2016-17 period. Hungary is at no risk of fiscal stress over the long term, but medium risk over the medium term. An ageing population poses a challenge to the sustainability of public finances. Determined progress towards the medium-term objective in line with preventive-arm requirements, as well as reform of the fiscal governance framework, are necessary in order to safeguard the sustainability of public finances over the medium term.

In the two-year 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. The exchange rate of the Hungarian forint against the euro exhibited, on average, a relatively high degree of volatility over the reference period. 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 past decade Hungary's current and capital account has improved markedly and has contributed to some reduction in the country's net foreign liabilities, which remain high.

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. Long-term interest rates in Hungary have decreased since 2009, with 12-month average rates having declined from above 9% to below 4%.

Achieving an environment that is conducive to sustainable convergence in Hungary requires stability-oriented economic policies and wide-ranging structural reforms. 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. However, Hungary would benefit from structural reforms aimed at promoting private sector-led growth, such as improving the governance of institutions, removing red tape and the excessive tax burden, and fostering private credit growth.

Hungarian law does not comply with all the requirements for central bank independence, the prohibition of monetary financing, the requirements for the single spelling of the euro and legal integration into the Eurosystem. Hungary is an EU Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.

4.5 Poland

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. Over the past ten years this rate 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%. Looking ahead, there are concerns regarding the sustainability of inflation convergence in Poland over the longer term. The catching-up process is likely to result in positive inflation differentials vis-à-vis 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.

Poland's general government deficit and debt complied with the Maastricht criteria in 2015. Poland has been subject to the preventive arm of the Stability and Growth Pact since 2015. The ECOFIN Council decided in June 2015 to abrogate the excessive deficit procedure for Poland, despite the deficit being above the reference value, on the grounds that the debt-to-GDP ratio was below 60% and the excess over the reference value was small and could be explained by the net cost of past

pension reforms. 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. Moreover, in the medium and long run, Poland faces medium risks to fiscal sustainability. Therefore, further progress towards the medium-term objective in line with preventive-arm requirements is essential for ensuring sound public finances over the medium and long term.

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. The exchange rate of the Polish zloty against the euro exhibited, on average, a relatively high degree of volatility over the reference period. 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. Poland's current and capital account has improved over the past decade, while the country's net foreign liabilities remain high.

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. Long-term interest rates in Poland have decreased since 2009, with 12-month average rates having declined from approximately 6% to below 3%.

Achieving an environment that is conducive to sustainable convergence in Poland requires stability-oriented economic policies, policy measures safeguarding financial stability and targeted structural reforms. With regard to macroeconomic imbalances, the European Commission did not select Poland for an in-depth review in its Alert Mechanism Report 2016. It is essential to preserve the currently strong financial position of the banking sector in order to ensure its sound contribution to economic growth, which should be supported by well targeted structural reforms to enhance competition in product markets and speed up innovation, privatisation and infrastructure modernisation.

Polish law does not comply with all the requirements for central bank independence, confidentiality, the monetary financing prohibition and legal integration into the Eurosystem. Poland is an EU Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.

4.6 Romania

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% for the criterion on price stability. Over the past ten years this rate 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%. Looking ahead, there are concerns regarding the sustainability of inflation convergence in Romania over the longer term. The catching-up process is likely to result in positive inflation differentials vis-à-vis 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.

Romania's general government deficit and debt complied with the Maastricht criteria in 2015. Romania has been subject to the preventive arm of the Stability and Growth Pact since 2013. According to the European Commission's Spring 2016 Economic Forecast, Romania has complied with its medium-term objective since 2013, but is at risk of a significant deviation in both 2016 and 2017. Furthermore, the expansionary fiscal measures being planned are expected to push the deficit above the 3% of GDP threshold in 2017 and put the debt on an upward path. The Commission's 2015 Fiscal Sustainability Report points to high sustainability risks in the medium term and medium sustainability risks in the long term, partly related to the rising cost of health care and long-term care. Further reforms in these areas and a prudent conduct of fiscal policy, ensuring a rapid return to the medium-term objective, are warranted in order to safeguard the sustainability of public finances.

In the two-year 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 involving a managed floating of the currency's exchange rate. The exchange rate of the Romanian leu against the euro exhibited, on average, a relatively high degree of volatility over the reference period. 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. 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.

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. Long-term interest rates in Romania have decreased since 2009, with 12-month average rates having declined from close to 10% to below 4%.

Achieving an environment that is conducive to sustainable convergence in Romania requires stability-oriented economic policies and wide-ranging structural reforms. 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. Nevertheless, there is considerable scope and a need for measures aimed at improving the institutional and business environment, boosting investment and competition in product markets, reducing youth and long-term unemployment, and improving both the quality and efficiency of the public administration and the judicial system. Significant efforts should also be made to improve Romania's very weak absorption of EU funds.

Romanian law does not comply with all the requirements for central bank independence, the monetary financing prohibition and legal integration into the Eurosystem. Romania is an EU Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.

4.7 Sweden

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. Over the past ten years this rate has fluctuated within a range from 0.2% to 3.4% and the average for that period was subdued, standing at 1.4%. Looking ahead, monetary policy and the stability-oriented institutional framework should continue to support the achievement of price stability in Sweden.

Sweden's general government deficit and debt complied with the Maastricht criteria in 2015. Sweden has been subject to the preventive arm of the Stability and Growth Pact since it came into force in 1998. According to the European Commission's Spring 2016 Economic Forecast, Sweden is expected to comply with its medium-term budgetary objective over the forecast horizon. From a debt sustainability perspective, Sweden faces low and medium risks over the medium and long term respectively, mainly related to the projected increase in long-term care expenditure. Reforms in this area and continued compliance with the medium-term objective over the coming years would ensure that the track record of sound public finances would be enhanced further.

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. The exchange rate of the Swedish krona against the euro exhibited, on average, a relatively high degree of volatility over the reference period. 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 past ten years Sweden has recorded large current account surpluses, usually coupled with a relatively small negative net international investment position.

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. Long-term interest rates in Sweden have decreased since 2009, with 12-month average rates having declined from above 3% to below 1%.

Maintaining an environment that is conducive to sustainable convergence in Sweden requires the continuation of stability-oriented economic policies, targeted structural reforms and measures to safeguard financial stability. With regard to macroeconomic imbalances, the European Commission selected Sweden for an in-depth review in its Alert Mechanism Report 2016 and concluded that Sweden is experiencing macroeconomic imbalances. Against this backdrop, decisive efforts are needed to address the risks to macroeconomic stability stemming from the ongoing housing boom and the elevated level of private debt.

Swedish law does not comply with all the requirements for central bank independence, the monetary financing prohibition and legal integration into the Eurosystem. Sweden is an EU Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty. Pursuant to the Treaty, Sweden has been under the obligation to adopt national

legislation with a view to integration into the Eurosystem since 1 June 1998. As yet no legislative action has been taken by the Swedish authorities to remedy the incompatibilities described in this and previous reports.

5 Examination of economic convergence in individual countries

5.1 Bulgaria

5.1.1 Price developments

In April 2016 the 12-month average rate of HICP inflation in Bulgaria was -1.0%, i.e. well below the reference value of 0.7% for the criterion on price stability (see Chart 5.1.1). 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 wide range, from -1.7% to 12.6%, and the average for that period was elevated, standing at 3.6%. Before the onset of the global financial crisis, inflation accelerated significantly on account of adjustments to administered prices, the harmonisation of excise duties with EU levels and a series of supply-side shocks. At the same time, Bulgaria also exhibited growing signs of an overheating economy and an increasingly tight labour market, coupled with large capital inflows. Having peaked at 12% in 2008, inflation then declined rapidly, mainly as a result of lower commodity prices and the contraction in economic activity in an environment of subsiding capital inflows and comprehensive fiscal consolidation measures. Since then economic activity has been subdued (see Table 5.1.1). Between 2009 and 2012 the average annual rate of inflation hovered around 3%, before dropping sharply to a low point of -1.6% in 2014. This fall in inflation was driven by declining commodity prices, an appreciation in the effective exchange rate of the lev and domestic factors, such as cuts in administered prices. In 2015 inflation recovered slightly. Unemployment also moderated, having increased significantly in the wake of the crisis. In recent years growth in nominal wages and unit labour costs has been much lower than before the crisis.

For the first four months of 2016, the average annual rate of HICP inflation stood at -1.5%. During that period inflation was driven down primarily by the drop in energy prices, most notably in fuel prices, given their large share in Bulgaria's HICP basket. Declines in the prices of durable goods, food and services also exerted downward pressure on overall HICP inflation.

Policy choices have played an important role in shaping inflation dynamics in Bulgaria over the past decade, most notably the orientation of monetary policy towards price stability. In 1997 Bulgaria adopted a currency board framework, under which the lev was first fixed to the Deutsche Mark and then to the euro in 1999. During the period 2004–08 monetary conditions under the currency board framework became too expansionary for a catching-up economy, partly due to strong capital inflows.

Inflation is expected to increase in the coming years, albeit remaining subdued; over the longer term there are concerns regarding the sustainability

of inflation convergence in Bulgaria. According to the European Commission's Spring 2016 Economic Forecast, the average annual rate of inflation will increase to -0.7% in 2016 and 0.9% in 2017. Risks to the medium-term inflation outlook are broadly balanced. Upside risks relate to an acceleration in the underlying growth momentum, while downside risks may arise from 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, since GDP per capita and price levels are still significantly lower in Bulgaria 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 Bulgaria requires stability-oriented economic policies and wide-ranging structural reforms. Given monetary policy's limited room for manoeuvre under the currency board framework, it is imperative that other policy areas provide the economy with the wherewithal to cope with country-specific shocks in order to prevent the reoccurrence of macroeconomic imbalances. Structural reforms to enhance the business and institutional environment are crucial in order to attract foreign direct investment and raise potential growth. These include significantly reducing corruption and ensuring an independent and effective judiciary system. In the context of the high level of long-term unemployment, additional measures to improve the employability of the workforce are required. It is also essential to strengthen national policies aimed at enhancing competition in product markets and to proceed with the liberalisation of regulated sectors. Additional efforts are also needed to ensure that Bulgaria continues to improve its absorption of EU funds. With regard to macroeconomic imbalances, the European Commission selected Bulgaria for an in-depth review in its Alert Mechanism Report 2016 and concluded that Bulgaria 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. The failure of Corporate Commercial Bank in 2014 revealed imprudent business practices in some credit institutions, coupled with inefficient supervision over them, and fundamental institutional problems. In order to maintain confidence in the financial system, it is essential that the authorities complete the asset quality review and stress tests relating to the banking and non-bank financial sectors. They need to ensure that sufficient resources are in place to follow up on these exercises effectively. Moreover, the process of enhancing the supervisory practices of Българска народна банка (Bulgarian National Bank) should continue in line with the results of the assessment of the implementation of the Basel Core Principles for Effective Banking Supervision in Bulgaria.¹¹² In order to deal with the high level of non-performing loans, the authorities should encourage the cleaning-up of banks' balance sheets by removing legal and judicial obstacles to the resolution of non-performing loans. Moreover, in order to minimise potential risks

¹¹² "Bulgaria: Financial Sector Assessment Program – Detailed Assessment of Observance on the Basel Core Principles for Effective Banking Supervision", *Country Report*, No 15/295, IMF, October 2015.

to financial stability associated with the high proportion of foreign currency loans, the recommendations of the ESRB should be taken into account.

5.1.2 Fiscal developments

The deficit and debt complied with the Maastricht criteria in 2015. In the reference year 2015 the general government budget balance recorded a deficit of 2.1% of GDP, i.e. below the 3% reference value. The general government gross debt-to-GDP ratio was 26.7%, well below the 60% reference value (see Table 5.1.2). Compared with the previous year, the deficit declined by 3.4 percentage points of GDP, while there was a smaller decline in the debt ratio (0.3 percentage points). The deficit ratio is forecast by the European Commission to decline slightly to 2.0% in 2016, while the government debt ratio increases moderately to 28.1% of GDP. 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 in 2016.

Bulgaria has been under the preventive arm of the Stability and Growth Pact since 2012. Owing to a rise in the budget deficit above the reference value in 2009, the ECOFIN Council decided on 13 July 2010 that an excessive deficit situation existed in Bulgaria and set 2011 as the deadline for correcting it. Following the correction of the excessive deficit, the ECOFIN Council abrogated the EDP for Bulgaria on 22 June 2012. While general government debt was well below the 60% of GDP reference value in the 2009-15 period, the general government deficit in Bulgaria reached 5.4% of GDP in 2014, i.e. above the reference value, mostly as a result of the one-off capital transfer related to the reclassification of the Deposit Insurance Fund within the government sector (amounting to 3% of GDP), but also sizeable revenue shortfalls and a large increase in public investment. The European Commission's report of 16 November 2015 assessed the exceeding of the reference value to be both exceptional and temporary, and therefore not warranting the opening of an EDP.

Non-cyclical factors have been the main contributors to the deficit dynamics during recent years. The improvement in the deficit ratio between 2010 and 2013, which amounted to 2.8% of GDP, can mainly be explained by an improvement in the structural balance (of 2.2 percentage points of GDP) and, to a lesser extent, by cyclical factors. The 2009 and 2014 deficit increases were almost entirely attributable to non-cyclical factors: revenue shortfalls in 2009 and capital transfers related to the reclassification within the government sector in 2014 (European Commission estimates are presented in Table 5.1.2).

Government debt-to-GDP ratio has remained well below the 60% reference value throughout the crisis, although it has recently increased. The debt ratio increased significantly, from 13.7% in 2009 to 17.1% of GDP in 2013, on the back of primary deficits as well as unfavourable interest-growth differentials. The increase in the debt to 27% of GDP in 2014 was mainly attributable to the financing of the budget deficit, the temporary accumulation of reserves, the loan to the Deposit Insurance Scheme and the provision of liquidity to the banking sector. Over the

forecast period, the debt-to-GDP ratio is on an upward trend, reaching 28.7% of GDP in 2017. An increasing debt level and, subsequently, higher interest expenditure could limit the necessary fiscal buffers to stabilise the economy in the event of an adverse shock. Potential risks pertain to possible additional support to the financial sector above that already incorporated in projections by the Bulgarian government, as well as public sector contingent liabilities stemming from state-owned enterprises. The government did not report contingent liabilities related to the financial sector.

In the presence of a credible currency board, the level and structure of public debt allows Bulgaria to manage its debt effectively. The share of government debt with a short-term maturity had been negligible, with only a temporary increase in 2014 (from about 2% to 23% – see Table 5.1.2). Taking into account the level of the debt ratio, fiscal balances are relatively insensitive to changes in interest rates. At the same time, the proportion of foreign currency-denominated government debt is high (79.1% in 2015). However, given that it is mostly denominated in euro, the anchor currency of Bulgaria's currency board framework, fiscal balances are relatively insensitive to changes in exchange rates other than the EUR/BGN exchange rate, which is fixed under the currency board.

The European Commission's Spring 2016 Economic Forecast points to risks of some deviation from the SGP's 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 be 1.8% of GDP in 2016 and 1.4% of GDP in 2017. Deviations from the adjustment path towards the structural balance target, in both 2016 and 2017, point to the need for further consolidation in order to achieve an annual fiscal adjustment of 0.5% of GDP towards the medium-term objective. In contrast, Bulgaria's medium-term fiscal policy, as presented in the 2016 Convergence Programme, projects a structural deficit of 1.7% in 2016 and of 0.5% and 0.2% of GDP in 2017 and 2018 respectively, below the medium-term budgetary objective of 1% of GDP.

In recent years Bulgaria has strengthened its national fiscal governance framework significantly, but there is still scope to further enhance the independence and effective operation of the relevant bodies. After delays in 2013-14, Bulgaria's fiscal governance framework has recently been modernised through the adoption of the Law on the Fiscal Council and Automatic Correction Mechanisms in 2015. This legislation introduced: (i) an independent advisory body which monitors and analyses the fiscal stance in line with the enhanced EU fiscal governance, and (ii) a set of rules to improve transparency in, and public awareness of, fiscal governance issues. Furthermore, the law defines the mechanisms automatically correcting deviations from the medium-term objective and enforcing the adjustment path towards it. However, the fiscal council was still not operational at the time of the cut-off date for this report. Moreover, a regular and comprehensive risk-based audit of tax compliance and the shadow economy, an increase in the efficiency of public spending and a limit on contingent liabilities related to the state-owned enterprises could help in minimising potential fiscal risks.

Over the long run, Bulgaria faces medium risks to fiscal sustainability, partly as a result of age-related expenditure on health care and long-term care. The European Commission's 2015 Fiscal Sustainability Report does not foresee any significant sustainability risks over the medium term, thanks to the very low starting point of the debt ratio. In the long run, however, Bulgaria appears to be facing medium risks, reflecting an unfavourable initial budget position compounded by age-related costs on health care and long-term care. Despite measures designed to tackle the costs of ageing, Bulgaria, according to the 2015 projections by the European Commission and the EU's Economic Policy Committee,¹¹³ is likely to experience a moderate increase in strictly age-related public expenditure (by 0.5 percentage points of GDP over the period 2013-2060 in the AWG reference scenario). In the AWG risk scenario, however, there is a notable increase in costs, amounting to 3.6 percentage points of GDP, mainly due to long-term care spending (2.5 percentage points of GDP) and health care (1.1 percentage points of GDP). These developments signal the need for further reforms in order to enhance the long-term sustainability of public finances.

Despite the low level of public debt, a prudent fiscal policy and reforms are essential for the medium-term sustainability of the public finances. A prudent and effective fiscal policy will ensure that Bulgaria complies with the preventive arm of the SGP and maintains buffers to alleviate adverse shocks. Further improvements in areas such as tax compliance, the informal economy and spending efficiency, followed by a credible fiscal framework strengthened by the efficient operation of the fiscal council, are essential for achieving medium-term fiscal sustainability. Moreover, there is scope for a more growth and environment-friendly tax system, a shift towards a lower tax wedge for lower-paid labour, an efficient use of property taxes and the cost-effective provision of healthcare services.

5.1.3 Exchange rate developments

In the two-year reference period from 19 May 2014 to 18 May 2016, the Bulgarian lev did not participate in ERM II, but its exchange rate was fixed to the euro at 1.95583 levs per euro within the framework of a currency board (see Chart 5.1.3). This framework, which was adopted in July 1997 to address the repercussions of a financial crisis and hyperinflationary pressures, was based initially on a commitment to maintain a fixed exchange rate to the Deutsche Mark. In January 1999 the reference currency was changed to the euro. Over the reference period the lev did not exhibit any deviation from the rate of 1.95583 levs per euro, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate. As implied by the currency board framework, Българска народна банка (Bulgarian National Bank) has continued to exchange on demand domestic currency against the anchor currency and vice versa at the fixed rate. Short-term interest rate differentials against the three-month EURIBOR stood at a low level throughout the reference period.

¹¹³ European Commission and Economic Policy Committee, "The 2015 Ageing Report: Economic and budgetary projections for the EU-28 Member States (2013-2060)".

The real effective exchange rate of the Bulgarian lev appreciated overall over the past ten years, although it has depreciated since 2009 (see Chart 5.1.4).

However, this indicator should be interpreted with caution, as during this period Bulgaria was subject to a process of economic convergence, which complicates any historical assessment of real exchange rate developments.

Bulgaria's current and capital account has improved over the past decade, while the country's net foreign liabilities remain high (see Table 5.1.3). After recording very large external deficits in 2007 and 2008, the combined current and capital account improved steadily and turned into a surplus from 2011. This improvement primarily reflected a substantial reduction in the goods deficit on account of the export-led recovery and subdued domestic demand following the sharp contraction in activity. The surplus widened to 3.1% of GDP in 2014 and 4.6% of GDP in 2015, amid further improvements in the goods balance and a growing capital account surplus owing to increased transfers to the government from EU institutions. The substantial adjustment in the balance of payments was associated with a significant contraction in net direct investment inflows from more than 20% of GDP in 2006 and 2007 to an average of 2.8% of GDP in the period from 2011 to 2015, while the balance on other investment turned into net outflows. Gross external debt increased substantially from 78.1% of GDP in 2008 to 97.4% in 2014, before declining to 82.9% in 2015. At the same time the country's net international investment position, which had deteriorated substantially from -58.0% of GDP in 2008 to -101.8% in 2009, improved to -74.8% in 2014 and -60.7% in 2015. However, the country's net foreign liabilities are still very high, with foreign direct investment accounting for the largest part of gross foreign liabilities. Fiscal and structural policies therefore continue to be important for supporting external sustainability and the competitiveness of the economy.

The Bulgarian 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 43.2% of total exports, while the corresponding figure for imports was similar, at 43.6%. The share of the euro area in Bulgaria's stock of direct investment liabilities stood at 63.4% and its share in the country's stock of portfolio investment liabilities was 54.1% in 2015. The share of Bulgaria's stock of foreign assets invested in the euro area amounted to 49.4% in the case of direct investment and 55.3% in the case of portfolio investment in 2015.

5.1.4 Long-term interest rate developments

Over the reference period from May 2015 to April 2016, long-term interest rates in Bulgaria were 2.5% on average and thus below the 4.0% reference value for the interest rate convergence criterion (see Chart 5.1.5).

Long-term interest rates in Bulgaria have decreased since 2009, with 12-month average rates having declined from above 7% to below 3%. After an initial steep decline in 2009 and 2010, a second decline could be observed in 2012. Between 2012 and the end of 2014, Bulgarian long-term interest rates remained within a

relatively narrow corridor of between 3% and 4%. Since mid-2015 12-month average long-term interest rates have fallen below 3.0%, reaching 2.5% in April 2016 (see Chart 5.1.5). It has to be kept in mind though that liquidity in the benchmark bond remains low. Interest rate developments should, therefore, be interpreted with some caution and over longer time horizons only. The banking sector turbulence throughout 2014 had some impact on longer-term sovereign yields. Furthermore, credit default swap prices have, despite some increase in December 2014, remained well below the levels observed between 2008 and 2012. Long-term interest rates again declined in 2015.

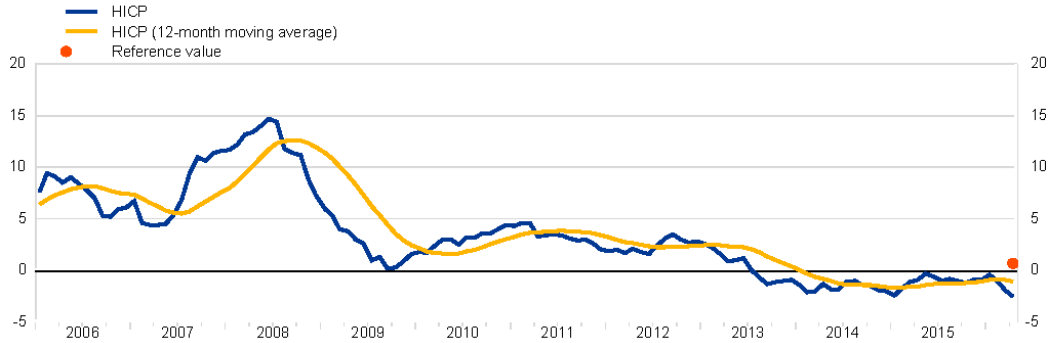
Bulgaria's long-term interest rate differentials vis-à-vis the euro area average closely mirrored developments in the level of long-term interest rates. The interest rate differential, which had increased during the 2008-09 financial crisis, decreased from 2009 onwards (see Chart 5.1.6). The reduction from 2009 onwards in Bulgarian long-term interest rates, coupled with an increase in euro area average rates, had gradually lowered the differential to around zero towards the end of 2012. Since then, the long-term interest rate differential with the euro area average has again increased slightly, to stand at 1.5 percentage points (2.2 percentage points with respect to the AAA euro area yield) at the end of the reference period.

Bulgarian capital markets are much smaller than in the euro area and still underdeveloped (see Table 5.1.4). Overall, there has been no further significant deepening of capital markets since the financial crisis. Stock market capitalisation, as a share of GDP, has declined in recent years, from a peak of 48.2% of GDP in 2007 to 9.9% at the end of 2015. Outstanding debt securities issued by non-financial institutions (a measure of market-based indebtedness) amounted to only 3.1% of GDP in 2015. Integration of the Bulgarian financial sector with the euro area, as measured by the claims of euro area banks on Bulgarian banks, is moderate. Bulgaria's financial sector is largely bank-based, with the degree of financial intermediation low compared with the euro area average, but in line with that of other recent EU Member States. MFI credit to non-government residents stood at 58.1% of GDP in 2015, down by slightly less than 10 percentage points from the peak levels in 2012 and 2013 (see Table 5.1.4). Claims of euro area MFIs on banks in Bulgaria have decreased over recent years. In an environment of ample liquidity and low demand for loans, foreign-owned subsidiaries in Bulgaria have gradually been reducing their dependence on parent group financing, turning instead to local deposits. This notwithstanding, foreign-owned banks continue to play a major role in the Bulgarian financial system.

Bulgaria - Price developments

Chart 5.1.1 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 5.1.1 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	3.5	6.4	0.7	3.4	2.4	0.4	-1.6	-1.1	-0.7	0.9
HICP excluding unprocessed food and energy	3.7	6.9	0.5	2.6	1.2	0.3	-1.3	-0.3	0.6	0.5
HICP at constant tax rates ³⁾	3.1	5.5	0.6	3.2	2.4	0.4	-1.6	-1.1	-	-
CPI	3.9	6.6	1.3	4.2	3.0	0.9	-1.4	-0.1	0.5	1.3
Private consumption deflator	2.5	4.1	0.9	4.5	3.6	-2.5	0.0	-0.8	-0.7	0.9
GDP deflator	3.9	6.2	1.7	6.9	1.6	-0.7	0.4	0.3	0.1	1.2
Producer prices ⁴⁾	4.1	6.4	1.9	8.6	5.3	-1.3	-0.9	-1.7	-	-
Related indicators										
Real GDP growth	2.3	3.1	1.5	1.6	0.2	1.3	1.5	3.0	2.0	2.4
GDP per capita in PPS ⁵⁾ (euro area = 100)	41.2	40.0	42.7	41.7	42.7	42.8	43.7	-	-	-
Comparative price levels (euro area = 100)	47.5	46.9	48.3	48.7	49.2	48.1	47.2	-	-	-
Output gap ⁶⁾	0.4	1.2	-0.5	-0.4	-0.6	-0.3	-0.7	-0.3	-0.6	-0.5
Unemployment rate (%) ⁷⁾	8.6	7.7	11.4	11.3	12.3	13.0	11.4	9.2	8.6	8.0
Unit labour costs, whole economy	5.8	8.0	3.6	2.8	4.8	7.0	4.4	-0.7	1.9	2.3
Compensation per employee, whole economy	8.4	10.7	6.1	6.8	7.7	8.8	5.6	1.8	3.6	4.3
Labour productivity, whole economy	2.4	2.5	2.4	3.9	2.8	1.7	1.2	2.6	1.7	2.0
Imports of goods and services deflator	3.1	4.9	1.3	8.7	5.1	-2.2	-1.9	-2.5	-2.5	1.6
Nominal effective exchange rate ⁸⁾	0.4	0.4	0.3	1.1	-1.4	2.0	2.0	-2.0	-	-
Money supply (M3) ⁹⁾	12.2	15.4	9.2	12.3	8.7	9.3	7.5	8.2	-	-
Lending from banks ¹⁰⁾	12.3	23.5	2.0	3.8	3.5	1.1	2.2	-0.3	-	-
Stock prices (SOFIX) ¹¹⁾	-44.2	-56.1	27.2	-11.1	7.2	42.3	6.2	-11.7	-	-
Residential property prices ¹²⁾	-2.7	-10.2	-1.1	-5.5	-1.9	-2.2	1.4	2.8	-	-

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.

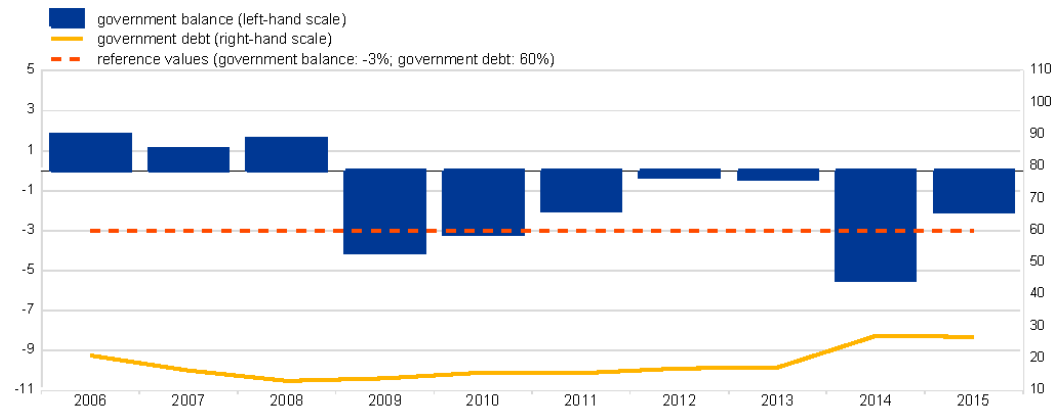
¹¹⁾ Multi-annual and annual figures represent the percentage change between the end of the given period and the end of the previous period.

¹²⁾ Data available since 2009.

Bulgaria - Fiscal developments

Chart 5.1.2 General government balance and debt

(as a percentage of GDP)



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

Table 5.1.2 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	-1.3	-0.5	-2.0	-2.0	-0.3	-0.4	-5.4	-2.1	-2.0	-1.6		
Total revenue	36.0	36.3	35.7	32.1	34.4	37.2	36.6	38.2	37.0	37.2		
Current revenue	34.3	35.2	33.3	30.9	32.7	35.0	34.0	34.1	35.5	35.5		
Direct taxes	5.3	5.6	5.1	4.6	4.7	5.1	5.4	5.5	5.6	5.5		
Indirect taxes	15.2	15.6	14.9	13.8	14.9	15.4	14.8	15.5	15.7	15.7		
Net social contributions	7.4	7.4	7.4	6.8	6.9	7.5	7.9	8.1	8.2	8.4		
Other current revenue ⁶⁾	6.3	6.7	6.0	5.7	6.2	7.1	6.0	5.0	6.1	5.8		
Capital revenue	1.7	1.1	2.4	1.2	1.7	2.2	2.6	4.1	1.4	1.7		
Total expenditure	37.3	36.8	37.7	34.1	34.7	37.6	42.1	40.2	38.9	38.7		
Current expenditure	31.7	31.3	32.2	30.4	30.7	33.3	33.2	33.6	33.3	33.3		
Compensation of employees	9.0	8.9	9.1	8.7	8.7	9.5	9.5	9.3	9.4	9.3		
Social benefits	12.7	11.8	13.7	13.0	13.0	13.9	14.5	14.3	14.7	14.8		
Interest payable	0.9	0.9	0.8	0.7	0.8	0.7	0.9	1.0	1.0	1.0		
Other current expenditure ⁷⁾	9.1	8.7	8.5	8.0	8.1	9.2	8.3	9.1	8.1	8.1		
Capital expenditure	5.6	5.6	5.5	3.7	4.0	4.4	8.9	6.6	5.6	5.5		
of which: Investment	4.7	4.9	4.5	3.4	3.4	4.1	5.2	6.2	5.0	4.9		
Cyclically adjusted balance	-1.4	-0.9	-1.9	-1.9	-0.1	-0.3	-5.2	-2.0	-1.8	-1.4		
One-off and temporary measures	.	.	-0.7	0.0	0.0	0.0	-3.2	-0.1	0.0	0.0		
Structural balance ⁸⁾	.	.	-1.2	-1.8	-0.1	-0.3	-2.0	-1.9	-1.8	-1.4		
Government debt	18.2	15.9	20.6	15.3	16.8	17.1	27.0	26.7	28.1	28.7		
Average residual maturity (in years)	7.0	7.3	6.7	6.6	6.1	6.7	5.6	8.4				
In foreign currencies (% of total)	77.2	77.1	77.3	74.6	79.0	72.8	80.8	79.1				
of which: Euro	59.2	53.4	65.1	55.0	62.9	58.8	71.4	77.4				
Domestic ownership (% of total)	46.8	42.7	50.9	53.6	48.9	52.3	47.8	52.2				
Medium and long-term maturity (% of total) ⁹⁾	96.8	99.4	94.2	97.2	99.9	98.0	76.9	99.2				
of which: Variable interest rate (% of total)	21.9	27.6	16.2	22.8	21.0	18.6	10.0	8.5				
Deficit-debt adjustment	-0.1	-1.0	0.7	-0.9	1.4	-0.1	4.8	-1.5				
Net acquisitions of main financial assets	-0.2	-0.3	0.0	-1.4	1.9	-1.7	3.7	-2.6				
Currency and deposits	0.3	0.7	-0.1	-0.9	2.3	-1.3	1.7	-2.1				
Debt securities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0				
Loans	-0.3	-0.7	0.1	-0.1	-0.1	-0.1	1.0	-0.5				
Equity and investment fund shares or units	-0.2	-0.3	0.0	-0.4	-0.3	-0.3	1.0	0.0				
Revaluation effects on debt	0.0	-0.1	0.0	0.1	-0.2	-0.3	0.3	0.2				
of which: Foreign exchange holding												
gains/losses	0.0	-0.1	0.0	0.1	-0.1	-0.2	0.3	0.1				
Other ¹⁰⁾	0.1	-0.6	0.7	0.4	-0.3	1.9	0.9	0.9				
Convergence programme: government balance	-	-	-	-	-	-	-	-	-1.9	-0.8	-0.4	-0.2
Convergence programme: structural balance	-	-	-	-	-	-	-	-	-1.7	-0.5	-0.2	0.0
Convergence programme: government debt	-	-	-	-	-	-	-	-	31.7	31.2	31.8	30.8

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.

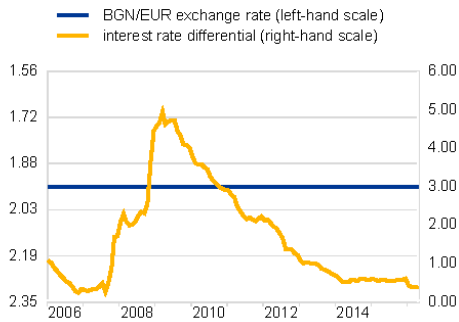
6) Original maturity of more than one year.

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

Bulgaria - Exchange rate and external developments

Chart 5.1.3 Bilateral exchange rate and short-term interest rate differential

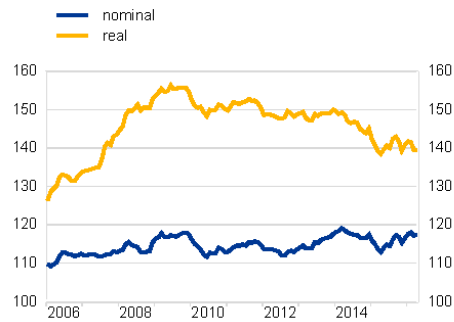
(BGN/EUR exchange rate: monthly averages; difference between three-month interbank interest rates and three-month EURIBOR: basis points, monthly values)



Sources: National data and ECB calculations.

Chart 5.1.4 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 5.1.3 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⁾	-2.1	-9.7	2.4	1.6	0.5	2.4	3.1	4.6	3.5	3.8
Current account balance	-3.6	-10.7	0.6	0.3	-0.9	1.3	0.9	1.4	2.3	2.7
Goods	-10.2	-15.8	-6.8	-6.6	-9.6	-7.0	-6.5	-4.3	.	.
Services	6.1	5.7	6.3	6.7	6.2	6.3	5.9	6.1	.	.
Primary income	-3.4	-3.6	-3.3	-3.9	-2.5	-3.8	-2.3	-4.1	.	.
Secondary income	3.9	3.0	4.5	4.1	5.0	5.7	3.8	3.7	.	.
Capital account balance	1.5	0.9	1.8	1.2	1.3	1.1	2.2	3.2	.	.
Combined direct and portfolio investment balance ³⁾	-4.3	-8.6	-2.9	-2.0	-0.4	-2.7	-4.9	-4.7	.	.
Direct investment	-4.9	-8.4	-2.8	-2.9	-2.6	-3.0	-2.1	-3.4	.	.
Portfolio investment	0.6	1.8	-0.2	0.9	2.1	0.3	-2.8	-1.3	.	.
Other investment balance	-0.3	-4.5	2.1	4.7	-2.4	5.8	0.0	2.6	.	.
Reserve assets	2.0	-0.2	3.4	0.4	5.1	-1.3	4.2	8.4	.	.
Exports of goods and services	58.4	50.2	63.3	59.5	61.1	64.7	64.9	66.4	.	.
Imports of goods and services	62.5	60.3	63.9	59.4	64.5	65.3	65.6	64.6	.	.
Net international investment position ⁴⁾	-	-	-74.2	-83.4	-78.4	-73.5	-74.8	-80.7	.	.
Gross external debt ⁴⁾	-	-	91.2	91.6	93.2	91.1	97.4	82.9	.	.
Internal trade with the euro area ³⁾										
Exports of goods and services	.	.	42.4	42.8	41.6	42.0	42.6	43.2	.	.
Imports of goods and services	.	.	42.3	41.9	41.9	41.9	42.4	43.6	.	.
Investment position with the euro area ³⁾										
Direct investment assets ⁴⁾	.	.	52.0	54.7	55.8	51.9	48.4	49.4	.	.
Direct investment liabilities ⁴⁾	.	.	65.6	69.1	66.8	64.4	64.6	63.4	.	.
Portfolio investment assets ⁴⁾	.	.	47.8	53.8	42.6	43.9	43.5	55.3	.	.
Portfolio investment liabilities ⁴⁾	.	.	62.6	65.9	72.4	63.5	56.9	54.1	.	.

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.

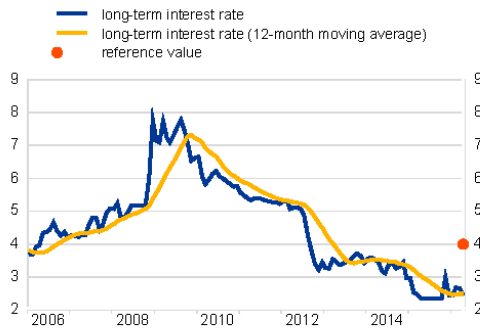
3) Differences between totals and sum of their components are due to rounding.

4) End-of-period outstanding amounts.

5) As a percentage of the total.

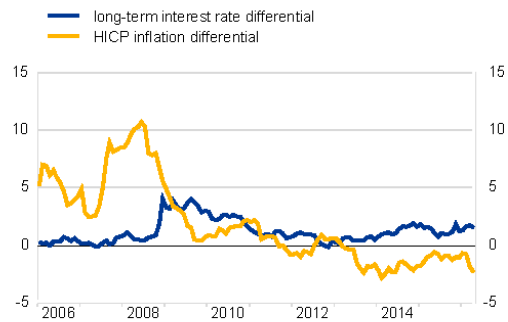
Bulgaria - Long-term interest rate developments

Chart 5.1.5 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 5.1.6 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 5.1.4 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									
Bulgaria ⁴⁾	4.6	5.5	3.8	4.5	3.5	3.3	2.5	2.5	-
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⁾	1.4	1.7	1.0	0.9	1.2	1.2	1.1	-	73.6
Debt securities issued by non-financial corporations ⁸⁾	1.9	1.4	2.4	1.3	3.2	3.1	3.1	-	10.8
Stock market capitalisation ⁹⁾	18.3	24.4	12.2	12.1	12.1	11.5	9.9	-	60.4
MFI credit to non-government residents ¹⁰⁾	63.2	62.0	64.3	67.7	67.5	61.1	58.1	-	114.7
Claims of euro area MFIs on resident MFIs ¹¹⁾	12.7	16.2	9.2	11.9	9.7	8.8	4.2	-	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.
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.

5.2 Czech Republic

5.2.1 Price developments

In April 2016 the 12-month average rate of HICP inflation in the Czech Republic was 0.4%, i.e. below the reference value of 0.7% for the criterion on price stability (see Chart 5.2.1). This rate is expected to remain broadly stable 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 6.6%, and the overall average for that period was moderate, standing at 2.1%. For most of the period under review, growth in compensation per employee exceeded labour productivity growth (see Table 5.2.1). In the years leading up to the global financial crisis, inflation picked up from moderate levels, mainly as a result of higher food and energy prices, and some administrative measures. Having peaked at an average annual rate of 6.3% in 2008, inflation fell sharply as global commodity prices declined and economic activity slowed. Yet, the recession that started in 2009 was relatively modest compared with that in other central and eastern European economies. Over the period 2010-12 the rebound in global commodity prices, as well as hikes in administered prices and the value added tax rate, gradually pushed up inflation. A temporary export-led recovery was accompanied by fiscal restrictions, which ultimately resulted in a further recession in 2012-13. This, along with the developments in global commodity prices, led to a significant fall in inflation between 2012 and 2015. In 2014 growth in import prices picked up, owing partly to the exchange rate floor of 27 korunas per euro set by Česká národní banka as a complementary and temporary instrument for lifting inflation towards its 2% inflation target. In the most recent years the Czech economy has returned to a path of solid growth. However, this robust performance has been exerting pressure on the exchange rate, forcing Česká národní banka since July 2015 to intervene on the foreign exchange market in order to uphold its commitment not to let the koruna appreciate against the euro beyond a level of close to 27.

For the first four months of 2016, the average annual rate of HICP inflation stood at 0.5%. The robust underlying growth momentum exerted upward pressure on consumer prices. At the same time, the decline in global commodity prices in 2015 weighed on headline inflation.

Policy choices have played an important role in shaping inflation dynamics in the Czech Republic over the past decade, most notably the orientation of monetary policy towards price stability. Since April 2001 the inflation target has been defined in terms of CPI inflation, originally as a continuously declining band and since 2006 as a flat point target. The CPI inflation target was set at 3% (± 1 percentage point) in 2006 and reduced to 2% (± 1 percentage point) on 1 January 2010. In November 2013, in order to fulfil its mandate to maintain price stability, Česká národní banka intervened to weaken the domestic currency and set the aforementioned exchange rate floor.

Inflation in the Czech Republic is expected to increase in the coming years, albeit remaining at a subdued level. According to the European Commission's Spring 2016 Economic Forecast, the average annual rate of HICP inflation will remain broadly stable in 2016, at around 0.5%, and increase to 1.4% in 2017. Risks to the medium-term inflation outlook are broadly balanced. Upside risks relate to stronger than expected wage increases amid tightening labour market conditions, while downside risks may arise from heightened uncertainty regarding developments in the global economy, which could reduce external price pressures. Looking further ahead, the catching-up process may have a bearing on inflation and/or the nominal exchange rate over the coming years, given that GDP per capita and price levels are still lower in the Czech Republic than in the euro area.

Achieving an environment that is conducive to sustainable convergence in the Czech Republic requires conducting price stability-oriented economic policies, including targeted structural reforms that are geared to ensuring macroeconomic stability. In order to boost potential growth, it is necessary to enhance the functioning of the labour market, for example, by reducing disincentives to work and addressing skill mismatches. It is also essential to strengthen competition in product markets (in particular the electricity, gas and telecommunications markets), to improve the effectiveness of the public administration and to increase investment in infrastructure. Against this background, additional efforts are needed to ensure that the Czech Republic maintains and improves its absorption of EU funds. Priority should also be given to further enhancing the business environment by removing impediments to conducting business and liberalising the regulated professions. Emphasis should continue to be placed on the expansion of the services sector and the fight against corruption in the public sector. As the process of income convergence vis-à-vis the euro area is slow, the implementation of these structural measures should facilitate further changes to the Czech Republic's growth model, which, until recently, has relied mainly on foreign direct investment and exports of manufacturing goods. With regard to macroeconomic imbalances, the European Commission did not select the Czech Republic 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 sustainable economic growth. In particular, continued vigilance and a careful monitoring of potential risks and close cross-border cooperation is needed, given the high level of foreign ownership in the financial sector. In June 2015 Česká národní banka issued a set of recommendations aimed at mitigating risks related to loans secured by residential property. The full implementation of these recommendations could help to mitigate the effect of housing credit on residential real estate prices. Furthermore, in December 2015 Česká národní banka decided to set the countercyclical capital buffer rate at 0.5%, applicable as of January 2017.

5.2.2 Fiscal developments

The deficit and debt complied with the Maastricht criteria in 2015. In the reference year 2015 the general government budget balance recorded a deficit of 0.4% of GDP, i.e. well below the 3% reference value and close to a balanced budget. The general government gross debt-to-GDP ratio was 41.1%, i.e. below the 60% reference value (see Table 5.2.2). Compared with the previous year, both the deficit and the debt-to-GDP ratio decreased by 1.5 and 1.6 percentage points of GDP respectively. The deficit ratio is forecast by the European Commission to increase slightly to 0.7% in 2016, while the government debt ratio is projected to increase 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 in 2016.

The Czech Republic has been subject to the preventive arm of the Stability and Growth Pact since 2014. Against the background of the rise in the budget deficit above the reference value in 2008, the ECOFIN Council decided on 2 December 2009 that an excessive deficit situation existed in the Czech Republic and set 2013 as the deadline for correcting it. The ECOFIN Council abrogated the excessive deficit procedure on 17 June 2014. Since 2014 the Czech Republic has been subject to the preventive arm, having complied with its medium-term objective of a structural deficit of no more than 1% of GDP in 2015. The European Commission's forecast projects the structural deficit to remain below the medium-term objective and, thus, in compliance with the preventive arm's requirements.

Non-cyclical factors have contributed to the deficit reduction over recent years, which have partly been offset by unfavourable cyclical developments.

The deficit ratio reached its peak at 5.5% of GDP in 2009 and declined to 0.4% of GDP in 2015. European Commission estimates (presented in Table 5.2.2) indicate that the structural balance improved by 4.5 percentage points between 2009 and 2015, reflecting the significant consolidation measures adopted by the Czech government, which were partly offset by adverse cyclical factors. Consolidation measures included increases in indirect taxation, property taxes and the social security contribution ceiling on the revenue side, as well as decreases in selected social benefits, reforms of the pension and healthcare systems, and cuts in the government wage bill and employment on the expenditure side.

The debt-to-GDP ratio increased strongly during the crisis, but has recently stabilised at levels below the 60% reference value. The debt ratio increased rapidly, from 28.7% of GDP in 2008 to 45.1% of GDP in 2013, driven by high primary deficits and the recession (see Chart 5.2.2). Since 2013 the debt ratio has been on a downward path on the back of deficit-debt adjustments, a recovery in GDP growth and a favourable contribution from the primary balance. The impact of deficit-debt adjustments over the entire period was volatile, with both debt-increasing and debt-decreasing effects in certain years before 2015 (see Table 5.2.2).

The level and structure of government debt protects the Czech Republic from sudden changes in market conditions. Debt remains long term and denominated in national currency. The share of government debt with a short-term maturity is low (5.2% in 2015 – see Table 5.2.2). Taking into account the level

of the debt ratio, fiscal balances are insensitive to changes in interest rates. At the same time, the proportion of foreign currency-denominated government debt is noticeable (13.5% in 2015), most of it being denominated in euro (92% of foreign-denominated debt). Taking the size of the debt as a share of GDP into consideration, this leaves fiscal balances relatively insensitive to changes in exchange rates. Despite some fluctuations, the share of debt denominated in euro and other foreign currency has been on a decreasing path since 2012, pointing to a decline in exchange-rate related vulnerabilities. The Czech Republic has not incurred contingent liabilities resulting from government interventions to support financial institutions or markets during the crisis.

The European Commission's Spring 2016 Economic Forecast points to compliance with the medium-term objective over the forecast horizon.

According to the European Commission's forecast, the structural deficit is projected to increase to 0.7% of GDP in 2016 and 0.9% of GDP in 2017 from a level of 0.4% of GDP in 2015. However, the structural deficit level will remain below the medium-term objective (i.e. a structural deficit of 1% of GDP) and, thus, in compliance with preventive arm's requirements. The Czech Republic's medium-term fiscal policy strategy, as presented in the 2016 Convergence Programme update submitted to the European Commission, projects the structural deficit to gradually increase, but to remain at the medium-term objective between 2017 and 2019.

The Czech Republic has strengthened its national fiscal governance framework significantly in recent years, but there is scope for further enhancement.

The Czech Republic's fiscal governance framework is in the process of being comprehensively strengthened by: (i) a national budgetary council, which will perform the function of an independent fiscal institution, legislated at constitutional level; (ii) a budgetary planning framework based on realistic and independently assessed macro and fiscal forecasts over the medium term; (iii) a modified numerical (expenditure) fiscal rule, which will encompass the whole public sector and is compatible with the medium-term objective; and (iv) increased transparency and accountability (open data portal, new act on management and financial control in public administration, etc.). However, reform implementation has been slow and the enforcement has been deemed to be weak thus far. In terms of broadening the scope of the current fiscal framework reforms and enforcing the rules more strictly, the Czech Republic would benefit from a streamlining of the tax system and a more efficient tax administration – addressing compliance gaps (especially for VAT) – as well as a comprehensive review of the tax system that is oriented towards reducing the tax wedge on labour and promoting taxation that promotes growth and the environment. The Czech Republic is not among the signatories to the Fiscal Compact. However, the authorities recently signalled their determination to ratify this treaty.

An ageing population poses a significant challenge to the long-term sustainability of public finances.

The European Commission's 2015 Fiscal Sustainability Report does not foresee any risks over the short and medium term, and foresees medium risks over the long term. This long-term risk assessment is largely a result of the projected impact of age-related public spending, and is further

compounded by the slightly unfavourable initial budgetary position. Regarding the increase in age-related spending, the Czech Republic has taken several measures. Notably, authorities have (i) introduced parametric reforms pertaining to the gradual increase in the statutory retirement age, (ii) proposed changes to the pension indexation scheme, and (iii) abolished the voluntary full-funded pillar scheme established in 2013. Despite some of these measures and an improvement in the demographic outlook in the 2015 projection vintage by the European Commission and the EU's Economic Policy Committee,¹¹⁴ the AWG report places the Czech Republic among the countries likely to experience a significant increase in strictly age-related public expenditure. This increase is forecast to amount to 3.1 percentage points of GDP between 2013 and 2060 in the AWG reference scenario and 8.4 percentage points of GDP in the AWG risk scenario (of which 5.2 percentage points and 1.7 percentage points of GDP stem from long-term care and health care respectively). These increases in ageing costs would be significantly above the EU average, suggesting that comprehensive pension and healthcare reforms are warranted in order to enhance the long-term sustainability of public finances.

Enhancing the current reforms, strictly enforcing the existing rules and having a prudent fiscal policy are necessary in order to retain the overall sound fiscal position of the Czech Republic. The Czech Republic should ensure compliance with its medium-term objective in 2016 and beyond. The risks to the fiscal sector should be contained through the introduction of reforms that tackle both expenditure (e.g. an anti-corruption plan and governance of the healthcare sector) and revenue (fighting tax evasion and streamlining the tax system). Over the longer term, the risks to medium-term fiscal sustainability are determined by the high and rising mandatory expenditure, combined with relatively large increases in ageing-related spending. Thus, comprehensive and determined structural reforms, focusing on the pension system, health care and improving the efficiency of public administration, are needed.

5.2.3 Exchange rate developments

In the two-year reference period from 19 May 2014 to 18 May 2016, the Czech koruna did not participate in ERM II, but traded under a flexible exchange rate regime involving a commitment by Česká národní banka not to let the currency appreciate beyond a certain level (see Chart 5.2.3). On 7 November 2013 Česká národní banka had announced that it would intervene in foreign exchange markets with the goal of weakening the koruna in order to prevent a long-term undershooting of the inflation target and made a temporary commitment not to let the exchange rate of the koruna against the euro appreciate beyond a level of 27 korunas per euro. This temporary commitment was initially expected to be in place at least until the beginning of 2015 and was later gradually extended until at least 2017. Over the reference period the Czech currency mostly traded close to its May 2014 average exchange rate against the euro of 27.437 korunas per euro, which is used as a

¹¹⁴ European Commission and Economic Policy Committee, "The 2015 Ageing Report: Economic and budgetary projections for the EU-28 Member States (2013-2060)", prepared by AWG.

benchmark for illustrative purposes in the absence of an ERM II central rate. On 18 May 2016 the exchange rate stood at 27.022 korunas per euro, i.e. 1.5% stronger than its average level in May 2014. Over the reference period the maximum upward deviation from this benchmark was 1.5%, while the maximum downward deviation amounted to 3.5%. Looking back over a longer period the exchange rate of the Czech koruna against the euro has appreciated by 4.4% over the past ten years.

The Czech koruna exhibited a low degree of volatility against the euro over the two-year reference period. After the introduction of a nominal exchange rate floor for the koruna vis-à-vis the euro, the koruna traded at more than 27 koruna per euro from November 2013 to the beginning of 2015. Subsequently, a strong economic performance and speculative capital inflows to the Czech economy, which coincided with monetary policy decisions in the country's key trading partners, added to upward pressures on the currency. Over the period under review Česká národní banka sold domestic currency in exchange for foreign currency to uphold its temporary commitment not to let the exchange rate appreciate beyond 27 korunas per euro. As a result of these interventions, foreign currency reserves increased and reached 39% of GDP in March 2016. Over the reference period short-term interest rate differentials against the three-month EURIBOR were overall small, and stood at 0.5 percentage point in the three-month period ending in March 2016.

The real effective exchange rate of the Czech koruna has appreciated overall over the past ten years, although it has depreciated since mid-2008 (see Chart 5.2.4). However, this indicator should be interpreted with caution, as during this longer period the Czech Republic was subject to a process of economic convergence, which complicates any historical assessment of real exchange rate developments.

The current account deficit gradually shrank and the balance turned positive from 2014, which resulted in a reduction in the country's net foreign liabilities (see Table 5.2.3). The external liabilities predominantly reflected direct investments. Since 2013 a surplus in the combined current and capital account has been recorded, which reached 3.3% of GDP in 2015. The shifts recorded in the Czech Republic's balance of payments over the past few years have also been associated with significant capital inflows. The large net inflows in direct investment of, on average, more than 5% of GDP exceeded the financing needs of the Czech economy up until 2007. However, the pace of net inflows of direct investment has since slowed. Against this background, gross external debt increased gradually to 70.7% of GDP in 2015. At the same time the country's net international investment position deteriorated up to 2012, before improving to reach -31.5% of GDP in 2015.

The Czech 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 63.1% of total exports, while the corresponding figure for imports was lower, at 52.8%. The share of the euro area in the Czech Republic's stock of inward direct investment stood at 80.3% in 2015, and its share in the country's stock of portfolio investment liabilities was 47.4% in 2015. The share of the Czech Republic's stock of foreign assets invested in the euro area amounted to 79.2% in the case of direct investment and 72.7% in the case of portfolio investment in 2015.

5.2.4 Long-term interest rate developments

Over the reference period from May 2015 to April 2016, long-term interest rates in the Czech Republic were 0.6% on average and thus well below the 4.0% reference value for the interest rate convergence criterion (see Chart 5.2.5).

Long-term interest rates in the Czech Republic have decreased from above 5% in 2009 to 0.4% at the end of the reference period. The fall in long-term interest rates was particularly pronounced in 2012 and 2014, with sovereign credit default swap prices also having decreased substantially in 2012, down from elevated levels during the euro area sovereign debt crisis. A further decrease in sovereign credit default swap prices was observed in 2014 when the Czech Republic returned to positive GDP growth. As with a number of euro area countries, some volatility of long-term rates could be observed in the context of the euro area sovereign debt crisis.

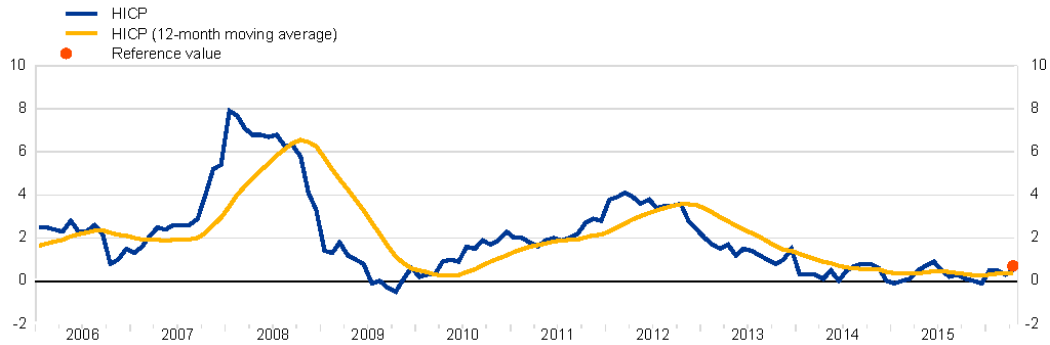
The Czech Republic's long-term interest rate differential vis-à-vis the euro area has remained negative since 2011. The interest rate differential, which had increased into positive territory during the 2008-09 financial crisis and peaked in late 2009, decreased from 2009 onwards and turned negative in late 2010 (see Chart 5.2.6). The long-term interest rate differential reached its low point in August 2012, when it stood at -1.5 percentage points. This marked decline reflected both domestic policy rate cuts and an improvement in euro area financial markets, which led to a decrease in the credit spread. The differential subsequently narrowed in 2013 when rates declined less than they did in the euro area. Since 2014, the long-term interest rate differential has remained between 0 and -1 percentage points, standing at -0.5 percentage points vis-à-vis the euro area average at the end of the reference period, with the Czech Republic's rates being 0.2 percentage points above the euro area AAA yield.

Capital markets in the Czech Republic are smaller and much less developed than those in the euro area (see Table 5.2.4). Stock market capitalisation, as a share of GDP, has declined in recent years, from a peak of close to 25% of GDP before the financial crisis to 14.2% at the end of 2015. Outstanding debt securities issued by non-financial institutions (a measure of market-based indebtedness) amounted to 7.6% of GDP in 2015. In common with most of the Czech Republic's regional peers, the limited development of non-bank capital markets is largely due to the Czech financial system being heavily bank-based, with a small share of assets under management being held by the insurance sector. Integration of the Czech Republic's financial sector with the euro area, as measured by the claims of euro area banks on the Czech Republic's banks, is moderate. The degree of financial intermediation is low compared with the euro area average, but in line with that of other non-euro area EU Member States in central and eastern Europe. MFI credit to non-government residents in 2015 stood at 54.7% of GDP – less than half the euro area average (see Table 5.2.4). Furthermore, claims of euro area MFIs on resident MFIs remain low, at less than half of the euro area average. This notwithstanding, both indicators have increased in recent years and now stand higher than they did prior to the financial crisis.

Czech Republic - Price developments

Chart 5.2.1 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 5.2.1 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	2.1	2.6	1.5	2.2	3.5	1.4	0.4	0.3	0.5	1.4
HICP excluding unprocessed food and energy	1.7	2.1	1.3	1.4	2.5	1.0	1.1	0.8	0.8	1.5
HICP at constant tax rates ³⁾	1.4	1.7	1.0	2.2	2.2	0.4	0.3	0.1	-	-
CPI	2.1	2.8	1.5	1.9	3.3	1.4	0.4	0.3	-	-
Private consumption deflator	1.6	2.2	1.1	1.6	2.2	0.9	0.5	0.1	0.5	1.4
GDP deflator	1.3	1.5	1.2	-0.2	1.4	1.4	2.5	0.7	1.0	1.3
Producer prices ⁴⁾	1.2	1.6	0.9	5.5	2.1	0.8	-0.8	-3.2	-	-
Related indicators										
Real GDP growth	1.9	2.4	1.3	2.0	-0.9	-0.5	2.0	4.2	2.1	2.6
GDP per capita in PPS ⁵⁾ (euro area = 100)	76.4	75.6	77.4	76.4	76.2	77.5	79.2	-	-	-
Comparative price levels (euro area = 100)	67.9	67.8	67.9	71.6	70.3	67.1	62.8	-	-	-
Output gap ⁶⁾	0.4	2.3	-1.4	-0.3	-1.6	-2.8	-2.2	0.0	0.2	0.7
Unemployment rate (%) ⁷⁾	6.3	6.2	6.4	6.7	7.0	7.0	6.1	5.1	4.5	4.4
Unit labour costs, whole economy	1.3	1.8	0.7	0.6	3.1	0.6	0.1	-0.5	1.5	1.3
Compensation per employee, whole economy	2.7	3.8	1.6	2.8	1.7	-0.3	1.5	2.4	3.2	3.6
Labour productivity, whole economy	1.4	1.9	0.9	2.2	-1.3	-0.8	1.4	3.0	1.7	2.3
Imports of goods and services deflator	0.4	-0.8	1.5	2.3	3.7	0.5	2.6	-1.5	-1.9	1.4
Nominal effective exchange rate ⁸⁾	0.7	3.4	-1.9	3.3	-4.3	-1.5	-4.8	-2.2	-	-
Money supply (M3) ⁹⁾	7.1	8.7	5.5	2.9	5.3	5.2	5.7	8.3	-	-
Lending from banks ¹⁰⁾	9.3	13.8	4.9	5.9	3.4	3.8	4.5	7.1	-	-
Stock prices (PX Index) ¹¹⁾	-35.1	-16.8	-21.9	-25.6	14.0	-4.8	-4.3	1.0	-	-
Residential property prices ¹²⁾	-0.1	-2.8	1.0	0.0	-1.4	0.0	2.4	4.0	-	-

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.

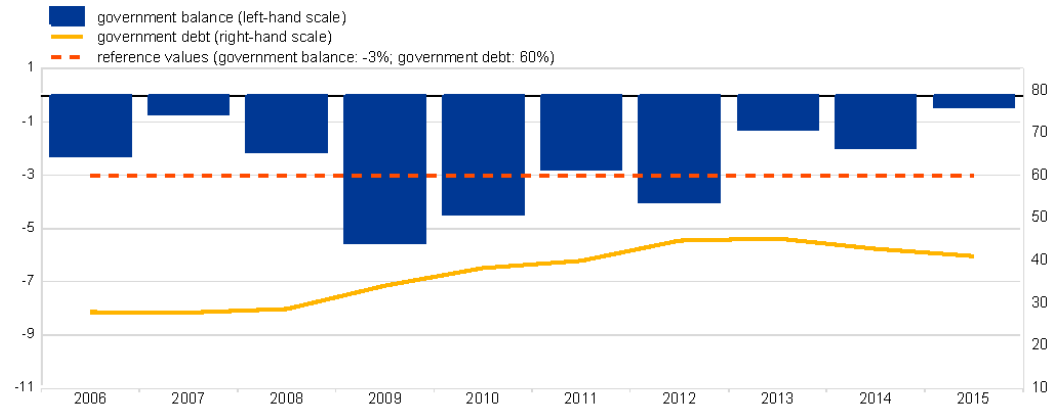
¹¹⁾ Multi-annual and annual figures represent the percentage change between the end of the given period and the end of the previous period.

¹²⁾ Data available since 2008.

Czech Republic - Fiscal developments

Chart 5.2.2 General government balance and debt

(as a percentage of GDP)



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

Table 5.2.2 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	-2.5	-3.0	-2.1	-2.7	-3.9	-1.3	-1.9	-0.4	-0.7	-0.6		
Total revenue	39.8	38.5	41.1	40.4	40.7	41.6	40.8	42.2	40.7	40.7		
Current revenue	38.7	37.5	39.8	39.1	39.8	40.6	39.6	40.0	39.8	39.9		
Direct taxes	7.4	7.6	7.2	7.0	7.0	7.2	7.4	7.4	7.3	7.4		
Indirect taxes	11.5	10.6	12.3	12.0	12.4	12.8	12.0	12.5	12.5	12.5		
Net social contributions	14.8	14.8	14.8	14.7	14.9	14.9	14.8	14.8	15.0	15.0		
Other current revenue ²⁾	5.0	4.5	5.5	5.4	5.5	5.7	5.4	5.4	5.0	5.0		
Capital revenue	1.2	1.0	1.3	1.3	1.0	1.0	1.2	2.2	0.9	0.9		
Total expenditure	42.4	41.5	43.2	43.2	44.7	42.8	42.8	42.6	41.4	41.3		
Current expenditure	36.3	35.1	37.5	37.5	37.6	38.2	37.5	36.7	36.9	36.8		
Compensation of employees	8.0	7.2	8.9	8.7	8.9	9.0	8.9	8.9	9.0	9.1		
Social benefits	16.9	17.5	18.3	16.2	16.4	16.6	16.3	15.9	16.0	15.9		
Interest payable	1.2	1.1	1.3	1.3	1.4	1.3	1.3	1.1	1.0	1.0		
Other current expenditure ³⁾	10.2	9.3	11.0	11.3	10.8	11.2	10.9	10.8	10.9	10.8		
Capital expenditure	6.0	6.4	5.7	5.6	7.1	4.7	5.3	5.9	4.4	4.6		
of which: Investment	4.6	4.9	4.4	4.5	4.2	3.7	4.2	5.2	3.8	3.9		
Cyclically adjusted balance	-2.7	-4.0	-1.5	-2.6	-3.2	-0.1	-1.0	-0.4	-0.8	-0.9		
One-off and temporary measures	-	-	-0.4	0.0	-1.8	-0.1	-0.2	0.0	0.0	0.0		
Structural balance ⁴⁾	-	-	-1.1	-2.8	-1.5	0.0	-0.8	-0.4	-0.7	-0.9		
Government debt	37.0	31.3	42.7	39.9	44.7	45.1	42.7	41.1	41.3	40.9		
Average residual maturity (in years)	-	-	-	-	-	-	-	-	-	-		
In foreign currencies (% of total)	15.0	13.6	16.4	16.4	18.6	19.2	14.4	13.5				
of which: Euro	14.0	12.7	15.3	15.2	17.6	18.2	13.4	12.4				
Domestic ownership (% of total)	77.4	71.1	83.6	84.1	86.4	84.3	84.5	78.9				
Medium and long-term maturity (% of total) ⁵⁾	92.4	92.4	92.4	90.8	89.8	93.1	93.5	94.8				
of which: Variable interest rate (% of total)	12.6	8.2	17.0	14.6	14.9	16.8	18.7	19.9				
Deficit-debt adjustment	-0.2	0.1	-0.4	-0.3	1.0	-0.4	-2.4	0.0				
Net acquisitions of main financial assets	0.0	0.1	-0.1	-0.7	3.3	-0.5	-2.5	-0.1				
Currency and deposits	0.1	0.3	-0.1	-0.9	3.2	-0.6	-2.5	0.1				
Debt securities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0				
Loans	0.1	0.1	0.1	0.2	0.1	0.2	0.0	-0.1				
Equity and investment fund shares or units	-0.1	-0.3	0.0	0.0	0.0	0.0	0.0	-0.1				
Revaluation effects on debt	-0.1	-0.1	-0.1	-0.1	-0.6	0.4	0.0	-0.2				
of which: Foreign exchange holding gains/losses	0.0	0.0	0.1	0.2	-0.2	0.5	0.1	-0.1				
Other ⁶⁾	-0.1	0.1	-0.2	0.5	-1.7	-0.3	0.1	0.3				
Convergence programme: government balance	-	-	-	-	-	-	-	-	-0.6	-0.5	-0.5	-0.5
Convergence programme: structural balance	-	-	-	-	-	-	-	-	-0.6	-1.0	-1.0	-1.0
Convergence programme: government debt	-	-	-	-	-	-	-	-	41.1	40.7	40.2	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.

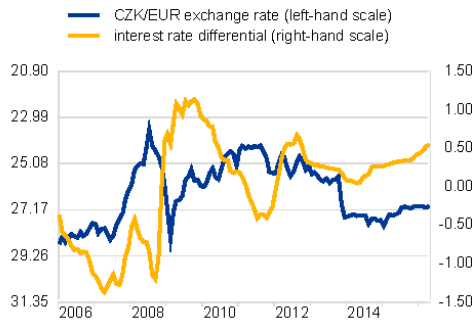
6) Original maturity of more than one year.

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

Czech Republic - Exchange rate and external developments

Chart 5.2.3 Bilateral exchange rate and short-term interest rate differential

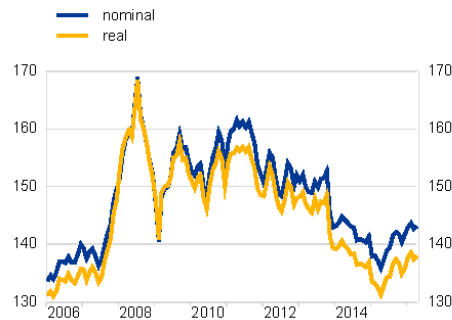
(CZK/EUR exchange rate: monthly averages; difference between three-month interbank interest rates and three-month EURIBOR: basis points, monthly values)



Sources: National data and ECB calculations.

Chart 5.2.4 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 5.2.3 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⁾	-0.2	-1.6	0.7	-1.8	-0.3	1.5	0.9	3.3	0.3	0.5
Current account balance	-1.4	-2.6	-0.8	-2.1	-1.6	-0.5	0.2	0.9	-1.5	-1.3
Goods	2.7	0.8	3.8	1.9	3.1	4.1	5.2	4.7	.	.
Services	1.9	2.1	1.7	2.0	1.9	1.7	1.3	1.7	.	.
Primary income	-5.6	-5.2	-5.8	-5.6	-5.9	-6.1	-6.1	-5.5	.	.
Secondary income	-0.3	-0.4	-0.3	-0.5	-0.7	-0.3	-0.2	0.0	.	.
Capital account balance	1.2	1.0	1.4	0.3	1.3	2.0	0.8	2.4	.	.
Combined direct and portfolio investment balance ⁴⁾	-2.8	-4.0	-2.1	-1.3	-4.4	-2.1	0.2	-3.1	.	.
Direct investment	-1.2	-1.4	-1.0	-1.1	-3.0	0.2	-1.9	0.6	.	.
Portfolio investment	-1.6	-2.6	-1.1	-0.1	-1.4	-2.3	2.1	-3.7	.	.
Other investment balance	0.4	0.7	0.3	-0.2	2.9	-0.6	-0.3	-0.4	.	.
Reserve assets	2.4	1.2	3.1	-0.4	2.0	4.5	1.7	7.9	.	.
Exports of goods and services	72.7	62.7	78.7	71.6	76.7	77.3	83.6	84.6	.	.
Imports of goods and services	68.2	59.7	73.2	67.7	71.7	71.4	77.1	78.2	.	.
Net international investment position ⁴⁾	-40.4	-41.9	-39.4	-43.2	-46.1	-39.4	-36.8	-31.5	.	.
Gross external debt ⁴⁾	58.2	49.3	63.8	54.8	60.2	63.5	68.6	70.7	.	.
Internal trade with the euro area ⁴⁾										
Exports of goods and services	63.6	65.0	62.8	64.2	62.2	62.3	62.3	63.1	.	.
Imports of goods and services	52.3	52.5	52.2	51.7	51.6	51.8	52.9	52.8	.	.
Investment position with the euro area ⁴⁾										
Direct investment assets ⁴⁾	78.5	78.0	78.7	80.4	79.1	78.8	76.2	79.2	.	.
Direct investment liabilities ⁴⁾	81.4	82.8	80.6	81.1	81.2	80.8	79.5	80.3	.	.
Portfolio investment assets ⁴⁾	75.2	76.5	74.5	75.9	75.9	73.8	73.9	72.7	.	.
Portfolio investment liabilities ⁴⁾	48.2	49.8	47.3	46.9	50.4	48.4	43.1	47.4	.	.

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.

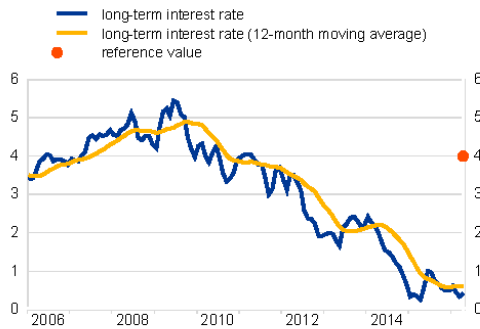
3) Differences between totals and sum of their components are due to rounding.

4) End-of-period outstanding amounts.

5) As a percentage of the total.

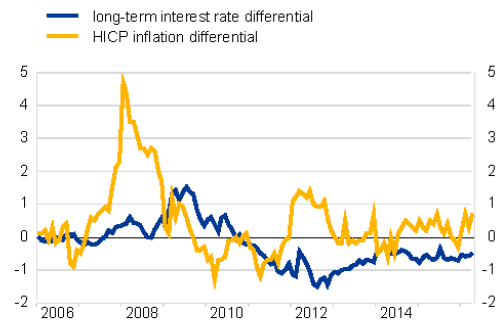
Czech Republic - Long-term interest rate developments

Chart 5.2.5 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 5.2.6 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 5.2.4 Long-term interest rates and indicators of financial development and integration
(as a percentage of GDP, unless otherwise indicated)

	2006-2015 ¹⁾	2006-2010 ¹⁾	2011-2015 ¹⁾	2012	2013	2014	2015	May 2015 to Apr. 2016	Memo item: euro area 2015
Long-term interest rates									
Czech Republic ²⁾	3.2	4.3	2.2	2.8	2.1	1.6	0.6	0.6	-
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⁾	17.9	15.8	20.0	19.5	23.9	19.6	19.0	-	73.6
Debt securities issued by non-financial corporations ⁴⁾	5.2	2.8	7.0	6.9	7.6	8.0	7.6	-	10.8
Stock market capitalisation ⁵⁾	20.4	24.8	16.1	17.7	14.8	14.8	14.2	-	60.4
MFI credit to non-government residents ⁶⁾	49.3	45.1	53.4	52.8	54.3	53.8	54.7	-	114.7
Claims of euro area MFIs on resident MFIs ⁷⁾	7.1	6.3	7.9	4.9	7.3	7.9	12.8	-	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.