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COVER NOTE

From:	Mr Mario DRAGHI, President of the European Central Bank
date of receipt:	23 May 2018
To:	Mr Donald TUSK, President of the European Council
Subject:	ECB Convergence report 2018 - Part 3.

Delegations will find attached the third part of the European Central Bank's Convergence report 2018.

Encl.:

ECB Convergence Report May 2018 - Part 3

5 Examination of economic convergence in individual countries

5.1 Bulgaria

5.1.1 Price developments

In March 2018 the 12-month average rate of HICP inflation in Bulgaria was 1.4%, i.e. below the reference value of 1.9% for the criterion on price stability (see Chart 5.1.1). This rate is expected to gradually 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 moderate, standing at 2.2%. During the period 2004-08 monetary conditions under the currency board framework became too expansionary for a catching-up economy, mainly as a result of strong capital inflows. In the middle of 2008 HICP inflation peaked at 14.7% amid signs of overheating in the Bulgarian economy before the onset of the global financial crisis. Thereafter, it declined rapidly up to the end of 2009, mainly owing to lower commodity prices and the contraction in economic activity in an environment of subsiding capital inflows and comprehensive fiscal consolidation measures. Between 2010 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. After a prolonged period of being in negative territory, inflation turned positive again in 2017. Robust economic growth and decreasing unemployment, together with a longer-term decline in the working age population, as well as administrative and policy factors, resulted in strongly rising nominal wages and unit labour costs, though at lower rates than before the crisis (see Table 5.1.1).

In the first quarter of 2018 the average annual rate of HICP inflation stood at 1.6%. In addition to higher administrative prices for utilities and a recovery in energy and commodity prices, strong domestic demand contributed to the increasing inflation rate. Hikes in the prices of food and services also exerted upward pressure on overall HICP inflation.

Inflation is expected to increase gradually in the coming years, albeit at a moderate pace, but over the longer term there are serious concerns regarding the sustainability of inflation convergence in Bulgaria. According to the European Commission's Spring 2018 Economic Forecast, the average annual rate of inflation will increase to 1.8% in 2018 and 2019. The risks to the medium-term inflation outlook are broadly balanced. Upside risks relate to an acceleration in the underlying growth momentum and the uncertainty about the outlook for oil prices,

while downside risks may arise from heightened uncertainty regarding developments in the global economy, which could reduce external price pressures. Looking further ahead, there are serious concerns regarding the sustainability of inflation convergence in Bulgaria over the longer term, also taking into account the recent increases in unit labour costs. 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. In particular, while hourly labour costs in Bulgaria are still the lowest in the EU, wage growth needs to be consistent with productivity growth, among other things, in order to safeguard price competitiveness and the attractiveness of Bulgaria to foreign investors.
Moreover, as Bulgaria has opted for a currency board arrangement, it is of key importance to contain inflation with appropriate policies, not least to strengthen productivity growth in the non-traded good sector.

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 (fiscal, macroprudential) 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, ensuring an independent and effective judicial system, and enhancing the education system. A further reduction in the declining – but still elevated – corporate debt burden would support corporate profitability, credit growth and investment. 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 long-term unemployment accounting for a large percentage of total unemployment, additional measures are needed to improve the employability and strengthen the skill level of the workforce, and to promote the economic inclusion of the most vulnerable segments of the population. With regard to macroeconomic imbalances, the European Commission selected Bulgaria for a further in-depth review in its Alert Mechanism Report 2018 and concluded that Bulgaria is experiencing macroeconomic imbalances.

Financial sector policies should be geared to safeguarding financial stability and ensuring that the financial sector makes a sound contribution to sustainable economic growth. Българска народна банка (Bulgarian National Bank) conducted an asset quality review and stress test exercise in 2016. The results showed that the banking system had recovered from the stress experienced in mid-2014. Moreover, the asset quality review and stress test exercise conducted by Българска народна банка found the banking system to be adequately capitalised and liquid at system level. According to the European Commission, the process of enhancing supervisory practices of Българска народна банка has

continued in line with the central bank's Plan on Reforms and Development of Banking Supervision. Notwithstanding the progress that has been made, credit risk is still a significant risk to financial stability, with non-performing loans to the
non-financial corporations sector being still elevated. The authorities should encourage the cleaning-up of banks' balance sheets by removing legal and juridical obstacles to the resolution of non-performing loans. Finally, in order to boost confidence in the financial system, comprehensive action plans need to be implemented to further enhance the supervision of the banking and non-banking sectors. In order to further bolster confidence in the financial system, the national competent authorities should continue to improve their supervisory practices, among other things, by following the applicable recommendations from the relevant international and European bodies, and by collaborating closely with other national supervisors of EU Member States within the supervisory colleges.

5.1.2 Fiscal developments

Bulgaria's general government balance and debt complied with the Maastricht criteria in 2017. In the reference year 2017 the general government budget recorded a surplus of 0.9% of GDP, thus comfortably meeting the 3% deficit reference value. The general government gross debt-to-GDP ratio was 25.4%, well below the 60% reference value (see Table 5.1.2). Compared with the previous year, the general government surplus increased, while the debt ratio declined notably (by
3.6 percentage points). The budget is forecast by the European Commission to record a surplus of 0.6% of GDP in 2018, while the government debt ratio is projected to decrease moderately, to 23.3% of GDP. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2017, nor is it expected to in 2018.

Bulgaria has been subject to 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 excessive deficit procedure for Bulgaria on 22 June 2012. Since then, while general government debt has been well below the 60% of GDP reference value, the general government balance has breached the reference value only in 2014, reaching a deficit of 5.5% of GDP, mostly as a result of the one-off capital transfer (amounting to 3.1% of GDP) related to the reclassification of the Deposit Insurance Fund within the government sector, but also of 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 excessive deficit procedure.

Both structural and cyclical factors have driven the consolidation path of the deficit ratio. The improvement in the deficit ratio during the period 2010-13, which amounted to 3.7 percentage points of GDP, can be explained mainly by an improvement in the structural balance (of 3.5 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). The fiscal consolidation that has taken place since 2014 is explained by the unwinding of the 2014 one-off capital transfer, as well as restraint in public spending combined with the economic upswing.

The government debt-to-GDP ratio remained well below the 60% reference value over the past decade and is expected to continue on its downward path. The debt ratio increased notably, from 13.7% in 2009 to 17.0% of GDP in 2013, on the back of primary deficits as well as unfavourable interest-growth differentials. The subsequent increase 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 Fund, and the provision of liquidity to a bank. Pre-financing operations were the main reason for the temporary peak in public debt in 2016, at 29% of GDP. The debt ratio started declining again in 2017, as the accumulated funds were drawn on to repay the maturing debt. Primary surpluses and, to a lesser extent, the favourable interest-growth differentials contributed to this decline in 2017, and are projected to lead to a further decrease in 2018-19, with the debt ratio reaching 21.4% of GDP by 2019. Potential risks pertain mainly to contingent liabilities stemming from state-owned enterprises.

In the presence of a long-lasting 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 has generally been negligible, with only a temporary increase in 2014 (to about 23%, only to return to below 1% the following year – see Table 5.1.2). Taking into account the share of debt with a variable interest rate and 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 (80.6% in 2017). However, given that it is mostly denominated in euro, the anchor currency of Bulgaria’s currency board framework, fiscal balances are insensitive to changes in exchange rates other than the euro/lev exchange rate, which is fixed under the currency board.

The European Commission's Spring 2018 Economic Forecast indicates compliance with the Stability and Growth Pact's preventive arm requirements in both 2018 and, under unchanged policies, 2019. According to the European Commission's Spring 2018 Economic Forecast, the structural balance is projected to remain in surplus, albeit decreasing slightly, from 0.9% of GDP in 2017 to 0.6% of GDP in both 2018 and 2019. As such, the projection foresees no risk of a deviation from either the medium-term objective (a structural deficit of 1% of GDP) or the expenditure benchmark. Bulgaria's medium-term fiscal policy, as presented in the 2018 Convergence Programme, supports this assessment, as it projects a balanced structural balance in 2018 and increasing surpluses of 0.2% in 2019 and 0.3% in 2020, and therefore a sizable margin compared with the medium-term objective.

In recent years Bulgaria has made progress on fiscal structural policies, but further improvement is needed. The mandate of the Fiscal Council has been strengthened recently, although further improvements in the areas of its technical and administrative capacities are still needed. The recent progress in tax collection should also be put on a firm footing. Possible future revenue overruns should be saved in order to mitigate risks, such as those stemming from: (i) contingent liabilities related to state-owned enterprises, (ii) the additional costs determined by an ageing population and emigration, (iii) the budget's function as potential backstop for the financial sector (a risk which, however, can be significantly mitigated by the framework of the Bank Recovery and Resolution Directive), and (iv) the costs of implementing the EU country-specific recommendations and national reform plans. In the same vein, any increases in public spending should take account of sustainability considerations. Moreover, enhancing the overall efficiency of the public sector, particularly with respect to public spending, could generate additional savings and enable a much-needed expansion in the stock of public capital – in terms of both quantity and quality.

Over the medium and long run Bulgaria faces low risks to fiscal sustainability. The European Commission's 2017 Debt Sustainability Monitor finds that Bulgaria faces low fiscal sustainability risks over the medium and long term,[129] thanks to the favourable initial budgetary position and the very low debt ratio. However, it points to risk scenario results, which use the assumptions of the Ageing Working Group (AWG) of the EU's Economic Policy Committee, as indicating higher (moving from low to medium) debt sustainability risks over the long term. This is corroborated by the 2015 projections by the European Commission and the Economic Policy Committee,[130] in which Bulgaria is assessed as being likely to experience a moderate increase in strictly age-related public expenditure (by 0.5 percentage points of GDP over the period 2013-60 in the AWG's reference scenario). In the AWG's 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 healthcare (1.1 percentage points of GDP). These projections 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 is needed. A consistent, prudent and effective fiscal policy will ensure that Bulgaria continues to comply with the preventive arm of the Stability and Growth Pact and maintains buffers to alleviate adverse shocks. Moreover, there is scope for a more growth and environment-friendly tax system, a shift towards a lower tax wedge for lower-paid labour, a more efficient use of property taxes, and a more cost-effective provision of healthcare services. Safeguarding and extending the current reductions in tax collection gaps, further reducing the informal economy and increasing spending efficiency on the basis of a credible fiscal framework strengthened by the efficient

[129] However, this assessment does not necessarily reflect the uncertainty surrounding the long-term assumptions and, for high-debt countries, has to be taken with caution.

[130] European Commission and Economic Policy Committee, "The 2015 Ageing Report: Economic and budgetary projections for the 28 EU Member States (2013-2060)", *European Economy series*, No 3, European Commission, 2015.

operation of the Fiscal Council are all essential measures for preserving medium-term fiscal sustainability.

5.1.3 Exchange rate developments

In the two-year reference period from 4 May 2016 to 3 May 2018, 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.

The real effective exchange rate of the Bulgarian lev has depreciated slightly over the past ten years (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 significantly over the past ten years, while the country's net foreign liabilities declined gradually, but remained high (see Table 5.1.3). After recording a very large external deficit in 2008, the combined current and capital account improved steadily and has recorded a surplus since 2011. This improvement primarily reflected a substantial reduction in the goods deficit on account of the export-led recovery and, in an initial phase, subdued domestic demand following a sharp contraction in activity. The surplus widened to 4.5% of GDP in 2016 and 5.5% in 2017. The rebalancing occurred 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 double-digit levels before the crisis to an average of 2.6% of GDP from 2013 to 2017, while the balance on other investment recorded net outflows. Gross external debt increased substantially from 78.1% of GDP in 2008 to 97.4% in 2014, before declining to 74.2% in 2017. At the same time the country's net international investment position improved from -75.2% of GDP in 2014 to -40.5% of GDP in 2017. In view of the country's level of net foreign liabilities, fiscal and structural policies 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 2017 exports of goods and services to the euro area constituted 44.6% of total exports, while the corresponding figure for imports was slightly lower, at 43.4%. In 2017 the share of the euro area in Bulgaria's stock of direct investment liabilities stood at 66.2% and its share in the country's stock of portfolio investment liabilities was 64.9%. The share of Bulgaria's stock of foreign assets invested in the euro area amounted to 43.7% in the case of direct investment and 44.1% for portfolio investment in 2017.

5.1.4 Long-term interest rate developments

Over the reference period from April 2017 to March 2018, long-term interest rates in Bulgaria stood at 1.4% on average and were thus below the 3.2% reference value for the interest rate convergence criterion (see Chart 5.1.5).

Long-term interest rates in Bulgaria continued to decrease over the reference period, with the 12-month average rate falling from 7.3% in November 2009 to 1.4% in March 2018. Following the onset of the financial crisis, the base interest rate in Bulgaria – the reference rate calculated as a simple monthly average of the values of the LEONIA (LEv OverNight Interest Average) index – fell from 5.2% in January 2009 to 0.2% in December 2010. Bulgaria's long-term interest rates declined over the period 2009-10. In 2012 the decline also reflected a drop in risk premia as markets started to perceive a waning in macro-financial risk in Bulgaria and the domestic banking sector began to show sufficient levels of liquidity. After a year of stability in 2013, the fall in long-term interest rates resumed in 2014 and has continued since then, dropping to 1.1% in March 2018 (see Chart 5.1.5). Since the second half of 2016, Bulgarian banks' demand for government debt securities has actively contributed to the decline in domestic long-term interest rates in the context of a limited supply of debt securities, weak credit demand, a high savings rate and low interest rates in the euro area. The steady improvement in Bulgaria's macroeconomic performance and the stability of its fiscal outlook have also contributed to the decline in the default risk on long-term Bulgarian debt – as measured by ten-year CDS spreads – which fell from over 500 basis points in early 2009 to around 100 basis points in the first quarter of 2018. Bulgaria's government debt is rated investment-grade by all of the three main rating agencies (Moody's: Baa2, S&P: BBB−, Fitch: BBB).

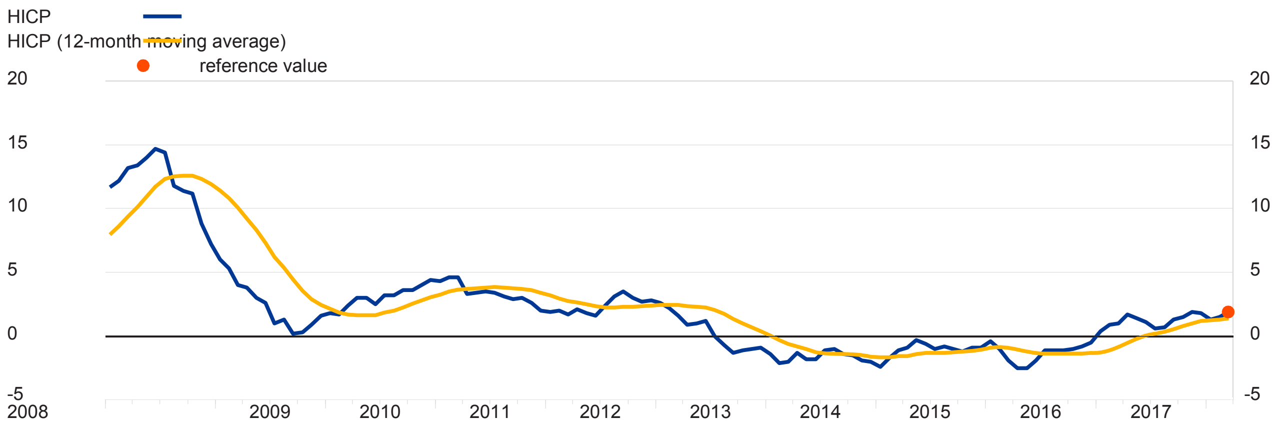
As a result of these movements in long-term interest rates on Bulgarian government bonds, the long-term interest rate differential vis-à-vis the euro area average closed in March 2018. After 2009 the decline in Bulgarian long-term interest rates and an increase in euro area average rates meant that the interest rate differential narrowed gradually, to stand at almost zero towards the end of 2012 (see Chart 5.1.6). Over the period 2013-14 the stabilisation of Bulgarian rates, combined with declining euro area average rates, resulted in some widening of that differential, which peaked in November 2014 at 1.9 percentage points, before declining and bottoming out at 0.7 percentage point in June 2015. Between then and October 2016, that differential fluctuated between 1.1 and 1.8 percentage points. By the end of 2016 it had started to decline once again, and it then turned negative in January and February 2018. The following month it stood at 0 basis points (+40 basis points vis-à-vis the AAA euro area yield).

Capital markets in Bulgaria are much smaller than in the euro area and still underdeveloped (see Table 5.1.4). Overall, there has been hardly any deepening of capital markets since the financial crisis. For instance, stock market capitalisation, as a percentage of GDP, has declined in recent years, from an average of 15% of GDP over the period 2008-12 to 13.2% over the period 2013-17. Market-based debt financing of domestic MFIs has remained quite constant since 2007, at around 1% of GDP. Over the same period, non-financial corporations in Bulgaria seem to have gained more access to the corporate debt market, as outstanding debt securities issued by this sector increased to an average of 3.4% of GDP over the period
2013-17, up from 1.3% of GDP over the period 2008-12. In 2017, euro area banks' claims on Bulgarian banks were at historically low levels, having been in decline since the start of the financial crisis. Measured by this indicator Bulgaria's financial sector is relatively integrated with the euro area. Bulgaria's financial sector is predominantly bank-based, but the degree of financial intermediation remains quite low compared with the euro area average, even if it is comparable with that of peer countries in the region. MFI credit to non-government residents stood at 54.1% of GDP in 2017, down by around 14 percentage points from its 2008-12 average.
Claims of euro area MFIs on banks in Bulgaria have been decreasing since 2007 and in 2017 stood at less than 3% of the total liabilities of Bulgarian MFIs. At end- 2017, the banking system in Bulgaria was largely foreign-owned (more than 76% of total banking assets) – with the country scoring quite high on this dimension of financial integration – and largely funded by deposits (around 98% of total liabilities). Its assets vis-à-vis the non-financial private sector were dominated by loans, 39% of which were denominated in foreign currency (almost entirely in euro).

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 April 2017 to March 2018 is the unweighted arithmetic average of the annual percentage changes in the HICP for Cyprus, Ireland and Finland plus 1.5 percentage points. The reference value is 1.9%.

Table 5.1.1 Measures of inflation and related indicators

(annual percentage changes, unless otherwise indicated)

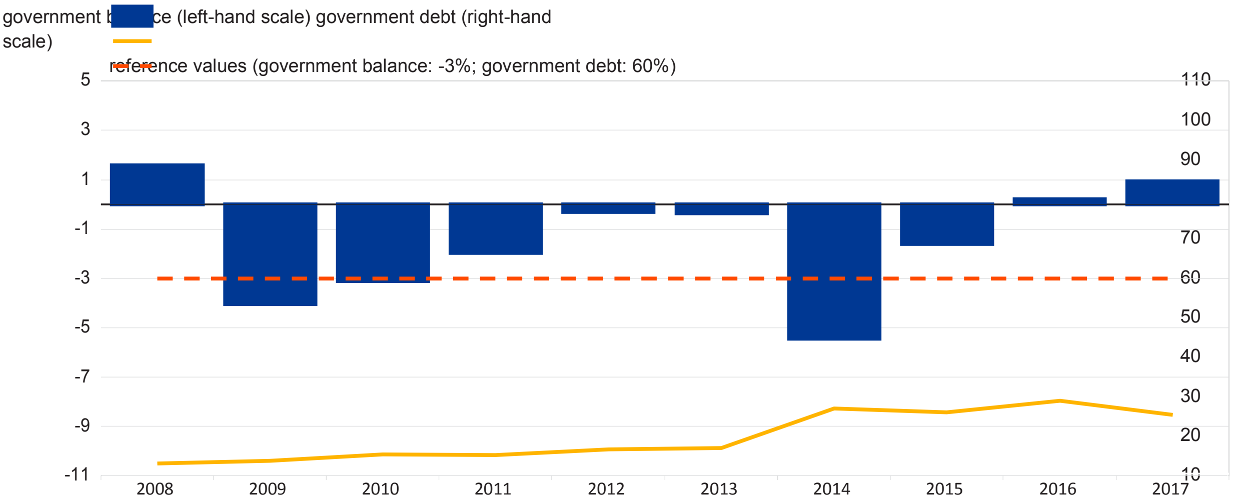
	2008-2017 1)	2008-2012 1)	2013-2017 1)	2013	2014	2015	2016	2017	2018 2)	2019 2)
Measures of inflation										
HICP	2.0	4.6	-0.5	0.4	-1.6	-1.1	-1.3	1.2	1.8	1.8
HICP excluding unprocessed food and energy	2.0	4.4	-0.3	0.3	-1.3	-0.3	-0.4	0.2	1.6	1.6
HICP at constant tax rates 3)	1.8	4.1	-0.6	0.4	-1.6	-1.1	-1.5	1.0	-	-
CPI	2.5	4.9	0.1	0.9	-1.4	-0.1	-0.8	2.1	1.7	1.8
Private consumption deflator	1.6	3.3	-0.1	-2.6	0.0	1.2	-0.1	1.1	1.8	1.8
GDP deflator	2.6	4.1	1.1	-0.7	0.5	2.2	2.2	1.2	2.2	2.3
Producer prices 4)	2.6	5.8	-0.5	-1.3	-0.9	-1.7	-2.8	4.2	-	-
Related indicators										
Real GDP growth	1.9	1.1	2.7	0.9	1.3	3.6	3.9	3.6	3.8	3.7
GDP per capita in PPS 5) (euro area = 100)	42.3	40.9	44.1	42.7	43.8	44.3	45.7	.	-	-
Comparative price levels (euro area = 100)	48.7	49.9	47.2	48.2	46.7	46.9	46.9	.	-	-
Output gap 6)	-0.3	0.1	-0.8	-0.8	-1.8	-1.3	-0.3	0.1	0.4	0.5
Unemployment rate (%) 7)	9.4	9.3	9.5	13.0	11.4	9.2	7.6	6.2	5.5	5.3
Unit labour costs, whole economy	5.6	6.9	4.4	7.4	4.6	2.3	2.3	5.7	4.8	3.6
Compensation per employee, whole economy	8.2	9.8	6.7	8.8	5.6	5.6	5.8	7.5	7.6	7.0
Labour productivity, whole economy	2.4	2.7	2.1	1.3	1.0	3.3	3.4	1.7	2.7	3.3
Imports of goods and services deflator	1.4	4.2	-1.2	-2.4	-1.9	-2.6	-5.1	6.2	1.7	1.4
Nominal effective exchange rate 8)	0.6	0.2	1.1	2.0	1.9	-2.2	2.2	1.8	-	-
Money supply (M3) 9)	8.0	7.8	8.1	9.3	7.5	8.2	7.2	8.5	-	-
Lending from banks 10)	5.6	8.5	2.8	1.1	2.2	-0.2	3.4	7.8	-	-
Stock prices (SOFIX) 11)	-61.7	-80.5	96.1	42.3	6.2	-11.7	27.2	15.5	-	-
Residential property prices	-0.2	-3.7	3.5	-2.2	1.4	2.8	7.0	8.7	-	-

Sources: European Commission (Eurostat, Directorate-General for Economic and Financial Affairs), 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 2018 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 from 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.

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)

	2008-2017 [1]	2008-2012 [1]	2013-2017 [1]	2013	2014	2015	2016	2017	2018 [2]	2019 [2]	2020	2021
Government balance	**-1.4**	**-1.6**	**-1.3**	**-0.4**	**-5.5**	**-1.6**	**0.2**	**0.9**	**0.6**	**0.6**	-	-
Total revenue	35.7	34.6	36.8	37.2	36.6	39.1	35.2	36.1	36.4	36.4	-	-
Current revenue	34.1	33.3	34.8	35.0	34.0	35.1	34.6	35.3	35.4	35.2	-	-
Direct taxes	5.3	5.0	5.5	5.1	5.4	5.4	5.6	5.9	5.9	5.9	-	-
Indirect taxes	15.0	14.7	15.2	15.3	14.8	15.4	15.4	15.1	15.1	15.1	-	-
Net social contributions	7.4	7.0	7.9	7.4	7.9	7.9	7.8	8.6	8.6	8.6	-	-
Other current revenue [3]	6.4	6.6	6.2	7.1	6.0	6.4	5.8	5.7	5.8	5.7	-	-
Capital revenue	1.7	1.3	2.0	2.2	2.6	4.0	0.6	0.8	1.0	1.2	-	-
Total expenditure	37.1	36.2	38.1	37.6	42.1	40.7	35.0	35.2	35.8	35.8	-	-
Current expenditure	32.1	31.5	32.7	33.2	33.2	33.8	31.1	32.2	32.4	31.9	-	-
Compensation of employees	9.1	8.9	9.3	9.5	9.5	9.4	9.0	9.3	9.6	9.7	-	-
Social benefits	13.3	12.7	13.9	13.8	14.5	13.9	13.8	13.6	13.8	13.5	-	-
Interest payable	0.8	0.8	0.8	0.7	0.9	0.9	0.9	0.8	0.7	0.7	-	-
Other current expenditure [4]	8.9	9.2	8.6	9.2	8.3	9.5	7.4	8.5	8.4	8.0	-	-
Capital expenditure	5.0	4.7	5.4	4.4	8.9	6.9	3.8	3.0	3.4	3.9	-	-
of which: Investment	4.2	4.4	4.1	4.0	5.2	6.6	2.6	2.1	2.9	3.5	-	-
Cyclically adjusted balance	-1.3	-1.6	-1.0	-0.1	-4.9	-1.2	0.3	0.9	0.5	0.5	.	.
One-off and temporary measures	.	.	-0.7	0.0	-3.2	-0.1	0.0	0.0	0.0	0.0	.	.
Structural balance [5]	.	.	-0.3	-0.1	-1.7	-1.1	0.3	0.9	0.5	0.5	.	.
Government debt	**19.8**	**14.8**	**24.9**	**17.0**	**27.0**	**26.0**	**29.0**	**25.4**	**23.3**	**21.4**	-	-
Average residual maturity (in years)	7.1	6.8	7.3	7.2	5.8	8.2	7.8	7.7	.	.	.	.
In foreign currencies (% of total)	77.8	76.3	79.2	73.4	80.9	79.1	82.1	80.6	.	.	.	.
of which: Euro	64.8	55.8	73.7	59.4	71.4	77.4	80.9	79.5	.	.	.	.
Domestic ownership (% of total)	50.0	48.1	51.9	52.3	47.7	52.7	51.5	55.4	.	.	.	.
Medium and long-term maturity (% of total) [6]	96.8	98.8	94.8	98.1	77.0	99.2	99.7	100.0	.	.	.	.
of which: Variable interest rate (% of total)	17.2	24.6	9.9	16.2	9.4	8.6	9.9	5.3	.	.	.	.
Deficit-debt adjustment	**0.3**	**-0.7**	**1.4**	**0.0**	**4.8**	**-1.1**	**4.8**	**-1.4**	.	.	.	.
Net acquisitions of main financial assets	0.2	-0.5	1.0	-1.7	3.7	-2.5	6.4	-0.9	.	.	.	.
Currency and deposits	0.2	-0.3	0.7	-1.3	1.6	-2.0	5.9	-0.8	.	.	.	.
Debt securities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	.	.	.	.
Loans	0.0	-0.2	0.2	-0.1	1.0	-0.5	0.6	0.0	.	.	.	.
Equity and investment fund shares or units	0.1	0.0	0.1	-0.3	1.0	0.0	-0.1	0.0	.	.	.	.
Revaluation effects on debt	0.0	0.1	0.0	-0.2	0.1	0.1	0.0	0.0	.	.	.	.
of which: Foreign exchange holding gains/losses	0.1	0.1	0.0	-0.2	0.3	0.1	0.0	0.0	.	.	.	.
Other [7]	0.1	-0.3	0.4	1.8	1.0	1.3	-1.6	-0.5	.	.	.	.
Convergence programme: government balance	-	-	-	-	-	-	-	-	0.0	0.3	0.5	0.2
Convergence programme: structural balance	-	-	-	-	-	-	-	-	0.0	0.2	0.3	0.0
Convergence programme: government debt	-	-	-	-	-	-	-	-	23.3	22.1	20.7	19.4

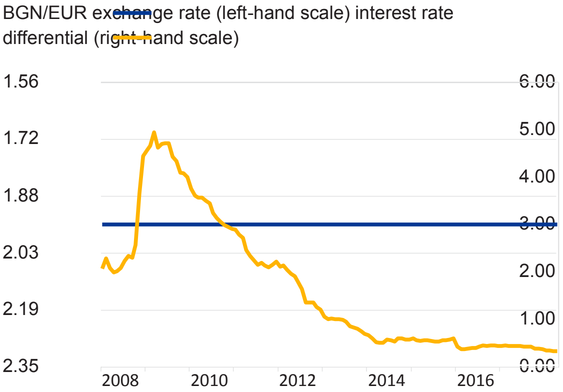
Sources: European System of Central Banks and European Commission (Eurostat, Directorate-General for Economic and Financial Affairs).

1) Multi-annual averages calculated using the arithmetic mean.
2) Data from the European Commission's Spring 2018 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 factors (sector reclassifications and statistical discrepancies).

Bulgaria - Exchange rate and external developments

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

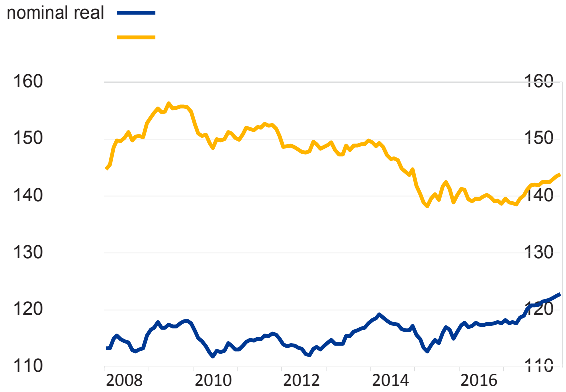
(BGN/EUR exchange rate: monthly averages; difference between three-month interbank interest rates and three-month EURIBOR: basis points, monthly values)



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)

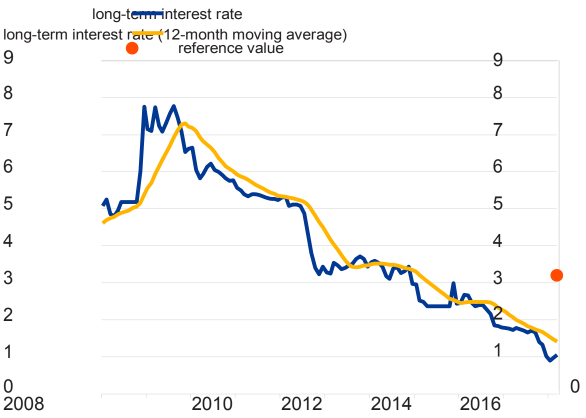
	2008-2017 [1)]	2008-2012 [1)]	2013-2017 [1)]	2013	2014	2015	2016	2017	2018 [2)]	2019 [2)]
Balance of payments										
Current account and capital account balance [3)]	-0.9	-5.5	3.6	2.4	2.3	3.1	4.5	5.5	3.2	2.7
Current account balance	-2.5	-6.5	1.6	1.3	0.1	0.0	2.3	4.5	1.4	0.8
Goods	-8.9	-12.7	-5.1	-7.0	-6.5	-5.8	-2.0	-4.1	.	.
Services Primary	6.1	6.0	6.2	6.3	5.9	6.6	6.1	6.0	.	.
income	-3.5	-3.4	-3.5	-3.8	-3.1	-4.5	-5.1	-1.1	.	.
Secondary income Capital	3.8	3.6	4.0	5.7	3.8	3.6	3.3	3.7	.	.
account balance	1.5	1.1	2.0	1.1	2.2	3.1	2.2	1.0	.	.
Combined direct and portfolio investment balance [3)]	-3.5	-4.4	-2.6	-2.6	-4.9	-6.4	-2.8	3.9	.	.
Direct investment Portfolio	-4.4	-6.1	-2.6	-3.0	-2.1	-5.1	-1.5	-1.4	.	.
investment	0.8	1.7	0.0	0.3	-2.8	-1.3	-1.3	5.2	.	.
Other investment balance	0.4	-2.3	3.1	5.8	0.1	4.8	4.1	0.8	.	.
Reserve assets	2.3	1.0	3.6	-1.3	4.2	8.2	7.2	-0.2	.	.
Exports of goods and services Imports	59.4	54.0	64.7	64.5	64.9	63.8	63.9	66.4	.	.
of goods and services	62.1	60.7	63.6	65.2	65.5	62.9	59.9	64.5	.	.
Net international investment position [4)]	-64.7	-70.1	-59.3	-73.3	-75.2	-61.2	-46.2	-40.5	.	.
Gross external debt [4)]	88.2	94.1	84.6	90.9	97.4	81.3	79.3	74.2	.	.
Internal trade with the euro area [5)]										
Exports of goods and services Imports	42.9	42.4	43.3	42.0	42.6	43.4	43.8	44.6	.	.
of goods and services	42.5	41.5	43.1	41.9	42.4	43.8	44.1	43.4	.	.
Investment position with the euro area [5)]										
Direct investment assets [4)] Direct	50.9	54.8	48.6	51.9	48.5	49.6	49.2	43.7	.	.
investment liabilities [4)] Portfolio	66.6	68.6	65.3	64.4	64.4	65.1	66.5	66.2	.	.
investment assets [4)] Portfolio	48.2	49.2	47.7	43.9	43.5	55.7	51.1	44.1	.	.
investment liabilities [4)]	65.8	74.1	60.8	63.6	57.0	53.9	64.3	64.9	.	.

Sources: European System of Central Banks and European Commission (Eurostat, Directorate-General for Economic and Financial Affairs).
Note: Backdata are available from 2008.

1) Multi-annual averages calculated using the arithmetic mean.
2) Data from the European Commission's Spring 2018 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.

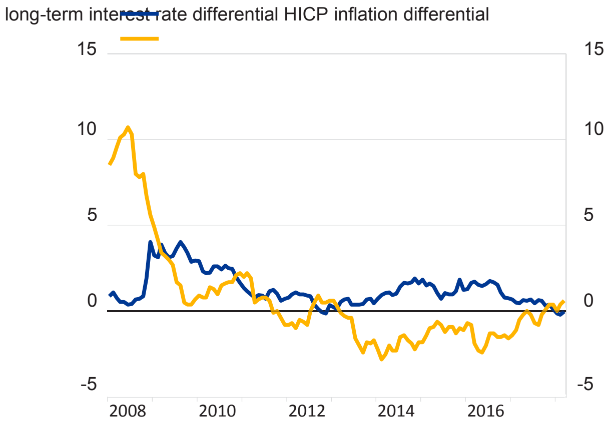
Bulgaria - Long-term interest rate developments

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 April 2017 to March 2018 is the unweighted arithmetic average of the interest rate levels in Cyprus, Ireland and Finland plus 2 percentage points. The reference value is 3.2%.

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)

	2008-2017 1)	2008-2012 1)	2013-2017 1)	2014	2015	2016	2017	Apr. 2017 to Mar. 2018	Memo item: euro area 2017
Long-term interest rates									
Bulgaria 2)	4.2	5.7	2.6	3.3	2.5	2.3	1.6	1.4	-
Euro area 2), 3)	2.8	4.0	1.6	2.0	1.2	0.9	1.1	1.1	-
Euro area AAA par curve, ten-year residual maturity 2), 3)	2.1	3.2	0.9	1.4	0.6	0.2	0.4	0.5	-
Indicators of financial development and integration									
Debt securities issued by financial corporations 4)	1.1	1.2	1.1	1.2	1.0	1.1	1.2	-	66.0
Debt securities issued by non-financial corporations 5)	2.4	1.3	3.4	3.1	2.8	4.1	3.7	-	11.3
Stock market capitalisation 6)	14.1	15.0	13.2	11.5	9.7	8.7	23.9	-	67.4
MFI credit to non-government residents 7)	63.5	68.3	58.7	61.1	56.7	54.2	54.1	-	108.1
Claims of euro area MFIs on resident MFIs 8)	11.2	16.8	5.7	8.8	4.2	3.0	2.9	-	26.3

Sources: European System of Central Banks and ECB calculations.
1) Multi-annual averages calculated using the arithmetic mean.
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 national central bank) 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 national central bank) held by euro area MFIs as a percentage of total liabilities of domestic MFIs (excluding the national central bank). Total liabilities exclude capital and reserves and remaining liabilities.

5.2 Czech Republic

5.2.1 Price developments

In March 2018 the 12-month average rate of HICP inflation in the Czech Republic was 2.2%, i.e. above the reference value of 1.9% for the criterion on price stability (see Chart 5.2.1). This rate is expected to gradually decline 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 0.2% to 6.6%, and the overall average for that period was moderate, standing at 1.9%. Between 2008 and 2010 annual HICP inflation fell sharply, from an average annual rate of 6.3% to 1.2%, as global commodity prices declined and economic activity slowed. Over the period 2010-12 the rebound in global commodity prices, together with hikes in administered prices and the value added tax rate, gradually pushed up inflation. A temporary export-led recovery and fiscal tightening were eventually followed by a recession in 2012-13. This, along with 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. For most of the period under review, growth in compensation per employee exceeded labour productivity growth (see Table 5.2.1). In the most recent years the Czech economy has returned to a path of solid growth. This robust performance has been exerting pressure on the exchange rate, forcing Česká národní banka to intervene on the foreign exchange market from July 2015 in order to uphold its commitment not to let the koruna appreciate against the euro beyond the aforementioned floor. Since 2016 strong economic activity and rising food prices have pushed up the rate of HICP inflation. The Czech economy is currently estimated to be operating somewhat above potential. In April 2017 the bank decided to end its commitment to a minimum exchange rate with the euro, as conditions for a future sustainable fulfilment of the 2% inflation target had been met. This was the first step towards normalising the monetary conditions and was followed by hikes in Česká národní banka's interest rates.

In the first quarter of 2018 the average annual rate of HICP inflation continued to moderate, standing at 1.7%, which is below the target. That decline was due mainly to base effects in food and fuel price inflation, together with base effects in core inflation, which stemmed from a fading of the impact of imputed rent growth and the introduction of electronic sales registration. At the same time, increasing wages as a result of tight labour market conditions and significant skill shortages continued to be a source of inflationary pressure.

The orientation of monetary policy towards price stability has played an important role in shaping inflation dynamics in the Czech Republic over the past decade. 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.
When the bank decided to abandon its aforementioned commitment to a minimum exchange rate with the euro in April 2017, the exit from the commitment was smooth, with the Czech koruna appreciating gradually and relatively moderately. The exit was the first step towards normalising the monetary conditions and was followed by three hikes in Česká národní banka's interest rates.

Inflation in the Czech Republic is expected to decelerate gradually over the forecast horizon, falling to below 2%. According to the European Commission's Spring 2018 Economic Forecast, the average annual rate of HICP inflation will decelerate gradually to 2.1% in 2018 and 1.8% in 2019 on the back of additional monetary policy tightening and further appreciation of the Czech koruna. The risks to the medium-term inflation outlook are broadly balanced. Upside risks relate to stronger than expected wage increases amid tightening labour market conditions and the uncertainty about the outlook for oil prices. Downside risks may arise from heightened uncertainty regarding developments related to the global economy.
Looking further ahead, the catching-up process may result in positive inflation differentials vis-à-vis the euro area, since GDP per capita and price levels are still lower in Czech Republic than in the euro area, unless this is counteracted by an appreciation of the nominal exchange rate. 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 the Czech Republic requires conducting price stability-oriented economic policies, including targeted structural reforms that are geared to ensuring macroeconomic stability. Medium to long-term vulnerabilities relate to the sustainability of the current growth model, which is based on massive past inflows of foreign direct investment and boosting export-oriented production capacity in low and medium-tech manufacturing sectors in an environment where growing labour shortages and persisting inefficiencies in the business environment are weighing on potential growth. Against this background, additional efforts are needed to remove unnecessary restrictions on conducting business and firms' market entry, and to support R&D and innovation. Moreover, the skill mismatch needs to be addressed by improving vocational education and training, and by removing impediments to flexible working arrangements. Owing to demographic constraints, employment creation will also require underrepresented groups, especially women, to participate more in the labour market. With regard to macroeconomic imbalances, the European Commission did not select the Czech Republic for an in-depth review in its Alert Mechanism Report 2018.

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, the increasing risk of an upward spiral of property prices and mortgage borrowing, fuelled by very low interest rates on loans, poses a challenge in the medium term. In December 2015 Česká národní banka set a countercyclical capital buffer rate for domestic exposures of 0.5% for the first time. Since then, the domestic economy has recorded a significant upward shift in the expansion phase of the economic and financial cycle, prompting the central bank to raise the countercyclical capital buffer rate to 1% with effect from 1 July 2018 and 1.25% with effect from 1 January 2019. In order to further bolster confidence in the financial system, the national competent authorities should continue to improve their supervisory practices, among other things, by following the applicable recommendations from the relevant international and European bodies, and by collaborating closely with other national supervisors of EU Member States within the supervisory colleges.

5.2.2 Fiscal developments

The Czech Republic's budget balance and debt complied with the Maastricht criteria in 2017. In the reference year 2017 the general government budget balance recorded a surplus of 1.6% of GDP, thus comfortably meeting the 3% deficit reference value. The general government gross debt-to-GDP ratio was 34.6%, i.e. well below the 60% reference value (see Table 5.2.2). Compared with the previous year, the government balance-to-GDP ratio improved by 0.9 percentage point, while the debt-to-GDP ratio decreased by 2.2 percentage points. A budget surplus is projected by the European Commission in 2018, albeit, at 1.4% of GDP, decreasing slightly compared with the previous year, while the government debt ratio is projected to fall to 32.7%. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2017, nor is it expected to do so in 2018.

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, comfortably meeting its medium-term objective of a structural deficit of no more than 1% of GDP. The European Commission's forecast projects the structural balance to remain positive in 2018 and 2019 and, thus, in compliance with the preventive arm's requirements.

Non-cyclical factors have contributed to the deficit reduction over recent years, whereas the cyclical factors have had a mixed impact. The deficit ratio reached its peak at 5.5% of GDP in 2009. It became a surplus of 1.6% of GDP in 2017. European Commission estimates (presented in Table 5.2.2) indicate that the structural balance improved by 6.8 percentage points in the period from 2010 to 2017, reflecting the significant consolidation measures adopted by the Czech government, while the cyclical factors were also predominantly positive, except for in 2012-13. Consolidation measures included, on the revenue side, increases in indirect taxation, property taxes and the social security contribution ceiling, as well as reforms aiming to improve tax compliance. On the expenditure side, the main measures were decreases in selected social benefits, reforms of the pension and healthcare systems, and cuts in the government wage bill and staff numbers.

The debt-to-GDP ratio increased strongly during the recent global financial crisis but has more recently followed a downward path, at levels well below the 60% reference value. The debt ratio increased rapidly, from 28.3% of GDP in 2008 to a peak of 44.9% of GDP in 2013, largely driven by high primary deficits and the recession (see Chart 5.2.2). Since 2013 it has been on a downward path, on the back of a recovery in GDP growth and an overall favourable contribution from the primary balance. The mobilisation of pre-existing reserves has contributed to a further debt reduction. In 2017, however, the deficit-debt adjustment reversed its impact on the debt ratio, as financing buffers were replenished (see Table 5.2.2).

The level and structure of government debt protect the Czech Republic from any sudden changes in market conditions, with the bulk of debt at long-term maturities and most debt denominated in local currency. The share of government debt with a short-term maturity is low (2.5% in 2017 – see Table 5.2.2). Taking into account also the share of debt with a variable interest rate and the overall level of the debt ratio, fiscal balances are relatively insensitive to changes in interest rates. The proportion of foreign currency-denominated government debt is noticeable (16.0% in 2017), mostly denominated in euro (97.1% of foreign-denominated debt). Considering also the size of the debt ratio that leaves fiscal balances relatively insensitive to changes in exchange rates. The share of debt denominated in euro and other foreign currencies has been on a decreasing path since 2013, pointing to a decline in exchange-rate related vulnerabilities. The Czech Republic did not carry out government interventions to support financial institutions and markets during the global financial crisis.

The European Commission's Spring 2018 Economic Forecast indicates compliance with the medium-term objective over the forecast horizon. According to the European Commission's forecast, the structural surplus is projected to decrease to 0.9% of GDP in 2018 and 0.2% of GDP in 2019 from a level of 1.2% of GDP in 2017. This means that the structural balance level will remain well within the country's medium-term objective (i.e. a structural deficit of 1% of GDP) and thus in compliance with the preventive arm's requirements. The Czech Republic's medium-term fiscal policy strategy, as presented in the 2018 Convergence Programme update submitted to the European Commission, projects the structural balance to remain slightly positive, thus meeting the medium-term objective, between 2018 and 2020.

The Czech Republic has recently strengthened its national fiscal governance framework, but there is scope for further improvement and steadfast enforcement. The national legislation implementing the EU Directive on requirements for budgetary frameworks was adopted. The main provisions of the implementing legislation are the following: (i) the establishment of an independent fiscal council to monitor and evaluate fiscal policy; (ii) the setting of a limit on general government debt (the "debt brake") along with (iii) the specification of the corrective measures to be taken in the event of the defined debt threshold of 55% of GDP being exceeded; (iv) the introduction of a special version of the debt rule for regional governments; (v) the establishment of an expenditure rule for the general government sector which will be derived from the medium-term objective (structural deficit of 1% of GDP).

An ageing population poses a significant challenge to the long-term sustainability of public finances. The European Commission's 2017 Debt Sustainability Monitor foresees low risks over the short, medium and long term[131], largely as a result of the favourable initial budgetary position and relatively low public debt level. However, the risk scenario based on the assumptions of the Ageing Working Group (AWG) of the EU's Economic Policy Committee implies, for the Czech Republic, higher debt sustainability risks over the long-term. Regarding the increase in age-related spending, the Czech Republic has on the whole taken measures that increase the sustainability of public finances, though some of these measures may also have opposing effects. Notably, the authorities have: (i) introduced parameters aimed at gradually increasing the statutory retirement age, but recently also a cap on the statutory retirement age at 65 years as part of a wider, non-automatic mechanism designed to regularly review future retirement age changes; (ii) adopted a new pension indexation scheme, but also enabled the government to discretionarily increase pensions by a higher rate; and (iii) abolished the voluntary fully-funded pillar scheme established in 2013. Despite the positive impact of some of these measures as well as an improvement in the demographic outlook in the 2015 projections by the European Commission and the Economic Policy Committee, the AWG's 2015 report[132] 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's reference scenario, and 8.4 percentage points of GDP in the risk scenario (of which 5.2 percentage points and 1.7 percentage points of GDP stem from long-term care and healthcare respectively). These increases in ageing costs would be significantly above the EU average, suggesting that comprehensive pension and healthcare reforms are warranted to improve the long-term sustainability of public finances.

To maintain its overall sound fiscal position, the Czech Republic must enhance the current reforms, strictly enforce the existing rules and follow a prudent fiscal policy. The Czech Republic should continue to ensure compliance with its medium-term objective in 2018 and beyond. The fiscal risks should be contained through the introduction of reforms that tackle both expenditure (e.g. an anti-corruption plan and reforms of governance of the healthcare sector) and revenue (continuing fighting tax evasion – by, among other things, extending the roll-out of the online sale registration, in 2018, to other sectors of the economy – 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,

[131] However, this assessment does not necessarily reflect the uncertainty surrounding the long-term assumptions and, for high-debt countries, has to be taken with caution.

[132] European Commission and Economic Policy Committee, "The 2015 Ageing Report: Economic and budgetary projections for the 28 EU Member States (2013-2060)", *European Economy series*, No 3, European Commission, 2015.

combined with relatively large increases in ageing-related spending. Thus, comprehensive and determined structural reforms are needed, focusing on the pension system, healthcare and improving the efficiency of public administration. A special focus should be on a comprehensive public investment reform and on enhancing the efficiency of public expenditure in general. Although public debt remains low, the debt management framework could be further improved by targeting a reduction of costs and risks in the medium term.

5.2.3 Exchange rate developments

In the two-year reference period from 4 May 2016 to 3 May 2018, the Czech koruna did not participate in ERM II, but traded until April 2017 under an 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). The commitment not to let the exchange rate of the koruna against the euro appreciate beyond a level of 27 korunas per euro ended on 6 April 2017, when Česká národní banka decided to discontinue this unconventional monetary policy measure. Over the reference period the Czech currency mostly traded stronger than its May 2016 average exchange rate against the euro of 27.0260 korunas per euro, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate. On 3 May 2018 the exchange rate stood at 25.5850 korunas per euro, i.e. 5.3% stronger than its average level in May 2016. Over the reference period the maximum upward deviation from this benchmark was 6.8%, while the maximum downward deviation amounted to 0.5%. Over the past ten years the exchange rate of the Czech koruna against the euro has appreciated by 1.9%.

The Czech koruna exhibited a low degree of volatility against the euro over the two-year reference period. Between May 2016 and April 2017, when the exchange rate floor for the koruna vis-à-vis the euro was in place, the koruna traded slightly weaker than 27 koruna per euro, with Česká národní banka intervening by selling korunas in the foreign exchange market. Following the discontinuation of the exchange rate commitment, the Czech koruna appreciated gradually and relatively moderately. Over the reference period short-term interest rate differentials against the three-month EURIBOR were relatively modest, albeit widening since mid-2017.

The real effective exchange rate of the Czech koruna has depreciated slightly over the past ten years (see Chart 5.2.4). Following a period of increased volatility at the height of the global financial crisis, the real effective exchange rate weakened until 2015, when it started on its recent appreciation trend. However, this indicator should be interpreted with caution, as during this period the Czech Republic was subject to a process of economic convergence, which complicates any historical assessment of real exchange rate developments.

The current and capital account has improved over the past ten years, while the country's net foreign liabilities have declined (see Table 5.2.3). After recording a deficit in the period 2008-12, the current and capital account turned into a surplus, mainly as a result of improvements in the balance on goods exports. On the financing side, the Czech Republic continued to be a recipient of net inflows of direct investment, and of portfolio investment and other investment, which increased markedly in 2015 and 2016, but were more than offset by a sharp increase in reserve assets. Against this background, the country's gross external debt increased from 67.8% of GDP in 2014 to 89.0% of GDP in 2017, while its net international investment position improved from -36.3% of GDP in 2014 to -27.2% of GDP in 2017.

The Czech economy is well integrated with the euro area through trade and investment linkages. In 2017 exports of goods and services to the euro area constituted 62.4% of total exports, while the corresponding figure for imports was 52.2%. In 2017 the share of the euro area in the Czech Republic's stock of inward direct investment stood at 80.6%, and its share in the country's stock of portfolio investment liabilities was 57.1%. The share of the Czech Republic's stock of foreign assets invested in the euro area amounted to 78.0% in the case of direct investment and 70.2% for portfolio investment in 2017.

5.2.4 Long-term interest rate developments

Over the reference period from April 2017 to March 2018, long-term interest rates in the Czech Republic stood at 1.3% on average and thus remained well below the 3.2% reference value for the interest rate convergence criterion (see Chart 5.2.5).

Long-term interest rates in the Czech Republic decreased from above 5% in mid-2009 to 1.8% at the end of the reference period. Historically, long-term interest rate developments in the Czech Republic have been quite closely linked to those in the euro area, especially during the sovereign debt crisis. After the start of the global financial crisis, long-term interest rates and sovereign credit default swap spreads declined in tandem in 2009. This development came to a halt with the onset of the euro area sovereign debt crisis, in the wake of which markets' perception of Czech sovereign risk also deteriorated. As a result, sovereign credit default swap prices almost doubled in one year, before recovering somewhat by early 2013.

Following the subsequent economic expansion, long-term interest rates dropped to around 0.5% by the end of 2015, among other things as a result of Česká národní banka's highly accommodative monetary policy. In the first three quarters of 2016 long-term interest rates dropped further, also reflecting the expectation that the central bank was going to end its commitment to not allowing the currency to appreciate beyond a level of 27 korunas per euro. Since then long-term interest rates have increased, reflecting global developments and an acceleration in economic growth combined with an expected rise in inflation. Accordingly, Česká národní banka raised interest rates twice in 2017 – and again, more recently, in February 2018. Since April 2016, credit default swap spreads for Czech government debt have fluctuated between 60 basis points and 80 basis points. The Czech Republic's government debt is rated investment-grade by all of the three main rating agencies (Moody's: A1; S&P: AA−; Fitch: A+).

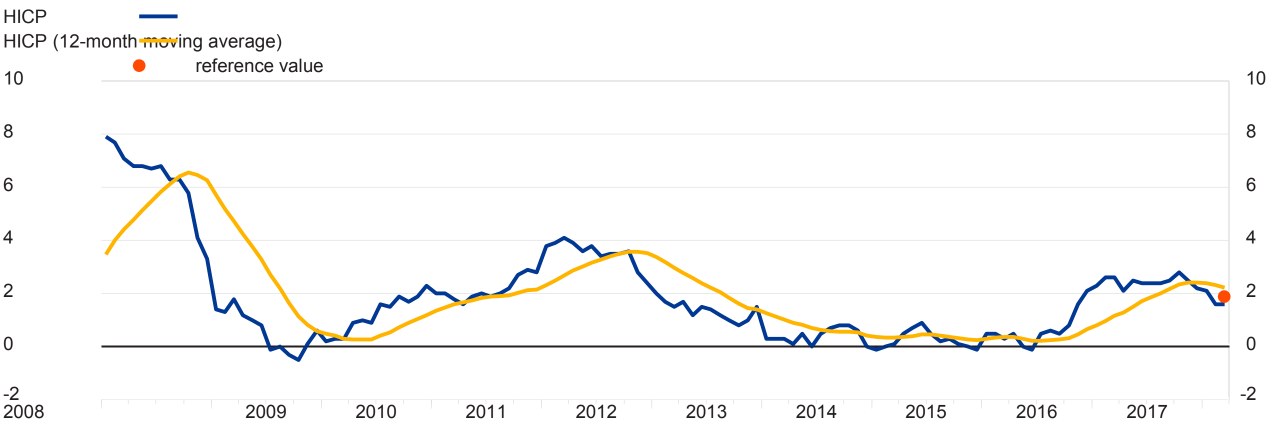
The Czech Republic's long-term interest rate differential vis-à-vis the euro area has recently returned to positive territory, having being negative during the period after 2011. The dynamics of the interest rate differential over the period
2009-12 reflected the fact that Czech long-term interest rates were declining more rapidly than euro area average rates. Particularly during the sovereign debt crisis, comparatively higher levels of sovereign risk in the euro area contributed to the continuous decline in the long-term interest rate differential, which bottomed out at
−1.5 percentage points in August 2012. In the autumn of that year, investors started to veer towards euro area government bonds again, pushing up the differential towards less negative values. In March 2014 it stood at −20 basis points and from then until September 2017 it fluctuated between −10 basis points and −70 basis points, returning to positive territory in October of that year. In March 2018 the interest rate differential stood at 0.7 percentage point (1.2 percentage points vis-à-vis 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 percentage of GDP, has declined markedly in recent years, from a peak of over 33% of GDP before the financial crisis to 13.6% at the end of 2017. Outstanding debt securities issued by non-financial institutions (a measure of market-based indebtedness) have stabilised around post-2012 yearly averages (at 7.5% of GDP in 2017), while those issued by financial institutions increased significantly in 2017 – owing to Česká národní banka's issuance of short-term bills – to stand at around 47% of GDP. Financial intermediation, as measured by MFI credit to non-government residents, stood at 55.3% of GDP in 2017 – slightly over half the euro area average. However, in some respects the integration of the Czech Republic's banking sector with the euro area has increased significantly in recent years, as claims of euro area MFIs on resident MFIs reached 25.2% of the total liabilities of domestic MFIs in 2017, which is very close to the euro area average. The development of the Czech Republic's capital markets in terms of size and intermediation capacity remains limited, but is in line with that of other non-euro area EU Member States in central and eastern Europe.

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 April 2017 to March 2018 is the unweighted arithmetic average of the annual percentage changes in the HICP for Cyprus, Ireland and Finland plus 1.5 percentage points. The reference value is 1.9%.

Table 5.2.1 Measures of inflation and related indicators

(annual percentage changes, unless otherwise indicated)

	2008-2017 [1)]	2008-2012 [1)]	2013-2017 [1)]	2013	2014	2015	2016	2017	2018 [2)]	2019 [2)]
Measures of inflation										
HICP	1.9	2.7	1.0	1.4	0.4	0.3	0.6	2.4	2.1	1.8
HICP excluding unprocessed food and energy	1.7	2.1	1.3	1.0	1.1	0.8	1.2	2.6	2.1	2.1
HICP at constant tax rates [3)]	1.3	1.8	0.8	0.4	0.3	0.1	0.4	2.6	-	-
CPI	1.9	2.8	1.0	1.4	0.4	0.3	0.7	2.5	-	-
Private consumption deflator	1.4	2.0	0.9	0.8	0.6	0.1	0.5	2.5	2.1	1.8
GDP deflator	1.2	0.9	1.6	1.4	2.5	1.2	1.2	1.4	2.7	1.5
Producer prices [4)]	0.5	2.0	-0.9	0.8	-0.8	-3.2	-3.3	1.8	-	-
Related indicators										
Real GDP growth	1.5	0.2	2.9	-0.5	2.7	5.3	2.6	4.4	3.4	3.1
GDP per capita in PPS [5)] (euro area = 100)	78.8	77.3	80.8	78.2	80.7	81.8	82.5	.	-	-
Comparative price levels (euro area = 100)	67.1	69.6	64.0	66.6	61.9	63.1	64.5	.	-	-
Output gap [6)]	-0.6	-0.2	-1.1	-3.1	-2.6	-0.3	-0.4	0.9	1.2	1.4
Unemployment rate (%) [7)]	5.7	6.4	5.0	7.0	6.1	5.0	4.0	2.9	2.4	2.4
Unit labour costs, whole economy	1.7	2.0	1.4	0.5	0.4	-0.8	3.3	3.8	4.1	3.2
Compensation per employee, whole economy	2.8	2.3	3.3	-0.3	2.6	3.0	4.6	6.7	6.8	6.2
Labour productivity, whole economy	1.1	0.3	1.8	-0.8	2.2	3.8	1.3	2.8	2.6	2.9
Imports of goods and services deflator	0.0	0.4	-0.4	0.5	2.5	-1.7	-3.5	0.1	-3.0	0.9
Nominal effective exchange rate [8)]	0.5	1.6	-0.5	-1.5	-4.9	-2.3	2.8	3.6	-	-
Money supply (M3) [9)]	5.8	4.2	7.4	5.2	5.7	8.3	6.7	11.2	-	-
Lending from banks [10)]	6.2	6.1	6.3	3.8	4.5	7.1	8.8	7.4	-	-
Stock prices (PX Index) [11)]	-40.6	-42.8	3.8	-4.8	-4.3	1.0	-3.6	17.0	-	-
Residential property prices [12)]	1.9	-1.8	5.0	0.0	2.5	4.0	7.2	11.7	-	-

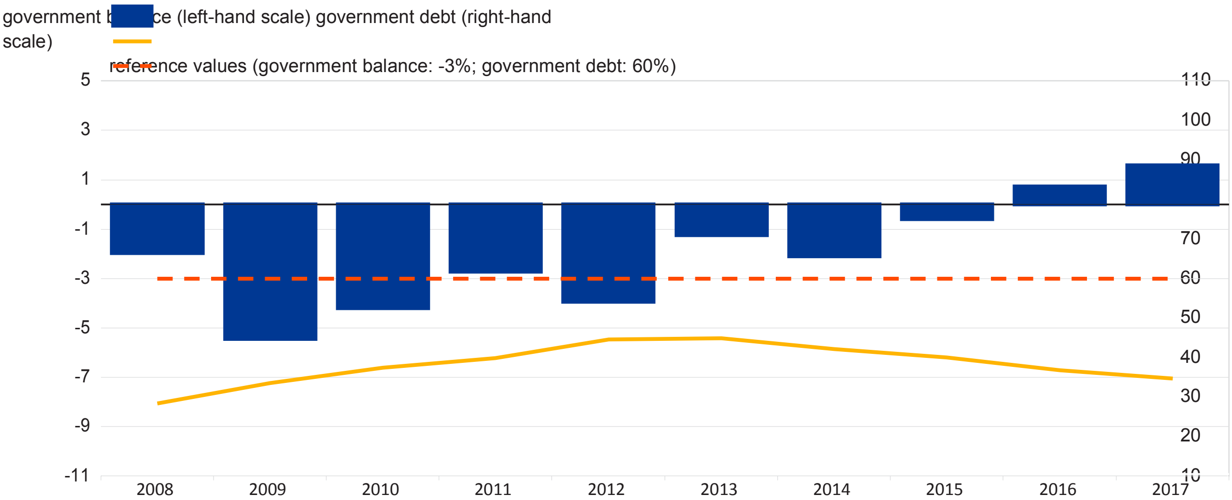
Sources: European Commission (Eurostat, Directorate-General for Economic and Financial Affairs), national data for CPI, money supply, lending from banks and residential property prices, and ECB calculations based on Thomson Reuters data for stock prices.

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 2018 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 from 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.

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)

	2008-2017 [1]	2008-2012 [1]	2013-2017 [1]	2013	2014	2015	2016	2017	2018 [2]	2019 [2]	2020	2021
Government balance	**-2.0**	**-3.7**	**-0.3**	**-1.2**	**-2.1**	**-0.6**	**0.7**	**1.6**	**1.4**	**0.8**	-	-
Total revenue	40.1	39.5	40.7	41.4	40.3	41.1	40.2	40.4	40.3	40.4	-	-
Current revenue	39.0	38.3	39.6	40.4	39.1	39.1	39.5	39.8	39.7	39.7	-	-
Direct taxes	7.3	7.1	7.4	7.2	7.3	7.2	7.6	7.7	7.8	7.8	-	-
Indirect taxes	11.8	11.3	12.3	12.7	11.8	12.2	12.3	12.5	12.2	12.0	-	-
Net social contributions	14.7	14.6	14.7	14.8	14.6	14.4	14.7	15.0	15.2	15.4	-	-
Other current revenue [3]	5.2	5.3	5.2	5.7	5.4	5.2	4.9	4.6	4.5	4.4	-	-
Capital revenue	1.1	1.2	1.1	1.0	1.2	2.0	0.6	0.6	0.7	0.7	-	-
Total expenditure	42.1	43.2	41.0	42.6	42.4	41.7	39.4	38.8	38.9	39.5	-	-
Current expenditure	36.5	36.7	36.2	38.0	37.0	35.7	35.5	34.9	34.7	35.1	-	-
Compensation of employees	8.8	8.7	8.9	8.9	8.8	8.7	8.8	9.1	9.3	9.6	-	-
Social benefits	15.7	15.8	15.6	16.5	16.1	15.4	15.3	14.9	14.8	15.0	-	-
Interest payable	1.2	1.3	1.1	1.3	1.3	1.1	0.9	0.7	0.7	0.7	-	-
Other current expenditure [4]	10.8	10.9	10.6	11.1	10.8	10.5	10.5	10.1	9.9	9.8	-	-
Capital expenditure	5.6	6.4	4.8	4.6	5.4	6.0	4.0	4.0	4.2	4.4	-	-
of which: Investment	4.5	5.0	3.9	3.7	4.1	5.1	3.3	3.3	3.6	3.7	-	-
Cyclically adjusted balance	-1.7	-3.6	0.1	0.1	-1.0	-0.5	0.9	1.2	0.9	0.2	.	.
One-off and temporary measures	.	.	-0.1	-0.1	-0.3	0.0	-0.1	0.0	0.0	0.0	.	.
Structural balance [5]	.	.	0.2	0.2	-0.7	-0.5	1.0	1.2	0.9	0.2	.	.
Government debt	**38.2**	**36.7**	**39.7**	**44.9**	**42.2**	**40.0**	**36.8**	**34.6**	**32.7**	**31.8**	-	-
Average residual maturity (in years)	-	-	-	-	-	-	-	-	.	.	.	.
In foreign currencies (% of total)	19.5	18.8	20.2	25.0	20.6	20.2	19.2	16.0	.	.	.	.
of which: Euro	18.3	17.5	19.2	23.7	19.3	18.8	18.5	15.6	.	.	.	.
Domestic ownership (% of total)	66.2	70.2	62.1	67.5	70.4	63.1	55.2	54.6	.	.	.	.
Medium and long-term maturity (% of total) [6]	93.6	91.8	95.5	92.5	93.3	94.4	99.7	97.5	.	.	.	.
of which: Variable interest rate (% of total)	13.7	12.1	15.4	15.3	17.1	18.1	14.6	11.8	.	.	.	.
Deficit-debt adjustment	**-0.2**	**0.1**	**-0.5**	**-0.4**	**-2.6**	**-0.2**	**-1.0**	**1.5**	.	.	.	.
Net acquisitions of main financial assets	0.1	0.4	-0.2	-0.5	-2.5	-0.1	0.4	1.9	.	.	.	.
Currency and deposits	0.2	0.5	0.0	-0.6	-2.5	0.1	0.6	2.3	.	.	.	.
Debt securities	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	.	.	.	.
Loans	0.1	0.2	-0.1	0.2	0.0	-0.1	-0.2	-0.3	.	.	.	.
Equity and investment fund shares or units	-0.1	-0.2	-0.1	0.0	0.0	-0.1	0.0	-0.1	.	.	.	.
Revaluation effects on debt	-0.1	-0.2	-0.1	0.3	-0.1	-0.2	0.0	-0.2	.	.	.	.
of which: Foreign exchange holding gains/losses	0.0	0.0	0.0	0.5	0.0	-0.1	0.0	-0.3	.	.	.	.
Other [7]	-0.2	-0.1	-0.3	-0.3	0.0	0.1	-1.3	-0.2	.	.	.	.
Convergence programme: government balance	-	-	-	-	-	-	-	-	1.5	1.1	1.1	0.9
Convergence programme: structural balance	-	-	-	-	-	-	-	-	0.8	0.2	0.2	0.2
Convergence programme: government debt	-	-	-	-	-	-	-	-	32.9	31.6	30.7	29.9

Sources: European System of Central Banks and European Commission (Eurostat, Directorate-General for Economic and Financial Affairs).

1) Multi-annual averages calculated using the arithmetic mean.
2) Data from the European Commission's Spring 2018 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 factors (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)

CZK/EUR exchange rate (left-hand scale) interest rate differential (right-hand scale)

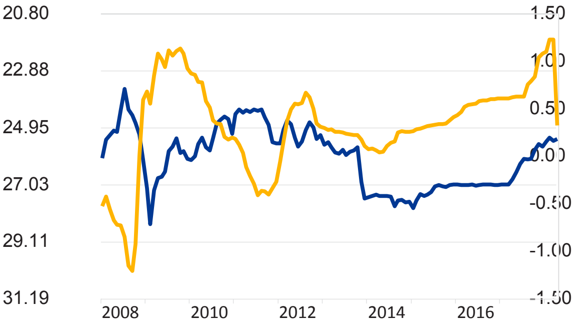
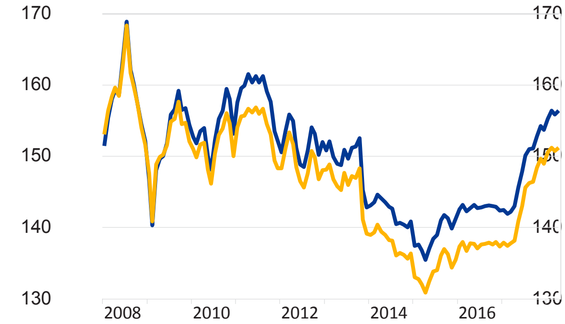


Chart 5.2.4 Effective exchange rates [1)]

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

nominal real



Sources: National data and ECB calculations.

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)

	2008-2017 [1)]	2008-2012 [1)]	2013-2017 [1)]	2013	2014	2015	2016	2017	2018 [2)]	2019 [2)]
Balance of payments										
Current account and capital account balance [3)]	0.2	-1.4	1.9	1.5	0.9	2.4	2.7	1.9	0.8	0.2
Current account balance	-0.9	-2.3	0.5	-0.5	0.2	0.2	1.6	1.0	0.3	-0.3
Goods	3.1	1.5	4.6	4.1	5.1	4.1	5.1	4.8	.	.
Services Primary	2.0	2.0	1.9	1.7	1.3	1.7	2.3	2.4	.	.
income	-5.5	-5.4	-5.6	-6.0	-6.0	-5.6	-5.3	-5.2	.	.
Secondary income Capital	-0.4	-0.4	-0.4	-0.3	-0.2	0.0	-0.6	-0.9	.	.
account balance	1.2	0.9	1.4	2.0	0.7	2.2	1.1	0.9	.	.
Combined direct and portfolio investment balance [3)]	-3.7	-3.5	-3.9	-2.0	0.2	-2.5	-7.4	-7.8	.	.
Direct investment Portfolio	-1.6	-1.7	-1.4	0.2	-1.9	1.1	-3.9	-2.7	.	.
investment	-2.2	-1.9	-2.5	-2.2	2.1	-3.6	-3.5	-5.1	.	.
Other investment balance	-1.3	1.0	-3.6	-0.5	-0.3	-1.2	-2.1	-13.7	.	.
Reserve assets	5.5	1.0	9.9	4.4	1.7	7.7	11.8	24.0	.	.
Exports of goods and services Imports	73.3	67.0	79.7	76.2	82.6	80.9	79.2	79.6	.	.
of goods and services	68.3	63.4	73.2	70.4	76.2	75.1	71.8	72.4	.	.
Net international investment position [4)]	-37.7	-42.9	-32.6	-39.2	-36.3	-33.2	-26.9	-27.2	.	.
Gross external debt [4)]	62.4	52.5	72.4	63.2	67.8	68.5	73.3	89.0	.	.
Internal trade with the euro area [5)]										
Exports of goods and services Imports	63.4	64.4	62.5	62.8	62.3	62.4	62.7	62.4	.	.
of goods and services	52.4	52.2	52.6	52.3	52.9	52.1	53.3	52.2	.	.
Investment position with the euro area [5)]										
Direct investment assets [4)] Direct	78.6	78.7	78.6	78.8	77.7	80.6	77.7	78.0	.	.
investment liabilities [4)] Portfolio	81.5	82.1	80.9	80.8	80.4	81.6	81.0	80.6	.	.
investment assets [4)] Portfolio	74.1	76.3	72.0	73.8	73.9	72.7	69.4	70.2	.	.
investment liabilities [4)]	49.5	49.9	49.1	48.3	43.3	47.3	49.4	57.1	.	.

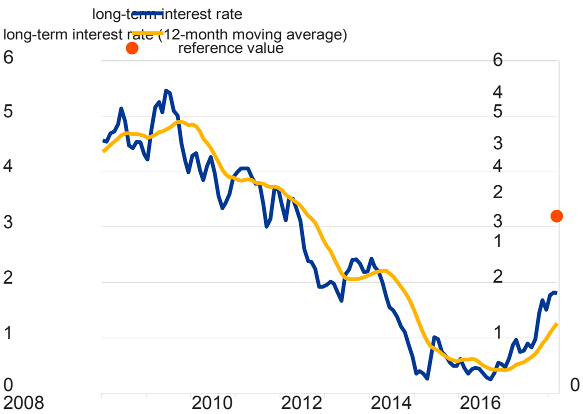
Sources: European System of Central Banks and European Commission (Eurostat, Directorate-General for Economic and Financial Affairs).

Note: Backdata are available from 2008.

1) Multi-annual averages calculated using the arithmetic mean.
2) Data from the European Commission's Spring 2018 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.

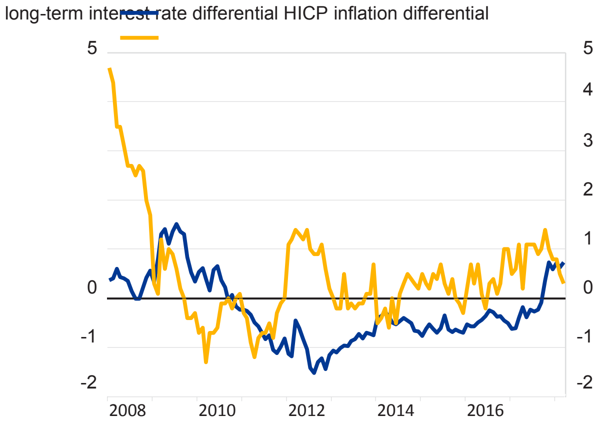
Czech Republic - Long-term interest rate developments

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 April 2017 to March 2018 is the unweighted arithmetic average of the interest rate levels in Cyprus, Ireland and Finland plus 2 percentage points. The reference value is 3.2%.

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)

	2008-2017 [1]	2008-2012 [1]	2013-2017 [1]	2014	2015	2016	2017	Apr. 2017 to Mar. 2018	Memo item: euro area 2017
Long-term interest rates									
Czech Republic [2]	2.6	4.0	1.1	1.6	0.6	0.4	1.0	1.3	-
Euro area [2), 3)]	2.8	4.0	1.6	2.0	1.2	0.9	1.1	1.1	-
Euro area AAA par curve, ten-year residual maturity [2), 3)]	2.1	3.2	0.9	1.4	0.6	0.2	0.4	0.5	-
Indicators of financial development and integration									
Debt securities issued by financial corporations [4]	21.9	17.3	26.5	19.3	18.5	24.2	46.7	-	66.0
Debt securities issued by non-financial corporations [5]	5.9	4.3	7.5	7.9	7.4	7.3	7.5	-	11.3
Stock market capitalisation [6]	16.9	20.0	13.9	14.6	13.9	12.6	13.6	-	67.4
MFI credit to non-government residents [7]	52.0	49.9	54.2	53.1	53.2	55.3	55.3	-	108.1
Claims of euro area MFIs on resident MFIs [8]	10.1	6.3	14.0	7.9	12.8	16.8	25.2	-	26.3

Sources: European System of Central Banks and ECB calculations.
1) Multi-annual averages calculated using the arithmetic mean.
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 national central bank) 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 national central bank) held by euro area MFIs as a percentage of total liabilities of domestic MFIs (excluding the national central bank). Total liabilities exclude capital and reserves and remaining liabilities.

5.3 Croatia

5.3.1 Price developments

In March 2018 the 12-month average rate of HICP inflation in Croatia was 1.3%, i.e. well below the reference value of 1.9% for the criterion on price stability (see Chart 5.3.1). This rate is expected to increase gradually 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 −0.8% to 6.0%, and the average for that period was moderate, standing at 1.8%. In 2008 average inflation peaked at close to 6%, reflecting a surge in food, energy and administered prices, alongside a build-up of domestic price pressures during a period of robust economic expansion. Thereafter, the global financial crisis led to an unwinding of the credit and housing boom. Inflation decreased rapidly as the economy moved into recession and global commodity prices declined. Following a cumulative decline in real GDP of more than 12% over the period 2009-14, economic growth has recovered since 2015 (see Table 5.3.1). Owing to increases in energy and food prices, inflation picked up in 2011 and 2012, before falling to a very low level in 2014 and entering negative territory in 2015 and 2016, largely on the back of lower commodity prices and subdued domestic price pressures. In 2017 inflation turned positive again, driven by food price developments and a recovery in domestic demand. However, wage growth has remained subdued since 2008 and growth in unit labour costs has been negative over the past few years. The unemployment rate, which rose sharply during the recession, decreased in the years from 2013 to 2017, albeit remaining at a high level.

In the first quarter of 2018 the average annual rate of HICP inflation stood at 1.1%. This inflation rate mainly reflected the contributions of services, energy and food prices, while non-energy industrial goods price inflation remained contained.

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

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

Inflation is expected to increase somewhat in the coming years, but over the longer term there are concerns regarding the sustainability of inflation convergence in Croatia. According to the European Commission's Spring 2018 Economic Forecast, the average annual rate of HICP inflation will increase to 1.4% in 2018 and 1.5% in 2019. Inflationary pressures are expected to rise as economic growth gains momentum. The risks to the inflation outlook are broadly balanced. In addition to the uncertainty about the outlook for oil prices, said risks relate to administrative prices on the upside and to the impact of a stronger kuna against the US dollar on the downside. Looking further ahead, the catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area, given that GDP per capita and price levels are still significantly lower in Croatia than in the euro area. In order to prevent the build-up of excessive price pressures and macroeconomic imbalances, the catching-up process must be supported by appropriate policies.

Achieving an environment that is conducive to sustainable convergence in Croatia requires stability-oriented economic policies and wide-ranging structural reforms. Given monetary policy's limited room for manoeuvre owing to the tightly managed floating exchange rate regime and the high level of euroisation, it is imperative that other policy areas provide the economy with the wherewithal to cope with country-specific shocks in order to ensure the correction of macroeconomic imbalances and to prevent their recurrence in the future. More specifically, structural reforms are needed to increase overall productivity and raise the potential growth of the economy. In particular, there is a need to strengthen national policies aimed at enhancing competition in product markets and to proceed with the liberalisation of regulated sectors. Priority should be given to improving the quality of the institutional, business and regulatory environment, including fighting corruption. In addition, it is essential to improve the effectiveness of the public administration and the judicial system. Modernising the country's infrastructure (in particular its rail network) would boost potential output and support a more streamlined allocation of resources. Against this background, significant efforts should be made to ensure that Croatia improves the efficiency of its absorption of EU funds. Measures should also be implemented to reduce mismatches in the labour market, enhance the quantity and quality of the labour supply, and align the education system with the needs of the market. This is particularly important given the high levels of structural and youth unemployment. Further progress is required in the review of social benefits in order to push up the very low participation rate. It is also crucial to achieve sufficient flexibility in wages. With regard to macroeconomic imbalances, the European Commission selected Croatia for an in-depth review in its Alert Mechanism Report 2018 and concluded that Croatia is experiencing excessive macroeconomic imbalances.

Financial sector policies should be geared to safeguarding financial stability and ensuring that the financial sector makes a sound contribution to sustainable economic growth. In view of the still high level of private sector debt, it is important to ensure that the necessary conditions are in place for an orderly deleveraging process. Despite the progress that has been made in reducing the volume of non-performing loans, the resolution framework should be strengthened further, particularly in order to improve the efficiency of court practice. In 2015 the government's intervention to allow the conversion of existing loans denominated in, or linked to, Swiss francs into loans denominated in, or linked to, euro, highlights the need for a more predictable legal system.[133] In order to further bolster confidence in the financial system, the national competent authorities should continue to improve their supervisory practices, among other things, by following the applicable recommendations from the relevant international and European bodies, and by collaborating closely with other national supervisors of EU Member States within the supervisory colleges. Finally, it is necessary to address the shortcomings in Croatia's corporate governance, accounting and auditing standards that were revealed by the Agrokor crisis.

5.3.2 Fiscal developments

Croatia's budget balance complied with the Maastricht criterion in 2017, while debt was above the threshold. In the reference year 2017 the general government budget balance recorded a surplus of 0.8% of GDP, thus comfortably meeting the 3% deficit reference value. The general government gross debt-to-GDP ratio was 78.0%, well above the 60% reference value (see Table 5.3.2), but it is declining in line with the debt reduction benchmark. Compared with the previous year, the government balance improved by 1.7 percentage points of GDP, while the debt ratio decreased by 2.7 percentage points of GDP. The government balance is forecast by the European Commission to record a surplus of 0.7% of GDP in 2018, while the government debt ratio is projected to decrease notably, to 73.7% of GDP. With regard to other fiscal factors, the deficit ratio exceeded the ratio of public investment to GDP over the period 2011-15, while over 2016-19 it is not expected to do so.

Croatia was subject to the corrective arm of the Stability and Growth Pact from 2014 until June 2017. The ECOFIN Council, following Croatia's accession to the EU in June 2013 and taking into account the level of the 2013 deficit, as well as the planned 2014 deficit – both of which breached the 3% deficit reference value – decided on 21 January 2014 to open an excessive deficit procedure, with the deadline for correcting the excessive deficit being 2016. In June 2017 the excessive deficit procedure was abrogated, in line with the correction time frame. The European Commission's Spring 2018 Economic Forecast projects the budget to be in surplus in 2018, therefore well below the 3% reference value, and the debt criterion to be met with a margin. It also indicates compliance with the requirements of the preventive arm of the Stability and Growth Pact in the same period.

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

Both cyclical and non-cyclical factors have contributed to the deficit changes over recent years. The deficit peaked in 2011 at 7.8% of GDP, driven by non--cyclical factors (presented in Table 5.3.2). In 2012 it improved markedly (by 2.6 percentage points of GDP) on account of a large structural adjustment, which was partly offset by unfavourable cyclical factors. On average, during 2012-15 the deficit remained high, standing well above the 3% reference value, owing to positive structural and negative cyclical factors. The relatively fast adjustment of the ratio which has taken place since 2014 was underpinned by both the structural effort and favourable macroeconomic developments.

The debt-to-GDP ratio, currently well above the 60% reference value, has been on a downward path since 2015. The debt ratio increased rapidly and continuously from 48.3% of GDP in 2009 to a peak of 84.0% of GDP in 2014. This sharp increase was driven by persistently high primary deficits, adverse interest-growth differentials due to unfavourable economic conditions, and significant deficit-debt adjustments (see Chart 5.3.2). The particularly strong deficit-debt adjustment in 2013 mainly reflected pre-financing for the first half of 2014. Since 2014 the debt ratio has been on a downward path, mostly reflecting primary surpluses, as well as some favourable deficit-debt adjustments (stemming from the use of existing resources). The government has not reported contingent liabilities related to the financial sector.

While Croatia is protected, to some extent, from interest rate shocks, the fiscal balances would be highly sensitive to potential exchange rate movements. The share of government debt with a short-term maturity is low (4.8% in 2017 – see Table 5.3.2). Taking into account the fact that the medium and long-term debt is entirely based on fixed rates, fiscal balances are relatively insensitive to interest rate changes. However, a high share of public debt is denominated in foreign currency (76.5% in 2017), mainly euro (94.6% of foreign-denominated debt). Taking the ratio of government debt to GDP into account, this implies that the fiscal balances are highly sensitive to exchange rate changes. The tightly managed float operated by Hrvatska narodna banka (designed to reduce exchange rate volatility against the euro) means that the high sensitivity of fiscal balances to euro/kuna exchange rate changes should be somewhat mitigated. The ratio of foreign currency-denominated public debt and the ratio of long-term maturity debt are both close to their medium-term trends.

The European Commission's Spring 2018 Economic Forecast foresees a budget balance and debt ratio trajectory compliant with the provisions of the Stability and Growth Pact in 2018 and 2019. According to the European Commission's latest forecast, the headline balance is projected to be at or just below a surplus of 0.8% of GDP, following a flat path, over the forecast horizon. In contrast, the structural balance is projected to deteriorate, remaining, however, well within the medium-term objective of a 1.75% structural deficit (from 2017 onwards). The projection is compliant with both the required structural adjustment and the expenditure benchmark. Croatia’s medium-term fiscal policy strategy, as presented in the 2018 update of the Convergence Programme, forecasts a similar path for the structural deficit, at 0.8% of GDP in 2018, 0.9% in 2019 and 0.8% in 2020 (i.e. compliant with the medium-term objective).

Croatia must continue to improve its fiscal framework. The fiscal strategy should focus on compositional issues so that public spending becomes more growth and employment-friendly, as well as more efficient. The new Administrative Fees and Tariffs Act and the new Public Procurement Act are steps in the right direction. Tax reforms have also been implemented and include a simplification and reduction in the personal income tax burden, a rationalisation of the corporate income tax, a reshuffle of VAT rates (favouring the agriculture and the energy sector) and the provision of fiscal incentives to write off non-performing loans. Draft legislation, in different stages of the adoption process, is related to the debt management strategy and enhancing the independent fiscal institutions. The new draft Fiscal Responsibility Act proposed by the government aims to reinforce numerical fiscal rules and align the framework with the EU fiscal rules, thereby strengthening the independence of the Fiscal Policy Committee. The government also plans to improve the institutional framework by introducing enhancements in medium-term budgetary planning.

The European Commission's 2017 Debt Sustainability Monitor suggests that Croatia faces a high debt sustainability risk over the medium term. The Debt Sustainability Monitor foresees low short-term risks of fiscal stress. Over the medium term, however, the risk level is high, in the light of the high stock of debt and the high sensitivity of the fiscal position to macroeconomic shocks. Over the long term, Croatia appears to be at low risk[134], mostly because of the projected decrease in age-related spending, related partly to the recent pension reforms. Although the recent changes are intended to tackle the sustainability of the pay-as-you-go system
– in view of a low worker-to-pensioner ratio – they are also designed to strike a balance with the adequacy of pension system. The necessity of this second objective is suggested by the low level of, and projected further decline in, the benefit ratio. In the future this could trigger increased social payments to support elderly people.
According to the 2015 projections by the European Commission and the EU's Economic Policy Committee, prepared by the Ageing Working Group (AWG)[135], Croatia is likely to experience a decrease in age-related public expenditure amounting to 2.5 percentage points of GDP by 2060, in the AWG's reference scenario, from a level of 20.7% of GDP in 2013. In the AWG's risk scenario, the reduction in the cost of ageing is 0.4 percentage point. This is mainly due to significant savings in gross pensions, which are projected to fall from 10.8% of GDP to 6.9% for the period 2013-60, while healthcare and long-term care spending are expected to increase by 2.7 and 1.1 percentage points of GDP, respectively, during the same period.

A prudent and credible fiscal policy and further fiscal structural reforms are needed for public finances to remain compliant with the provisions of the Stability and Growth Pact over the medium term. Although the budget projections are assessed to be compliant with the Pact's provisions, the need to further reduce the debt level and build buffers calls for proper use to be made of the current

[134] However, this assessment does not necessarily reflect the uncertainty surrounding the long-term assumptions and, for high-debt countries, has to be taken with caution.

[135] European Commission and Economic Policy Committee, "The 2015 Ageing Report: Economic and budgetary projections for the 28 EU Member States (2013-2060)", *European Economy series*, No 3, European Commission, 2015.

economic upturn. A prudent fiscal policy that implements further taxation reforms and changes to increase the efficiency of public spending – especially with respect to the public administration and the education system – should also create space to tackle longer-term risks. These pertain to the expenditure increases (such as in pensions, social assistance and health-related costs) that could stem from adverse demographic and emigration trends. Also, in order to consolidate the current downward debt path, the fiscal responsibility legislation should be enforced in an efficient and disciplined manner. Contingent liabilities originating from both
state-owned enterprises and systemically relevant private firms should make the further strengthening of the governance framework a priority. Finally, a comprehensive debt management framework, efficiently enforced, should partly mitigate the risks originating from the sensitivity to financing conditions as well as the remaining risks related to the debt's currency structure.

5.3.3 Exchange rate developments

In the two-year reference period from 4 May 2016 to 3 May 2018, the Croatian kuna did not participate in ERM II, but traded under an exchange rate regime involving a tightly managed floating of the currency's exchange rate. The Croatian kuna was stable over the reference period and traded close to its May 2016 average exchange rate against the euro of 7.498 kuna per euro, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate (see Chart 5.3.3). On 3 May 2018 the exchange rate stood at 7.415 kuna per euro, i.e.
1.1% stronger than its average level in May 2016. Over the reference period the maximum upward deviation from this benchmark was 1.4%, while the maximum downward deviation amounted to 1.1%. Over the past ten years the exchange rate of the Croatian kuna against the euro has depreciated by 2.2%.

The exchange rate of the Croatian kuna against the euro exhibited, on average, a low degree of volatility over the reference period. This reflected the strategy of Hrvatska narodna banka to limit exchange rate fluctuations by means of occasional interventions in the foreign exchange market. Over the reference period Hrvatska narodna banka conducted ten foreign exchange interventions by selling domestic currency for euro. The purpose was to alleviate appreciation pressures caused by favourable tourist seasons and improved macroeconomic performance. Over the reference period short-term interest rate differentials against the three-month EURIBOR remained broadly stable at a low level.

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

Croatia's current and capital account has improved over the past ten years and the country's net foreign liabilities have declined, but remain high (see Table 5.3.3). After a progressive increase in the external deficit in the period up to 2008, the combined current and capital account improved and has remained in surplus since 2012, reaching 3.7% of GDP in 2016 and 4.3% of GDP in 2017. These developments primarily reflected improvements in the balance of trade in services owing to the favourable tourist seasons, as well as growth in exports of goods. The surplus widened notably in 2015 to 5.1% of GDP, mainly reflecting one-off effects related to the impact of the conversion of loans in Swiss francs on bank profits. From 2016 the deficit in the primary income balance widened again after foreign banks resumed dividend payments and profit repatriation. Gross external debt peaked at 107.0% of GDP in 2014, but steadily declined thereafter, to 83.1% of GDP in 2017. At the same time the country's net international investment position, which had deteriorated substantially from -73.8% of GDP in 2008 to -94.0% of GDP in 2010, improved to reach -63.0% in 2017. However, the country's net foreign liabilities remain very high. Fiscal and structural policies therefore continue to be important for supporting external sustainability and the competitiveness of the economy.

The Croatian economy is well integrated with the euro area through trade linkages. In 2017 exports of goods and services to the euro area constituted 54.8% of total exports, while the corresponding figure for imports was higher, at 59.3%. In 2017 the share of the euro area in Croatia's stock of inward direct investment stood at 67.9% and its share in the country's stock of portfolio investment liabilities was 60.6%. The share of Croatia's stock of foreign assets invested in the euro area amounted to 55.6% in the case of direct investment and 20.7% for portfolio investment in 2017.

5.3.4 Long-term interest rate developments

Over the reference period from April 2017 to March 2018, long-term interest rates in Croatia stood at 2.6% on average and thus remained below the 3.2% reference value for the interest rate convergence criterion (see Chart 5.3.5).

Long-term interest rates in Croatia stood at 2.2% at the end of the reference period, having continued on the downward path that started at the end of 2009, when long-term interest rates stood at around 8.5%. However, that path was interrupted occasionally, the most significant turnaround taking place during the second half of 2011 on the back of uncertainty regarding both the impact of the euro area sovereign debt crisis and the sustainability of the global economic recovery. At that time, credit default swap spreads on Croatian long-term debt doubled in a few months and remained at very elevated levels until early 2012, even though interest rates had declined by more than 200 basis points. In 2013 long-term interest rates rose again, by 80 basis points. However, in contrast to the rise in 2011, the 2013 increase was driven by domestic factors in an environment of declining yields across the globe. As a result, Croatia's credit rating was downgraded to below investment- grade and credit default swap spreads ranked among the highest in the EU. Similarly, in 2015 risk premia on Croatian long-term bond yields and credit default swap spreads rose as a result of weakening economic growth, perceived political uncertainty and an increase in the costs expected to be incurred by domestic banks following the conversion of loans denominated in Swiss francs into euro. Since 2015 long-term interest rates in Croatia have been falling steadily, reaching a historical low of 2.2% in March 2018. The decline since May 2016, the end of the last review period, can be attributed mainly to a combination of accommodative monetary policy, a return to economic growth and a significant consolidation of public finances. The improvement in investors' perception of Croatian sovereign risk is also reflected in the large decline in credit default swap spreads, which have halved since the end of 2015. Two of the three main rating agencies upgraded the country's outlook in the course of the first quarter of 2018. Nevertheless, at the end of the reference period, Croatia's credit rating remained below investment-grade.

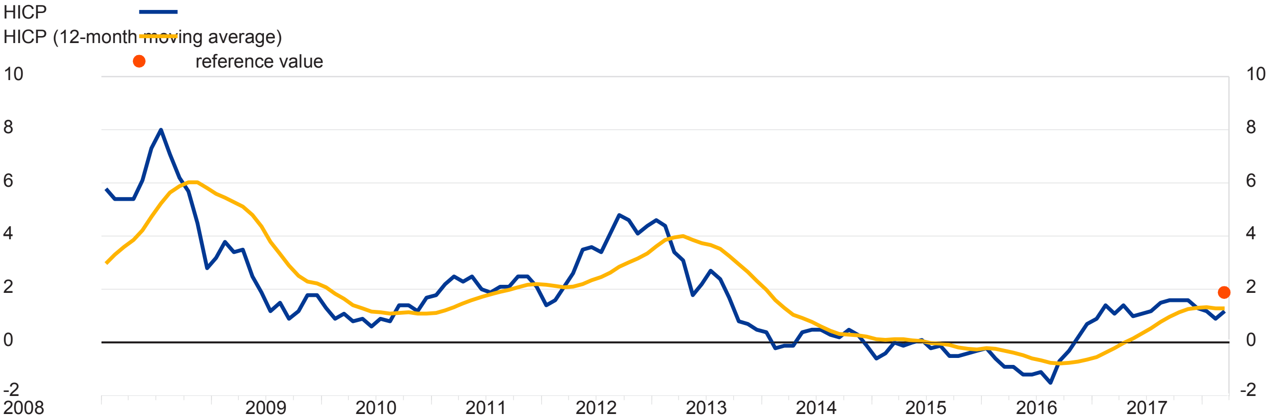
Croatia's long-term interest rate differential vis-à-vis the euro area has declined since mid-2016 and stood at 1.1 percentage points in March 2018. The interest rate differential has fallen gradually since the start of the financial crisis, when it topped 500 basis points (September 2009). During the period 2010-12, it fluctuated between 160 and 320 basis points, and between 2013 and 2014 it never exceeded 230 basis points. As of 2015 it started to rise again, owing to persistent structural weaknesses and anaemic economic growth, and then stabilised around 300 basis points during the summer of 2016. Since then the combination of accommodative monetary policy, signs of an incipient economic recovery and significant fiscal consolidation has been reflected in a decline in the long-term interest rate differential, which stood at 1.1 percentage points in March 2018.

Capital markets in Croatia are smaller and much less developed than those in the euro area (see Table 5.3.4), yet they are among the most developed in central and eastern Europe. The Croatian financial system is still dominated by foreign-owned banks (about 63% of total financial sector assets), but non-banking institutions also play an important role in financial intermediation. In particular, insurance corporations and, since their establishment in 1999, pension funds account for around 20% of total financial sector assets. Stock market capitalisation, as a percentage of GDP, is higher than in many peer countries in the region, standing at slightly less than 40% in 2017. Overall, the degree of financial intermediation remains much lower than in the euro area, and MFI credit to private residents, as a percentage of GDP, has been declining since 2011. The corporate debt market remains quite underdeveloped, as the share of debt securities issued by financial and non-financial institutions as a percentage of GDP remains very low, standing at 0.2% and 4.1% respectively at the end of 2017. The integration of Croatia's banking sector with the euro area, as measured by the claims of euro area banks on Croatian banks, fell significantly between 2014 and 2017. The claims of euro area MFIs on resident MFIs decreased from 12.5% of GDP in 2014 to 3.4% of GDP in 2017. In early 2018 a large percentage of loans continued to be denominated in foreign currencies – particularly in the case of loans to Croatian households, with such loans accounting for around 51% of total loans to households. Most of those loans were denominated in euro, with the implementation of the Swiss franc loan conversion in 2015-16 reducing the share of loans denominated in Swiss francs to around 0.8% of total loans to households.

Croatia - Price developments

Chart 5.3.1 HICP inflation and reference value [1)]

(annual percentage changes)



Sources: European Commission (Eurostat) and ECB calculations.
1) The basis of the calculation of the reference value for the period from April 2017 to March 2018 is the unweighted arithmetic average of the annual percentage changes in the HICP for Cyprus, Ireland and Finland plus 1.5 percentage points. The reference value is 1.9%.

Table 5.3.1 Measures of inflation and related indicators

(annual percentage changes, unless otherwise indicated)

	2008-2017 [1)]	2008-2012 [1)]	2013-2017 [1)]	2013	2014	2015	2016	2017	2018 [2)]	2019 [2)]
Measures of inflation										
HICP	1.7	2.9	0.6	2.3	0.2	-0.3	-0.6	1.3	1.4	1.5
HICP excluding unprocessed food and energy	1.7	2.3	1.0	2.1	0.6	0.8	0.2	1.3	1.3	1.5
HICP at constant tax rates [3)]	1.3	2.5	0.2	1.9	-0.6	-0.6	-0.8	1.2	-	-
CPI	1.7	3.0	0.3	2.2	-0.2	-0.5	-1.1	1.1	-	-
Private consumption deflator	1.6	3.2	0.1	1.9	-0.5	-0.5	-1.2	1.0	1.4	1.5
GDP deflator	1.4	2.5	0.4	0.8	0.1	0.0	-0.1	1.2	2.1	1.9
Producer prices [4)]	1.7	5.1	-1.6	0.4	-2.7	-3.8	-3.9	2.1	-	-
Related indicators										
Real GDP growth	-0.2	-1.9	1.5	-0.6	-0.1	2.3	3.2	2.8	2.8	2.7
GDP per capita in PPS [5)] (euro area = 100)	56.1	56.3	55.7	55.8	55.2	55.6	56.3	.	-	-
Comparative price levels (euro area = 100)	67.9	70.2	65.0	66.4	64.8	64.0	64.8	.	-	-
Output gap [6)]	-1.4	-0.8	-2.1	-3.9	-4.2	-2.4	-0.7	0.9	2.3	3.1
Unemployment rate (%) [7)]	13.4	11.8	15.1	17.4	17.2	16.1	13.4	11.2	9.6	8.5
Unit labour costs, whole economy	-0.1	2.0	-2.2	-2.9	-2.6	-0.7	-3.0	-1.7	0.0	0.3
Compensation per employee, whole economy	0.3	2.1	-1.4	-0.9	-5.2	0.4	-0.2	-1.1	1.1	1.4
Labour productivity, whole economy	0.4	0.1	0.8	2.0	-2.7	1.1	2.9	0.6	1.1	1.1
Imports of goods and services deflator	1.1	2.6	-0.3	0.2	-0.6	-0.9	-2.2	2.2	1.3	1.6
Nominal effective exchange rate [8)]	-0.2	-1.1	0.6	0.9	0.3	-2.1	2.6	1.6	-	-
Money supply (M3) [9)]	3.0	1.6	3.6	2.8	0.1	4.2	5.3	5.6	-	-
Lending from banks [10)]	-0.6	-2.3	0.1	-0.1	-1.7	-2.4	0.5	4.5	-	-
Stock prices (CROBEX) [11)]	-64.8	-66.8	5.9	3.1	-2.7	-3.2	18.1	-7.6	-	-
Residential property prices [12)]	-1.9	-3.2	-0.8	-4.0	-1.6	-2.9	0.9	3.8	-	-

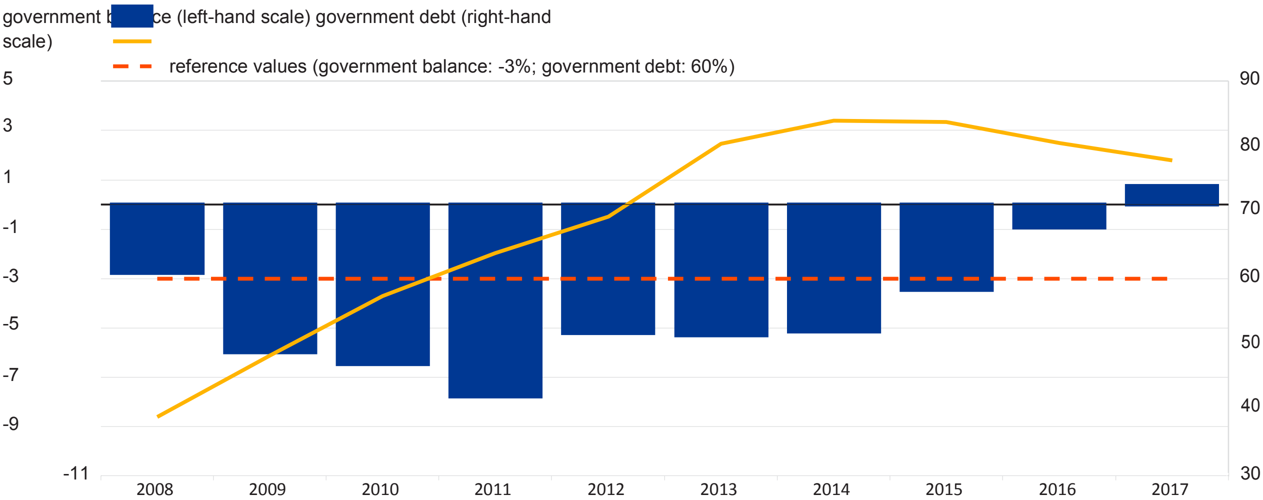
Sources: European Commission (Eurostat, Directorate-General for Economic and Financial Affairs), national data for CPI, money supply, lending from banks and residential property prices, and ECB calculations based on Thomson Reuters data for stock prices.

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 2018 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 from 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.

Croatia - Fiscal developments

Chart 5.3.2 General government balance and debt

(as a percentage of GDP)



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

Table 5.3.2 Government budgetary developments and projections

(as a percentage of GDP, unless otherwise indicated)

	2008-2017 [1]	2008-2012 [1]	2013-2017 [1]	2013	2014	2015	2016	2017	2018 [2]	2019 [2]	2020	2021
Government balance	**-4.2**	**-5.6**	**-2.8**	**-5.3**	**-5.1**	**-3.4**	**-0.9**	**0.8**	**0.7**	**0.8**	-	-
Total revenue	43.1	41.6	44.5	42.4	43.0	44.9	46.3	46.0	45.8	45.4	-	-
Current revenue	42.7	41.4	44.0	42.2	42.7	44.4	45.5	45.1	44.9	44.3	-	-
Direct taxes	6.5	6.7	6.4	6.5	6.3	6.1	6.6	6.3	6.4	6.3	-	-
Indirect taxes	18.3	17.6	19.1	18.6	18.5	19.1	19.4	19.7	19.7	19.6	-	-
Net social contributions	11.7	11.7	11.8	11.2	11.8	12.0	11.9	11.9	12.0	11.9	-	-
Other current revenue [3]	6.0	5.3	6.8	5.8	6.1	7.2	7.5	7.1	6.8	6.5	-	-
Capital revenue	0.4	0.3	0.6	0.3	0.3	0.5	0.8	0.9	1.0	1.0	-	-
Total expenditure	47.3	47.3	47.3	47.7	48.1	48.4	47.2	45.3	45.1	44.6	-	-
Current expenditure	41.7	40.9	42.5	42.9	43.0	43.4	42.2	41.2	41.0	40.3	-	-
Compensation of employees	11.7	12.0	11.4	11.6	11.4	11.4	11.4	11.4	11.4	11.3	-	-
Social benefits	16.1	15.7	16.5	16.6	16.9	17.0	16.0	15.7	15.7	15.5	-	-
Interest payable	2.9	2.5	3.2	3.2	3.4	3.5	3.1	2.7	2.5	2.4	-	-
Other current expenditure [4]	11.1	10.8	11.4	11.5	11.2	11.5	11.7	11.4	11.3	11.2	-	-
Capital expenditure	5.6	6.4	4.8	4.8	5.2	4.9	5.0	4.0	4.1	4.2	-	-
of which: Investment	3.9	4.4	3.3	3.7	3.6	3.2	3.2	2.7	2.7	2.8	-	-
Cyclically adjusted balance	-3.6	-5.3	-1.8	-3.5	-3.2	-2.3	-0.6	0.3	-0.3	-0.6	.	.
One-off and temporary measures	.	.	0.0	-0.2	0.2	0.0	0.1	-0.1	0.0	0.0	.	.
Structural balance [5]	.	.	-1.9	-3.2	-3.4	-2.4	-0.7	0.4	-0.3	-0.6	.	.
Government debt	**68.5**	**55.6**	**81.4**	**80.5**	**84.0**	**83.8**	**80.6**	**78.0**	**73.7**	**69.7**	-	-
Average residual maturity (in years)	5.3	5.5	5.1	5.1	5.0	5.1	4.8	5.4	.	.	.	.
In foreign currencies (% of total)	77.0	76.3	77.7	78.0	78.8	78.6	76.5	76.5	.	.	.	.
of which: Euro	72.0	70.3	73.6	74.1	74.7	74.4	72.5	72.4	.	.	.	.
Domestic ownership (% of total)	57.2	55.2	59.1	57.1	57.5	58.4	61.5	61.0	.	.	.	.
Medium and long-term maturity (% of total) [6]	91.6	89.5	93.6	91.2	92.2	94.3	95.1	95.2	.	.	.	.
of which: Variable interest rate (% of total)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	.	.	.	.
Deficit-debt adjustment	**0.7**	**0.9**	**0.4**	**5.8**	**-1.6**	**-1.7**	**-1.6**	**1.2**	.	.	.	.
Net acquisitions of main financial assets	0.5	0.7	0.3	3.7	-0.5	-1.4	-0.9	0.5	.	.	.	.
Currency and deposits	0.3	0.6	-0.1	3.2	-0.7	-1.6	-1.4	0.3	.	.	.	.
Debt securities	0.0	0.0	0.0	0.0	0.0	-0.1	0.0	0.0	.	.	.	.
Loans	0.3	0.1	0.4	0.5	0.3	0.3	0.6	0.3	.	.	.	.
Equity and investment fund shares or units	0.0	-0.1	0.0	0.0	-0.1	0.0	-0.1	0.0	.	.	.	.
Revaluation effects on debt	0.2	0.4	0.0	0.6	0.2	0.2	-0.6	-0.3	.	.	.	.
of which: Foreign exchange holding gains/losses	0.2	0.4	0.1	0.6	0.5	0.1	-0.6	-0.4	.	.	.	.
Other [7]	0.0	-0.2	0.1	1.6	-1.3	-0.6	-0.1	1.0	.	.	.	.
Convergence programme: government balance	-	-	-	-	-	-	-	-	-0.5	-0.5	0.0	0.5
Convergence programme: structural balance	-	-	-	-	-	-	-	-	-0.8	-0.9	-0.8	-0.4
Convergence programme: government debt	-	-	-	-	-	-	-	-	75.1	72.1	69.1	65.9

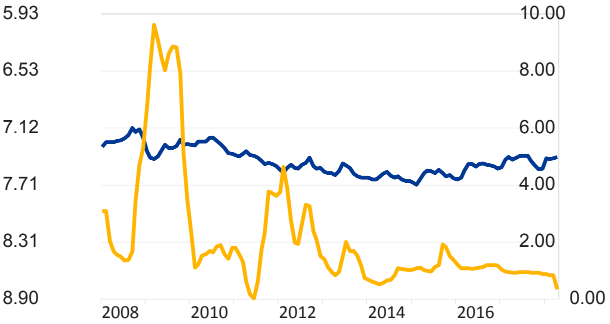
Sources: European System of Central Banks and European Commission (Eurostat, Directorate-General for Economic and Financial Affairs).

1) Multi-annual averages calculated using the arithmetic mean.
2) Data from the European Commission's Spring 2018 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 factors (sector reclassifications and statistical discrepancies).

Croatia - Exchange rate and external developments

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

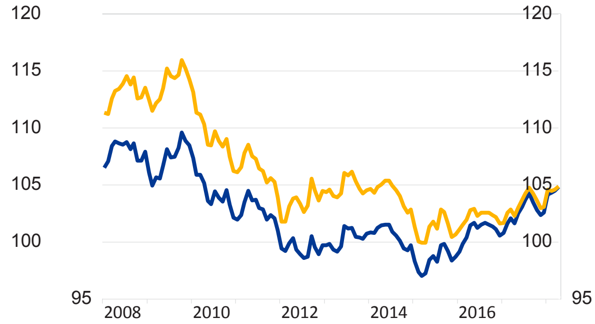
(HRK/EUR exchange rate: monthly averages; difference between three-month interbank interest rates and three-month EURIBOR: basis points, monthly values)



Sources: National data and ECB calculations.

Chart 5.3.4 Effective exchange rates 1)

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



Source: ECB.

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

Table 5.3.3 External developments

(as a percentage of GDP, unless otherwise indicated)

	2008-2017 1)	2008-2012 1)	2013-2017 1)	2013	2014	2015	2016	2017	2018 2)	2019 2)
Balance of payments										
Current account and capital account balance 3)	0.1	-3.1	3.3	1.1	2.3	5.1	3.7	4.3	.	.
Current account balance	-0.3	-3.2	2.7	0.9	1.9	4.4	2.4	3.8	.	.
Goods	-15.9	-16.1	-15.7	-15.1	-15.0	-15.6	-15.8	-16.8	.	.
Services Primary	15.6	13.7	17.6	15.4	16.9	17.8	18.6	19.0	.	.
income	-2.7	-3.3	-2.0	-2.0	-2.0	-0.7	-3.3	-2.2	.	.
Secondary income Capital	2.6	2.4	2.8	2.6	2.1	2.9	2.9	3.8	.	.
account balance	0.3	0.1	0.6	0.1	0.4	0.7	1.3	0.5	.	.
Combined direct and portfolio investment balance 3)	-3.2	-4.3	-2.1	-6.3	0.1	-0.8	-1.2	-2.1	.	.
Direct investment Portfolio	-2.6	-3.1	-2.1	-1.9	-1.6	-0.5	-4.0	-2.7	.	.
investment	-0.6	-1.2	0.1	-4.5	1.7	-0.3	2.8	0.6	.	.
Other investment balance	0.3	-1.7	2.4	1.0	2.0	3.3	4.8	0.8	.	.
Reserve assets	1.5	-	1.5	4.2	-1.2	1.7	-0.6	3.3	.	.
Exports of goods and services Imports	42.9	38.6	47.3	42.8	45.3	48.0	49.0	51.5	.	.
of goods and services	43.2	40.9	45.4	42.5	43.4	45.8	46.2	49.3	.	.
Net international investment position 4)	-81.5	-86.6	-76.4	-87.9	-85.1	-76.2	-69.7	-63.0	.	.
Gross external debt 4)	98.2	99.1	97.4	105.2	107.0	101.9	89.8	83.1	.	.
Internal trade with the euro area 5)										
Exports of goods and services Imports	55.3	52.2	56.5	56.1	56.4	57.9	57.4	54.8	.	.
of goods and services	55.4	46.7	58.8	55.2	59.5	60.2	59.9	59.3	.	.
Investment position with the euro area 5)										
Direct investment assets 4) Direct	.	-	47.5	-	48.3	49.5	45.2	47.2	.	.
investment liabilities 4) Portfolio	.	-	69.8	-	69.0	70.1	72.3	67.9	.	.
investment assets 4) Portfolio	.	-	26.5	-	25.8	18.1	41.5	20.7	.	.
investment liabilities 4)	50.3	51.2	49.5	45.1	48.3	47.6	50.9	55.6	.	.

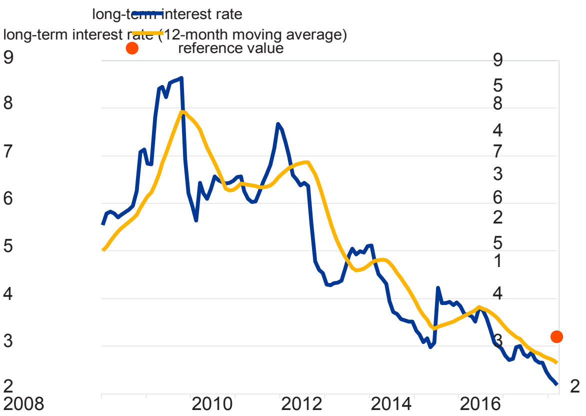
Sources: European System of Central Banks and European Commission (Eurostat, Directorate - General for Economic and Financial Affairs).

Note: Backdata are available from 2008.

1) Multi-annual averages calculated using the arithmetic mean. For direct investment assets and liabilities and portfolio investment assets with the euro area, the average for the period 2013-2017 refers to 2014-2017.
2) Data from the European Commission's Spring 2018 Economic Forecast.
3) Differences between totals and sum of their components are due to rounding.
4) End-of-period outstanding amounts.
5) As a percentage of the total.

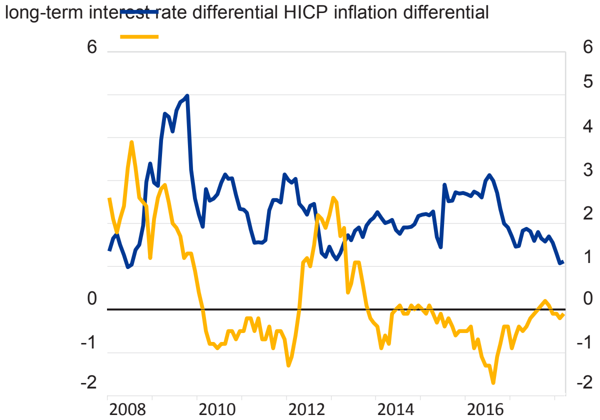
Croatia - Long-term interest rate developments

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



Sources: European System of Central Banks and ECB calculations.
1) The basis of the calculation of the reference value for the period from April 2017 to March 2018 is the unweighted arithmetic average of the interest rate levels in Cyprus, Ireland and Finland plus 2 percentage points. The reference value is 3.2%.

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



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

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

	2008-2017 1)	2008-2012 1)	2013-2017 1)	2014	2015	2016	2017	Apr. 2017 to Mar. 2018	Memo item: euro area 2017
Long-term interest rates									
Croatia 2)	5.1	6.6	3.7	4.1	3.6	3.5	2.8	2.6	-
Euro area 2), 3)	2.8	4.0	1.6	2.0	1.2	0.9	1.1	1.1	-
Euro area AAA par curve, ten-year residual maturity 2), 3)	2.1	3.2	0.9	1.4	0.6	0.2	0.4	0.5	-
Indicators of financial development and integration									
Debt securities issued by financial corporations 4)	0.4	-	0.4	0.4	0.4	0.4	0.2	-	66.0
Debt securities issued by non-financial corporations 5)	5.0	-	5.0	4.8	5.2	5.3	4.1	-	11.3
Stock market capitalisation 6)	39.0	-	39.0	38.6	38.1	42.5	39.3	-	67.4
MFI credit to non-government residents 7)	68.2	73.3	65.2	69.5	65.9	61.4	58.5	-	108.1
Claims of euro area MFIs on resident MFIs 8)	12.7	19.1	8.8	12.5	8.2	4.7	3.4	-	26.3

Sources: European System of Central Banks and ECB calculations.
1) Multi-annual averages calculated using the arithmetic mean.
2) Average interest rate.
3) Included for information only.
4) Outstanding amount of debt securities issued by resident MFIs and other financial corporations. Data available since 2013.
5) Outstanding amount of debt securities issued by resident non-financial corporations. Data available since 2013.
6) Outstanding amount of listed shares issued by residents at the end of the period at market values. Data available since 2013.
7) MFI (excluding national central bank) credit to domestic non-MFI residents other than general government. Credit includes outstanding amounts of loans and debt securities. Data available since 2010.
8) Outstanding amount of deposits and debt securities issued by domestic MFIs (excluding the national central bank) held by euro area MFIs as a percentage of total liabilities of domestic MFIs (excluding the national central bank). Total liabilities exclude capital and reserves and remaining liabilities. Data available since 2010.

5.4 Hungary

5.4.1 Price developments

In March 2018 the 12-month average rate of HICP inflation in Hungary was 2.2%, i.e. above the reference value of 1.9% for the criterion on price stability (see Chart 5.4.1). This rate is expected to increase gradually over the coming months.

Over the past ten years the 12-month average rate of HICP inflation has fluctuated within a relatively wide range, from −0.3% to 7.3%, and the average for that period was elevated, standing at 3.0%. In 2008 and 2009 the sharp economic slowdown drove down the average annual rate of HICP inflation from a previous peak to 6.1% and 4.0% respectively. However, successive commodity price shocks and frequent changes to indirect taxes and administered prices caused consumer price inflation in Hungary to remain relatively volatile during the period under review. In 2010 and 2011 Hungary experienced a weak economic recovery driven by external demand. While domestic demand remained subdued amid wage restraint, hikes in indirect taxes and the depreciation of the forint contributed to a rebound in consumer price inflation, which stood at 4.7% in 2010 and remained elevated at 3.9% in 2011. In 2012 economic activity declined again, while inflation increased to 5.7% as a result of, among other things, a hike in the value added tax rate. The ensuing economic recovery was to a large extent supported by government intervention in an environment characterised by a contraction in bank lending to the private sector. In recent years inflation expectations have become increasingly better anchored. As inflation receded, the Magyar Nemzeti Bank continued to loosen its monetary policy stance. In 2014 and 2015 the average annual rate of HICP inflation was close to zero owing to a combination of factors, including global commodity price developments, utility price cuts, relatively muted wage growth and subdued external price pressures. However, since 2016 consumer price inflation has accelerated again, reaching 2.4% in 2017 on account of the ongoing economic recovery.

In the first quarter of 2018 the average annual rate of HICP inflation stood at 2.0%. Strong domestic demand, supported by a sharply declining unemployment rate, robust wage growth and an accommodative fiscal and monetary policy stance, made an increasing contribution to domestically generated inflation. However, this was partly offset by developments in global commodity prices and subdued inflation in the euro area.

Policy choices have played an important role in shaping inflation dynamics in Hungary over the past decade, most notably the orientation of monetary policy towards price stability. The Magyar Nemzeti Bank defines its inflation target as an annual rate of consumer price inflation of 3%. This was adopted in August 2005. In addition, in March 2015 the Magyar Nemzeti Bank adopted an ex-ante tolerance band of ±1 percentage point around this inflation target. Successive cuts in administrative prices, which constitute a large share of Hungary's HICP basket of goods and services, helped to contain consumer price inflation. In late 2008 Hungary's large external financing needs necessitated an EU-IMF financial assistance programme, which, following a change of government, was discontinued in June 2010. In November 2011 Hungary requested further precautionary financial assistance from the EU and the IMF, but the ensuing negotiations were not completed and Hungary did not request any further assistance.

Inflation is expected to increase in the coming years, and over the longer term, there are concerns regarding the sustainability of inflation convergence in Hungary. According to the European Commission's Spring 2018 Economic Forecast, the rate of inflation is projected to remain broadly unchanged at 2.3% in 2018, before accelerating to 3.0% in 2019. This outlook is based on expectations that economic growth will continue to be relatively strong, with robust job creation and dynamic compensation per employee growth expected to contribute to pushing up private consumption and inflation. The risks to the inflation outlook are assessed as being mainly on the upside, relating to stronger than expected wage pressures stemming from a further tightening of labour market conditions, the emergence of capacity constraints in the economy and the uncertainty about the outlook for oil prices. Looking further ahead, the catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area, since GDP per capita and price levels are still significantly lower in Hungary than in the euro area, unless this is counteracted by an appreciation of the nominal exchange rate. In order to prevent the build-up of excessive price pressures and macroeconomic imbalances, the catching-up process must be supported by appropriate policies.

Achieving an environment that is conducive to sustainable convergence in Hungary requires stability-oriented economic policies and wide-ranging structural reforms. More specifically, economic policies promoting private sector-led growth in order to drive up the level of potential growth are essential.
Improving the quality of public institutions and ensuring that they are free from undue political intervention are prerequisites for private sector-led economic growth. The red tape for businesses should be cut further, with special taxes and levies at the sectoral level needing to be reconsidered. Enhanced governance, stronger institutions and a better functioning administration at the national level should, among other things, help to improve the absorption of EU funds. With regard to macroeconomic imbalances, the European Commission did not select Hungary for an in-depth review in its Alert Mechanism Report 2018.

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 terms of the banking sector, progress in strengthening balance sheets has been made over the past few years. This has included bolstering capital positions, increasing liquidity buffers and reducing the volume of non-performing loans. However, given that the increase in banks' net income was largely due to one-off factors, there has not yet been any material improvement in banks' underlying profitability. Against this background, further efforts aimed at achieving a sustainable improvement in bank profitability could focus on increasing cost efficiency and diversifying sources of income in the context of the low interest rate environment. With the bottoming-out of the downturn in the credit cycle, financial policies should continue to aim at maintaining the sustainability of growth in lending to the private sector. It is necessary to prevent the build-up of macrofinancial imbalances fuelled by rapid increases in asset prices, particularly in certain segments of the real estate market. In order to further bolster confidence in the financial system, the national competent authorities should continue to improve their supervisory practices, among other things, by following the applicable recommendations from the relevant international and European bodies, and by collaborating closely with other national supervisors of EU Member States within the supervisory colleges.

5.4.2 Fiscal developments

Hungary's deficit complied with the Maastricht criterion in 2017, whereas debt was above the reference value. In the reference year 2017 the general government budget balance recorded a deficit of 2.0% of GDP, i.e. below the 3% reference value. The general government debt ratio was 73.6%, i.e. above the 60% reference value (see Table 5.4.2). Compared with the previous year, the deficit ratio increased by 0.3 percentage point of GDP, while the debt ratio decreased by 2.4 percentage points.
The deficit ratio is forecast by the European Commission to increase further to 2.4% in 2018, while the debt ratio is projected to continue to decrease, to 73.3%. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2017, nor is it expected to do so in 2018. However, it should be noted that Eurostat has expressed a reservation on the quality of the data reported by Hungary in relation to the sector classification of the foundations created by the Magyar Nemzeti Bank – the discussion of this issue has been mentioned in previous Eurostat data releases.[136] Moreover, the reclassification of Eximbank (Hungarian Export-Import Bank Plc) inside the general government sector, which triggered the withdrawal of Eurostat's previously expressed reservation,[137] resulted in a moderate upward revision of the debt ratio, of about 2 percentage points of GDP in 2015 and 2016 and by smaller amounts in previous years.

Hungary has been subject to the preventive arm of the Stability and Growth Pact since 2013. It recorded deficits in excess of 3% of GDP each year up to 2012. Hungary's excessive deficit procedure ended on 21 June 2013. The European Commission's Spring 2018 Economic Forecast projects the structural deficit to move further away from the medium-term objective in 2018, pointing to a high risk of a significant deviation from the preventive arm's requirements. This assessment and conclusion is also supported by the projected deviation from the expenditure benchmark. The debt criterion is projected to be met with a margin.

[136] See "Provision of deficit and debt data for 2017 - first notification", *Eurostat news release*, No 69, 23 April 2018.

[137] See "Provision of deficit and debt data for 2016 - second notification", *Eurostat news release*, No 160, 23 October 2017, "Provision of deficit and debt data for 2016 - first notification", *Eurostat news release*, No 67, 24 April 2017, "Provision of deficit and debt data for 2015 - second notification", *Eurostat news release*, No 204, 21 October 2016, and "Provision of deficit and debt data for 2015 - first notification", *Eurostat press release*, No 76, 21 April 2016.

Cyclical factors explain most of the deficit dynamics over recent years. In the period under review the deficit ratio reached its peak in 2011, at 5.4% of GDP, and followed a downward trend until 2016. It started increasing again in 2017, and is projected to peak at a level of 2.4% of GDP in 2018. European Commission estimates (presented in Table 5.4.2) indicate that the impact of automatic stabilisers explain, on average and consistently, a large part of the deterioration in the deficit ratio and the subsequent consolidation. The structural deficit dynamics offset the cyclical developments over the period to some extent, with notable structural consolidations in both 2009 and 2012. Over the period 2017-18, the fiscal loosening is explained by a rise in the structural deficit, partially compensated by a more buoyant economy.

The debt-to-GDP ratio increased sharply before starting to trend downwards from 2011, albeit at levels above the 60% reference value. The debt ratio increased rapidly, from 65.5% of GDP in 2007 to 80.5% of GDP in 2011, driven by an unfavourable interest-growth differential and high deficit-debt adjustments (see Chart 5.4.2). These were partly related to the support granted to the financial sector and partly to the debt revaluation effects stemming from exchange rate dynamics. Since 2011 the debt ratio has been mostly on a downward path, underpinned largely by persistent primary surpluses. The effects of deficit-debt adjustments were partially offset, on average, by the debt-increasing effect of the interest-growth differential (see Table 5.4.2). In 2017, however, the interest-growth differential started having a debt-decreasing effect. While deficit-debt adjustments over the past few years, stemming mainly from the sizeable capital transfer that resulted from the state takeover of mandatory second-pillar private pension assets, have been favourable, the deficit-debt adjustments over the forecast period are likely to slow the downward path of the debt ratio. Hungary has not incurred contingent liabilities resulting from government interventions to support financial institutions or markets during the global financial crisis.

The level and structure of government debt indicate sensitivity to exchange rate movements and to interest rate variations. The share of government debt with a short-term maturity is noticeable (17.8% in 2017 – see Table 5.4.2). Taking into account the level of the debt ratio, as well as the share of debt with a variable interest rate, fiscal balances are sensitive to changes in interest rates. At the same time, the proportion of foreign currency-denominated government debt, almost exclusively in euro, is relatively high (25.8% in 2017). This leaves fiscal balances relatively sensitive to changes in the exchange rate vis-à-vis the euro. Despite some fluctuations, the share of debt denominated in euro and other foreign currency has been on a decreasing path since 2011, pointing to a decline in debt-related vulnerabilities.

The European Commission's Spring 2018 Economic Forecast points to a high risk of a significant deviation from the adjustment path towards the medium-term objective over the forecast horizon. According to the European Commission's latest forecast, the structural deficit is projected to increase further from a level of 3.1% of GDP in 2017 to 3.6% of GDP in 2018, returning to 3.3% of GDP in 2019, thereby deviating from the medium-term objective of 1.5% of GDP and pointing to a high risk of a significant deviation from the provisions of the preventive arm of the Stability and Growth Pact. The risk is further substantiated by the deviation from the expenditure benchmark over the same time span. However, the debt ratio path is assessed as being compliant with the debt criterion, with a margin. Hungary's medium-term fiscal policy strategy, as presented in the 2018 Convergence Programme update, also points to deviations from the preventive's arm requirements in 2018, followed, however, by a return to the medium-term objective by 2020.

Despite some progress in reforming the fiscal framework, there is scope for further improvement. Hungary has implemented/announced measures that are designed to reduce the – by international standards – high tax ratio, and especially the high tax wedge. The measures also impact both supply and demand in the labour market, with consequences for future ageing costs. The minimum wage and the guaranteed minimum wage have been increased (in order to support wage growth at the lower end of the wage distribution), with offsetting measures on the employer side, i.e. reductions in the social security contribution rate and corporate income tax rate. Some sector-specific taxes, such as the bank levy, have been also lowered, in order to foster faster capital accumulation. However, these developments should be accompanied by steps to: (i) continue to improve the national fiscal governance framework (with a particular focus on expanding the competencies of the Fiscal Council, as well as enforcing its already legislated attributes); (ii) increase tax administration efficiency in order to further address compliance gaps; (iii) continue to move away from sector-specific distortionary taxation; (iv) increase expenditure efficiency by, among other things, strengthening transparency and competition in public procurement and complying with a medium-term budget programming process; and (v) curb contingent liabilities (e.g. stemming from state-owned enterprises and also future investment commitments).

Hungary is at low risk of fiscal stress over the short term, but at high risk over the medium term and medium risk over the long term, mostly on account of projected adverse demographic developments. The European Commission's 2017 Debt Sustainability Monitor points to low risk over the short term and high risk over the medium term. This medium-term risk is due to the high stock of debt, the estimated initial budgetary position and the offsetting effect of the projected medium-term savings in age-related budgetary costs. Some pension system reforms have been introduced, such as: (i) reducing benefit levels, partly via changes in the pension indexation scheme; (ii) reducing the number of recipients (in line with at least the increase in life expectancy); and (iii) changing the tax system to incentivise favourable demographic developments, higher participation rates and other favourable labour supply and demand developments pertaining to the quantity, structure and quality of labour. Despite these reforms with a favourable impact on projected ageing costs, the expenditure-increasing impact of adverse demographics is, over the long run, still one of the highest in Europe, leading to a medium risk classification for debt sustainability over the long term[138]. Also, the Ageing Working Group's (AWG) 2015 risk scenario outcome implies higher long-term debt

[138] However, this assessment does not necessarily reflect the uncertainty surrounding the long-term assumptions and, for high-debt countries, has to be taken with caution.

sustainability risks for Hungary. Moreover, these developments raise concerns regarding the future adequacy of the pension system in Hungary. As such, the 2015 Ageing Report,[139]prepared by the AWG, suggests that Hungary will experience an increase in strictly age-related public expenditure of 0.9 percentage point of GDP by 2060, in the AWG's reference scenario, from a level of 20.5% of GDP in 2013. In the AWG's risk scenario, the increase is projected to be 5.4 percentage points of GDP (arising mostly from increases of 4.2% and 1.5% of GDP in long-term care and health care respectively), which is significantly above the EU average. All these factors suggest that further pension reform is needed to improve the long-term sustainability of public finances.

Further improvements in the fiscal governance framework and a prudent fiscal policy are needed to safeguard the sustainability of public finances over the medium term and beyond. Hungary should further improve the competencies of the Fiscal Council and the capacity to enforce its existing functions with a view to increasing the transparency and accountability of the fiscal framework. Moreover, respecting the European fiscal rules and the EU statistical methodology used to assess fiscal developments will foster a more transparent and sounder management of public finances. Combined with measures to increase the efficiency of both revenues and expenditure, this should bring public finances towards a more sustainable future trajectory. Moreover, avoiding significant deviations from the provisions of the Stability and Growth Pact, and ensuring compliance with both the medium-term objective and the expenditure benchmark, would bring the still high debt ratio onto a firm downward path, thus also reducing the risks to fiscal sustainability.

5.4.3 Exchange rate developments

Over the reference period from 4 May 2016 to 3 May 2018, the Hungarian forint did not participate in ERM II, but traded under a flexible exchange rate regime. In the two-year reference period the Hungarian forint traded close to its May 2016 average exchange rate against the euro of 314.58 forints per euro, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate (see Chart 5.4.3). On 3 May 2018 the exchange rate stood at 314.06 forints per euro, i.e. 0.2% stronger than its average level in May 2016. Over the reference period the maximum upward deviation from this benchmark was 3.6%, while the maximum downward deviation amounted to 1.2%. Over the past ten years the exchange rate of the Hungarian forint against the euro has depreciated by 26.8%.

The exchange rate of the Hungarian forint against the euro exhibited, on average, a relatively high degree of volatility over the reference period. The gradually declining short-term interest rate differentials, as well as the existing macroeconomic and external vulnerabilities in Hungary may have contributed to a

[139] European Commission and Economic Policy Committee, "The 2015 Ageing Report: Economic and budgetary projections for the 28 EU Member States (2013-2060)", *European Economy series*, No 3, European Commission, 2015.

relatively high degree of exchange rate volatility, although the reduction in macroeconomic imbalances and external vulnerabilities overall contributed to an appreciation of the currency. Between May and October 2016 the Hungarian forint appreciated against the euro amid an improving outlook for growth in the domestic economy and in the country's key trading partners, the gradual normalisation of the Federal Reserve System's monetary policy and reduced risk aversion in financial markets, which was reflected in declining interest rate differentials. The currency continued to appreciate – albeit amid increased exchange rate volatility – until the third quarter of 2017. Since then the Hungarian forint has started to depreciate
vis-à-vis the euro in an environment of further decreasing short-term interest rate differentials with the euro area and a broad-based strengthening of the euro.

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

Over the past ten years Hungary's current and capital account has improved markedly and has contributed to a reduction in the country's net foreign liabilities, which remain high (see Table 5.4.3). Following a sharp reversal in its combined current and capital account balance, from a deficit of 5.8% of GDP in 2008 to a small surplus of 0.9% of GDP in 2009, Hungary recorded steady improvements in its external balance. In 2013 the combined current and capital account balance reached 7.3% of GDP, largely reflecting a substantial adjustment in the goods and services balance owing to robust export growth supported by the expanded capacities of export-oriented sectors and relatively subdued domestic demand together with an increasing capital account surplus reflecting larger transfers from the EU budget. The combined current and capital account surplus has since declined somewhat, but remains at elevated levels. The sharp reversal in Hungary's external position was coupled with a significant adjustment of capital flows. Over the past ten years Hungary has continued to be a net recipient of foreign direct investment flows, while it has become a net exporter of capital in the form of portfolio investment and other investment. Against this background, gross external debt decreased from 144.7% of GDP in 2013 to 122.2% of GDP in 2016 and 103.0% of GDP in 2017. As a result, Hungary's net international investment position improved, from -83.1% of GDP in 2013 to -60.3% of GDP in 2016 and -54.6% of GDP in 2017. However, the country's net foreign liabilities remain very high. Fiscal and structural policies therefore continue to be important for supporting external sustainability and the competitiveness of the economy.

The Hungarian economy is well integrated with the euro area through trade and investment linkages. In 2017 exports of goods and services to the euro area constituted 56.2% of total exports, while the corresponding figure for imports was higher, at 58.2%. In 2017 the share of the euro area in Hungary's stock of inward direct investment stood at 65.0% and its share in the country's stock of portfolio investment liabilities was 35.0%. The share of Hungary's stock of foreign assets invested in the euro area amounted to 17.8% in the case of direct investment and 60.5% for portfolio investment in 2017.

5.4.4 Long-term interest rate developments

Over the reference period from April 2017 to March 2018, long-term interest rates in Hungary stood at 2.7% on average and thus remained below the 3.2% reference value for the interest rate convergence criterion (see Chart 5.4.5).

Long-term interest rates in Hungary have been on a downward path since 2009. The decline in long-term interest rates on government bonds from the peaks recorded at the beginning of 2009 came to a temporary halt during 2010-11, when domestic factors, the euro area sovereign debt crisis and uncertainty regarding the prospects for an EU-IMF financial assistance programme led to a sizeable increase in long-term interest rates, which stood at approximately 10% by the end of 2011. In 2012 improving macroeconomic conditions, lower global risk aversion and decisive measures to loosen monetary policy brought long-term interest rates down to around 5%. Following a temporary increase in 2013, long-term interest rates started to decline again in 2014, reaching 3% in March 2015. Since then they have moved broadly in tandem with euro area average rates. More recently, the Magyar Nemzeti Bank introduced a foreign exchange swap facility, as well as long-term interest rate swaps, in order to more effectively ensure loose monetary conditions also in longer segments of the yield curve. Furthermore, the Magyar Nemzeti Bank also started making regular purchases of mortgage bonds, which are regarded as standard monetary policy tools.

That, in combination with the active use of central bank forward guidance, has contributed to the fall in long-term interest rates, which declined from 3.5% in March 2017 to 2.6% in March 2018. Since March 2018, credit default spreads for Hungarian government debt have returned to the levels recorded in the summer of 2008, prior to the financial crisis. Hungary's government debt is rated investment-grade by all of the three main rating agencies.

Overall, Hungary's long-term interest rate differential vis-à-vis the euro area average has been on a downward path since 2006, albeit it increased somewhat towards the end of the reference period, standing at 1.5 percentage points in March 2018 (see Chart 5.4.6). Since the onset of the financial crisis, the dynamics of the interest rate differential between Hungary and the euro area have very closely followed developments in both global risk aversion and domestic factors. The interest rate differential widened during the 2008-09 financial crisis, owing to investors seeking safe havens, and narrowed during 2009-10 on the back of a

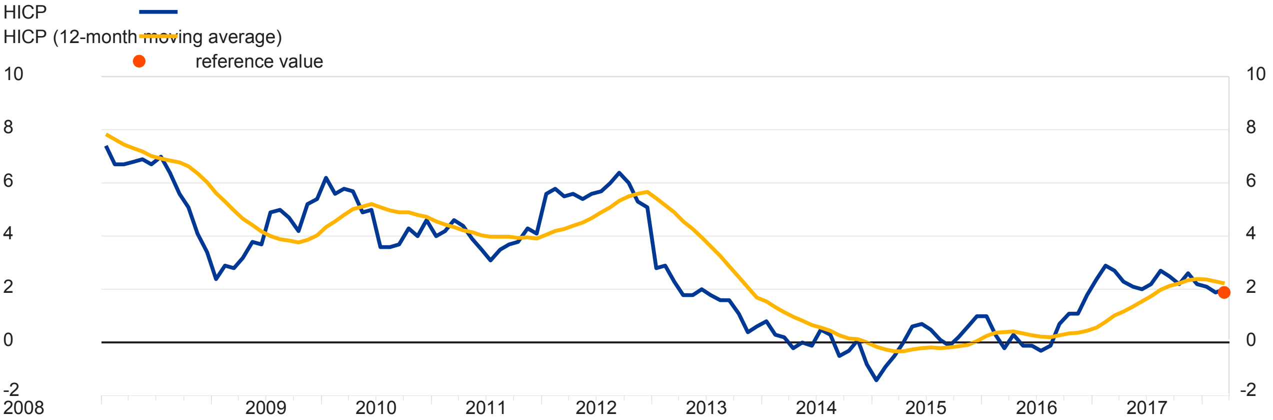
broad-based increase in global risk aversion. Subsequently, from 2011 to the summer of 2012 it widened again as a result of the heightened perceived riskiness of the sustainability of the Hungarian debt situation. This widening lasted until the Magyar Nemzeti Bank initiated a series of interest rate cuts that reduced its base rate from 7% in December 2011 to 0.9% in May 2016. In 2017 further monetary policy easing and a reduction in the perceived riskiness of the Hungarian sovereign debt situation contributed to a further narrowing of the long-term interest rate differential vis-à-vis the AAA euro area yield. This differential then increased again, standing at 2 percentage points at the end of the reference period.

Capital markets in Hungary are much smaller than in the euro area and still underdeveloped (see Table 5.4.4). Stock market capitalisation, as a percentage of GDP, remains rather low, but has increased over the past four years to stand at above 21% of GDP in 2017, which is above the levels prevailing before the crisis. Outstanding debt securities issued by non-financial corporations (a measure of market-based indebtedness) have hardly increased since 2015. By contrast, while debt securities issued by financial institutions have continued to decline over the past two years, mortgage bonds are expected to play a more significant role after the introduction (in 2017) and the tightening (in 2018) of the mortgage funding adequacy ratio. The integration of Hungary's financial sector with the euro area, as measured by the claims of euro area banks on Hungarian banks, is quite low and has been decreasing since 2008 owing to deleveraging in the Hungarian banking sector. The degree of financial intermediation is low compared with the euro area average and among the lowest in the region. MFI credit to non-government residents in 2017 stood at 35.3% of GDP, approximately 19 percentage points down from its 2012 level. This was partly attributable to legal changes requiring banks to pay compensation to consumers for previous interest rate increases and exchange rate margins which had been deemed unjustified. The level of claims of euro area MFIs on resident MFIs has also been declining since 2012 and stood at 3.4% of GDP in 2017.

Hungary - Price developments

Chart 5.4.1 HICP inflation and reference value 1)

(annual percentage changes)



Sources: European Commission (Eurostat) and ECB calculations.
1) The basis of the calculation of the reference value for the period from April 2017 to March 2018 is the unweighted arithmetic average of the annual percentage changes in the HICP for Cyprus, Ireland and Finland plus 1.5 percentage points. The reference value is 1.9%.

Table 5.4.1 Measures of inflation and related indicators

(annual percentage changes, unless otherwise indicated)

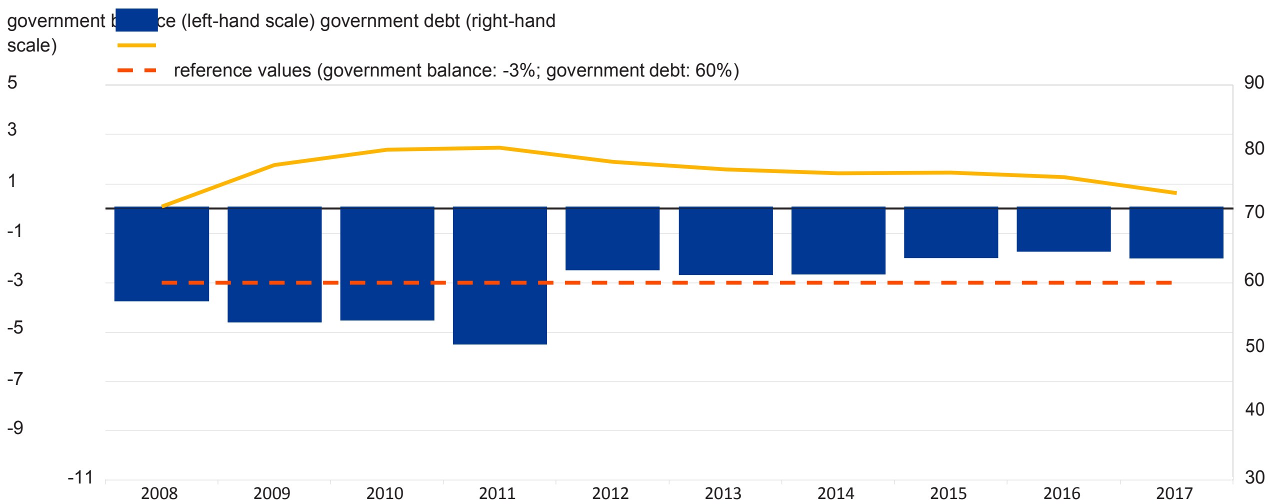
	2008-2017 1)	2008-2012 1)	2013-2017 1)	2013	2014	2015	2016	2017	2018 2)	2019 2)
Measures of inflation										
HICP	2.9	4.9	0.9	1.7	0.0	0.1	0.4	2.4	2.3	3.0
HICP excluding unprocessed food and energy	3.0	4.1	1.9	3.0	1.6	1.3	1.4	2.1	2.1	3.2
HICP at constant tax rates 3)	2.2	3.5	0.9	1.2	0.0	0.0	0.6	2.9	-	-
CPI	2.9	4.9	0.8	1.7	-0.2	-0.1	0.4	2.4	2.3	3.0
Private consumption deflator	2.8	4.7	0.9	1.8	0.9	-0.2	-0.2	2.3	2.3	3.0
GDP deflator	3.0	3.4	2.6	2.9	3.4	1.9	1.0	3.7	2.8	3.0
Producer prices 4)	2.7	6.4	-0.9	-0.5	-2.1	-3.1	-3.1	4.6	-	-
Related indicators										
Real GDP growth	1.0	-1.1	3.2	2.1	4.2	3.4	2.2	4.0	4.0	3.2
GDP per capita in PPS 5) (euro area = 100)	61.4	59.8	63.5	62.7	63.9	63.9	63.4	.	-	-
Comparative price levels (euro area = 100)	60.0	61.7	57.9	58.0	57.1	57.9	58.5	.	-	-
Output gap 6)	-1.3	-2.4	-0.2	-2.7	-0.7	0.3	0.3	1.6	2.4	2.3
Unemployment rate (%) 7)	8.5	10.2	6.8	10.1	7.7	6.8	5.1	4.2	3.7	3.6
Unit labour costs, whole economy	2.2	2.4	2.0	0.8	1.4	-2.4	4.4	5.8	4.2	2.8
Compensation per employee, whole economy	2.5	2.4	2.6	1.8	0.8	-1.5	4.0	7.9	7.4	5.6
Labour productivity, whole economy	0.3	0.0	0.6	1.0	-0.6	0.9	-0.4	2.0	3.1	2.7
Imports of goods and services deflator	1.2	2.9	-0.4	-0.8	0.3	-1.0	-2.1	1.7	1.8	1.6
Nominal effective exchange rate 8)	-2.1	-3.3	-0.9	-0.9	-2.8	-3.6	1.2	1.6	-	-
Money supply (M3) 9)	4.5	3.0	6.0	6.2	2.9	6.3	6.3	8.5	-	-
Lending from banks 10)	-2.9	-4.4	-1.3	-4.1	-3.5	-8.1	3.2	6.5	-	-
Stock prices (BUX) 11)	50.1	-30.7	116.7	2.2	-10.4	43.8	33.8	23.0	-	-
Residential property prices	2.2	-2.5	7.2	-2.6	4.2	13.1	13.4	8.5	-	-

Sources: European Commission (Eurostat, Directorate-General for Economic and Financial Affairs), 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 2018 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 from 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.

Hungary - Fiscal developments

Chart 5.4.2 General government balance and debt

(as a percentage of GDP)



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

Table 5.4.2 Government budgetary developments and projections

(as a percentage of GDP, unless otherwise indicated)

	2008-2017 1)	2008-2012 1)	2013-2017 1)	2013	2014	2015	2016	2017	2018 2)	2019 2)	2020	2021
Government balance	**-3.1**	**-4.1**	**-2.1**	**-2.6**	**-2.6**	**-1.9**	**-1.7**	**-2.0**	**-2.4**	**-2.1**	-	-
Total revenue	45.7	45.1	46.2	46.7	46.8	48.2	44.9	44.5	44.7	45.0	-	-
Current revenue	43.7	43.5	44.0	44.1	43.8	44.2	44.3	43.5	42.6	42.6	-	-
Direct taxes	7.6	8.1	7.0	6.6	6.8	7.0	7.4	7.4	6.8	6.9	-	-
Indirect taxes	17.6	17.0	18.3	18.4	18.3	18.7	18.2	18.0	18.0	17.8	-	-
Net social contributions	13.0	12.9	13.1	12.9	12.9	13.1	13.6	12.8	12.4	12.5	-	-
Other current revenue 3)	5.5	5.5	5.6	6.2	5.8	5.5	5.1	5.2	5.3	5.4	-	-
Capital revenue	1.9	1.6	2.2	2.6	2.9	4.0	0.6	1.0	2.1	2.4	-	-
Total expenditure	48.8	49.2	48.4	49.3	49.4	50.1	46.5	46.5	47.1	47.1	-	-
Current expenditure	42.7	44.0	41.4	43.3	42.0	40.6	40.9	39.8	39.0	38.4	-	-
Compensation of employees	10.6	10.7	10.5	10.0	10.3	10.5	10.9	10.8	10.6	10.5	-	-
Social benefits	17.7	19.0	16.4	18.1	16.9	16.1	15.8	15.1	13.7	13.2	-	-
Interest payable	3.9	4.3	3.6	4.5	4.0	3.5	3.2	2.8	2.6	2.5	-	-
Other current expenditure 4)	10.5	10.1	10.8	10.7	10.9	10.5	11.0	11.1	12.1	12.3	-	-
Capital expenditure	6.1	5.2	7.0	5.9	7.3	9.5	5.6	6.7	8.1	8.7	-	-
of which: Investment	4.1	3.5	4.8	4.4	5.3	6.6	3.1	4.4	5.5	5.8	-	-
Cyclically adjusted balance	-2.5	-2.9	-2.0	-1.3	-2.2	-2.0	-1.8	-2.8	-3.6	-3.3	.	.
One-off and temporary measures	.	.	0.0	0.1	-0.1	0.0	-0.1	0.4	0.0	0.0	.	.
Structural balance 5)	.	.	-2.1	-1.4	-2.1	-2.0	-1.8	-3.1	-3.6	-3.3	.	.
Government debt	**76.9**	**77.7**	**76.0**	**77.1**	**76.6**	**76.7**	**76.0**	**73.6**	**73.3**	**71.0**	-	-
Average residual maturity (in years)	4.4	4.6	4.3	4.6	4.5	4.3	4.1	4.0	.	.	.	.
In foreign currencies (% of total)	40.9	46.4	35.4	43.0	40.9	36.8	30.6	25.8	.	.	.	.
of which: Euro	39.8	44.3	35.3	42.5	40.9	36.8	30.6	25.8	.	.	.	.
Domestic ownership (% of total)	46.9	41.8	52.0	41.8	45.3	52.1	58.2	62.5	.	.	.	.
Medium and long-term maturity (% of total) 6)	86.6	88.9	84.4	85.5	86.6	85.4	82.1	82.2	.	.	.	.
of which: Variable interest rate (% of total)	7.6	4.3	10.9	5.5	11.4	12.6	11.4	13.8	.	.	.	.
Deficit-debt adjustment	**0.6**	**0.1**	**1.1**	**0.0**	**2.4**	**2.1**	**0.0**	**1.1**	.	.	.	.
Net acquisitions of main financial assets	0.9	1.4	0.5	-1.2	1.2	0.4	2.3	-0.2	.	.	.	.
Currency and deposits	0.3	0.6	0.0	-1.3	0.6	-0.8	2.0	-0.6	.	.	.	.
Debt securities	0.0	0.1	-0.1	0.2	-0.3	0.0	-0.1	0.0	.	.	.	.
Loans	0.3	0.1	0.5	0.3	0.6	0.8	0.3	0.3	.	.	.	.
Equity and investment fund shares or units	0.4	0.6	0.1	-0.3	0.4	0.4	0.0	0.1	.	.	.	.
Revaluation effects on debt	0.7	1.0	0.5	0.7	1.4	0.2	-0.1	0.1	.	.	.	.
of which: Foreign exchange holding gains/losses	0.8	1.0	0.5	0.8	1.7	0.3	-0.2	-0.1	.	.	.	.
Other 7)	-1.1	-2.3	0.1	0.4	-0.1	1.4	-2.2	1.2	.	.	.	.
Convergence programme: government balance	-	-	-	-	-	-	-	-	-2.4	-1.8	-1.5	-1.2
Convergence programme: structural balance	-	-	-	-	-	-	-	-	-2.1	-1.7	-1.4	-1.2
Convergence programme: government debt	-	-	-	-	-	-	-	-	73.2	69.6	66.7	63.4

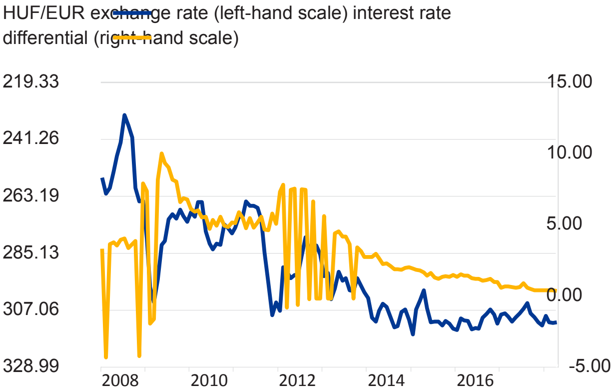
Sources: European System of Central Banks and European Commission (Eurostat, Directorate-General for Economic and Financial Affairs).

1) Multi-annual averages calculated using the arithmetic mean.
2) Data from the European Commission's Spring 2018 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 factors (sector reclassifications and statistical discrepancies).

Hungary - Exchange rate and external developments

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

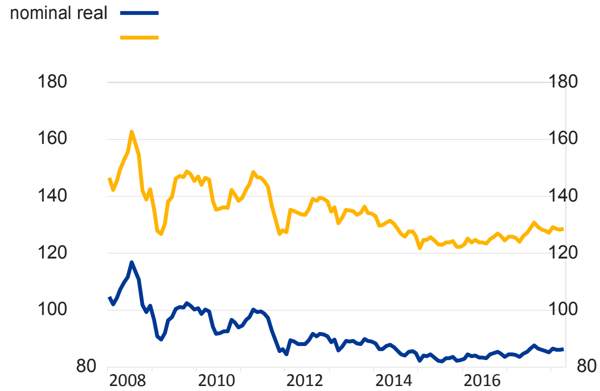
(HUF/EUR exchange rate: monthly averages; difference between three-month interbank interest rates and three-month EURIBOR: basis points, monthly values)



Sources: National data and ECB calculations.

Chart 5.4.4 Effective exchange rates [1)]

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



Source: ECB.

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

Table 5.4.3 External developments

(as a percentage of GDP, unless otherwise indicated)

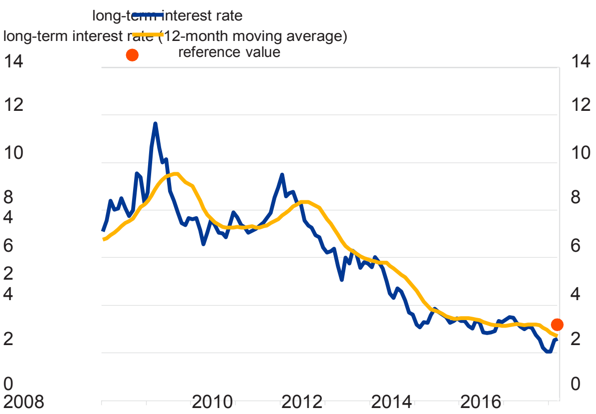
	2008-2017 [1)]	2008-2012 [1)]	2013-2017 [1)]	2013	2014	2015	2016	2017	2018 [2)]	2019 [2)]
Balance of payments										
Current account and capital account balance [3)]	3.5	0.9	6.1	7.3	5.2	8.0	5.9	4.0	4.1	3.8
Current account balance	1.3	-1.0	3.5	3.7	1.5	3.4	6.0	2.8	1.2	0.9
Goods	2.6	2.1	3.0	3.3	2.0	4.0	4.0	1.9	.	.
Services Primary	3.7	2.4	4.9	3.7	4.3	4.9	5.9	5.8	.	.
income	-4.2	-4.8	-3.6	-2.6	-4.2	-4.5	-2.5	-4.1	.	.
Secondary income Capital	-0.8	-0.7	-0.9	-0.6	-0.7	-1.0	-1.4	-0.9	.	.
account balance	2.2	1.9	2.6	3.6	3.7	4.6	0.0	1.2	.	.
Combined direct and portfolio investment balance [3)]	-0.6	-1.8	0.7	-3.0	0.3	2.7	1.9	1.4	.	.
Direct investment Portfolio	-1.7	-1.6	-1.8	0.0	-2.7	-2.3	-2.4	-1.7	.	.
investment	1.1	-0.3	2.5	-2.9	2.9	5.1	4.3	3.1	.	.
Other investment balance	1.8	-1.9	5.6	8.7	2.8	8.1	6.7	1.7	.	.
Reserve assets	1.0	3.5	-1.6	1.2	0.7	-4.4	-5.3	0.0	.	.
Exports of goods and services Imports	84.9	81.4	88.3	85.2	87.1	90.0	89.5	90.0	.	.
of goods and services	78.6	76.9	80.4	78.3	80.7	81.1	79.5	82.2	.	.
Net international investment position [4)]	-85.2	-101.7	-68.7	-83.1	-78.5	-67.1	-60.3	-54.6	.	.
Gross external debt [4)]	144.6	160.3	128.9	144.7	144.6	130.0	122.2	103.0	.	.
Internal trade with the euro area [5)]										
Exports of goods and services Imports	56.6	56.8	56.5	55.7	58.1	55.1	57.2	56.2	.	.
of goods and services	56.3	54.4	58.3	56.5	58.6	57.9	60.2	58.2	.	.
Investment position with the euro area [5)]										
Direct investment assets [4)] Direct	35.9	42.6	29.1	36.3	34.1	37.8	19.7	17.8	.	.
investment liabilities [4)] Portfolio	58.2	55.3	61.0	56.3	55.8	60.1	67.8	65.0	.	.
investment assets [4)] Portfolio	64.6	64.0	65.1	67.5	70.6	65.1	62.0	60.5	.	.
investment liabilities [4)]	46.1	53.1	39.0	45.3	41.9	38.1	34.7	35.0	.	.

Sources: European System of Central Banks and European Commission (Eurostat, Directorate-General for Economic and Financial Affairs).
Note: Backdata are available from 2008.

1) Multi-annual averages calculated using the arithmetic mean.
2) Data from the European Commission's Spring 2018 Economic Forecast.
3) Differences between totals and sum of their components are due to rounding.
4) End-of-period outstanding amounts.
5) As a percentage of the total.

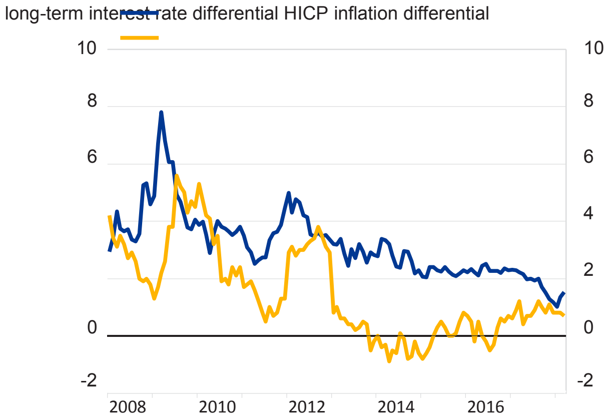
Hungary - Long-term interest rate developments

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



Sources: European System of Central Banks and ECB calculations.
1) The basis of the calculation of the reference value for the period from April 2017 to March 2018 is the unweighted arithmetic average of the interest rate levels in Cyprus, Ireland and Finland plus 2 percentage points. The reference value is 3.2%.

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



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

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

	2008-2017 [1]	2008-2012 [1]	2013-2017 [1]	2014	2015	2016	2017	Apr. 2017 to Mar. 2018	Memo item: euro area 2017
Long-term interest rates									
Hungary [2]	6.0	8.0	4.1	4.8	3.4	3.1	3.0	2.7	-
Euro area [2], [3]	2.8	4.0	1.6	2.0	1.2	0.9	1.1	1.1	-
Euro area AAA par curve, ten-year residual maturity [2], [3]	2.1	3.2	0.9	1.4	0.6	0.2	0.4	0.5	-
Indicators of financial development and integration									
Debt securities issued by financial corporations [4]	17.8	23.9	11.7	9.2	9.5	6.8	5.9	-	66.0
Debt securities issued by non-financial corporations [5]	1.7	1.8	1.7	1.9	1.1	1.9	1.4	-	11.3
Stock market capitalisation [6]	16.8	17.5	16.1	11.6	14.8	18.7	21.4	-	67.4
MFI credit to non-government residents [7]	52.0	63.2	40.7	44.6	38.3	37.0	35.3	-	108.1
Claims of euro area MFIs on resident MFIs [8]	13.9	21.2	6.5	8.0	5.7	3.7	3.4	-	26.3

Sources: European System of Central Banks and ECB calculations.
1) Multi-annual averages calculated using the arithmetic mean.
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 national central bank) 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 national central bank) held by euro area MFIs as a percentage of total liabilities of domestic MFIs (excluding the national central bank). Total liabilities exclude capital and reserves and remaining liabilities.

5.5 Poland

5.5.1 Price developments

In March 2018 the 12-month average rate of HICP inflation in Poland was 1.4%, i.e. below the reference value of 1.9% for the criterion on price stability (see Chart 5.5.1). This rate is expected to increase gradually over the coming months.

Over the past ten years the 12-month average rate of HICP inflation has fluctuated within a relatively wide range, from −0.7% to 4.3%, and the average for that period was moderate, standing at 2.0%. Between the beginning of 2008 and summer 2010, annual HICP inflation fell from a rate of around 4.5% to slightly below 2.0%, owing to a relatively short-lived economic slowdown – Poland was the only EU Member State that avoided a decline in output in 2009 – and lower global commodity prices. Thereafter, inflationary pressures re-emerged, supported by the robust recovery in economic activity and a hike in the value added tax rate in 2011. As a result, Narodowy Bank Polski had to increase interest rates over the period from 2011 to mid-2012. In 2012 the Polish economy slowed on account of weak domestic demand and unfavourable external conditions. The weakening of domestic economic activity, along with a significant fall in global commodity prices, contributed to a sharp decline in inflation over the period 2013-15. In 2015 the average annual rate of HICP inflation stood at −0.7%, despite the stronger rate of real GDP growth since mid-2013 and notwithstanding the fact that Narodowy Bank Polski cut its main policy rate to a historical low of 1.50% in March 2015. Since then the main policy rate has remained at that level. HICP inflation has risen gradually since mid-2016 on the back of relatively strong economic activity and increases in energy and food prices. In 2017 the average annual rate of HICP inflation stood at 1.6% (see Table 5.5.1).

In the first quarter of 2018 the average annual rate of HICP inflation stood at 1.0%. This low level of inflation contrasts with the ongoing buoyancy of domestic economic activity and unemployment rates that are falling to historically low levels. Overall, domestic price pressures remain subdued. This is also reflected in the low levels of HICP inflation excluding unprocessed food and energy, the annual rate of which was 0.8% in the first quarter of 2018.

Policy choices have played an important role in shaping inflation dynamics in Poland over the past decade, most notably the orientation of monetary policy towards price stability. Narodowy Bank Polski operates a floating exchange rate system and since 1998 has had an inflation-targeting monetary policy framework in place. The medium-term CPI inflation target has been 2.5% (±1 percentage point) since 2004. Inflation developments have been broadly supported by a number of reforms designed to strengthen financial market stability, increase labour market flexibility and enhance product market competition.

Inflation is expected to increase over the coming years, and over the longer term there are concerns about the sustainability of inflation convergence in Poland. According to the European Commission's Spring 2018 Economic Forecast, average annual HICP inflation is projected to fall to 1.3% in 2018, before increasing to 2.5% in 2019. Relatively strong real GDP growth and further declines in the unemployment rate are likely to support a pick-up in inflation towards the central bank's inflation target. The risks to the inflation outlook are broadly balanced. Upside risks may arise from stronger than expected wage pressures on the back of tightening labour market conditions and the uncertainty about the outlook for oil prices. Downside risks relate to heightened uncertainty regarding developments in the global economy, which could reduce external price pressures. Looking further ahead, the catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area, given that GDP per capita and price levels are still lower in Poland than in the euro area, unless this is counteracted by an appreciation of the nominal exchange rate. In order to prevent the build-up of excessive price pressures and macroeconomic imbalances, the catching-up process must be supported by appropriate policies.

Achieving an environment that is conducive to sustainable convergence in Poland requires stability-oriented economic policies and targeted structural reforms. Although the Polish economy managed to weather the global financial crisis comparatively well, a number of structural issues remain unresolved. In order to enhance potential growth and resource allocation, efforts are needed to boost competition in product markets and speed up innovation, privatisation and infrastructure modernisation. Improvements in the business environment and the rule of law could help to attract private investment. In the labour market, a number of structural weaknesses need to be addressed, for example, by strengthening vocational education and reducing labour market mismatches, as well as by boosting the labour force participation rate. It is also essential that structural reforms are carried out to tackle disincentives to work, particularly those resulting from income taxation and pension schemes. With regard to macroeconomic imbalances, the European Commission did not select Poland for an in-depth review in its Alert Mechanism Report 2018.

Financial sector policies should be geared to safeguarding financial stability and ensuring that the financial sector makes a sound contribution to economic growth. In view of the tax on financial institutions' assets that was introduced in February 2016, the sharp increase in the share of state-controlled credit institutions in 2017 and the ongoing uncertainty regarding the regulation on the conversion of foreign exchange-denominated mortgage loans, it is essential to preserve the currently strong financial position of the banking sector. This would help to maintain foreign investors' confidence and support the supply of credit to the real economy.

The Polish Resolution Act[140], which implements the Bank Recovery and Resolution Directive[141], was adopted in June 2016 and entered into force in October 2016. In order to further bolster confidence in the financial system, the national competent

[140] Act of 10 June 2016 on the Bank Guarantee Fund, Deposit Guarantee Scheme and Resolution.

[141] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council (OJ L 173, 12.6.2014, p. 190).

authority should continue to improve its supervisory practices, among other things, by following the applicable recommendations from the relevant international and European bodies, and by collaborating closely with other national supervisors of EU countries within the supervisory colleges.

5.5.2 Fiscal developments

Poland's government deficit and debt complied with the Maastricht criteria in 2017. In the reference year 2017 the general government budget balance recorded a deficit of 1.7% of GDP, i.e. well below the 3% reference value. The general government gross debt-to-GDP ratio was 50.6%, i.e. below the 60% reference value (see Table 5.5.2). Compared with the previous year, the deficit and debt ratios fell by 0.7 and 3.5 percentage points of GDP respectively. The deficit ratio is forecast by the European Commission to remain broadly at the same level in 2018 and 2019, on the basis of unchanged policies for the latter year. The debt-to-GDP ratio is also projected to stabilise at around 49% in 2018 and 2019. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2017, nor is it expected to do so in 2018.

Poland has been subject to the preventive arm of the Stability and Growth Pact since 2015. The ECOFIN Council abrogated the excessive deficit procedure in Poland on 19 June 2015, one year earlier than the extended deadline. While the deficit was above the 3% of GDP reference value in 2014, the Council found Poland to be eligible for specific provisions under the excessive deficit procedure that deal with systemic pension reforms. However, the European Commission's Spring 2018 Economic Forecast points to risks of a significant deviation from the requirements of the preventive arm in 2018 (i.e. the adjustment of the structural balance by 0.5% of GDP and the expenditure benchmark).

The recent reduction in the deficit is attributable to both non-cyclical factors and the economic upswing. The deficit ratio declined from 2.6% of GDP in 2015 to 1.7% of GDP in 2017. According to European Commission estimates (presented in Table 5.5.2), the cyclical component of the deficit has recently contributed to a greater extent than the improvement in the structural balance. The better than expected performance of the fiscal balance in 2017 reflects both better cyclical economic developments and stronger tax compliance, primarily as a result of improvements in VAT collection. In addition, the fiscal balance continued to benefit from a considerable reduction in the interest bill in relation to GDP.

The debt-to-GDP ratio increased notably in 2015 and 2016, but subsequently declined, remaining below the 60% reference value. The debt ratio increased by about 3 percentage points over 2015-16, reaching around 54% of GDP, mainly on account of unfavourable deficit-debt adjustments. It then declined by 3.5 percentage points in 2017, supported by strong economic growth and a favourable deficit-debt adjustment. In the coming years, debt is expected to be broadly stable, as these factors subside. The government has not reported any contingent liabilities related to the financial sector.

The structure of government debt exposes Poland to some extent to changes in interest rates and exchange rate fluctuations. While the share of short-term debt in total government debt is negligible (0.8% in 2017 – see Table 5.5.2), a proportion of medium and long-term debt (around 21% in 2017) is subject to a variable interest rate. Overall, taking both characteristics and the level of the debt-to-GDP ratio into consideration, the budget balance remains relatively sensitive to changes in interest rates. The share of foreign currency-denominated government debt is high (31.8% in 2017), with around 81% denominated in euro. As a result, and taking the debt-to-GDP ratio into account, the fiscal balance is relatively sensitive to exchange rate fluctuations.

The European Commission's Spring 2018 Economic Forecast points to the risk of a significant deviation from the adjustment path towards the medium-term objective. The European Commission's Spring 2018 Economic Forecast indicates a deterioration in the structural balance by 0.1 percentage point of GDP in 2018. This represents a significant deviation from the improvement of 0.5 percentage point of GDP that is required under the preventive arm of the Stability and Growth Pact. The government's plans presented in the 2018 Convergence Programme update assume that the headline and structural deficit ratios will slowly decline over the projection horizon after increasing in 2018. The headline deficit is projected by the government to be 2.1% of GDP in 2018 and 1.5% of GDP in 2019. The structural deficit is expected to deteriorate by 0.7 of a percentage point of GDP in 2018, reaching a peak of 2.8% of GDP, but then to decrease to 2.3% of GDP in 2019. This would imply at a slower pace than the Stability and Growth Pact requires, at least in 2018. Strong macroeconomic conditions are expected to support revenue collection, while expenditures are seen increasing owing to higher public investment (in line with the acceleration of absorption of EU funds from the 2014-20 EU Financial Framework) and pension spending. However, Poland is not expected, according to the government's projection, to achieve its medium-term objective of a structural deficit of 1.0% of GDP by 2021. The fiscal strategy is not yet fully underpinned by specific measures.

The Polish fiscal framework is robust, but its effectiveness has room to improve in practice. The constitutional debt rule provides a safeguard against exceeding the 60% reference value. The medium-term budgetary planning is based on the Multiannual State Financial Plan, and a permanent expenditure rule limiting the growth of public spending to trend GDP growth (or below if government debt is above pre-specified thresholds) has been in place since 2015. However, the lowering of the legal retirement age back to 65 years for men and 60 for women, which was enacted in October 2017, will result in higher pension spending. Tax compliance has benefited from the recent implementation of a broad range of measures. VAT revenue, especially, grew at a faster pace than implied by macroeconomic developments in 2017. Also the fiscal system for private sector business has been streamlined, with a set of new regulations in 2017. Policies aimed at improving tax collection should be continued. Moreover, in line with the provisions of the fiscal compact, Poland should, before joining the euro area, put in place the institutions responsible at national level for monitoring compliance with EU fiscal rules and ensure their independence.

Over the medium and long term, Poland faces medium risks to fiscal sustainability. The analysis laid out in the European Commission's 2018 Debt Sustainability Report points to medium risk over the medium and long term[142]. This stems largely from an unfavourable initial budgetary position, mainly due to a negative structural balance. Regarding age-related costs, the 2015 Ageing Report, prepared by the Ageing Working Group (AWG),[143] projects a moderate rise (of 1.3 percentage point) by 2060 in the AWG's reference scenario, from a level of 20.7% of GDP in 2013). In the AWG's risk scenario, ageing costs increase notably over the period (by 3.3 percentage points of GDP), albeit by less than the EU average of 3.8 percentage points. The expected increase is entirely driven by healthcare and long-term care spending, whereas pension and education spending act as mitigating factors. The costs associated with the recent decrease in the retirement age will be around 0.3% of GDP in the short term. These developments signal the need for reforms in order to address the expected spending pressures.

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

5.5.3 Exchange rate developments

In the two-year reference period from 4 May 2016 to 3 May 2018, the Polish zloty did not participate in ERM II, but traded under a flexible exchange rate regime. Over most of the reference period the Polish zloty traded significantly stronger than its May 2016 average exchange rate against the euro of 4.4039 zlotys per euro, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate (see Chart 5.5.3). On 3 May 2018 the exchange rate stood at 4.2628 zlotys per euro, i.e. 3.2% stronger than its average level in May 2016. Over the reference period the maximum upward deviation from this benchmark was 5.9%, while the maximum downward deviation amounted to 2.2%. Over the past ten years the exchange rate of the Polish zloty against the euro has depreciated by 25.2%, although the beginning of that period was marked by the effects of the global financial crisis.

[142] However, this assessment does not necessarily reflect the uncertainty surrounding the long-term assumptions and, for high-debt countries, has to be taken with caution.

[143] European Commission and Economic Policy Committee, "The 2015 Ageing Report: Economic and budgetary projections for the 28 EU Member States (2013-2060)", *European Economy series*, No 3, European Commission, 2015.

The exchange rate of the Polish zloty against the euro exhibited, on average, a relatively high degree of volatility over the reference period. However, exchange rate volatility overall tended to decrease somewhat over the reference period, reflecting a stable main policy rate, improved domestic conditions and no major disturbances in global financial markets. After some fluctuations within a relatively narrow range in the second half of 2016, the Polish zloty appreciated against the euro from the end of 2016, a trend that was only temporarily interrupted in the third quarter of 2017. The appreciation of the Polish zloty took place in a context of broadly stable short-term interest rate differentials vis-à-vis euro area assets and the gradual normalisation of monetary policy by the Federal Reserve System from the end of 2015. Exchange rate developments may therefore have mostly reflected the strong and resilient macroeconomic performance of the Polish economy. Over the reference period short-term interest rate differentials against the three-month EURIBOR remained, on average, relatively wide on account of monetary policy rates being higher in Poland than in the euro area. The spreads have remained largely stable at around 2.0 percentage points over the reference period. A Flexible Credit Line (FCL) arrangement with the IMF was in place between mid-2009 and November 2017. Over the reference period, the FCL amounted to SDR 13 billion until January 2017, when it was renewed for a reduced amount of SDR 6.5 billion. This further signalled Poland's intention to exit the FCL, which eventually occurred in November 2017. Poland did not receive any disbursements over the entire period that the FCL was in place. As this arrangement helped to reduce risks related to financial vulnerabilities, it might also have contributed to reducing the risk of exchange rate pressures.

The real effective exchange rate of the Polish zloty has depreciated over the past ten years (see Chart 5.5.4). Following a period of increased volatility at the height of the global financial crisis, the real effective exchange rate weakened until 2016, when it started on its recent appreciation trend. However, this indicator should be interpreted with caution, as during this period Poland was subject to a process of economic convergence, which complicates any historical assessment of real exchange rate developments.

Poland's current and capital account has improved over the past ten years, while the country's net foreign liabilities remain high (see Table 5.5.3).
Following relatively large deficits in the period 2008-12, the current and capital account subsequently recorded a small surplus. This mostly reflected an improvement in the goods and services balance on account of strengthening exports. On the financing side, Poland received net inflows in direct and portfolio investment from 2008 to 2017. Gross external debt increased up to 2016 and declined in 2017, reaching 67.7% of GDP. Over this period Poland's net international investment position deteriorated, reaching -61.9% of GDP in 2017. Fiscal and structural policies therefore continue to be important for supporting external sustainability and the competitiveness of the economy.

The Polish economy is well integrated with the euro area through trade and investment linkages.
In 2017 exports of goods and services to the euro area constituted 55.7% of total exports, while the corresponding figure for imports was

slightly higher at 58.0%. In 2017 the share of the euro area in Poland's stock of inward direct investment stood at 78.5%, and its share in the country's stock of portfolio investment liabilities was 36.8%. The share of Poland's stock of foreign assets invested in the euro area amounted to 56.6% in the case of direct investment and 42.8% for portfolio investment in 2017.

5.5.4 Long-term interest rate developments

Over the reference period from April 2017 to March 2018, long-term interest rates in Poland stood at 3.3% on average and were thus just above the reference value for the interest rate convergence criterion (see Chart 5.5.5).

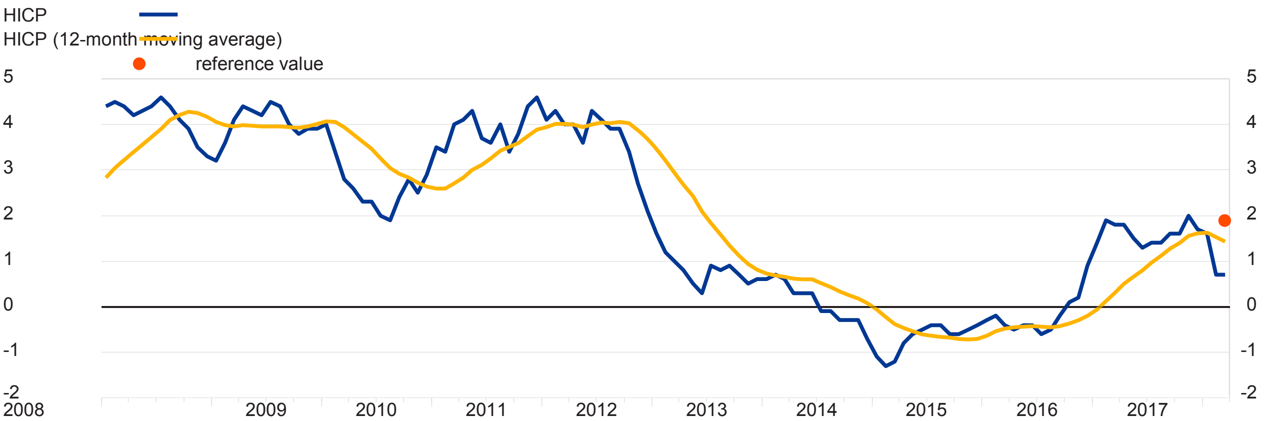
Long-term interest rates in Poland started to decline some time after the start of the financial crisis in 2009 (see Chart 5.5.5). From 2009 to 2010 long-term interest rates in Poland hovered around 6%. In 2011 Narodowy Bank Polski implemented a series of hikes in its policy rate to counteract rising inflation in the context of a buoyant economy. Over the next two years spillover effects from the global and euro area crises also pushed up credit default swap spreads, despite an improvement in Poland's fiscal stance. From 2012 – except for the second half of 2013 – Polish long-term interest rates fell continuously owing to slower domestic and global economic growth in combination with the loose monetary policy stance in the euro area and other major jurisdictions, to stand at only slightly above 2% at the beginning of 2015. Since then they have been rising steadily on the back of stronger economic growth and higher than expected inflation, reaching 3.3% in March 2018. Credit default spreads remain low by historical standards and also in comparison with the peer countries in the region. Currently, Poland's government debt is rated investment-grade by all of the three main rating agencies.

Poland's long-term interest rate differential vis-à-vis the euro area has fluctuated within a relatively small range since 2008 (see Chart 5.5.6). For most of the period the interest rate differential has moved within a band of between approximately 1 and 2 percentage points. Only in 2009 and 2010 did it consistently exceed 2 percentage points, peaking at around 2.6 percentage points towards the end of 2009. With the subsequent reductions in Poland's long-term interest rates between 2011 and 2013 having been somewhat more pronounced than in the euro area, it reached a low point of 0.6 percentage point in spring 2013. Since then it has increased again, following the end of the previous easing cycle, amid expectations of a gradual economic recovery. However, standing at 2.2 percentage points in March 2018, the interest rate differential continues to be at levels broadly in line with those observed over the past ten years (2.7 percentage points vis-à-vis the euro area AAA yield).

Capital markets in Poland are smaller and much less developed than in the euro area (see Table 5.5.4). The market for both financial and non-financial corporate debt was still much smaller than the euro area average at the end of 2017. In the same year stock market capitalisation increased to more than 30% of GDP, one of the highest levels in the region. The integration of Poland's financial sector with the euro area, as measured by the claims of euro area banks on Polish banks, is limited. Claims of euro area MFIs accounted for slightly over 4% of Polish banks' liabilities at the end of 2017. The degree of financial intermediation in Poland is in line with the peer countries in the region and, as measured by the credit extended by MFIs to the private sector, amounted to 56.0% of GDP in 2017 (compared with around 110% in the euro area). Foreign ownership of banks in Poland, while remaining elevated, has declined markedly in recent years on the back of government initiatives.

Poland - Price developments

Chart 5.5.1 HICP inflation and reference value [1)]
(annual percentage changes)



Sources: European Commission (Eurostat) and ECB calculations.
1) The basis of the calculation of the reference value for the period from April 2017 to March 2018 is the unweighted arithmetic average of the annual percentage changes in the HICP for Cyprus, Ireland and Finland plus 1.5 percentage points. The reference value is 1.9%.

Table 5.5.1 Measures of inflation and related indicators
(annual percentage changes, unless otherwise indicated)

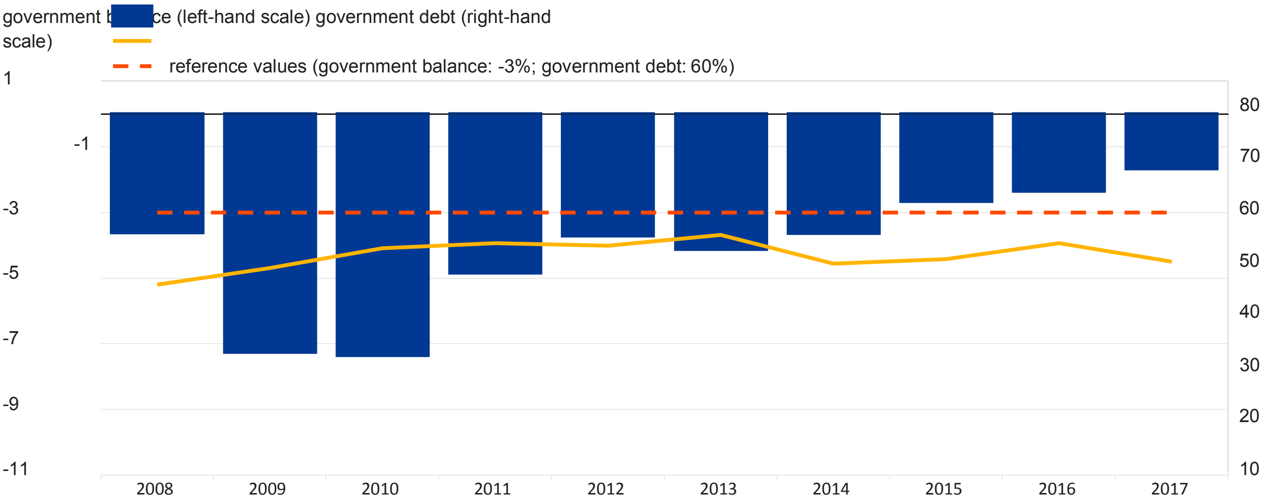
	2008-2017 [1)]	2008-2012 [1)]	2013-2017 [1)]	2013	2014	2015	2016	2017	2018 [2)]	2019 [2)]
Measures of inflation										
HICP	2.0	3.7	0.3	0.8	0.1	-0.7	-0.2	1.6	1.3	2.5
HICP excluding unprocessed food and energy	1.8	3.0	0.7	1.0	0.6	0.3	0.3	1.1	0.9	2.5
HICP at constant tax rates [3)]	1.7	3.1	0.2	0.5	-0.3	-0.7	-0.2	1.6	-	-
CPI	2.0	3.7	0.3	0.9	0.0	-0.9	-0.6	2.0	1.5	2.5
Private consumption deflator	1.8	3.5	0.1	0.4	-0.1	-1.1	-0.4	1.9	1.5	2.5
GDP deflator	1.9	3.0	0.7	0.3	0.5	0.8	0.3	1.9	1.7	2.4
Producer prices [4)]	2.2	4.5	-0.1	-1.2	-1.4	-2.4	0.0	4.8	-	-
Related indicators										
Real GDP growth	3.3	3.5	3.2	1.4	3.3	3.8	3.0	4.6	4.3	3.7
GDP per capita in PPS [5)] (euro area = 100)	60.0	57.2	63.6	62.6	63.3	64.2	64.2	.	-	-
Comparative price levels (euro area = 100)	56.2	57.9	54.1	54.4	55.0	54.5	52.7	.	-	-
Output gap [6)]	0.4	1.5	-0.6	-1.4	-1.2	-0.6	-0.6	0.7	1.5	1.5
Unemployment rate (%) [7)]	8.3	8.9	7.6	10.4	9.0	7.5	6.2	4.9	4.1	3.9
Unit labour costs, whole economy	1.7	2.8	0.7	0.2	0.6	-0.6	2.6	0.7	3.2	3.9
Compensation per employee, whole economy	4.3	5.9	2.8	1.7	2.2	1.7	5.1	4.0	6.8	7.4
Labour productivity, whole economy	2.6	3.0	2.2	1.5	1.5	2.3	2.4	3.2	3.5	3.4
Imports of goods and services deflator	2.0	4.8	-0.6	-1.1	-1.9	-1.3	-0.3	1.5	1.5	1.7
Nominal effective exchange rate [8)]	-1.1	-2.4	0.2	1.4	1.6	-2.8	-2.4	3.4	-	-
Money supply (M3) [9)]	8.8	10.0	7.6	6.2	7.8	8.9	9.1	5.9	-	-
Lending from banks [10)]	7.6	10.1	5.2	4.0	5.4	5.8	3.8	7.3	-	-
Stock prices (Warsaw General Index) [11)]	14.5	-14.7	34.3	8.1	0.3	-9.6	11.4	23.2	-	-
Residential property prices [12)]	0.0	-1.7	0.7	-4.4	1.0	1.5	1.9	3.9	-	-

Sources: European Commission (Eurostat, Directorate-General for Economic and Financial Affairs), 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 2018 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 from 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 2011.

Poland - Fiscal developments

Chart 5.5.2 General government balance and debt

(as a percentage of GDP)



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

Table 5.5.2 Government budgetary developments and projections

(as a percentage of GDP, unless otherwise indicated)

	2008-2017 1)	2008-2012 1)	2013-2017 1)	2013	2014	2015	2016	2017	2018 2)	2019 2)	2020	2021
Government balance	**-4.1**	**-5.3**	**-2.9**	**-4.1**	**-3.6**	**-2.6**	**-2.3**	**-1.7**	**-1.4**	**-1.4**	-	-
Total revenue	39.0	39.0	38.9	38.5	38.6	38.9	38.8	39.6	40.3	40.5	-	-
Current revenue	38.0	38.0	38.0	37.5	37.5	37.8	38.2	38.8	39.2	39.2	-	-
Direct taxes	7.1	7.2	7.0	6.7	6.8	6.9	7.1	7.4	7.4	7.4	-	-
Indirect taxes	13.4	13.6	13.1	12.9	12.8	12.8	13.5	13.7	13.9	13.6	-	-
Net social contributions	12.9	12.3	13.6	13.4	13.2	13.5	13.8	13.9	14.1	14.3	-	-
Other current revenue 3)	4.6	4.9	4.3	4.6	4.6	4.5	3.8	3.9	3.8	3.8	-	-
Capital revenue	1.0	1.1	0.9	1.0	1.2	1.1	0.6	0.8	1.1	1.3	-	-
Total expenditure	43.1	44.4	41.8	42.6	42.3	41.6	41.1	41.2	41.7	41.9	-	-
Current expenditure	37.9	38.5	37.3	38.1	37.3	36.8	37.4	36.8	36.7	36.8	-	-
Compensation of employees	10.5	10.7	10.3	10.4	10.4	10.2	10.2	10.1	10.0	10.1	-	-
Social benefits	16.4	16.1	16.6	16.4	16.3	16.2	17.2	17.0	17.2	17.1	-	-
Interest payable	2.2	2.4	1.9	2.5	1.9	1.8	1.7	1.6	1.5	1.5	-	-
Other current expenditure 4)	8.8	9.2	8.5	8.8	8.7	8.6	8.3	8.1	8.1	8.1	-	-
Capital expenditure	5.2	5.9	4.5	4.5	5.0	4.8	3.7	4.4	5.0	5.1	-	-
of which: Investment	4.6	5.2	4.0	4.1	4.5	4.4	3.3	3.7	4.4	4.5	-	-
Cyclically adjusted balance	-4.3	-6.1	-2.6	-3.4	-3.0	-2.3	-2.0	-2.0	-2.2	-2.2	.	.
One-off and temporary measures	.	.	0.0	0.0	-0.2	0.0	0.0	0.0	0.0	0.0	.	.
Structural balance 5)	.	.	-2.5	-3.4	-2.8	-2.3	-2.0	-2.0	-2.2	-2.2	.	.
Government debt	**51.9**	**51.3**	**52.4**	**55.7**	**50.3**	**51.1**	**54.2**	**50.6**	**49.6**	**49.1**	-	-
Average residual maturity (in years)	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	.	.	.	.
In foreign currencies (% of total)	30.9	28.4	33.4	29.8	35.3	34.9	35.1	31.8	.	.	.	.
of which: Euro	22.9	20.3	25.4	21.8	26.0	26.4	27.2	25.7	.	.	.	.
Domestic ownership (% of total)	50.9	56.5	45.3	49.3	42.0	42.2	45.6	47.5	.	.	.	.
Medium and long-term maturity (% of total) 6)	97.6	95.8	99.4	99.9	99.6	99.0	99.2	99.2	.	.	.	.
of which: Variable interest rate (% of total)	16.0	12.1	20.0	17.6	18.9	21.0	21.0	21.4	.	.	.	.
Deficit-debt adjustment	**-1.0**	**-0.4**	**-1.5**	**-1.2**	**-7.0**	**0.4**	**2.3**	**-1.8**	.	.	.	.
Net acquisitions of main financial assets	-0.5	-0.8	-0.2	-1.5	0.8	-1.0	0.9	0.0	.	.	.	.
Currency and deposits	0.0	0.1	-0.1	-1.1	0.6	-0.9	0.9	-0.2	.	.	.	.
Debt securities	0.0	0.0	0.1	0.2	-0.2	0.0	0.1	0.2	.	.	.	.
Loans	0.0	0.0	0.0	0.0	0.2	0.0	0.1	0.0	.	.	.	.
Equity and investment fund shares or units	-0.5	-0.9	-0.1	-0.6	0.2	-0.1	-0.2	0.0	.	.	.	.
Revaluation effects on debt	0.4	0.5	0.3	0.0	1.2	0.5	1.0	-1.2	.	.	.	.
of which: Foreign exchange holding gains/losses	0.3	0.4	0.1	-0.1	0.9	0.5	0.8	-1.4	.	.	.	.
Other 7)	-0.9	-0.2	-1.6	0.2	-9.0	0.9	0.4	-0.6	.	.	.	.
Convergence programme: government balance	-	-	-	-	-	-	-	-	-2.1	-1.5	-1.1	-0.7
Convergence programme: structural balance	-	-	-	-	-	-	-	-	-2.8	-2.3	-1.8	-1.3
Convergence programme: government debt	-	-	-	-	-	-	-	-	50.4	50.4	48.7	46.0

Sources: European System of Central Banks and European Commission (Eurostat, Directorate-General for Economic and Financial Affairs).

1) Multi-annual averages calculated using the arithmetic mean.
2) Data from the European Commission's Spring 2018 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 factors (sector reclassifications and statistical discrepancies).

Poland - Exchange rate and external developments

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

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

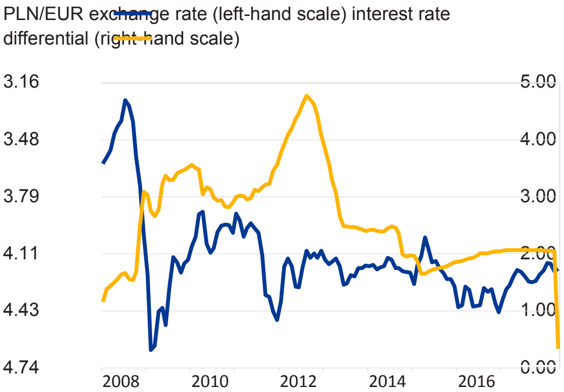
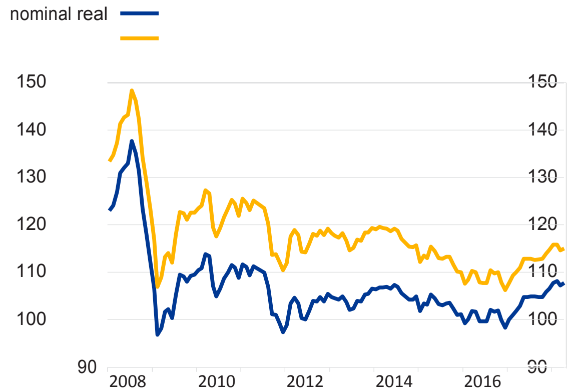


Chart 5.5.4 Effective exchange rates 1)

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



Sources: National data and ECB calculations.

Source: ECB.

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

Table 5.5.3 External developments

(as a percentage of GDP, unless otherwise indicated)

	2008-2017 [1]	2008-2012 [1]	2013-2017 [1]	2013	2014	2015	2016	2017	2018 [2]	2019 [2]
Balance of payments										
Current account and capital account balance [3]	-1.1	-3.2	1.1	1.0	0.4	1.8	0.8	1.6	1.5	1.5
Current account balance	-2.9	-4.9	-0.8	-1.3	-2.1	-0.6	-0.3	0.3	0.3	0.0
Goods	-1.7	-3.4	0.1	-0.1	-0.8	0.5	0.7	0.2	.	.
Services Primary	2.1	1.3	2.8	1.9	2.2	2.5	3.3	4.0	.	.
income	-3.2	-2.8	-3.5	-3.0	-3.4	-3.4	-4.0	-3.8	.	.
Secondary income Capital	-0.1	0.0	-0.2	-0.1	-0.1	-0.2	-0.3	0.0	.	.
account balance	1.8	1.7	1.9	2.3	2.4	2.4	1.1	1.3	.	.
Combined direct and portfolio investment balance [3]	-3.3	-5.0	-1.5	-0.8	-1.9	-1.5	-2.0	-1.3	.	.
Direct investment Portfolio	-1.6	-1.8	-1.4	-0.8	-2.4	-2.1	-1.2	-0.3	.	.
investment	-1.7	-3.2	-0.1	0.0	0.4	0.7	-0.8	-1.0	.	.
Other investment balance	-0.8	-2.1	0.5	-0.3	0.7	1.6	-3.0	3.4	.	.
Reserve assets	1.3	2.2	0.7	0.2	0.1	0.2	4.8	-1.5	.	.
Exports of goods and services Imports	45.0	40.1	49.9	46.0	47.4	49.3	52.3	54.2	.	.
of goods and services	44.6	42.2	47.0	44.2	46.0	46.3	48.3	50.0	.	.
Net international investment position [4]	-61.8	-59.5	-64.0	-69.6	-67.7	-61.0	-60.1	-61.9	.	.
Gross external debt [4]	66.7	62.5	71.0	70.5	71.2	70.5	75.1	67.7	.	.
Internal trade with the euro area [5]										
Exports of goods and services Imports	55.8	56.2	55.6	54.1	55.5	56.6	56.1	55.7	.	.
of goods and services	58.0	57.7	58.2	57.5	57.6	58.7	59.3	58.0	.	.
Investment position with the euro area [5]										
Direct investment assets [4] Direct	62.0	60.0	63.1	65.6	64.5	65.7	63.2	56.6	.	.
investment liabilities [4] Portfolio	76.9	74.8	78.1	77.4	78.5	77.8	78.6	78.5	.	.
investment assets [4] Portfolio	53.6	54.2	53.3	59.3	58.9	57.8	47.6	42.8	.	.
investment liabilities [4]	42.7	46.0	39.3	42.7	40.6	37.3	39.1	36.8	.	.

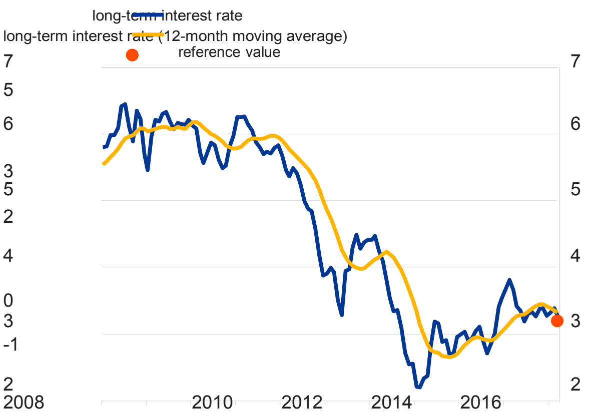
Sources: European System of Central Banks and European Commission (Eurostat, Directorate-General for Economic and Financial Affairs).

Note: Backdata are available from 2008.

1) Multi-annual averages calculated using the arithmetic mean.
2) Data from the European Commission's Spring 2018 Economic Forecast.
3) Differences between totals and sum of their components are due to rounding.
4) End-of-period outstanding amounts.
5) As a percentage of the total.

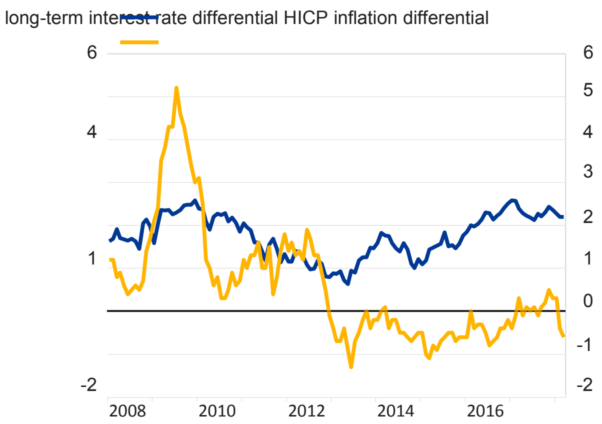
Poland - Long-term interest rate developments

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



Sources: European System of Central Banks and ECB calculations.
1) The basis of the calculation of the reference value for the period from April 2017 to March 2018 is the unweighted arithmetic average of the interest rate levels in Cyprus, Ireland and Finland plus 2 percentage points. The reference value is 3.2%.

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



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

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

	2008-2017 1)	2008-2012 1)	2013-2017 1)	2014	2015	2016	2017	Apr. 2017 to Mar. 2018	Memo item: euro area 2017
Long-term interest rates									
Poland 2)	4.6	5.8	3.3	3.5	2.7	3.0	3.4	3.3	-
Euro area 2), 3)	2.8	4.0	1.6	2.0	1.2	0.9	1.1	1.1	-
Euro area AAA par curve, ten-year residual maturity 2), 3)	2.1	3.2	0.9	1.4	0.6	0.2	0.4	0.5	-
Indicators of financial development and integration									
Debt securities issued by financial corporations 4)	8.0	6.8	9.1	8.5	7.8	8.6	10.0	-	66.0
Debt securities issued by non-financial corporations 5)	4.1	3.2	5.0	4.9	5.0	5.6	5.3	-	11.3
Stock market capitalisation 6)	30.3	29.0	31.5	33.6	28.3	28.6	32.1	-	67.4
MFI credit to non-government residents 7)	53.3	50.7	55.9	55.4	56.9	57.8	56.0	-	108.1
Claims of euro area MFIs on resident MFIs 8)	8.6	11.6	5.7	5.8	5.4	4.8	4.3	-	26.3

Sources: European System of Central Banks and ECB calculations.
1) Multi-annual averages calculated using the arithmetic mean.
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 national central bank) 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 national central bank) held by euro area MFIs as a percentage of total liabilities of domestic MFIs (excluding the national central bank). Total liabilities exclude capital and reserves and remaining liabilities.

5.6 Romania

5.6.1 Price developments

In March 2018 the 12-month average rate of HICP inflation in Romania was 1.9%, i.e. at the reference value of 1.9% for the criterion on price stability (see Chart 5.6.1). This rate is expected to increase significantly over the coming months.

Over the past ten years the 12-month average rate of HICP inflation has fluctuated within a relatively wide range, from −1.7% to 8%, and the average for that period was elevated, standing at 3.4%. In 2008 HICP inflation peaked at the high level of 7.9% amid signs of overheating in the Romanian economy in the years leading up to the global financial crisis. The subsequent deceleration in inflation was supported by a sharp contraction in economic activity in 2009 and 2010, which was followed by a rather moderate recovery (see Table 5.6.1). Following three years of wage cuts, mainly in the public sector, from 2009 to 2011 (including a 25% cut in public sector wages in 2010), compensation per employee rose again as of 2012, albeit at a somewhat lower rate than before 2009. In 2014 and, in particular, in 2015, inflation declined to historically low levels, closely reflecting developments in energy and food prices, which together represent around 50% of Romania's HICP basket of goods and services. The fall in HICP inflation was also driven by successive cuts in indirect taxes. In particular, on the back of a reduction in the value added tax (VAT) rate from 24% to 9% on food items, non-alcoholic beverages and food services, which took place in June 2015, HICP inflation declined sharply and entered into negative territory. Further tax cuts and the reduction of excise duties in 2016 and 2017 meant that HICP inflation remained negative throughout 2016, before turning positive again at the beginning of 2017. Additional fiscal stimuli, sharp increases in public and minimum wages and a positive output gap fuelled inflationary pressures and, along with temporary supply-side factors, pushed up the rate of inflation in the fourth quarter of that year. This, together with the inflation outlook, led Banca Naţională a României to narrow the interest rate corridor on standing facilities around the policy rate by +/-0.25 percentage point in October and November 2017 to the standard width of +/-1 percentage point and to step up this adjustment of the monetary policy stance by raising the key policy rate from the historically low levels it had stood at since May 2015, from 1.75% to 2% in January 2018 and to 2.25% the following month.

In the first quarter of 2018 the average annual rate of HICP inflation stood at 3.7%. The significant increase in the rate of inflation partly reflects statistical effects from past cuts in indirect taxes and fees. Fiscal stimuli and income policies aimed at boosting household consumption resulted in two-digit increases in compensation per employee, thus adding to inflationary pressures. HICP inflation has risen against the backdrop of a moderate increase in inflation across the globe, buoyant growth in real GDP supported by an expansionary fiscal policy and a positive output gap.

Policy choices have played an important role in shaping inflation dynamics in Romania over the past decade, most notably the orientation of monetary

policy towards price stability. In 2005 Banca Naţională a României shifted to an inflation-targeting framework combined with a managed floating exchange rate regime. The annual CPI inflation target was initially set at 7.5% and was reduced gradually to stand at 2.5% starting in 2013, with a 1 percentage point variation band around the central target.

Inflation is expected to increase in the coming years, and over the longer term there are serious concerns regarding the sustainability of inflation convergence in Romania. According to the European Commission's Spring 2018 Economic Forecast, average annual HICP inflation is expected to pick up further to 4.2% in 2018, before tempering to 3.4% in 2019. The risks surrounding the forecast are broadly balanced. Upside risks are associated with increasing wage pressure on the back of wage hikes in the public sector and a series of minimum wage increases, as well as the tightness of labour market conditions. Moreover, in addition to the uncertainty about the outlook for oil prices, there are risks stemming from the persistent uncertainty regarding the progress made on structural reforms and from potential fiscal slippages in the context of an unstable political environment, which could, in turn, lead to depreciation pressures on the leu. Downside risks to the inflation outlook are related to the heightened uncertainty regarding developments in the global economy, which could reduce external price pressures. Looking further ahead, the catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area, given that GDP per capita and price levels are still significantly lower in Romania than in the euro area, unless this is counteracted by an appreciation of the nominal exchange rate. In order to prevent the build-up of excessive price pressures and macroeconomic imbalances, the catching-up process must be supported by appropriate policies.

Achieving an environment that is conducive to sustainable convergence in Romania requires stability-oriented economic policies and wide-ranging structural reforms. To enhance growth prospects and competitiveness, it is essential to advance structural reforms (including the fight against corruption) and to enhance the quality and efficiency of the public administration, the country's institutions and the judicial system. More specifically, the government should further increase competition, including by implementing product market reforms that would boost private investment. Improving Romania's very weak absorption of EU funds also warrants attention, in particular with a view to improving the quality of the infrastructure in the energy and transport sectors. Turning to the labour market, measures aimed at reducing sizeable skill mismatches and shortages need to be stepped up to reduce labour market tensions. With regard to macroeconomic imbalances, the European Commission did not select Romania for an in-depth review in its Alert Mechanism Report 2018, but highlighted issues related to its external position and the sustainability of its fiscal policy.

Financial sector policies should be geared to continuing to safeguard financial stability and ensuring that the financial sector makes a sound contribution to economic growth. In order to safeguard financial sector stability in the future, it is of utmost importance to continue the clean-up of bank balance sheets and to support a sustainable recovery in lending, in particular to non-financial corporations. While specific policy measures have significantly reduced the volume of non-performing loans and foreign exchange exposures, there is a risk to financial stability stemming from emerging concerns about the procyclical fiscal stance prompting the return of macroeconomic imbalances. In order to further bolster confidence in the financial system, the national competent authorities should continue to improve their supervisory practices, among other things, by following the applicable recommendations from the relevant international and European bodies, and by collaborating closely with other national supervisors of EU Member States within the supervisory colleges.

5.6.2 Fiscal developments

Romania's government deficit and debt complied with the Maastricht criteria in 2017. In the reference year 2017 the general government budget balance recorded a deficit of 2.9% of GDP, just below the 3% reference value. The general government gross debt-to-GDP ratio was 35.0%, well below the 60% reference value (see Table 5.6.2). Compared with the previous year, the deficit ratio stayed broadly at the same level, while the debt ratio decreased by 2.3 percentage points of GDP. The European Commission's Spring 2018 European Economic Forecast expects the deficit to deteriorate markedly, to 3.4% of GDP, in 2018 as a result of a sharp increase in social benefits and public wages as part of the Unified Wage Law, as well as a cut in personal income taxation. These measures are to be only partially compensated by changes in the design of the social security contribution system and their implications. On a no-policy-change basis, the Commission expects the deficit to worsen further to 3.8% of GDP in 2019. Government debt is projected to increase to 36.4% of GDP in 2019. With regard to other fiscal factors, the deficit ratio was broadly equal to the ratio of public investment to GDP in 2017 and is projected to exceed it in 2018.

Romania has been subject to the preventive arm of the Stability and Growth Pact since 2013. Since June 2017 it has been subject to a significant deviation procedure. The ECOFIN Council abrogated the excessive deficit procedure on 21 June 2013, and Romania achieved its medium-term objective of a structural deficit of 1% of GDP over the period 2013-15. The structural deterioration in 2016, however, led to a divergence from the medium-term objective. Following the European Commission's issuance of an early warning letter in February 2017 and a recommendation in May 2017, the Council issued a recommendation on 16 June 2017 that Romania achieve an adjustment of the structural balance amounting to 0.5% of GDP in 2017 with a view to correcting the significant observed deviation from the adjustment path toward the medium-term budgetary objective. However, the structural deterioration continued in 2017, with the European Commission's Spring 2018 projections indicating a widening gap vis-à-vis the medium-term budgetary objective also in 2018. The Commission therefore on 22 November 2017 issued an additional recommendation for a structural adjustment of at least 0.8% of GDP in 2018.

Sizeable procyclical expansionary measures led to the deficit increase in 2016-17. Following the significant consolidation efforts over the period 2010-12 in particular, the fiscal stance became expansionary in 2016.The deficit rose from 0.8% of GDP in 2015 to 3% in 2016, before dropping to just below the 3% reference value in 2017. Tax cuts, most notably the reduction in the standard VAT rate by 4 percentage points in 2016 and an additional percentage point in 2017, had a negative effect on tax revenues. On the expenditure side, public wages increased considerably, which, however, was more than offset by a cut in capital expenditure. European Commission estimates (presented in Table 5.6.2) indicate that improving cyclical conditions have had favourable effects on the budget balance since 2013, and notably so in 2017. The structural balance deteriorated by 3.1 percentage points during 2016-17, reflecting the significant expansionary measures adopted by the government over that period. This coincided with the closure of the output gap, which turned positive in 2017, highlighting the procyclical discretionary nature of the budgetary deterioration.

The debt-to-GDP ratio more than tripled during the global financial crisis, reaching 39.1% of GDP in 2014, but remained well below the 60% reference value. The debt-to-GDP ratio increased rapidly from 12.4% of GDP in 2008 to 36.9% of GDP in 2012, driven by high primary deficits and the impact of the recession (see Chart 5.6.2). After 2012 the increase in the debt ratio slowed on the back of a gradually improving primary balance and a recovery in real GDP growth. The main reason for the increase in the debt ratio in 2012 and 2014 was the build-up of a foreign currency-denominated cash buffer. In 2015 the ratio decreased moderately for the first time since the crisis, followed by a further slight reduction in 2016 and a notable reduction in 2017 (mainly due to the interest-growth differential). European Commission estimates point to a risk of adverse debt dynamics in the years to come, with debt being on an increasing path already from 2018, largely as a result of the deterioration in the primary balance (see Table 5.6.2).The Romanian government has not incurred contingent liabilities resulting from government interventions to support financial institutions and financial markets during the crisis.

The level and structure of government debt indicate that Romania's fiscal balances are protected from sudden changes in interest rates; however, the balances are sensitive to exchange rate fluctuations. The share of government debt with a short-term maturity is low (5.0% of overall debt in 2017 – see Table 5.6.2). Taking into account medium and long-term debt with a variable interest rate as a percentage of GDP, fiscal balances appear relatively insensitive to interest rate changes. The proportion of foreign currency-denominated government debt is high (51.7% in 2017), despite dropping since 2014. Taking the size of the debt in relation to GDP into consideration, it can therefore be concluded that the fiscal balances are relatively sensitive to exchange rate movements, mainly the euro/leu exchange rate, as a large part of the debt is denominated in euro (83.6% of foreign-denominated debt in 2017). After decreasing during the global financial crisis, the share of debt with a medium and long-term maturity reached a peak of 95.0% in 2017.

Following the significant deviation from the adjustment path towards the medium term objective in 2016-17, there are also risks of a significant

deviation from the Stability and Growth Pact's preventive arm requirements in 2018 and 2019. According to the European Commission's Spring 2018 Economic Forecast, the structural deficit is projected to increase to 3.8% of GDP in 2018 and 4.2% in 2019, on account of expansionary fiscal measures such as direct tax cuts and higher spending on public wages and social benefits. These measures are only partly compensated by changes in the design of the social security contribution system (mainly shifting social security contributions from employers to employees) and their implications. Net expenditure growth is projected to be well above the benchmark rate, pointing to a significant deviation from the provisions of the Stability and Growth Pact. This procyclical fiscal stance is expected to push the deficit above the 3% of GDP reference value in 2018 and put the debt-to-GDP ratio on an upward path. Romania's medium-term fiscal policy strategy, as presented in the April 2018 Convergence Programme update, projects a different path, with only a slight deterioration in the government deficit in 2018, to 3% of GDP, and an improvement in 2019. For 2018 the government projection of the deterioration in the structural deficit is similar to that of the European Commission. In contrast to the Commission, however, the government projects an improvement in the structural deficit in 2019, although the deviation from the medium-term objective in both 2018 and 2019 is still considerable. Therefore, further consolidation measures are needed in both years to ensure compliance with the Stability and Growth Pact's provisions.

Romania has strengthened its national fiscal governance framework significantly in recent years, but the framework has not always been applied effectively. Romania's fiscal governance framework has been strengthened following the adoption of the fiscal compact (through the implementation of a structural budget balance rule, a debt rule and a correction mechanism), the creation of an independent Fiscal Council in 2010 and reform of the tax collection agency.
The Romanian authorities should fully support the Fiscal Council by submitting the budget on a more timely basis and by increasing the transparency of macroeconomic and fiscal forecasts and the budget documentation. The government should also increase efforts to improve its public finance management, reform the public administration, make tax policy and administration more efficient, improve tax collection and combat tax evasion. Well-designed privatisations and governance reforms of state-owned enterprises should continue.

Romania faces high sustainability risks in the medium term and the need to address the projected increase in healthcare and long-term care spending. The European Commission's 2017 Debt Sustainability Monitor points to low risks over the short term, but high risks over the medium term and medium risks over the long term[144]. The medium-term risk classification has worsened from medium to high risk, largely driven by the deterioration in the forecast structural primary balance. Also, the 2015 Ageing Working Group's (AWG) risk scenario outcome implies higher long-term debt sustainability risks for Romania. As far as age-related public spending is concerned, Romania took steps to tackle costs in the period 2010 to 2014, but more recently has taken measures in the opposite direction. The authorities (i)

[144] However, this assessment does not necessarily reflect the uncertainty surrounding the long-term assumptions and, for high-debt countries, has to be taken with caution.

implemented the comprehensive pension reform that was passed in 2010, and (ii) introduced a basic package of health policies in 2014 to improve the efficiency of healthcare. Nevertheless, according to the 2015 projections by the European Commission and the EU's Economic Policy Committee, prepared by the AWG,[145] Romania is likely to experience a notable increase in strictly age-related public expenditure from a level of 15.5% of GDP in 2013 to 17.6% by the year 2060, in the AWG's reference scenario. In the risk scenario, the increase in the cost of ageing amounts to 5.2 percentage points of GDP, significantly above the average for the 28 EU Member States. This has been further exacerbated by the Romanian government's decision to partially re-establish the special pensions abolished in 2010, by the 2017 pension increases, as well as by the recent parametric reforms to the second pillar of the pension system and their effects on pension system sustainability. All these developments suggest that further reforms are needed to improve the long-term sustainability of public finances.

Additional reforms and a sound fiscal position in line with the provisions of the Stability and Growth Pact are needed to safeguard the sustainability of public finances over the medium term. Romania must ensure compliance with the requirements of the Stability and Growth Pact in 2018 and beyond. The expansionary measures currently being pursued, which appear unwarranted by the cyclical position of the economy, are responsible for the substantial fiscal deterioration. Significant consolidation is required to return to the medium-term objective. Additional government investment should be financed by better absorption of EU funds, with a view to improving the quality of public infrastructure. The Romanian government should make further efforts to improve the tax collection system, fight tax evasion, increase spending efficiency, advance structural fiscal reforms (including in the corporate governance of state-owned enterprises) and tackle the projected increase in healthcare and long-term care spending.

5.6.3 Exchange rate developments

Over the reference period from 4 May 2016 to 3 May 2018, 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. In the two-year reference period the Romanian leu traded mostly close to its May 2016 average exchange rate against the euro of 4.4991 lei per euro, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate (see Chart 5.6.3).
On 3 May 2018 the exchange rate stood at 4.6658 lei per euro, i.e. 3.7% weaker than its average level in May 2016. Over the reference period the maximum upward deviation from this benchmark was 1.2%, while the maximum downward deviation amounted to 3.8%. Over the past ten years, the exchange rate of the Romanian leu against the euro has depreciated by 27.5%.

[145] European Commission and Economic Policy Committee, "The 2015 Ageing Report: Economic and budgetary projections for the 28 EU Member States (2013-2060)", *European Economy series*, No 3, European Commission, 2015.

The exchange rate of the Romanian leu against the euro exhibited, on average, a relatively high degree of volatility over the reference period. Although the performance of the Romanian economy was relatively strong, the leu depreciated throughout the reference period, reflecting tensions surrounding a possible
re-emergence of internal and external balances owing to an expansionary fiscal policy stance. Over the reference period short-term interest rate differentials against the three-month EURIBOR remained at somewhat wide and, on average, increasing levels on account of monetary policy rates in Romania being higher than in the euro area. Reflecting the widening of the inflation differential vis-á-vis the euro area, the spreads increased gradually over the review period amid two interest rate increases by Banca Naţională a României in January and February 2018.

Romania was under post-programme surveillance by the European Union until spring 2018. In 2009 an international financial assistance programme led by the EU and the IMF was agreed for Romania. This was followed by two precautionary financial assistance programmes, totalling €4 billion each, which ran from 2011 to 2013 and from 2013 to 2015 respectively. The last programme expired in September 2015. Romania did not draw on the resources of the precautionary arrangements. As these three consecutive agreements helped to reduce financial vulnerabilities, they might also have contributed to reducing exchange rate pressures over the reference period.

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

Romania's current and capital account has improved substantially over the past ten years, while the country's net foreign liabilities have declined gradually, but remain high (see Table 5.6.3). After reaching double-digit levels from 2006 to 2008, the combined current and capital account deficit declined to 3.4% of GDP in 2012 and then recorded a surplus from 2013, averaging 0.5% from 2013 to 2017. From 2017 the current and capital account balance turned negative again, reflecting a deterioration in the goods deficit that was driven mainly by a moderation in Romania's export performance and strong domestic demand, in particular household consumption. At the same time the external deficit was reduced. The deficit has been financed mainly by net inflows in direct and portfolio investment since 2012 and by official borrowing in the period 2009-11. Gross external debt increased substantially to 75.5% of GDP in 2012 and decreased as of 2013 to 49.8% in 2017. The country's net international investment position deteriorated in the period up to 2012 and improved thereafter, to -45.7% of GDP in 2017. However, the country's net foreign liabilities remain high. Fiscal and structural policies therefore continue to be important for supporting external sustainability and the competitiveness of the economy.

The Romanian economy is well integrated with the euro area through trade and investment linkages. In 2017 exports of goods and services to the euro area constituted 57.2% of total exports, while the corresponding figure for imports amounted to 54.4%. In 2017 the share of the euro area in Romania's stock of inward direct investment stood at 82.6% and its share in the country's stock of portfolio investment liabilities was 54.7%. The share of Romania's stock of foreign assets invested in the euro area amounted to 81.7% in the case of direct investment and 65.9% for portfolio investment in 2017.

5.6.4 Long-term interest rate developments

Over the reference period from April 2017 to March 2018, long-term interest rates in Romania stood at 4.1% on average and were thus above the 3.2% reference value for the interest rate convergence criterion (see Chart 5.6.5).

Long-term interest rates in Romania stood at 4.5% in March 2018, marking an increase of 110 basis points since May 2016 and a return to levels last recorded in the summer of 2015. Owing to the global financial crisis and a deteriorating domestic outlook, long-term interest rates rose by 400 basis points in 2009, standing at 11.5% in July of that year. From that point until February 2017 they closely followed developments across the globe, particularly in the euro area, and hit a historical low of 2.8% in February 2015. Since then, however, they have diverged from the euro area average, rising steadily from 3.8% in January 2017 to 4.5% in March 2018, possibly because of higher inflation expectations and potential fiscal slippages that may prevent Romania from meeting its planned fiscal targets.
Concerns regarding the sustainability of the country's fiscal stance may also explain why credit default swap spreads for Romanian government bonds remain higher than in most peer countries in the region. Romania's government debt is rated at the first investment-grade notch by all of the three main rating agencies.

As a result of recent increases in Romania's longer-term sovereign bond yields, the long-term interest rate differential vis-à-vis the euro area has been increasing and now stands at levels last seen at the end of 2012. Along with the rise in the long-term interest rate differential vis-à-vis the euro area, interest rate volatility for Romanian sovereign bonds also increased, reaching levels last experienced during the periods 2006-08 and 2010-12, when the differential fluctuated within a range of 2 to 4 percentage points. Those periods stand in stark contrast with the prolonged period of low volatility from 2013 to mid-2017, during which the long-term interest rate differential remained well below 3 percentage points.

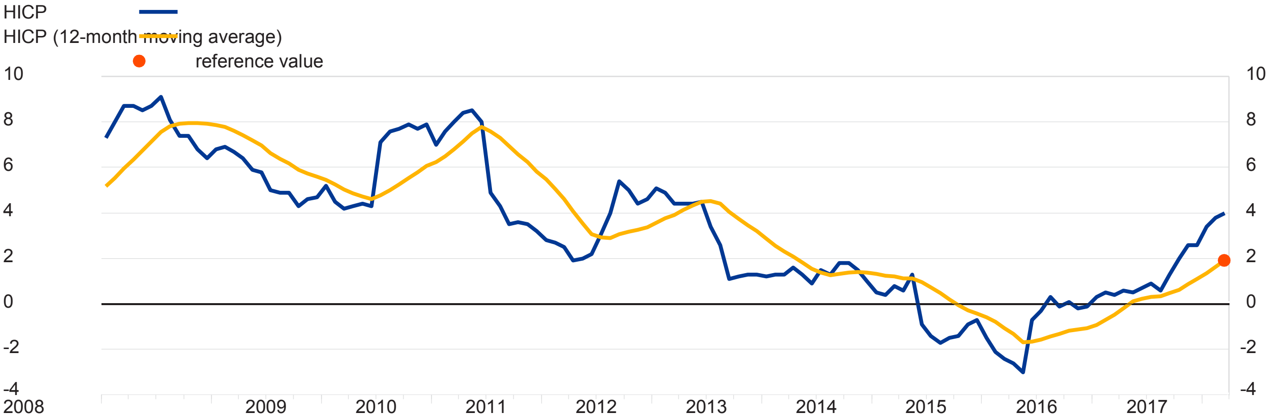
Capital markets in Romania are much smaller than in the euro area and still underdeveloped (see Table 5.6.4). At the end of 2017 both financial and
non-financial corporate debt markets were small, even in comparison with the peer countries in the region, with outstanding debt securities in both markets amounting to much less than 1% of GDP. Romania's equity market is also still quite small, as its stock market capitalisation, at 9.3% of GDP in 2017, ranks among the lowest in the region. In Romania, foreign-owned banks accounted for 77% of total banking assets in 2017. The degree of financial intermediation is quite small and the lowest in the region, as measured by the credit extended by MFIs to the private sector, which

stood at 27.1% of GDP in 2017. Romania’s financial sector is, in some respects, more integrated with the euro area than other countries in the region. For example, the claims of euro area banks on Romanian banks, although they have been on a downward path in recent years, stood at 7.2% of GDP in 2017, which is one of the highest levels in the region. Over the past two years the currency denomination of MFI loans extended to the private sector changed significantly, with the share of domestic currency-denominated loans to households in total loans having increased from 49% in 2015 to 66% in 2017. Likewise, the share of domestic currency- denominated loans to non-financial corporations in total loans rose from 52% in 2015 to 60% in 2017, thus reducing the sensitivity of the sustainability of private sector debt to exchange rate developments.

Romania - Price developments

Chart 5.6.1 HICP inflation and reference value [1)]

(annual percentage changes)



Sources: European Commission (Eurostat) and ECB calculations.
1) The basis of the calculation of the reference value for the period from April 2017 to March 2018 is the unweighted arithmetic average of the annual percentage changes in the HICP for Cyprus, Ireland and Finland plus 1.5 percentage points. The reference value is 1.9%.

Table 5.6.1 Measures of inflation and related indicators

(annual percentage changes, unless otherwise indicated)

	2008-2017 [1)]	2008-2012 [1)]	2013-2017 [1)]	2013	2014	2015	2016	2017	2018 [2)]	2019 [2)]
Measures of inflation										
HICP	3.3	5.7	0.8	3.2	1.4	-0.4	-1.1	1.1	4.2	3.4
HICP excluding unprocessed food and energy	3.4	5.8	1.0	2.3	1.7	0.7	-0.2	0.8	3.3	3.5
HICP at constant tax rates [3)]	2.9	4.0	1.9	3.0	1.1	1.2	2.1	2.0	-	-
CPI	3.2	5.7	0.8	4.0	1.1	-0.6	-1.6	1.3	4.2	3.4
Private consumption deflator	3.6	5.8	1.5	2.6	1.2	0.9	0.9	2.0	4.2	3.4
GDP deflator	4.6	6.3	3.0	3.4	1.7	2.6	2.1	5.3	5.2	4.0
Producer prices [4)]	3.0	5.6	0.5	3.7	0.2	-1.8	-2.6	3.1	-	-
Related indicators										
Real GDP growth	2.4	0.4	4.5	3.5	3.1	4.0	4.8	6.9	4.5	3.9
GDP per capita in PPS [5)] (euro area = 100)	49.9	47.9	52.5	50.9	51.6	52.7	54.7	.	-	-
Comparative price levels (euro area = 100)	52.5	53.0	51.9	52.0	52.1	52.1	51.4	.	-	-
Output gap [6)]	-1.6	-1.3	-1.9	-3.6	-3.1	-2.5	-1.5	1.2	1.4	1.1
Unemployment rate (%) [7)]	6.5	6.6	6.3	7.1	6.8	6.8	5.9	4.9	4.5	4.4
Unit labour costs, whole economy	4.4	5.8	3.0	-0.6	4.3	-3.3	4.1	11.2	4.9	2.7
Compensation per employee, whole economy	7.8	8.0	7.6	3.8	6.7	1.9	10.1	16.0	8.7	6.7
Labour productivity, whole economy	3.2	2.1	4.4	4.4	2.3	5.3	5.8	4.3	3.6	3.9
Imports of goods and services deflator	3.1	7.4	-1.1	-6.0	-0.9	-1.2	-1.2	4.4	3.7	2.9
Nominal effective exchange rate [8)]	-2.8	-5.7	0.2	2.7	0.8	-2.4	0.8	-0.6	-	-
Money supply (M3) [9)]	8.2	7.3	9.1	8.7	7.8	8.4	9.5	11.2	-	-
Lending from banks [10)]	4.4	6.6	2.2	-3.5	-1.3	4.5	3.3	8.5	-	-
Stock prices (BET) [11)]	-21.1	-47.6	50.6	26.1	9.1	-1.1	1.2	9.4	-	-
Residential property prices [12)]	-1.7	-8.4	2.5	-0.3	-2.1	2.9	6.0	6.1	-	-

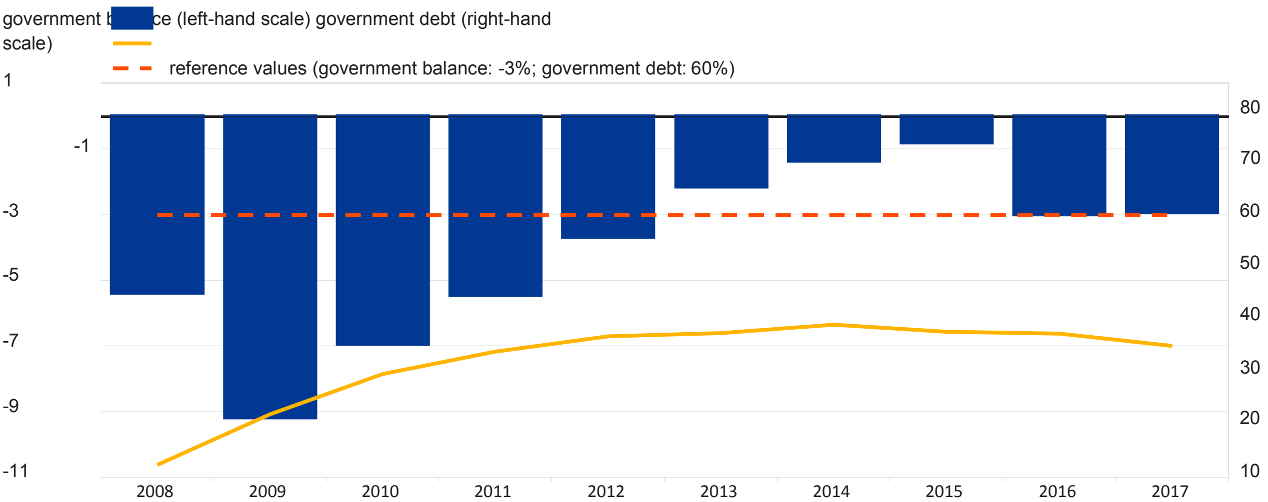
Sources: European Commission (Eurostat, Directorate-General for Economic and Financial Affairs), national data for CPI, money supply, lending from banks and residential property prices, and ECB calculations based on Thomson Reuters data for stock prices.

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 2018 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 from potential GDP: a positive (negative) sign indicates that actual GDP is above (below) potential GDP.
7) Definition conforms to International Labour Organization guidelines.
8) EER-38 group of trading partners. A positive (negative) sign indicates an appreciation (depreciation).
9) The series includes repurchase agreements with central counterparties.
10) Not adjusted for the derecognition of loans from the MFI statistical balance sheet due to their sale or securitisation.
11) Multi-annual and annual figures represent the percentage change between the end of the given period and the end of the previous period.
12) Data available since 2010.

Romania - Fiscal developments

Chart 5.6.2 General government balance and debt

(as a percentage of GDP)



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

Table 5.6.2 Government budgetary developments and projections

(as a percentage of GDP, unless otherwise indicated)

	2008-2017 [1]	2008-2012 [1]	2013-2017 [1]	2013	2014	2015	2016	2017	2018 [2]	2019 [2]	2020	2021
Government balance	**-4.1**	**-6.1**	**-2.0**	**-2.1**	**-1.3**	**-0.8**	**-3.0**	**-2.9**	**-3.4**	**-3.8**	-	-
Total revenue	32.7	32.7	32.8	33.2	33.6	35.0	31.6	30.5	30.9	31.1	-	-
Current revenue	31.3	31.5	31.0	31.7	31.5	32.3	30.2	29.3	29.6	29.5	-	-
Direct taxes	6.1	6.0	6.2	5.9	6.2	6.6	6.5	6.1	4.7	4.8	-	-
Indirect taxes	12.0	11.9	12.0	12.7	12.7	13.2	11.3	10.3	10.4	10.5	-	-
Net social contributions	9.0	9.3	8.7	8.6	8.5	8.1	8.8	9.3	10.7	10.6	-	-
Other current revenue [3]	4.2	4.3	4.0	4.6	4.1	4.4	3.6	3.6	3.7	3.7	-	-
Capital revenue	1.5	1.1	1.8	1.5	2.1	2.7	1.5	1.2	1.3	1.5	-	-
Total expenditure	36.8	38.8	34.8	35.4	35.0	35.8	34.6	33.4	34.3	34.9	-	-
Current expenditure	30.7	31.9	29.6	29.7	29.4	29.4	29.5	30.1	30.8	31.3	-	-
Compensation of employees	8.8	9.1	8.4	8.1	7.7	7.7	8.9	9.7	10.4	10.3	-	-
Social benefits	12.0	12.5	11.6	11.7	11.5	11.5	11.5	11.6	11.6	11.8	-	-
Interest payable	1.5	1.4	1.6	1.8	1.6	1.6	1.5	1.3	1.4	1.4	-	-
Other current expenditure [4]	8.4	8.8	8.1	8.2	8.5	8.6	7.5	7.4	7.5	7.6	-	-
Capital expenditure	6.1	6.9	5.2	5.7	5.6	6.4	5.1	3.3	3.5	3.6	-	-
of which: Investment	4.9	5.7	4.1	4.5	4.3	5.1	3.6	2.8	2.9	3.1	-	-
Cyclically adjusted balance	-3.5	-5.7	-1.4	-0.9	-0.3	0.1	-2.5	-3.3	-3.9	-4.2	.	.
One-off and temporary measures	.	.	0.0	0.0	0.0	0.3	-0.4	0.0	-0.1	0.0	.	.
Structural balance [5]	.	.	-1.4	-0.9	-0.3	-0.2	-2.1	-3.3	-3.8	-4.2	.	.
Government debt	**32.2**	**27.0**	**37.3**	**37.5**	**39.1**	**37.7**	**37.4**	**35.0**	**35.3**	**36.4**	-	-
Average residual maturity (in years)	5.2	4.9	5.4	4.4	5.3	5.4	5.7	6.2	.	.	.	.
In foreign currencies (% of total)	56.1	57.9	54.4	56.7	57.5	53.9	52.2	51.7	.	.	.	.
of which: Euro	45.4	46.2	44.6	47.0	46.8	43.7	42.1	43.2	.	.	.	.
Domestic ownership (% of total)	49.4	49.4	49.4	45.5	47.8	50.5	51.9	51.5	.	.	.	.
Medium and long-term maturity (% of total) [6]	86.3	78.9	93.8	93.8	93.3	93.6	93.1	95.0	.	.	.	.
of which: Variable interest rate (% of total)	18.5	25.7	11.4	12.9	11.4	11.5	9.9	11.2	.	.	.	.
Deficit-debt adjustment	**0.2**	**0.1**	**0.2**	**0.9**	**2.0**	**0.2**	**-0.8**	**-1.1**	.	.	.	.
Net acquisitions of main financial assets	0.5	0.5	0.5	0.7	1.6	-0.6	1.9	-1.0	.	.	.	.
Currency and deposits	0.6	0.6	0.7	0.9	1.6	-0.5	2.0	-0.5	.	.	.	.
Debt securities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	.	.	.	.
Loans	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	.	.	.	.
Equity and investment fund shares or units	-0.2	-0.2	-0.2	-0.3	0.0	-0.1	-0.1	-0.5	.	.	.	.
Revaluation effects on debt	0.2	0.4	-0.1	-0.2	-0.3	-0.2	-0.2	0.3	.	.	.	.
of which: Foreign exchange holding gains/losses	0.3	0.5	0.2	0.3	0.0	0.2	0.1	0.5	.	.	.	.
Other [7]	-0.5	-0.8	-0.2	0.3	0.8	1.0	-2.6	-0.4	.	.	.	.
Convergence programme: government balance	-	-	-	-	-	-	-	-	-3.0	-2.4	-1.8	-1.5
Convergence programme: structural balance	-	-	-	-	-	-	-	-	-3.3	-2.8	-2.4	-2.0
Convergence programme: government debt	-	-	-	-	-	-	-	-	35.4	35.8	35.4	34.5

Sources: European System of Central Banks and European Commission (Eurostat, Directorate-General for Economic and Financial Affairs).

1) Multi-annual averages calculated using the arithmetic mean.
2) Data from the European Commission's Spring 2018 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 factors (sector reclassifications and statistical discrepancies).

Romania - Exchange rate and external developments

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

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

RON/EUR exchange rate (left-hand scale) interest rate differential (right-hand scale)

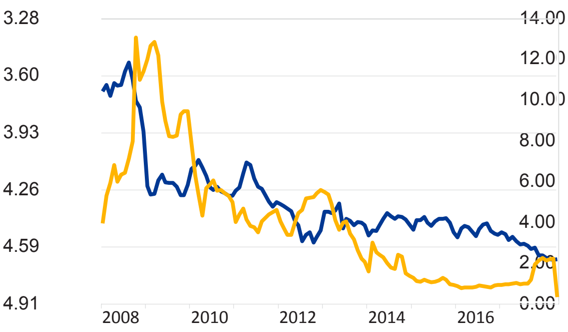
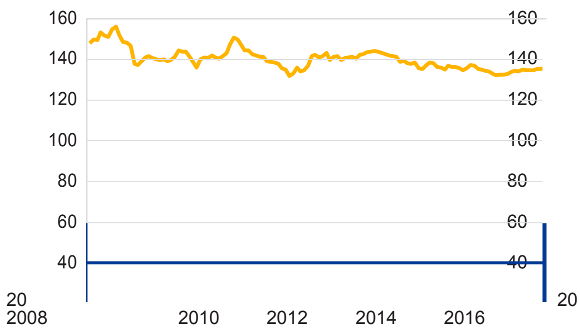


Chart 5.6.4 Effective exchange rates [1)]

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

nominal real



Sources: National data and ECB calculations. Source: ECB.

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

Table 5.6.3 External developments

(as a percentage of GDP, unless otherwise indicated)

	2008-2017 [1)]	2008-2012 [1)]	2013-2017 [1)]	2013	2014	2015	2016	2017	2018 [2)]	2019 [2)]
Balance of payments										
Current account and capital account balance [3)]	-2.5	-5.6	0.5	1.0	2.0	1.2	0.4	-2.2	-2.1	-2.1
Current account balance	-3.9	-6.1	-1.7	-1.1	-0.7	-1.2	-2.1	-3.3	-3.6	-3.9
Goods	-6.8	-8.7	-5.0	-4.0	-4.3	-4.8	-5.5	-6.3	.	.
Services Primary	2.7	1.4	4.0	3.2	3.9	4.2	4.5	4.2	.	.
income	-1.9	-1.5	-2.2	-2.2	-1.4	-2.3	-2.6	-2.6	.	.
Secondary income Capital	2.1	2.7	1.5	1.9	1.1	1.7	1.5	1.4	.	.
account balance	1.4	0.6	2.2	2.1	2.6	2.4	2.5	1.2	.	.
Combined direct and portfolio investment balance [3)]	-3.7	-3.7	-3.7	-5.8	-3.7	-1.9	-3.2	-3.9	.	.
Direct investment Portfolio	-2.5	-2.8	-2.2	-2.0	-1.8	-1.9	-2.7	-2.4	.	.
investment	-1.2	-0.9	-1.5	-3.7	-1.9	0.0	-0.6	-1.5	.	.
Other investment balance	0.7	-2.6	4.1	5.5	6.6	3.6	2.8	1.9	.	.
Reserve assets	0.6	0.8	0.3	1.4	-0.9	-0.4	1.3	0.2	.	.
Exports of goods and services Imports	36.2	31.6	40.8	39.5	41.2	40.9	41.3	41.3	.	.
of goods and services	40.3	38.9	41.8	40.2	41.7	41.5	42.2	43.4	.	.
Net international investment position [4)]	-57.0	-60.5	-53.5	-61.9	-56.8	-53.7	-49.4	-45.7	.	.
Gross external debt [4)]	63.4	68.2	58.6	68.3	62.9	57.4	54.8	49.8	.	.
Internal trade with the euro area [5)]										
Exports of goods and services Imports	.	.	54.7	52.6	53.0	54.9	55.9	57.2	.	.
of goods and services	.	.	54.1	54.0	52.7	54.5	54.9	54.4	.	.
Investment position with the euro area [5)]										
Direct investment assets [4)] Direct	.	.	77.4	56.6	81.7	85.1	82.0	81.7	.	.
investment liabilities [4)] Portfolio	.	.	82.8	83.1	82.9	83.2	82.4	82.6	.	.
investment assets [4)] Portfolio	.	.	61.0	57.3	53.7	64.0	63.9	65.9	.	.
investment liabilities [4)]	59.7	68.9	50.6	49.1	50.2	47.1	51.9	54.7	.	.

Sources: European System of Central Banks and European Commission (Eurostat, Directorate-General for Economic and Financial Affairs).

Note: Backdata are available from 2008.

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

2) Data from the European Commission's Spring 2018 Economic Forecast.

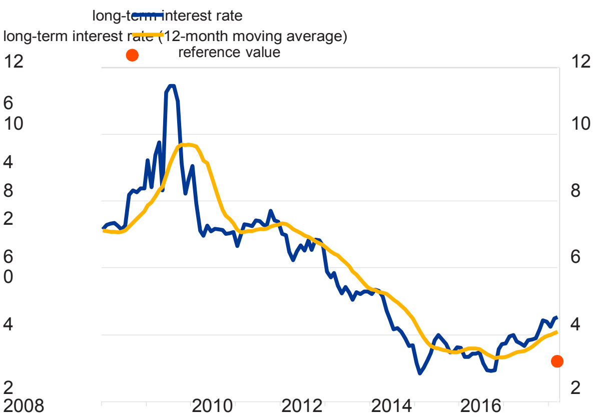
3) Differences between totals and sum of their components are due to rounding.

4) End-of-period outstanding amounts.

5) As a percentage of the total.

Romania - Long-term interest rate developments

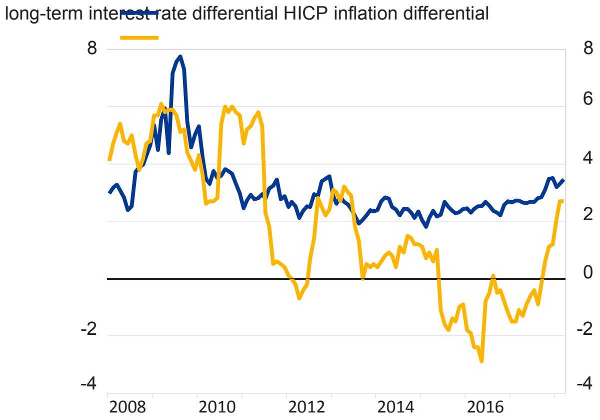
Chart 5.6.5 Long-term interest rate 1) (monthly averages in percentages)



Sources: European System of Central Banks and ECB calculations.
1) The basis of the calculation of the reference value for the period from April 2017 to March 2018 is the unweighted arithmetic average of the interest rate levels in Cyprus, Ireland and Finland plus 2 percentage points. The reference value is 3.2%.

Chart 5.6.6 Long-term interest rate and HICP inflation differentials vis-à-vis the euro area

(monthly averages in percentage points)



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

Table 5.6.4 Long-term interest rates and indicators of financial development and integration

(as a percentage of GDP, unless otherwise indicated)

	2008-2017 1)	2008-2012 1)	2013-2017 1)	2014	2015	2016	2017	Apr. 2017 to Mar. 2018	Memo item: euro area 2017
Long-term interest rates									
Romania 2)	5.9	7.7	4.1	4.5	3.5	3.3	4.0	4.1	-
Euro area 2), 3)	2.8	4.0	1.6	2.0	1.2	0.9	1.1	1.1	-
Euro area AAA par curve, ten-year residual maturity 2), 3)	2.1	3.2	0.9	1.4	0.6	0.2	0.4	0.5	-
Indicators of financial development and integration									
Debt securities issued by financial corporations 4)	0.2	0.2	0.3	0.3	0.3	0.2	0.3	-	66.0
Debt securities issued by non-financial corporations 5)	0.0	0.0	0.1	0.1	0.1	0.1	0.0	-	11.3
Stock market capitalisation 6)	9.6	9.1	10.1	11.3	9.5	9.0	9.3	-	67.4
MFI credit to non-government residents 7)	34.4	38.4	30.5	31.6	30.5	28.9	27.1	-	108.1
Claims of euro area MFIs on resident MFIs 8)	20.6	27.9	13.3	16.6	13.0	9.5	7.2	-	26.3

Sources: European System of Central Banks and ECB calculations.
1) Multi-annual averages calculated using the arithmetic mean.
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 national central bank) 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 national central bank) held by euro area MFIs as a percentage of total liabilities of domestic MFIs (excluding the national central bank). Total liabilities exclude capital and reserves and remaining liabilities.

5.7 Sweden

5.7.1 Price developments

In March 2018 the 12-month average rate of HICP inflation in Sweden was 1.9%, i.e. at the reference value of 1.9% for the criterion on price stability (see Chart 5.7.1). 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 range from 0.2% to 3.4%, and the average for that period was subdued, standing at 1.4%. In 2008 inflation picked up from moderate levels, driven largely by the spike in global commodity prices and the sharp depreciation of the krona. In the wake of the global financial crisis, inflation declined substantially amid plummeting commodity prices and ample spare capacity in the Swedish economy. The unemployment rate increased and unit labour cost growth declined. Despite the subsequent recovery in economic activity, spare capacity persisted for some time, not enabling companies to pass the cost pressures fully through to final prices. The steady appreciation of the krona in nominal effective terms from 2009 to 2013, along with low external price pressures, also kept a lid on consumer price inflation over that period. In 2015 inflation picked up from very low levels, supported by the lagged effects of the krona's depreciation in 2014 and strong economic growth (see Table 5.7.1). The upward trend in inflation was underpinned by an accommodative monetary policy stance. In particular, Sveriges Riksbank reduced its main policy rate into negative territory and launched a programme of government bond purchases. Since early 2017 HICP inflation has hovered between 1.4% and 2.3% as volatile energy prices have contributed to fitful inflation growth. Amid historically low interest rates and supply-side frictions in the housing market, house prices have increased substantially over recent years, together with household indebtedness. However, house prices fell at the end of 2017. The increased supply of housing in recent years may have contributed to that slowdown.

In the first quarter of 2018 the average annual rate of HICP inflation stood at 1.7%. Despite the strong underlying growth momentum, underpinned by an accommodative monetary policy stance, this was lower than expected on account of a slowdown in services inflation and wage increases remaining moderate.

Policy choices have played an important role in shaping inflation dynamics in Sweden over the past decade, most notably the orientation of monetary policy towards price stability. Since 1995 Sveriges Riksbank has had an inflation target that is quantified as an annual rise of 2.0% in the CPI. In June 2010 the tolerance margin of ±1 percentage point was removed from the policy objective. Sweden's institutional framework, which fosters prudent fiscal policy and wage formation, has generally lent support to the achievement of price stability. However, in September 2017 Sveriges Riksbank decided to use inflation measured in terms of the CPIF (the CPI with a fixed interest rate) as a formal target variable for monetary policy, while keeping the target for monetary policy at 2.0%. It also decided to use a variation band of ±1 percentage point to illustrate uncertainty surrounding the development of inflation.

Inflation in Sweden is expected to decline slightly in the coming years, remaining below 2.0%. According to the European Commission's Spring 2018 Economic Forecast, average annual HICP inflation is set to remain at 1.9% in 2018 and to decrease slightly 2019, reaching 1.7%. Although rising resource utilisation is expected to fuel inflationary pressures, moderate wage hikes and the anticipated appreciation of the krona over the next few years will keep a lid on price increases. The risks to the inflation outlook are broadly balanced. A key upside risk relates to the build-up of stronger than expected domestic price pressures amid robust economic growth and to the uncertainty about the outlook for oil prices. Downside risks relate to heightened uncertainty regarding developments in the global economy and the potential appreciation of the krona. Moreover, if the decline in house prices continues and lasts for longer than anticipated, this could have an appreciable negative impact on the economy as a whole. Looking further ahead, monetary policy and the stability-oriented institutional framework should continue to support the achievement of price stability in Sweden.

Maintaining an environment that is conducive to sustainable convergence in Sweden requires the continuation of stability-oriented economic policies and targeted structural reforms. Further steps are needed to address the risks to macroeconomic stability arising from historically high house prices and the associated high and rising level of household indebtedness. In particular, no steps have yet been taken to gradually reduce the fiscal incentives for loan-financed home ownership with a view to curbing mortgage demand. Against this backdrop, the European Commission concluded in its Alert Mechanism Report 2018 that, although some progress had been made in implementing measures to address the issues of overvalued house prices and the associated high and rising level of household indebtedness, Sweden is still experiencing macroeconomic imbalances.

Financial sector policies should be geared to continuing to safeguard financial stability and ensuring that the financial sector makes a sound contribution to economic growth. Given banks' large exposure to the housing sector and their heavy reliance on short-term funding, financial sector policies should aim to prepare the ground for a "soft landing". The resilience of the banking sector has improved in recent years, as banks have built up liquidity buffers and increased their capital ratios. At the end of 2017 the Swedish government also agreed to tighten the amortisation requirement that was implemented in June 2016. However, more steps are needed to further strengthen Sweden's systemic risk oversight and macroprudential framework, especially when considering the structure of the Swedish banking system, which makes it particularly vulnerable to shocks. In particular, increasing the countercyclical buffer rate from 2.0% to 2.5% could be one way of enhancing Swedish banks' resilience to cyclical developments. In order to further bolster confidence in the financial system, the national competent authorities should continue to improve their supervisory practices, among other things, by following the applicable recommendations from the relevant international and

European bodies, and by collaborating closely with other national supervisors of EU countries within the supervisory colleges.

5.7.2 Fiscal developments

Sweden's budget balance and debt complied with the Maastricht criteria in 2017. In 2017 the general government sector recorded a surplus of 1.3% of GDP, thus comfortably meeting the 3% deficit reference value. The general government gross debt-to-GDP ratio was 40.6%, i.e. well below the 60% reference value (see Table 5.7.2). Compared with the previous year, the surplus improved by 0.1 percentage point of GDP and the debt-to-GDP ratio declined by 1.5 percentage points of GDP. According to the European Commission's Spring 2018 Economic Forecast, the surplus ratio is projected to decrease to 0.8% in 2018, while the government debt ratio is projected to decrease to 38.0%. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2017, nor is it expected to do so in 2018.

Sweden is currently subject to the preventive arm of the Stability and Growth Pact. Sweden has never been subject to an ECOFIN Council decision on the existence of an excessive deficit. According to the information provided in the 2018 Convergence Programme in April 2018, Sweden is expected to comply with its medium-term objective (a structural deficit of at most 1% of GDP) over the programme horizon. The European Commission's Spring 2018 Economic Forecast projects the structural balance to remain within the medium-term objective from 2017 to 2019 and also that Sweden remains in compliance with the expenditure benchmark. It therefore assesses the country to be compliant with the preventive arm requirements throughout the reference period.

The deficit-to-GDP ratio stayed at levels well within the 3% reference value during the global financial crisis. The budget balance subsequently peaked in 2017 at a surplus of 1.3% of GDP, after improving by 2.0 percentage points since 2009. The European Commission's estimates (see Table 5.7.2) indicate that cyclical factors improved the budget balance by 3.1 percentage points of GDP between 2009 and 2017, following their significant deficit-increasing impact in 2008 and 2009 (by 5.3 percentage points) as the Swedish government let automatic stabilisers operate freely. The structural balance deteriorated by 1.2 percentage points between 2009 and 2017, while no substantial temporary or one-off measures occurred in that period.

The debt-to-GDP ratio increased progressively after the global financial crisis but started declining in 2015, while staying at levels well below the 60% reference value. The debt ratio increased steadily from its post-crisis trough of 37.9% of GDP in 2011 to its peak of 45.5% of GDP in 2014, mainly driven by large deficit-debt adjustments (see Table 5.7.2). Primary deficits more than offset the debt-reducing interest-growth differentials in the same period. Between 2014 and 2017, the debt-to-GDP ratio decreased by 4.9 percentage points to 40.6% on account of debt-reducing interest-growth differentials and sizeable primary surpluses, which more than offset positive deficit-debt adjustments. Contingent liability risks remain low, as the banking sector is fully capitalised and public provisions related to the support given to financial institutions are negligible.

Sweden's government debt structure shows that fiscal balances are relatively sensitive to interest rate fluctuations, but relatively insensitive to exchange rate fluctuations. The share of government debt with a short-term maturity is relatively high (24.9% in 2017 – see Table 5.7.2). Taking into account the share of debt with a variable interest rate and the level of the debt ratio, fiscal balances are relatively sensitive to changes in interest rates. At the same time, the proportion of government debt denominated in foreign currency is relatively high (23.6% in 2017). However, taking the small size of the debt as a percentage of GDP into consideration, this leaves fiscal balances relatively insensitive to exchange rate movements.

The European Commission's Spring 2018 Economic Forecast indicates compliance under the preventive arm of the Stability and Growth Pact. According to the Commission's latest forecast, a structural surplus of 1.2% of GDP in 2017 is projected to decline to 0.7% of GDP in 2018 and, under unchanged policies, to increase again to 1.0% in 2019. The forecast therefore sees no risk of deviation from the medium-term objective (i.e. a structural deficit of at most 1% of GDP).
Sweden's medium-term fiscal policy strategy, as presented in the 2018 Convergence Programme update, indicates full compliance with the preventive arm requirements over the forecast horizon. The structural balance is projected to improve from a surplus of 0.7% of GDP in 2018 to 1.7% in 2021, thus remaining comfortably within the country's medium-term objective.

Sweden has reduced its surplus target but continues to have a strong fiscal governance framework. In November 2017 the Riksdag adopted the proposal of a cross-party committee to reduce the general government surplus target from 1% to 1/3% of GDP over the business cycle. The new target, which will apply from 2019, is still much more ambitious than the structural balance targets of the EU fiscal framework. The previous very ambitious target of a government surplus of 1% of GDP could not be attained over the last economic cycle despite the overall prudent fiscal policy. In addition, a new debt anchor was introduced into the fiscal framework, targeting a debt-to-GDP ratio (Maastricht definition) of 35% of GDP. A deviation from the debt anchor by 5 percentage points or more in either direction requires the government to submit a report to Parliament explaining the causes of the deviation and presenting an action plan to address it. A debt level of 35% was chosen since it leaves a significant safety margin to the Maastricht reference value of 60% of GDP. The Swedish fiscal framework also includes a three-year rolling nominal expenditure ceiling for central government and the pension system, and a balanced budget requirement for local governments. Overall, the national fiscal framework remains strong, and compliance with the new surplus target would support the medium-term sustainability of public finances in line with the requirements of the Stability and Growth Pact.

Sweden faces low risks to the medium-term and long-term sustainability of public finances. The detailed examination performed for the European

Commission's 2017 Debt Sustainability Monitor foresees no risks over the short term and low risks over the medium term as well as in the long term.[146] Contingent liabilities mostly stem from the ratio of bank loans to deposits, which signals high risks for Sweden, although Sweden is one of the few countries for which non-performing loan ratios do not appear to be problematic. However, the 2015 Ageing Working Group's (AWG) risk scenario outcome implies higher long-term debt sustainability risks for Sweden. According to the 2015 projections by the European Commission and the EU's Economic Policy Committee, prepared by the AWG,[147] an ageing population poses some challenges to Swedish public finances in the long term. According to the AWG reference scenario, strictly age-related expenditure is projected to rise by 0.7 percentage points of GDP by the year 2060 from a level of 25.1% of GDP in 2013, mainly driven by long-term care costs. In the AWG risk scenario, the increase in the cost of ageing amounts to 3.8 percentage points of GDP, a figure that was partly determined by long-term care costs.

Sweden should build on its strong track record and comply with the new national surplus target in order to ensure the credibility of its revised fiscal framework and continued compliance with the requirements of the preventive arm of the Stability and Growth Pact. Sweden should continue to anchor sound public finances in its rule-based fiscal framework and should comply with its revised surplus target, thus ensuring compliance with its medium-term objective in the years to come. In the short-to-medium term, risks are low and mainly relate to the composition of government debt as a result of its relative sensitivity to interest rate fluctuations. However, Sweden should focus on minimising further debt-financed expansionary policies since the scope for additional stimulus is limited owing to the significant commitments included in the 2018 budget. In the long term, fiscal risks arise from age-related expenditure, particularly in the area of long-term care.
Therefore, the Swedish government should adhere to its commitment to diversify its liability structure towards safer components, such as long-term and
krona-denominated debt. Most importantly, the government should contain the growth in age-related expenditure in order to stave off long-term risks to the sustainability of public finances.

5.7.3 Exchange rate desvelopments

In the two-year reference period from 4 May 2016 to 3 May 2018, the Swedish krona did not participate in ERM II, but traded under a flexible exchange rate regime. Over the reference period the Swedish currency mostly traded significantly weaker than its May 2016 average exchange rate against the euro of 9.2948 kronor per euro, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate (see Chart 5.7.3). On 3 May 2018 the exchange rate stood at

[146] However, this assessment does not necessarily reflect the uncertainty surrounding the long-term assumptions and, for high-debt countries, has to be taken with caution.

[147] European Commission and Economic Policy Committee, "The 2015 Ageing Report: Economic and budgetary projections for the 28 EU- Member States (2013-2060)", *European Economy series*, No 3, European Commission, 2015.

10.6045 kronor per euro, i.e. 14.1% weaker than its average level in May 2016. Over the reference period the maximum upward deviation from this benchmark was 0.76%, while the maximum downward deviation amounted to 14.2%. Over the past ten years the exchange rate of the Swedish krona against the euro has depreciated by 13.9%. In February and October 2017 Sveriges Riksbank announced that it was extending its decision of 4 January 2016 that enables it to intervene quickly in the foreign exchange market where necessary to ensure that developments in the krona exchange rate do not comprise a serious risk to the upturn in inflation. Furthermore, Sveriges Riksbank maintained a swap agreement with the ECB for borrowing up to
€10 billion in exchange for Swedish kronor, which had been in place since 20 December 2007 with the aim of facilitating the functioning of financial markets and providing euro liquidity to the latter if needed. As this agreement helped to reduce financial vulnerabilities, it might also have had an impact on the exchange rate of the Swedish krona against the euro.

The exchange rate of the Swedish krona against the euro exhibited, on average, a relatively high degree of volatility over the two-year reference period. Following the announcement by Sveriges Riksbank at the start of 2016 enabling it to conduct exchange rate interventions where necessary, the Swedish currency depreciated vis-à-vis the euro until early November 2016. Thereafter, the krona strengthened by around 6.2% against the euro until early February 2017 on account of the strong performance of the Swedish economy, before weakening again following the extension by Sveriges Riksbank of its decision enabling it to intervene quickly in the foreign exchange market where necessary. Between June and September 2017 the Swedish currency appreciated vis-à-vis the euro, before again depreciating up to the end of 2017, erasing most of the previous gains it had recorded against the euro. More recently the krona has depreciated. Over the reference period short-term interest rate differentials against the three-month EURIBOR were overall very small and stood at -0.1 percentage point in the three-month period ending in April 2018.

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

Over the past ten years Sweden has recorded large current account surpluses, and, more recently, its net international investment position turned positive (see Table 5.7.3). In 2017 the surplus in the combined current and capital account of the balance of payments stood at 3.0% of GDP, reflecting surpluses in the goods, services and primary income balances. The corresponding net capital outflows in the financial account were mainly in direct investment and other investment. Gross external debt, which is concentrated in monetary and financial institutions, stood at 174.4% of GDP in 2017. Over the past ten years Sweden recorded on average a relatively small negative net international investment position until 2013, before recording an increasingly positive net international investment position, reaching 9.4% of GDP in 2017.

The Swedish economy is well integrated with the euro area through trade and investment linkages. In 2017 exports of goods and services to the euro area constituted 40.3% of total exports, while the corresponding figure for imports was higher, at 50.0%. In 2017 the share of the euro area in Sweden's stock of inward direct investment stood at 59.0%, and its share in the country's stock of portfolio investment liabilities was 36.7%. The share of Sweden's stock of foreign assets invested in the euro area amounted to 50.5% in the case of direct investment and to 36.2% for portfolio investment in 2017.

5.7.4 Long-term interest rate developments

Over the reference period from April 2017 to March 2018, long-term interest rates in Sweden stood at 0.7% on average and thus remained well below the 3.2% reference value for the interest rate convergence criterion (see Chart 5.7.5).

Long-term interest rates in Sweden have been on a downward path since mid-2008, falling from above 4% to 0.8% at the end of the reference period. At the onset of the financial crisis, Sweden was running a fiscal surplus, which meant there was significant scope for the implementation of countercyclical policies.
Furthermore, Sweden was not affected by the tensions in the sovereign bond markets that characterised the euro area during the period 2010-12. During the second half of 2010 there was a brief break in the downward trend in long-term interest rates, when Sveriges Riksbank raised interest rates. Subsequently, in 2011 the downward trend resumed on the back of bond investors rebalancing their portfolios by reducing their holdings of euro area debt, in spite of the interest rate hikes. After a period of relative stability in 2012, long-term interest rates rose again in 2013 in line with those in the euro area and despite a relatively loose monetary policy, mainly owing to investors veering away from government bonds and towards riskier assets, such as equities. In 2014 long-term interest rates declined by almost 200 basis points, as in December of that year Sveriges Riksbank cut interest rates to 0% in response to subdued domestic inflation developments. The following year, they rose only marginally, as the effects of strong GDP growth were partly offset by persistently low inflation and further monetary policy accommodation. In 2016 they declined further, hitting a historical low of 0.1% in the summer owing to the impact of further rate cuts and additional purchases of government bonds. Since then, they have broadly followed international developments, rising by 70 basis points to 0.8% in March 2018]. Sweden's government debt is rated at the top investment-grade notch by all of the three main rating agencies.

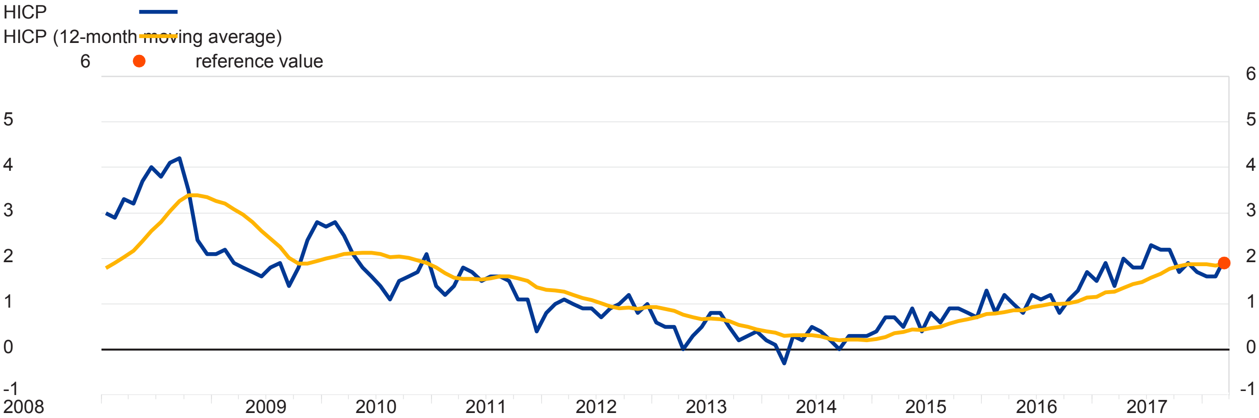
Historically, the dynamics of Sweden's long-term interest rate differential vis-à-vis the highest-rated euro area countries can be divided into two periods. Between 2006 and 2012 many investors perceived Sweden's sovereign bonds as safe-haven assets. As a result, yields on longer-term sovereign bonds were below those seen in most euro area countries, even AAA-rated countries. Since 2013, as the turbulence on euro area sovereign debt markets has subsided, the differential with respect to the highest-rated euro area countries has turned positive, averaging 0.3 percentage point. However, the differential vis-à-vis average euro area long-term interest rates remained negative up to the end of the reference period.

Capital markets in Sweden are highly developed, with corporate bond issuance and stock market capitalisation accounting for a higher percentage of GDP than in the euro area (see Table 5.7.4). In particular, relative to GDP, outstanding amounts of debt securities issued by non-financial corporations in Sweden are more than twice as large as in the euro area, and the Swedish stock market, as a percentage of GDP, is more than twice the size of that of the euro area. The integration of Sweden's financial sector with the euro area, as measured by the claims of euro area banks on Swedish banks, is moderate. Claims of euro area MFIs accounted for 8.2% of Swedish banks' total liabilities in 2017. Sweden's financial sector is highly developed. This is evident, among other indicators, in the provision of bank loans to the private sector. At the end of 2017 this amounted to 135.6% of GDP, which is somewhat higher than the corresponding figure in the euro area of 108.1%. The Swedish banking sector is well integrated into the EU and global financial system and has a high level of foreign loan exposures owing to the dominant role it plays in the Nordic and Baltic euro area countries.

Sweden - Price developments

Chart 5.7.1 HICP inflation and reference value [1)]

(annual percentage changes)



Sources: European Commission (Eurostat) and ECB calculations.
1) The basis of the calculation of the reference value for the period from April 2017 to March 2018 is the unweighted arithmetic average of the annual percentage changes in the HICP for Cyprus, Ireland and Finland plus 1.5 percentage points. The reference value is 1.9%.

Table 5.7.1 Measures of inflation and related indicators

(annual percentage changes, unless otherwise indicated)

	2008-2017 [1)]	2008-2012 [1)]	2013-2017 [1)]	2013	2014	2015	2016	2017	2018 [2)]	2019 [2)]
Measures of inflation										
HICP	1.4	1.9	0.9	0.4	0.2	0.7	1.1	1.9	1.9	1.7
HICP excluding unprocessed food and energy	1.3	1.6	0.9	0.5	0.5	1.1	1.1	1.5	1.5	1.7
HICP at constant tax rates [3)]	1.3	1.8	0.7	0.4	0.2	0.5	1.0	1.7	-	-
CPI	1.0	1.6	0.5	0.0	-0.2	0.0	1.0	1.8	-	-
Private consumption deflator	1.4	1.8	1.1	0.7	1.1	0.9	1.0	1.7	1.9	2.1
GDP deflator	1.7	1.8	1.7	1.1	1.8	2.1	1.6	2.1	2.1	2.3
Producer prices [4)]	1.1	1.8	0.5	-0.7	0.1	-1.1	0.0	4.1	-	-
Related indicators										
Real GDP growth	1.6	0.5	2.8	1.2	2.6	4.5	3.2	2.4	2.6	2.0
GDP per capita in PPS [5)] (euro area = 100)	116.4	116.2	116.6	117.1	116.4	117.1	115.9	.	-	-
Comparative price levels (euro area = 100)	117.9	113.0	123.9	127.4	122.8	121.8	123.6	.	-	-
Output gap [6)]	-1.3	-1.7	-0.9	-2.6	-2.1	-0.1	0.4	0.1	0.1	-0.3
Unemployment rate (%) [7)]	7.6	7.8	7.4	8.0	7.9	7.4	6.9	6.7	6.3	6.3
Unit labour costs, whole economy	2.0	3.0	1.1	1.7	1.0	-0.3	1.3	2.0	1.7	1.8
Compensation per employee, whole economy	2.7	3.0	2.4	2.0	2.2	2.7	2.8	2.1	2.7	2.4
Labour productivity, whole economy	0.6	0.0	1.2	0.3	1.1	3.0	1.5	0.1	1.0	0.7
Imports of goods and services deflator	0.6	0.7	0.5	-2.8	1.8	1.3	-1.7	3.8	4.7	1.8
Nominal effective exchange rate [8)]	-0.4	0.7	-1.4	3.0	-3.7	-6.2	0.8	-0.8	-	-
Money supply (M3) [9)]	5.2	4.3	6.0	3.1	4.2	6.1	8.4	8.4	-	-
Lending from banks [10)]	5.4	5.4	5.3	3.0	5.1	4.4	7.3	6.9	-	-
Stock prices (OMXS30) [11)]	45.8	2.2	42.7	20.7	9.9	-1.2	4.9	3.9	-	-
Residential property prices	5.8	3.1	8.6	5.5	9.4	13.1	8.6	6.4	-	-

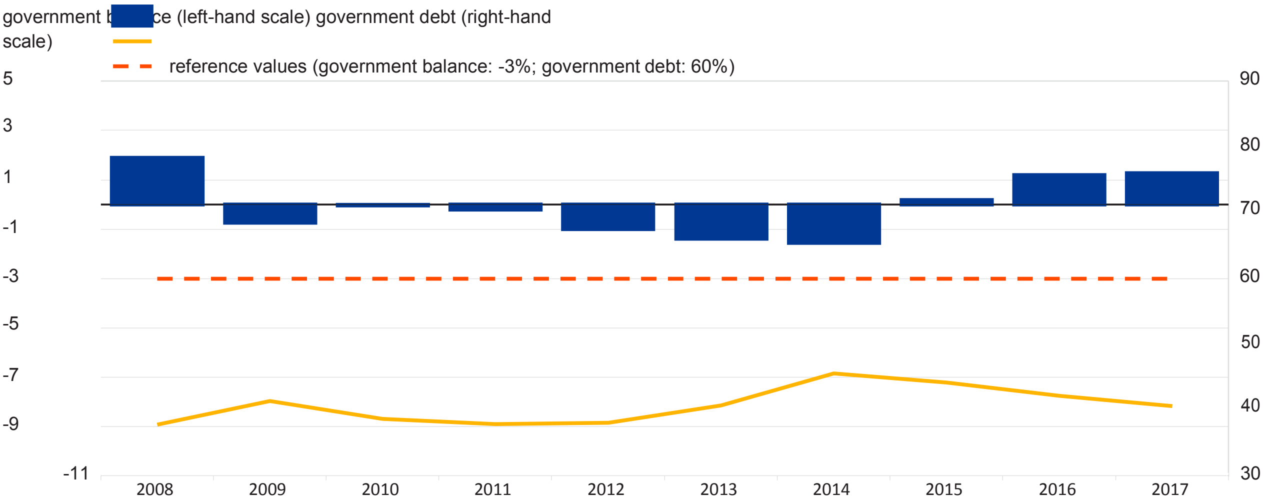
Sources: European Commission (Eurostat, Directorate-General for Economic and Financial Affairs), national data for CPI, money supply, lending from banks and residential property prices, and ECB calculations based on Thomson Reuters data for stock prices.

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 2018 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 from potential GDP: a positive (negative) sign indicates that actual GDP is above (below) potential GDP.
7) Definition conforms to International Labour Organization guidelines.
8) EER-38 group of trading partners. A positive (negative) sign indicates an appreciation (depreciation).
9) The series includes repurchase agreements with central counterparties.
10) Not adjusted for the derecognition of loans from the MFI statistical balance sheet due to their sale or securitisation.
11) Multi-annual and annual figures represent the percentage change between the end of the given period and the end of the previous period.

Sweden - Fiscal developments

Chart 5.7.2 General government balance and debt

(as a percentage of GDP)



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

Table 5.7.2 Government budgetary developments and projections

(as a percentage of GDP, unless otherwise indicated)

	2008-2017 1)	2008-2012 1)	2013-2017 1)	2013	2014	2015	2016	2017	2018 2)	2019 2)	2020	2021
Government balance	**0.0**	**0.0**	**-0.1**	**-1.4**	**-1.6**	**0.2**	**1.2**	**1.3**	**0.8**	**0.9**	-	-
Total revenue	50.6	51.1	50.2	50.6	49.6	49.8	50.6	50.3	49.7	49.3	-	-
Current revenue	50.4	50.9	50.0	50.3	49.4	49.6	50.5	50.2	49.5	49.1	-	-
Direct taxes	18.2	18.1	18.3	17.8	17.8	18.4	18.7	18.6	18.3	18.3	-	-
Indirect taxes	22.2	22.3	22.1	22.2	21.8	21.8	22.4	22.4	22.3	22.2	-	-
Net social contributions	3.3	3.3	3.3	3.4	3.4	3.3	3.3	3.3	3.3	3.3	-	-
Other current revenue 3)	6.7	7.2	6.3	6.9	6.4	6.1	6.0	5.8	5.6	5.4	-	-
Capital revenue	0.2	0.2	0.2	0.4	0.1	0.3	0.2	0.2	0.1	0.1	-	-
Total expenditure	50.7	51.1	50.3	52.0	51.1	49.6	49.4	49.1	48.9	48.4	-	-
Current expenditure	46.0	46.5	45.6	47.3	46.5	45.1	44.8	44.4	44.1	43.7	-	-
Compensation of employees	12.5	12.5	12.6	12.8	12.7	12.4	12.5	12.6	12.6	12.6	-	-
Social benefits	18.2	18.3	18.2	18.9	18.5	18.0	18.0	17.6	16.4	16.2	-	-
Interest payable	0.9	1.2	0.5	0.8	0.7	0.4	0.4	0.4	0.3	0.2	-	-
Other current expenditure 4)	14.4	14.5	14.3	14.9	14.7	14.2	13.9	13.9	14.8	14.6	-	-
Capital expenditure	4.6	4.6	4.6	4.7	4.6	4.5	4.6	4.7	4.7	4.7	-	-
of which: Investment	4.4	4.5	4.4	4.5	4.4	4.2	4.4	4.5	4.6	4.6	-	-
Cyclically adjusted balance	0.7	1.0	0.5	0.1	-0.3	0.3	0.9	1.2	0.7	1.0	.	.
One-off and temporary measures	.	.	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	.	.
Structural balance 5)	.	.	0.5	0.1	-0.3	0.3	0.9	1.2	0.7	1.0	.	.
Government debt	**40.7**	**38.8**	**42.6**	**40.7**	**45.5**	**44.2**	**42.1**	**40.6**	**38.0**	**35.5**	-	-
Average residual maturity (in years)	-	-	-	-	-	-	-	-	.	.	.	.
In foreign currencies (% of total)	23.1	20.7	25.5	27.5	25.6	24.9	26.1	23.6	.	.	.	.
of which: Euro	9.1	9.0	9.1	10.4	9.0	8.4	9.0	8.9	.	.	.	.
Domestic ownership (% of total)	68.4	70.7	66.1	62.2	57.7	63.3	70.9	76.7	.	.	.	.
Medium and long-term maturity (% of total) 6)	73.8	73.1	74.4	77.4	70.0	72.5	77.2	75.1	.	.	.	.
of which: Variable interest rate (% of total)	13.1	15.1	11.1	12.8	11.3	9.9	10.8	10.7	.	.	.	.
Deficit-debt adjustment	**1.5**	**0.6**	**2.3**	**2.1**	**5.0**	**1.7**	**1.2**	**1.6**	.	.	.	.
Net acquisitions of main financial assets	1.5	1.1	1.9	2.7	3.8	-0.7	0.5	3.0	.	.	.	.
Currency and deposits	0.3	0.1	0.4	-0.2	2.0	-0.4	0.2	0.3	.	.	.	.
Debt securities	0.4	-0.1	1.0	0.0	1.4	0.2	0.6	2.8	.	.	.	.
Loans	1.1	1.1	1.2	3.4	0.7	0.8	0.4	0.5	.	.	.	.
Equity and investment fund shares or units	-0.3	0.0	-0.7	-0.6	-0.4	-1.3	-0.7	-0.6	.	.	.	.
Revaluation effects on debt	0.3	0.0	0.6	0.5	1.2	0.6	0.6	0.0	.	.	.	.
of which: Foreign exchange holding gains/losses	0.1	-0.2	0.4	0.1	1.4	0.6	0.5	-0.4	.	.	.	.
Other 7)	-0.3	-0.5	-0.1	-1.1	-0.1	1.7	0.1	-1.4	.	.	.	.
Convergence programme: government balance	-	-	-	-	-	-	-	-	1.0	1.0	1.3	1.9
Convergence programme: structural balance	-	-	-	-	-	-	-	-	0.5	0.5	0.8	1.7
Convergence programme: government debt	-	-	-	-	-	-	-	-	37.3	34.2	31.6	29.0

Sources: European System of Central Banks and European Commission (Eurostat, Directorate-General for Economic and Financial Affairs).

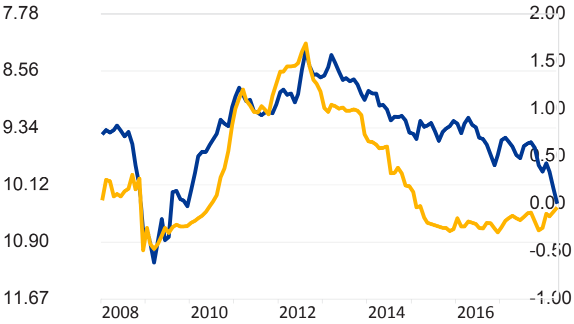
1) Multi-annual averages calculated using the arithmetic mean.
2) Data from the European Commission's Spring 2018 Economic Forecast, except for convergence programme data.
3) Sales and other current revenue.
4) Intermediate consumption, subsidies payable and other current expenditure.
5) Cyclically-adjusted balance excluding one-off and other temporary measures.
6) Original maturity of more than one year.
7) Time of recording differences and other factors (sector reclassifications and statistical discrepancies).

Sweden - Exchange rate and external developments

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

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

SEK/EUR exchange rate (left-hand scale) interest rate differential (right-hand scale)

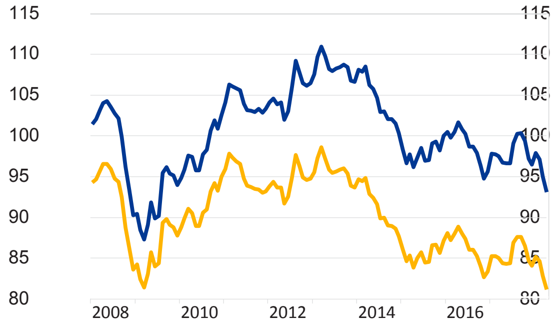


Sources: National data and ECB calculations.

Chart 5.7.4 Effective exchange rates 1)

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

nominal real



Source: ECB.

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

Table 5.7.3 External developments

(as a percentage of GDP, unless otherwise indicated)

	2008-2017 [1]	2008-2012 [1]	2013-2017 [1]	2013	2014	2015	2016	2017	2018 [2]	2019 [2]
Balance of payments										
Current account and capital account balance [3]	5.1	6.0	4.2	5.0	4.4	4.4	4.2	3.0	4.0	4.3
Current account balance	5.3	6.2	4.3	5.2	4.5	4.6	4.2	3.1	4.1	4.4
Goods	3.6	4.5	2.7	3.2	3.0	2.8	2.3	2.4	.	.
Services Primary	1.2	0.8	1.7	1.7	1.3	2.2	2.1	1.0	.	.
income	2.1	2.6	1.5	2.1	1.9	1.2	1.1	1.4	.	.
Secondary income Capital	-1.7	-1.7	-1.6	-1.8	-1.8	-1.7	-1.4	-1.6	.	.
account balance	-0.2	-0.2	-0.2	-0.2	-0.1	-0.2	-0.1	-0.1	.	.
Combined direct and portfolio investment balance [3]	-1.0	-2.0	0.0	-3.9	4.9	-1.2	-0.1	0.2	.	.
Direct investment Portfolio	2.0	2.6	1.5	4.6	0.9	1.5	-1.2	1.6	.	.
investment	-3.0	-4.6	-1.5	-8.5	4.0	-2.7	1.1	-1.4	.	.
Other investment balance	2.9	4.5	1.3	6.5	-1.7	3.0	-3.6	2.4	.	.
Reserve assets	0.7	0.7	0.8	2.6	0.0	0.3	0.8	0.1	.	.
Exports of goods and services Imports	45.2	46.1	44.3	43.6	44.3	45.6	43.8	44.3	.	.
of goods and services	40.4	40.9	39.9	38.7	40.0	40.5	39.3	41.0	.	.
Net international investment position [4]	-5.0	-9.0	-0.9	-15.7	-2.2	-1.2	5.0	9.4	.	.
Gross external debt [4]	186.2	191.3	181.2	185.0	190.6	181.6	174.2	174.4	.	.
Internal trade with the euro area [5]										
Exports of goods and services Imports	39.4	39.0	39.8	40.1	40.2	38.8	39.6	40.3	.	.
of goods and services	48.8	48.7	48.9	49.5	48.1	47.6	49.4	50.0	.	.
Investment position with the euro area [5]										
Direct investment assets [4] Direct	50.9	52.0	49.7	50.9	50.0	49.3	47.7	50.5	.	.
investment liabilities [4] Portfolio	58.4	59.2	57.5	57.7	57.2	57.2	56.5	59.0	.	.
investment assets [4] Portfolio	39.2	41.4	37.0	40.8	34.3	37.0	36.9	36.2	.	.
investment liabilities [4]	34.4	35.3	33.6	31.7	31.2	33.4	35.0	36.7	.	.

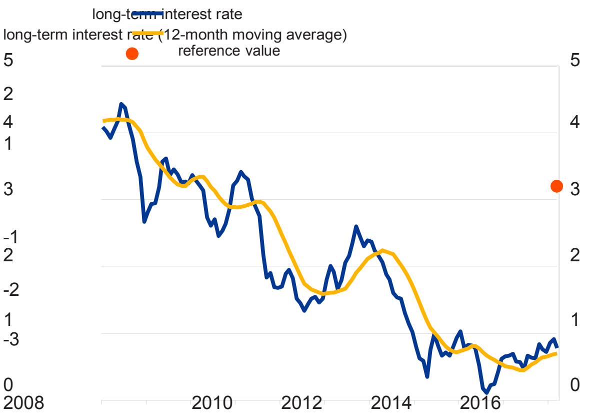
Sources: European System of Central Banks and European Commission (Eurostat, Directorate-General for Economic and Financial Affairs).

Note: Backdata are available from 2008.

1) Multi-annual averages calculated using the arithmetic mean.
2) Data from the European Commission's Spring 2018 Economic Forecast.
3) Differences between totals and sum of their components are due to rounding.
4) End-of-period outstanding amounts.
5) As a percentage of the total.

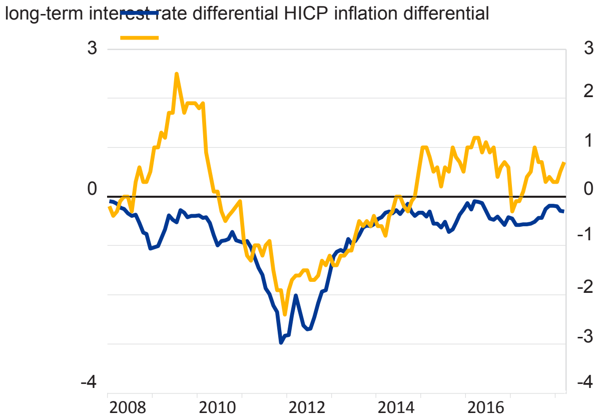
Sweden - Long-term interest rate developments

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



Sources: European System of Central Banks and ECB calculations.
1) The basis of the calculation of the reference value for the period from April 2017 to March 2018 is the unweighted arithmetic average of the interest rate levels in Cyprus, Ireland and Finland plus 2 percentage points. The reference value is 3.2%.

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



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

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

	2008-2017 1)	2008-2012 1)	2013-2017 1)	2014	2015	2016	2017	Apr. 2017 to Mar. 2018	Memo item: euro area 2017
Long-term interest rates									
Sweden 2)	2.0	2.8	1.1	1.7	0.7	0.5	0.7	0.7	-
Euro area 2), 3)	2.8	4.0	1.6	2.0	1.2	0.9	1.1	1.1	-
Euro area AAA par curve, ten-year residual maturity 2), 3)	2.1	3.2	0.9	1.4	0.6	0.2	0.4	0.5	-
Indicators of financial development and integration									
Debt securities issued by financial corporations 4)	109.1	104.0	114.2	117.8	113.3	113.0	113.0	-	66.0
Debt securities issued by non-financial corporations 5)	18.8	16.6	21.0	19.4	20.1	20.8	23.6	-	11.3
Stock market capitalisation 6)	111.5	92.3	130.6	127.4	131.5	135.2	138.7	-	67.4
MFI credit to non-government residents 7)	129.0	125.9	132.1	132.2	129.2	132.2	135.6	-	108.1
Claims of euro area MFIs on resident MFIs 8)	9.0	9.5	8.6	9.0	8.3	9.1	8.2	-	26.3

Sources: European System of Central Banks and ECB calculations.
1) Multi-annual averages calculated using the arithmetic mean.
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 national central bank) 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 national central bank) held by euro area MFIs as a percentage of total liabilities of domestic MFIs (excluding the national central bank). Total liabilities exclude capital and reserves and remaining liabilities.

6 Statistical methodology of convergence indicators

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

National statistical authorities in each Member State and the EU statistical authority within the European Commission (Eurostat) should enjoy professional independence and ensure that European statistics are impartial and of a high quality. This is in line with the principles laid down in Article 338(2) of the Treaty, the Regulation European statistics[148] and the European Statistics Code of Practice[149] (hereinafter referred to as the Code of Practice). Article 2(1) of the Regulation on European statistics states that the development, production and dissemination of European statistics shall be governed by the following statistical principles: a) professional independence; b) impartiality; c) objectivity; d) reliability; e) statistical confidentiality; and f) cost effectiveness. Pursuant to Article 11 of the Regulation, these statistical principles are further elaborated on in the Code of Practice.

Against this background, this chapter reviews the quality and integrity of the convergence indicators in terms of the underlying statistics. It provides information on the statistical methodology of the convergence indicators, as well as on the compliance of the underlying statistics with the standards necessary for an appropriate assessment of the convergence process.

[148] Regulation (EC) No 223/2009 of the European Parliament and of the Council of 11 March 2009 on European statistics and repealing Regulation (EC, Euratom) No 1101/2008 of the European Parliament and of the Council on the transmission of data subject to statistical confidentiality to the Statistical Office of the European Communities as amended by Regulation (EU) 2015/759 of the European Parliament and of the Council of 29 April 2015, Council Regulation (EC) No 322/97 on Community Statistics, and Council Decision 89/382/EEC, Euratom establishing a Committee on the Statistical Programmes of the European Communities (OJ L 87, 31.03.2009, p. 164).

[149] The European Statistics Code of Practice was endorsed by the European Commission in its Recommendation of 25 May 2005 on the independence, integrity and accountability of the national and Community statistical authorities (COM(2005) 217 final), and updated by the European Statistical System (ESS) Committee in September 2011 and December 2017.

6.1 Institutional features relating to the quality of statistics for the assessment of the convergence process

The governance of the European Statistical System (ESS) has been progressively improved, in particular with the adoption of the Code of Practice in 2005. In the specific context of the EU fiscal surveillance system and of the excessive deficit procedure (EDP), Council Regulation (EU) No 679/2010[150] granted Eurostat new competences for regularly monitoring and verifying public finance data, which it exercises by conducting more in-depth dialogue visits to Member States and by extending such visits to public entities supplying upstream public finance data to the national statistical institutes (NSIs).

Furthermore, the legislative package of six legal texts adopted to strengthen the economic governance structure of the euro area and the EU as a whole relies on high-quality statistical information, which needs to be produced under robust quality management.[151] In this context, the Code of Practice was revised in September 2011 in order to distinguish between the principles to be implemented by ESS members and the principles relating to the institutional environment that are to be implemented by Member State governments. In 2017 it was revised again in order to emphasise that NSIs and Eurostat ensure the coordination of all activities involved in the development, production and dissemination of European statistics (produced in accordance with the Regulation on European statistics[152]) at the level of the national statistical system and the ESS respectively.

In 2015 the Regulation on European statistics was amended[153] **in order to, among other things, clarify that the principle of professional independence of NSIs applies unconditionally.** Statistics must indeed be developed, produced and disseminated in an independent manner, free of any pressures from political or interest groups or from EU or national authorities, and existing institutional frameworks must not be allowed to restrict this principle.

[150] Council Regulation (EU) No 679/2010 of 26 July 2010 amending Regulation (EC) No 479/2009 as regards the quality of statistical data in the context of the excessive deficit procedure (OJ L 198, 30.07.2010, p. 1).

[151] On 13 December 2011, the reinforced Stability and Growth Pact entered into force with a new set of rules for economic and fiscal surveillance. These measures, known as the "six-pack", consist of five regulations and one directive, proposed by the European Commission and approved by all EU Member States and the European Parliament in October 2011.

[152] European statistics are developed, produced and disseminated by both the ESS and the ESCB but under separate legal frameworks reflecting their respective governance structures. The members of the ESCB are not involved in the production of European statistics pursuant to the Regulation on European statistics. However, with a view to minimising the reporting burden and guaranteeing the coherence necessary to produce European statistics, the ESS and the ESCB cooperate closely, while complying with the statistical principles as set out in Article 2(1) of the Regulation. Given that some of those European statistics may be compiled by NCBs in their capacity as members of the ESCB, the NSIs and the NCBs also cooperate closely in accordance with national arrangements with a view to guaranteeing the production of complete and coherent European statistics, while ensuring the necessary cooperation between the ESS and the ESCB.

[153] Regulation (EU) 2015/759 of the European Parliament and of the Council of 29 April 2015 amending Regulation (EC) No 223/2009 on European statistics (OJ L 123, 19.5.2015, p. 90).

The independence of other statistical authorities responsible for the compilation of European statistics (e.g. ministries of finance) also needs to be assured. In addition, responsibility for the publication of statistics by other statistical authorities needs to be clearly identified in order to distinguish statistical releases from political statements. In Poland and Romania, the Ministry of Finance compiles EDP debt data. In Bulgaria, the Ministry of Finance compiles quarterly government debt data, while the NSI compiles annual government debt. The institutional responsibilities for the compilation of EDP data and GFS in the countries are shown in Table 6.1. In Romania, the Law on the organisation and functioning of official statistics includes the principle of professional independence and applies to all statistical processes and products. In Bulgaria and Poland, although the independence of the compilers at the Ministries of Finance is not guaranteed by law, the monitoring and quality assurance of the EDP data and GFS compiled by the Ministries of Finance form part of the coordination role of the NSI.

Table 6.1

Quality and integrity of convergence statistics

		Bulgaria	Czech Republic
Institutional features relating to the quality and integrity of the statistics used in assessing the convergence process			
	Legal independence of the national statistical institute	In accordance with the Law on Statistics, statistics are based on the principles of professional independence, impartiality, objectivity, reliability, statistical confidentiality and cost effectiveness. Under Article 8 of the Law on Statistics, the President of the NSI is appointed by the Prime Minister. The term of office is fixed (seven years; reappointment is possible, only once).	Under Article 5 of the State Statistical Service Act, statistics are based on objectivity, impartiality and independence. Under Article 3, the Head of the NSI is appointed by the President of the Republic.
	Administrative supervision and budget autonomy	The NSI has the status of a state agency and is directly subordinated to the Council of Ministers. It has budget autonomy on the basis of an annual amount assigned from the state budget.	The NSI is a central statistical agency within the public administration. It has budget autonomy on the basis of an annual amount assigned from the state budget.
	Legal mandate for data collection	The Law on Statistics determines the main principles of data collection.	The State Statistical Service Act determines the main principles of data collection.
	Legal provisions regarding statistical confidentiality	Under Articles 25 to 27a of the Law on Statistics, the confidentiality of the statistical data is secured.	Under Articles 16, 17 and 18 of the State Statistical Service Act, the confidentiality of the statistical data is secured.
HICP inflation[1]			
	Compliance with legal minimum standards	Eurostat made a compliance monitoring visit in 2013 and published a report in 2015 confirming that the methods used for producing the HICP are satisfactory. There were no apparent instances of non-compliance with the HICP methodology.	Eurostat made a compliance monitoring visit in 2008 and published a report in 2009 confirming that, in general, the methods used for producing the HICP are satisfactory. There were no apparent instances of non-compliance with the HICP methodology.
	Other issues	Eurostat considered the representativeness of the HICP to be generally appropriate.	Eurostat considered the representativeness of the HICP in terms of accuracy and reliability to be generally adequate.
Government finance statistics			
	Data coverage	Revenue, expenditure, deficit and debt data are provided for the period 2008-17.	Revenue, expenditure, deficit and debt data are provided for the period 2008-17.
	Outstanding statistical issues	No major outstanding statistical issues identified.	No major outstanding statistical issues identified.
	Institution responsible for the compilation of statistics	The NSI compiles the non-financial and financial accounts of government, as well as annual government debt. The Ministry of Finance compiles quarterly government debt.	The NSI compiles the non-financial and financial accounts of government, as well as government debt.

1) The full reports on the findings and recommendations of the HICP compliance monitoring visits for each country are available at http://ec.europa.eu/eurostat/web/hicp/methodology/compliance-monitoring.

Table 6.1

Quality and integrity of convergence statistics (cont'd)

		Croatia	Hungary
Institutional features relating to the quality and integrity of the statistics used in assessing the convergence process			
	Legal independence of the national statistical institute	Under Article 5 of the Official Statistics Act, statistics are based on the principles of relevance, impartiality, reliability, transparency, timeliness, professional independence, cost effectiveness, consistency, publicity, statistical confidentiality, the use of individual data for exclusively statistical purposes, and public accountability. The Head of the NSI is appointed by the Government and is accountable to the Government.	Under Article 1 and 3/A of Act XLVI on Statistics, statistics are based on objectivity, independence and confidentiality. The Head of the NSI is appointed by the Prime Minister. The term of office is fixed (six years; reappointment is possible, only twice).
	Administrative supervision and budget autonomy	The NSI is a state administration organisation which autonomously performs its tasks in conformity with the law. It has budget autonomy on the basis of an annual amount assigned from the state budget.	The NSI is a public administration under the immediate supervision of the Government. It has budget autonomy on the basis of an annual amount assigned from the state budget.
	Legal mandate for data collection	The Official Statistics Act determines the main principles of data collection.	Act XLVI on Statistics determines the main principles of data collection.
	Legal provisions regarding statistical confidentiality	Under Article 59 of the Official Statistics Act, the confidentiality of the statistical data is secured.	Under Article 17 of Act XLVI on Statistics, the confidentiality of the statistical data is secured.
HICP inflation[1]			
	Compliance with legal minimum standards	Eurostat made a compliance monitoring visit in 2015 and published a report in that year confirming that, in general, the methods used for producing the HICP are satisfactory. Some instances of non-compliance with the HICP methodology were identified, but those were considered by Eurostat to be limited and unlikely to have a major impact in practice on the annual average rates of change in the HICP.	Eurostat made a compliance monitoring visit in 2008 and published a report in 2009 confirming that, in general, the methods used for producing the HICP are satisfactory. Some instances of non-compliance with the HICP methodology were identified, but those were considered by Eurostat to be limited and unlikely to have a major impact in practice on the annual average rates of change in the HICP.
	Other issues	Eurostat considered that comparability with the HICP of other countries can be regarded as assured.	Eurostat considered the representativeness of the HICP in terms of accuracy and reliability to be generally adequate.
Government finance statistics			
	Data coverage	Revenue, expenditure, deficit and debt data are provided for the period 2008-17.	Revenue, expenditure and deficit data are provided for the period 2008-17.
	Outstanding statistical issues	No major outstanding statistical issues identified.	In April 2018 Eurostat expressed a reservation on the quality of the data reported by Hungary in relation to the sector classification of the foundations created by the Magyar Nemzeti Bank.
	Institution responsible for the compilation of statistics	The NSI compiles the non-financial accounts; the NCB compiles the debt and financial accounts.	The NSI compiles the non-financial accounts; the NCB compiles the debt and financial accounts.

Table 6.1

Quality and integrity of convergence statistics (cont'd)

		Poland	Romania
Institutional features relating to the quality and integrity of the statistics used in assessing the convergence process			
	Legal independence of the national statistical institute	Under Article 1 of the Law on Official Statistics, statistics are based on reliability, objectivity and transparency. The Head of the NSI is selected by open competition and appointed by the President of the Council of Ministers. The term of office is fixed (five years).	The autonomy of official statistics is stated in the Statistical Law, together with the principles of confidentiality, transparency, reliability, proportionality, statistical deontology and cost/efficiency ratio. The Head of the NSI is appointed by the Prime Minister. The term of office is fixed (six years; reappointment is possible, only once).
	Administrative supervision and budget autonomy	The NSI is a central agency within the public administration under supervision of the President of the Council of Ministers. It has budget autonomy on the basis of an annual amount assigned from the state budget.	In accordance with the Statistical Law, the NSI is a specialised institution, subordinated to the Government. It is financed via the state budget.
	Legal mandate for data collection	The Law on Official Statistics determines the main principles of data collection.	In accordance with the Statistical Law, "the official statistics in Romania are implemented and coordinated by the NSI".
	Legal provisions regarding statistical confidentiality	Under Articles 10, 11, 12, 38, 39 and 54 of the Law on Official Statistics, the confidentiality of the statistical data is secured.	The Statistical Law states that "during statistical research, from collection to dissemination, the official statistics services and statisticians have the obligation to adopt and implement all the necessary measures for protecting the data referring to individual statistics subjects (natural or legal persons), data obtained directly from statistical research or indirectly through administrative sources or from other suppliers".
HICP inflation[1]			
	Compliance with legal minimum standards	Eurostat made a compliance monitoring visit in 2015 and published a report in 2016 confirming that, in general, the methods used for producing the HICP are satisfactory. There were no apparent instances of non-compliance with the HICP methodology.	Eurostat made a compliance monitoring visit in 2007 and published a report in that year confirming that, in general, the methods used for producing the HICP are satisfactory. There were no apparent instances of non-compliance with the HICP methodology.
	Other issues	Eurostat considered the representativeness of the HICP in terms of accuracy and reliability to be generally adequate.	Eurostat considered the representativeness of the HICP in terms of accuracy and reliability to be generally adequate.
Government finance statistics			
	Data coverage	Revenue, expenditure, deficit and debt data are provided for the period 2008-17.	Revenue, expenditure, deficit and debt data are provided for the period 2008-17.
	Outstanding statistical issues	No major outstanding statistical issues identified.	No major outstanding statistical issues identified.
	Institution responsible for the compilation of statistics	The NSI compiles the non-financial and financial accounts of government. The Ministry of Finance compiles government debt.	The NSI compiles the non-financial accounts of government. The Ministry of Finance compiles government debt. The NCB compiles the financial accounts of government.

Table 6.1

Quality and integrity of convergence statistics (cont'd)

		Sweden
Institutional features relating to the quality and integrity of the statistics used in assessing the convergence process		
	Legal independence of the national statistical institute	Under Section 3 of the Official Statistics Act, statistics are objective and available to the public. The Head of the NSI is appointed by the Government. The term of office is fixed (for a maximum of three years).
	Administrative supervision and budget autonomy	The NSI is a central statistics agency, subordinated to, but not part of, the Ministry of Finance. Approximately half of its turnover is provided by the Ministry of Finance, the other half by charging government agencies and commercial customers for statistical production and advice.
	Legal mandate for data collection	The Official Statistics Act determines the main principles of data collection.
	Legal provisions regarding statistical confidentiality	Under Sections 5 and 6 of the Official Statistics Act, the confidentiality of the statistical data is secured.
HICP inflation[1]		
	Compliance with legal minimum standards	Eurostat made a compliance monitoring visit in 2011 and published a report in 2013 confirming that, in general, the methods used for producing the HICP are satisfactory. Some instances of non-compliance with the HICP methodology were identified, but those were considered by Eurostat to be limited and unlikely to have a major impact in practice on the annual average rates of change in the HICP.
	Other issues	Eurostat considered the representativeness of the HICP in terms of accuracy and reliability to be generally adequate.
Government finance statistics		
	Data coverage	Revenue, expenditure, deficit and debt data are provided for the period 2008-17.
	Outstanding statistical issues	There is a unit currently classified as an MFI, which may be subject to reclassification into government sector.
	Institution responsible for the compilation of statistics	The NSI compiles the non-financial and financial accounts of government, as well as government debt.

6.2 HICP inflation

This section considers the methodology and quality of the statistics underlying the measurement of price developments, specifically the HICP. The HICP was developed for the purpose of assessing convergence in terms of price stability on a comparable basis. It is published for all EU Member States by

Eurostat.[154] The HICP covering the euro area as a whole has been the main measure of price developments for the single monetary policy of the ECB since January 1999.

Article 1 of Protocol (No 13) on the convergence criteria (annexed to the Treaties) requires price convergence to be measured by means of the CPI on a comparable basis, taking into account differences in national definitions.
Council Regulation (EC) No 2494/95[155] was adopted in October 1995 and the new Regulation (EU) 2016/792[156] entered into force in June 2016. The HICPs have also been harmonised on the basis of EU Council and European Commission regulations. They use common standards for the coverage of the items, the territory and the population included (all these elements are major reasons for differences between national CPIs). Common standards have also been established in several other areas, for example the treatment of new goods and services.

The HICPs use annually updated expenditure weights (or, until 2011, less frequent updates if this did not have a significant effect on the index) and cover all goods and services included in household final monetary consumption expenditure. The latter is derived from the national accounts domestic concept of household final consumption expenditure but excludes owner-occupied housing. The prices observed are the prices households actually pay for goods and services in monetary transactions and thus include all taxes (minus subsidies) on products, e.g. VAT and excise duties. Expenditure on health,
education and social services is covered to the extent that it is financed (directly or through private insurance) by households and not reimbursed by the government. HICP administered prices refer to prices which are directly set or significantly influenced by the government, including national regulators. They are based on a common definition and compilation, and are published by Eurostat.

Eurostat must ensure that the statistical practices used to compile national HICPs comply with HICP methodological requirements and that good practices in the field of consumer price indices are being followed. Eurostat carries out compliance monitoring visits and publishes its findings in information notes made available on its website.

6.3 Government finance statistics

This section describes the methodology and quality of the statistics used to measure fiscal developments. GFS are based mainly on national accounts

[154] For details on the HICP legislative framework, recommendations and information notes in force, see the *Compendium of HICP reference documents*, Publications Office of the European Union, Luxembourg, 2013.

[155] Council Regulation (EC) No 2494/95 of 23 October 1995 concerning harmonized indices of consumer prices (OJ L 257, 27.10.1995, p. 1).

[156] Regulation (EU) 2016/792 of the European Parliament and of the Council of 11 May 2016 on harmonised indices of consumer prices and the house price index, and repealing Council Regulation (EC) No 2494/95 (OJ L 135, 24.5.2016, p. 11).

concepts as defined in the ESA 2010[157] and Commission Regulation (EU) No 220/2014[158]. They refer to the institutional sector "general government" as defined in the ESA 2010. This comprises central government, state government (in Member States with a federal structure), local government and social security funds. It typically does not include public corporations.

The general government deficit (−)/surplus (+) is equal to the ESA 2010 item "net lending (+)/net borrowing (−)", which in turn is equal to "total revenue" minus "total expenditure". The primary government deficit/surplus is the government deficit/surplus excluding interest expenditure.

The general government debt is the sum of the outstanding gross liabilities at nominal value (face value) in currency and deposits, debt securities (e.g. government bills, notes and bonds) and loans. It excludes financial derivatives, such as swaps[159], as well as trade credits[160] and other liabilities not represented by a financial document, such as overpaid tax advances. It also excludes contingent liabilities, such as government guarantees and pension commitments. While government debt is a gross concept in the sense that neither financial nor non-financial assets are deducted from liabilities, it is consolidated within the general government sector and therefore does not include government debt held by other government units.

The measure of GDP used for compiling government deficit and debt ratios is the ESA 2010 GDP at current market prices.

6.3.1 Data source

The NCBs provide the ECB with detailed GFS data under the ECB's GFS Guideline.[161] Although the Guideline is only legally binding for the euro area NCBs, the non-euro area EU NCBs also transmit GFS data to the ECB by the same deadlines and using the same procedures. The Guideline lays down requirements for the transmission of annual data with detailed breakdowns of annual revenue and expenditure and the deficit-debt adjustment. In addition, it requests figures on general government debt with breakdowns by instrument, by initial and residual maturity and by holder.

[157] See Regulation (EU) No 549/2013 of the European Parliament and of the Council of 21 May 2013 on the European system of national and regional accounts in the European Union (OJ L 174/1, 26.06.2013).

[158] Commission Regulation (EU) No 220/2014 of 7 March 2014 amending Council Regulation (EC) No 479/2009 as regards references to the European system of national and regional accounts in the European Union (OJ L 69/101, 08.03.2014).

[159] However, on the basis of a Eurostat guidance note released in 2008, lump sums received by government under off-market interest rate swaps are treated as government loans.

[160] A 2012 Eurostat decision stipulates that trade credits that are refinanced without recourse to the original holder and trade credits that are renegotiated beyond the simple extension of the initial maturity need to be reclassified as loans and are thus included in the EDP general government debt.

[161] Guideline ECB/2014/21 of 3 June 2014 amending Guideline ECB/2013/23 on government finance statistics (OJ L 267, 6.9.2014, p. 9).

6.3.2 Methodological issues

The GFS must comply with the ESA 2010 and reflect decisions and guidelines issued by Eurostat for specific cases involving the general government sector. The borderline classification cases between the financial, non-financial and general government sectors continue to be examined closely by Eurostat and statistical compilers and may lead to further reclassifications and changes in the EDP and GFS data.

In the Czech Republic and Hungary, there are MFIs that are reclassified into the general government sector for EDP purposes. These units are classified as part of the financial sector in other statistical data compiled by the NCB (e.g. monetary and financial statistics, and balance of payments statistics). The resultant discrepancy in sector classification between those statistics and GFS is well documented and has been made known to users.

In Sweden, there is a unit that is currently classified as part of the financial sector and it is on the ECB's list of MFIs; however, its reclassification into the government sector is currently under discussion.

In April 2018 Eurostat expressed a reservation on the quality of the data reported by Hungary in relation to the sector classification of the foundations created by the Hungarian National Bank. Eurostat considers that these foundations, including their subsidiaries, should be classified inside general government.

6.4 Exchange rates

Article 3 of Protocol (No 13) on the convergence criteria defines what is meant by the criterion on participation in the ERM of the European Monetary System. The bilateral exchange rates of the Member States' currencies vis-à-vis the euro are daily reference rates recorded by the ECB at 14:15 CET and published on the ECB's website.[162] Nominal and real effective exchange rates (EERs) are constructed by applying trade weights (based on a geometric weighting) to the bilateral nominal and real exchange rates of the Member States' currencies vis-à-vis the currencies of 38 trading partners. Both nominal and real EER statistics are calculated by the ECB.

6.5 Long-term interest rates

Article 4 of Protocol (No 13) on the convergence criteria requires interest rates to be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions. While Article 5 assigns the responsibility for providing the statistical data for the application of the

[162] From 1 July 2016 the ECB's euro foreign exchange reference rates will be published at around 16:00 CET (see press release: http://www.ecb.europa.eu/press/pr/date/2015/html/pr151207.en.html).

Protocol to the European Commission, the ECB, given its expertise in the area, assists in this process by defining representative long-term interest rates and collecting the data from the NCBs for transmission to the Commission. This is a continuation of the work carried out by the EMI as part of the preparations for Stage Three of EMU in close liaison with the Commission. The conceptual work resulted in the definition of seven key features to be considered in the calculation of long-term interest rates, as presented in Table 6.2. Long-term interest rates refer to bonds denominated in national currency.

Table 6.2

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

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

6.6 Other factors

The last paragraph of Article 140(1) of the Treaty states that the reports of the European Commission and the ECB shall take account of, in addition to the four main criteria, the results of the integration of markets, the situation and development of the national balance of payments and an examination of the development of unit labour costs and other price indices. Whereas, for the four main criteria, Protocol (No 13) stipulates that the Commission will provide the data to be used for the assessment of compliance and describes those statistics in more detail, it makes no reference to the provision of statistics for these "other factors".

With regard to the results of the integration of markets, two sets of indicators are used. These are: i) statistics on financial development and integration referring to the structure of the financial system;[163] and ii) statistics on financial and non-financial integration with the euro area.[164]

The data covering the structure of the financial system are provided by the NCBs. The data underlying the indicators concerning the debt securities issued by resident financial corporations (MFIs and non-monetary financial corporations) and

[163] Debt securities issued by resident corporations, stock market capitalisation, MFI credit to non- government residents and claims of euro area MFIs on resident MFIs.

[164] External trade and investment position with the euro area.

non-financial corporations are reported by the respective NCBs in accordance with the methodology set out in Guideline ECB/2014/43[165]. The indicator relating to stock market capitalisation refers to listed shares issued by resident corporations following the methodology given in the same Guideline. The indicators concerning MFI credit to residents and claims of euro area MFIs on resident MFIs are based on available data collected by the ECB as part of the MFI balance sheet statistics collection framework. The data are obtained from the countries under review and, for the latter indicator, also from the euro area countries covered by Regulation (EU) No 1071/2013[166]. Historical data are compiled by the relevant NCBs, where appropriate. For the indicators mentioned, the statistical data relating to the euro area cover the countries that had adopted the euro at the time to which the statistics relate.

Balance of payments and international investment position statistics are compiled in accordance with the concepts and definitions laid down in the sixth edition of the IMF's Balance of Payments and International Investment Position Manual (BPM6)[167] and with compilation guidance provided by the ECB and Eurostat. This Convergence Report examines developments in the current (goods, services, primary income and secondary income) and capital accounts; the sum of the balances of these two accounts corresponds to the net lending/net borrowing of the total economy. In addition, developments in the main components of the financial account are presented together with the net international investment position and gross external debt of each country. Exports and imports of goods and services are presented vis-à-vis both the rest of the world and the euro area countries. Direct and portfolio investment assets and liabilities with the euro area are also directly identified. Forecasted data are taken from the European Commission's Economic Forecast.[168]

The Convergence Report also looks at the development of unit labour costs and other price indices. With regard to producer price indices, these data refer to domestic sales of total industry excluding construction. The statistics are collected on a harmonised basis under the EU regulation concerning short-term statistics.[169] Statistics on unit labour costs (calculated as compensation per employee divided by GDP chain-linked volumes per person employed) are derived from data provided under the ESA 2010 transmission programme. Statistics on the harmonised unemployment rate (calculated as the number of unemployed over the labour force) take into account persons between the ages of 15 and 74.

[165] Guideline ECB/2014/43 of the European Central Bank of 6 November 2014 amending Guideline ECB/2014/15 on monetary and financial statistics (OJ L 93, 9.4.2015, p. 82).

[166] Regulation (EU) No 1071/2013 of the European Central Bank of 24 September 2013 concerning the balance sheet of the monetary financial institutions sector (recast) (OJ L 297, 7.11.2013, p. 1).

[167] For further details, see European Union balance of payments and international investment position statistical methods ("B.o.p. and i.i.p. book"), ECB, Frankfurt am Main, 2016.

[168] The economic forecasts made by the Directorate-General for Economic and Financial Affairs (DG ECFIN) on behalf of the European Commission: http://ec.europa.eu/economy_finance/eu/forecasts/index_en.htm

[169] Council Regulation (EC) No 1165/98 of 19 May 1998 concerning short-term statistics (OJ L 162, 5.6.1998, p. 1).

7 Examination of compatibility of national legislation with the Treaties

The following country assessments report only on those provisions of national legislation which the ECB considered to be problematic from the perspective of their compatibility with provisions on the independence of NCBs in the Treaty (Article 130) and the Statute (Articles 7 and 14.2), provisions on confidentiality (Article 37 of the Statute), prohibitions on monetary financing (Article 123 of the Treaty) and privileged access (Article 124 of the Treaty), and the single spelling of the euro as required by EU law. They also cover the perspective of legal integration of the NCBs into the Eurosystem (in particular as regards Articles 12.1 and 14.3 of the Statute).[170]

7.1 Bulgaria

7.1.1 Compatibility of national legislation

The following legislation forms the legal basis for Българска народна банка (Bulgarian National Bank) and its operations:

- the Bulgarian Constitution,[171]
- the Law on Българска народна банка (Bulgarian National Bank) (hereinafter the "Law on BNB").[172]

The Law on counter-corruption and unlawfully acquired assets forfeiture (hereinafter the "Law on counter-corruption")[173] applies to public office holders.

In addition, the Law on credit institutions[174] has become relevant since it conferred on Българска народна банка (Bulgarian National Bank) new tasks in relation to the establishment of a central credit register and a bank account register.

There have been no major changes in relation to the points identified in the ECB's Convergence Report of June 2016, and those comments are therefore repeated in this year's assessment.

[170] According to Section 2.2.2.1 of this Convergence Report.
[171] Constitution of the Republic of Bulgaria, Darjaven vestnik issue 56, 13.7.1991.
[172] Law on Българска народна банка (Bulgarian National Bank), Darjaven vestnik issue 46, 10.6.1997.
[173] Darjaven vestnik issue 7, 19.01.2018.
[174] Darjaven vestnik issue 59, 21.07.2006.

7.1.2 Independence of the NCB

With regard to the independence of Българска народна банка (Bulgarian National Bank), the Law on BNB and the Law on counter-corruption need to be adapted as set out below.

7.1.2.1 Institutional independence

Article 44 of the Law on BNB prohibits the Council of Ministers and other bodies and institutions from giving instructions to Българска народна банка (Bulgarian National Bank), the Governor or the members of the Governing Council. It further prohibits Българска народна банка (Bulgarian National Bank), its Governor and the members of its Governing Council from seeking or taking instructions from the Council of Ministers or from any other body or institution. The ECB understands that the provision encompasses both national and foreign institutions in line with Article 130 of the Treaty and Article 7 of the Statute. For legal certainty reasons, at the first opportunity, this provision should be brought fully into line with Article 130 of the Treaty and Article 7 of the Statute.

7.1.2.2 Personal independence

Article 14(1) of the Law on BNB lists the grounds for dismissal of the members of the Governing Council, according to which the National Assembly or Bulgaria's President may relieve a member of the Governing Council from office, including the Governor, if they: (i) no longer fulfil the conditions required for the performance of their duties under Article 11(4);[175] (ii) are in practice unable to perform their duties for more than six months; or (iii) have been guilty of serious professional misconduct.

The first part of Article 14(1) of the Law on BNB cross-refers to the conditions of appointment and election in Article 11(4). To avoid any circumvention of the conditions for dismissal of Governors as established by Article 14.2 of the Statute, the first part of Article 14(1) of the Law on BNB should only provide for conditions that are objective, clearly defined and linked to the performance of duties of the members of the Governing Council. The second part of Article 14(1) of the Law on BNB is in addition to the two grounds for dismissal provided for in Article 14.2 of the Statute. The third part narrows the concept of "serious misconduct" in Article 14.2 of the Statute to "serious professional misconduct".

[175] Under Article 11(4) of the Law on BNB, a member of the Governing Council, including the Governor, may not: (i) be sentenced to imprisonment for a premeditated crime; (ii) declared bankrupt in their capacity as sole proprietor or general partner in a commercial company; (iii) have been a member of a managing or supervisory body of a company or cooperative in the two years prior to the said company or cooperative being declared insolvent; (iv) be sole proprietor, unlimited liability partner in a trading company, manager, trade proxy, trade representative, procurator, trade agent, liquidator or receiver, member of a management or controlling body of a trade company or a cooperative, with the exception of companies where Българска народна банка (Bulgarian National Bank) participates; (v) be a spouse of, live with, be a relative in direct or lateral line up to and including the fourth degree, or be connected by marriage up to and including the second degree to a member of the Governing Council.

Therefore Article 14(1) of the Law on BNB needs to be adapted further in order to fully comply with Article 14.2 of the Statute.

The Law on counter-corruption repealed the Law on the prevention of conflicts of interests in January 2018. At the same time, Article 80(1) of the Law on counter- corruption replicates the former provision of Article 33(1) Law on the prevention of conflicts of interests, providing that the ascertainment of a conflict of interests by an enforceable legal act is a ground for the dismissal of the Governor, Deputy Governors and the other members of the Governing Council of Българска народна банка (Bulgarian National Bank). Thus, the Law on counter-corruption specifies a ground for dismissal that is in addition to the two grounds contained in Article 14.2 of the Statute. Therefore, the Law on counter-corruption is incompatible with the Treaty and the Statute and needs to be brought into line with them.[176]

The Law on BNB is silent on the right of national courts to review a decision to dismiss any member, other than the Governor, of Българска народна банка (Bulgarian National Bank) decision-making bodies, who is involved in the performance of ESCB-related tasks. Even though this right may be available under general law, providing specifically for such a right of review would increase legal certainty.

Article 12(1) and (2) of the Law on BNB provide for the National Assembly's powers to elect the Governor and the Deputy Governors of Българска народна банка (Bulgarian National Bank). In a 2009 case, the National Assembly claimed and acted upon the claim that it has the power to annul or amend its previous decisions, including decisions concerning the election of the Governor and Deputy Governors of Българска народна банка (Bulgarian National Bank) taken under Article 12(1) and (2) of the Law on BNB. In practice, any proper election or appointment of members of an NCB's decision-making body should enable them to assume office following their election. Once elected or appointed, the Governor and the other members of the Governing Council of Българска народна банка (Bulgarian National Bank) may not be dismissed under conditions other than those mentioned in Article 14.2 of the Statute, even if they have not yet taken up their duties. Therefore, taking the above-mentioned case into account, the ECB reiterates that the Law on BNB should be revised to mirror the wording of Article 14.2 of the Statute and to provide specifically for a right of review of decisions removing members of Българска народна банка (Bulgarian National Bank) decision-making bodies from office.

7.1.3 Confidentiality

Article 4(2) of the Law on BNB provides that Българска народна банка (Bulgarian National Bank) may not disclose or pass to third parties any information obtained which is of a confidential banking or commercial nature for banks and the other participants in the money turnover and credit relations, except in the cases provided for by the Law on the protection of classified information. Under Article 23(2) of the

[176] See also Opinion CON/2009/13.

Law on BNB, the employees of Българска народна банка (Bulgarian National Bank) may not disclose any information concerning negotiations, contracts entered into, the level of assets on customers' deposits and their operations, information received by Българска народна банка (Bulgarian National Bank), as well as any circumstances concerning the activities of Българска народна банка (Bulgarian National Bank) or its customers which constitute official, banking, commercial or other secrecy protected by law, even after the termination of their contracts of employment. Under Article 37 of the Statute, professional secrecy is an ESCB-wide matter. Therefore, the ECB assumes that Articles 4(2) and 23(2) of the Law on BNB are without prejudice to the confidentiality obligations towards the ECB and the ESCB.

7.1.4 Monetary financing and privileged access

Article 45(1) of the Law on BNB provides that Българска народна банка (Bulgarian National Bank) may not grant credits or guarantees in any form whatsoever, including through the purchase of debt instruments, to the Council of Ministers, municipalities, or to other government or municipal institutions, organisations and undertakings. Pursuant to Article 45(2) of the Law on BNB, this does not apply to the extension of credits to state-owned and municipal banks in emergency cases of liquidity risk that may affect the stability of the banking system. Article 45(1) and (2) of the Law on BNB need to be adjusted to be fully consistent with the Treaty. In particular, the range of public sector entities referred to in Article 45(1) of the Law on BNB needs to be extended to include central governments, regional, local or other public authorities, public undertakings and bodies governed by public law of other Member States and EU institutions and bodies to fully mirror the wording of Article 123 of the Treaty. Moreover, Article 45(1) of the Law on BNB needs to be slightly redrafted to ensure that it accurately reflects the prohibition of monetary financing to cover both (a) lending 'to' the range of public sector entities; and (b) purchases of debt instruments 'from' the range of public sector entities.

The prohibition of monetary financing prohibits the direct purchase of public sector debt, but such purchases in the secondary market are allowed, in principle, as long as such secondary market purchases are not used to circumvent the objective of Article 123 of the Treaty. For this reason the word 'direct' should be inserted in Article 45(1) of the Law on BNB.

Furthermore, while acknowledging the particularities arising out of the currency- board regime, i.e. prohibition on Българска народна банка (Bulgarian National Bank) extending credit to credit institutions other than in the context of emergency liquidity operations, it is recommended that the scope of the exemption addressed to publicly-owned credit institutions is brought into line with the scope of the exemption under the Treaty.

Pursuant to Article 56 of the Law on credit institutions Българска народна банка (Bulgarian National Bank) operates a central credit register while pursuant to Article 56a Българска народна банка (Bulgarian National Bank) operates a bank account register. The costs of obtaining information from these registers by government and judicial authorities are to be borne by the state budget. In order to further ensure compatibility with the monetary financing prohibition, the Law on credit institutions would benefit from a limitation of Българска народна банка (Bulgarian National Bank)'s liability in relation to the operation of the two registers[177].

7.1.5 Legal integration of the NCB into the Eurosystem

With regard to the legal integration of Българска народна банка (Bulgarian National Bank) into the Eurosystem, the Law on BNB needs to be adapted in the respects set out below.

7.1.5.1 Tasks

Monetary policy

Article 2(1) and Article 3, Article 16, items 4 and 5 and Articles 28, 30, 31, 32, 35, 38, 41 and 61 of the Law on BNB, which provide for the powers of Българска народна банка (Bulgarian National Bank) in the field of monetary policy and instruments for the implementation thereof, do not recognise the ECB's powers in this field.

Article 33 of the Law of BNB, which empowers Българска народна банка (Bulgarian National Bank) to enter into certain financial transactions, also fails to recognise the ECB's powers in this field.

Collection of statistics

Article 4(1) and Article 42 of the Law on BNB, which provide for the powers of Българска народна банка (Bulgarian National Bank) relating to the collection of statistics, do not recognise the ECB's powers in this field.

Official foreign reserve management

Article 20(1) and Articles 28, 31 and 32 of the Law on BNB, which provide for the powers of Българска народна банка (Bulgarian National Bank) with regard to the management of official foreign reserves, do not recognise the ECB's powers in this field.

[177] See paragraph 3.1.6 of Opinion CON/2015/46, paragraph 3.2.1 of Opinion CON/2016/19 and paragraph 2.2 of Opinion CON/2016/57.

Payment systems

Articles 2(4) and 40(1) of the Law on BNB, which provide for the powers of Българска народна банка (Bulgarian National Bank) with regard to the promotion of the smooth operation of payment systems, do not recognise the ECB's powers in this field.

Issue of banknotes

Article 2(5), Article 16, item 9, and Articles 24 to 27 of the Law on BNB, which provide for the powers of Българска народна банка (Bulgarian National Bank) with regard to the issue of banknotes and coins, do not recognise the Council's and the ECB's powers in this field.

7.1.5.2 Financial provisions

Appointment of independent auditors

Article 49(4) of the Law on BNB, which provides that the external auditor is appointed by the Governing Council for a term of three years on the basis of a procedure complying with the Law on public procurement, does not recognise the Council's and the ECB's powers under Article 27.1 of the Statute.

Financial reporting

Article 16, item 11 and Articles 46 and 49 of the Law on BNB do not reflect the obligation to comply with the Eurosystem's regime for financial reporting of NCB operations, pursuant to Article 26 of the Statute.

7.1.5.3 Exchange rate policy

Articles 28, 31, 32 of the Law on BNB, which provide for the powers of Българска народна банка (Bulgarian National Bank) with regard to the exchange rate policy, do not recognise the Council's and the ECB's powers in this field.

7.1.5.4 International cooperation

Article 5, Article 16, item 12 and Article 37(4) of the Law on BNB, which provide for the powers of Българска народна банка (Bulgarian National Bank) with regard to international cooperation, do not recognise the ECB's powers in this field.

7.1.5.5 Miscellaneous

Articles 61 and 62 of the Law on BNB do not recognise the ECB's powers to impose sanctions.

7.1.6 Conclusions

The Law on BNB, the Law on counter-corruption and the Law on credit institutions do not comply with all the requirements for central bank independence, the monetary financing prohibition, and legal integration into the Eurosystem. Bulgaria is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.

7.2 Czech Republic

7.2.1 Compatibility of national legislation

The following legislation forms the legal basis for Česká národní banka and its operations:

- the Czech Constitution,[178]
- the Law on Česká národní banka (hereinafter the "Law on CNB").[179]

The assessment takes into account the relevant amendments made to the Law on CNB by Law No 135/2014 Coll., Laws No 204/2015 Coll. and 375/2015 Coll., Law No 377/2015 Coll. and Laws No 258/2016 and 183/2017 amending Law No 6/1993 Coll. on Česká národní banka and other related laws.[180] It also takes into account the current Law No 166/1993 Coll. on the Supreme Audit Office (hereinafter the "Law on NKU").

In relation to the points identified in the ECB's Convergence Report of June 2016 which were not addressed by the above amendments, the comments made in that report are largely repeated, with the exception set out below.

7.2.2 Independence of the NCB

Česká národní banka has been faced in the recent past with accumulated losses that were higher than its capital and reserve levels, and which had been carried over for several years. A negative capital situation may adversely affect an NCB's ability to

[178] Constitutional Law No 1/1993 Coll.

[179] Law No 6/1993 Coll.

[180] In respect of Laws No. 135/2014 and 375/2015, see Opinion CON/2015/22.

perform its ESCB-related tasks as well as its national tasks. At the end of 2016, Česká národní banka had positive net equity.

With regard to Česká národní banka's independence, the Law on CNB needs to be adapted as set out below.

7.2.2.1 Functional independence

Article 2(1) of the Law on CNB provides that in addition to the primary objective of price stability, Česká národní banka's objective is "to ensure financial stability and the safe and sound operation of the financial system in the Czech Republic". In line with Article 127(1) of the Treaty, the secondary objective of Česká národní banka should be stated to be without prejudice to Česká národní banka's primary objective of maintaining price stability.

7.2.2.2 Institutional independence

Article 3 of the Law on CNB obliges Česká národní banka to submit a report on monetary development to the Chamber of Deputies at least twice a year for review; the Law on CNB also provides for an optional extraordinary report to be prepared pursuant to a Chamber of Deputies resolution. The Chamber of Deputies has the power to acknowledge the report or ask for a revised report; such a revised report must comply with the Chamber of Deputies' requirements. These parliamentary powers could potentially breach the prohibition on giving instructions to NCBs pursuant to Article 130 of the Treaty and Article 7 of the Statute.

In addition, Article 47(5) of the Law on CNB requires Česká národní banka to submit a revised report if the Chamber of Deputies rejects its annual financial report. This revised report must comply with the Chamber of Deputies' requirements. Such parliamentary powers breach the prohibition on approving, annulling or deferring decisions. Article 3 and Article 47(5) of the Law on CNB are therefore incompatible with central bank independence and should be adapted accordingly.

Further, Article 130 of the Treaty and Article 7 of the Statute are partially mirrored in the Law on CNB. Article 9(1) of the Law on CNB expressly prohibits Česká národní banka and its Board from seeking or taking instructions from the President of the Republic, from Parliament, from the Government, from administrative authorities of the Czech Republic, from the bodies, institutions or other entities of the European Union, from governments of the Member States or from any other body, but it does not expressly prohibit the Government from seeking to influence the members of Česká národní banka's decision-making bodies in situations where this may have an impact on Česká národní banka's fulfilment of its ESCB-related tasks. In this respect the Law on CNB needs to be adapted to be fully consistent with Article 130 of the Treaty and Article 7 of the Statute.

Pursuant to the Law on NKU, the Supreme Audit Office (NKU) is empowered to audit Česká národní banka's financial management as regards its operating expenditure and expenditure for the purchase of property. The ECB understands that: (i) the NKU's auditing powers in relation to Česká národní banka are without prejudice to Article 9 of the Law on CNB, which concerns the general prohibition on Česká národní banka seeking or taking instructions from other entities; and (ii) the NKU has no power to interfere with either the external auditors' opinion or with Česká národní banka's ESCB-related tasks.

In so far as this understanding is correct, the NKU's auditing powers vis-à-vis Česká národní banka are not incompatible with central bank independence.

7.2.2.3 Personal independence

The Law on CNB, in particular Article 6, no longer refers to the Governor's right in the case of dismissal to seek a remedy before the Court of Justice of the European Union in accordance with Article 14.2 of the Statute. The ECB understands that although the Law on CNB is silent on the jurisdiction of the Court of Justice of the European Union to hear cases with regard to decisions to dismiss the Governor, Article 14.2 of the Statute applies. It is noted in this regard that Article 14.2 of the Statute is cited in a footnote to Article 6(10) of the Law on CNB, which deals with relieving a Česká národní banka board member from office.

The Law on CNB is also silent on the right of national courts to review a decision to dismiss any member, other than the Governor, of Česká národní banka's Board who is involved in the performance of ESCB-related tasks. Even though this right may be available under general law, providing specifically for such a right of review would increase legal certainty.

7.2.3 Monetary financing and privileged access

Under Article 33a of the Law on CNB, Česká národní banka, upon request, may provide the Financial Market Guarantee System (FMGS) with short-term credit guaranteed by government bonds or other securities underwritten by the Government and owned by the FMGS, for a maximum of three months, where the FMGS does not have sufficient funds to perform its tasks and this situation might jeopardise the stability of the financial market. Article 33a of the Law on CNB has no provision requiring Česká národní banka to provide temporary loans or other types of repayable financial assistance in order to address an urgent situation. Even if such funding is discretionary, temporary and in the interests of financial stability, it should be expressly stipulated that the funding may be granted only in demonstrably urgent cases in order to be compatible with the monetary financing prohibition. Further, when exercising its discretion to grant a loan, Česká národní banka must ensure that it is not in effect taking over a government task. In particular, central bank support for deposit guarantee schemes should not amount to a systematic 'pre-funding' operation. For the reasons laid down in this paragraph, Article 33a of the Law on CNB should be amended to include more express safeguards in relation to the conditions under which Česká národní banka may finance the FMGS, in order to avoid incompatibility with the monetary financing prohibition under Article 123 of the Treaty.[181]

Article 34a of the Law on CNB aims at addressing defects highlighted in the ECB's Convergence Report in relation to the prohibition on monetary financing, but fails to provide for an exception to the monetary financing prohibition in favour of publicly owned credit institutions in the context of the supply of reserves. Article 34a(2) of the Law on CNB provides instead for an exception with reference to "publicly owned banks, foreign banks and savings banks and credit unions". Article 34a(2) of the Law on CNB should be amended to reflect the text of Article 123(2) of the Treaty accordingly.

7.2.4 Legal integration of the NCB into the Eurosystem

With regard to Česká národní banka's legal integration into the Eurosystem, the Law on CNB and Law No 2/1969 Coll., establishing ministries and other central administrative bodies of the Czech Republic (hereinafter the "Law on competences") need to be adapted as set out below.

7.2.4.1 Economic policy objectives

Article 2(1) of the Law on CNB, the last sentence of which provides that without prejudice to its primary objective, Česká národní banka shall support the general economic policies of the Government leading to sustainable economic growth and the general economic policies in the EU with a view to contributing to the achievement of the objectives of the EU, is not fully compatible with Article 127(1) of the Treaty and Article 2 of the Statute. The Law on CNB should make it clear that the objective of financial stability and the objective of supporting the general economic policies of the Government leading to sustainable growth are subordinate not only to the primary objective of price stability as specified in Section 6.2.2.1 but also to the secondary objective of the ESCB.

7.2.4.2 Tasks

Monetary policy

Article 2(2)(a), Article 5(1) and Part Five (namely Articles 23 to 26) of the Law on CNB, which provide for Česká národní banka's powers in the field of monetary policy and instruments for the implementation thereof, do not recognise the ECB's powers in this field.

[181] See paragraphs 3.1.2 and 3.1.3 of Opinion CON/2015/22.

Articles 28, 29, 32 and 33 of the Law on CNB, which empower Česká národní banka to enter into certain financial transactions, also fail to recognise the ECB's powers in this field.

Official foreign reserve management

Article 35(c) and Articles 36 and 47a of the Law on CNB, which provide for Česká národní banka's powers relating to foreign reserve management, do not recognise the ECB's powers in this field. Article 4(1) of the Law on competences, according to which the Ministry of Finance is the central administrative body for, inter alia, "foreign exchange affairs including the State's claims and obligations towards foreign entities" does not recognise the ECB's powers in this field.

Payment systems

Article 2(2)(c) and Articles 38 and 38a of the Law on CNB, which provide for Česká národní banka's powers relating to the smooth operation of payment systems, do not recognise the ECB's powers in this field. Article 4(1) of the Law on competences, according to which the Ministry of Finance is the central administrative body for, inter alia, "payments systems", does not recognise the ECB's powers in this field.

Issue of banknotes

Article 2(2)(b) of the Law on CNB, which empowers Česká národní banka to issue banknotes and coins, and Part Four of the Law on CNB, namely Articles 12 to 22, which specify Česká národní banka's powers in this field and the related implementing instruments, do not recognise the Council's and the ECB's powers in this field.

7.2.4.3 Financial provisions

Appointment of independent auditors

Article 48(2) of the Law on CNB, which provides that Česká národní banka's annual financial statements are audited by auditors selected on the basis of an agreement between Česká národní banka's Board and the Minister for Finance, does not recognise the Council's and the ECB's powers under Article 27.1 of the Statute.

Financial reporting

Article 48 of the Law on CNB does not reflect Česká národní banka's obligation to comply with the Eurosystem's regime for financial reporting of NCB operations, pursuant to Article 26 of the Statute.

7.2.4.4 Exchange rate policy

Article 35 of the Law on CNB, which authorises Česká národní banka to conduct exchange rate policy, does not recognise the Council's and the ECB's powers in this field. Article 4 of the Law on competences also fails to recognise the Council's and the ECB's powers in this field.

7.2.4.5 International cooperation

Article 2(3) of the Law on CNB, which empowers Česká národní banka to cooperate and negotiate agreements with the central banks of other countries and international financial institutions, does not recognise the ECB's powers in this field.

7.2.4.6 Miscellaneous

Article 37 of the Law on CNB, which provides for the respective legislative powers of Česká národní banka and the Ministry of Finance in areas relating, inter alia, to currency, the circulation of money, the financial market, the adoption of the euro in the Czech Republic, the payment system, foreign exchange management, and the status, competence, organisation and activities of Česká národní banka, does not recognise the Council's and the ECB's powers in this field.

Article 43e of the Law on CNB requires Česká národní banka to "ensure ongoing protection of confidential statistical information obtained on the basis of this Law … so that such information is used for statistical purposes only". While Article 43f(1)(a) of the Law on CNB expressly allows Česká národní banka to provide confidential statistical information to another member of the ESCB to the extent and at the level of detail necessary to perform ESCB tasks, in compliance with Article 8(4)(a) of Council Regulation (EC) No 2533/98,[182] Article 43e of the Law on CNB should be redrafted so as not to contradict Article 43f(1)a of that Law.

Article 46a of the Law on CNB, which sets out the sanctions against third parties which fail to comply with their statistical obligations, does not recognise the Council's and the ECB's powers to impose sanctions.

[182] Council Regulation (EC) No 2533/98 of 23 November 1998 concerning the collection of statistical information by the European Central Bank (OJ L 318, 27.11.1998, p. 8).

7.2.5 Conclusions

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

7.3 Croatia

7.3.1 Compatibility of national legislation

The following legislation forms the legal basis for Hrvatska narodna banka and its operations:

- the Croatian Constitution,[183]
- the Law on Hrvatska narodna banka (hereinafter the "Law on HNB").[184]
- There have been no changes in relation to the points identified in the ECB's Convergence Report of June 2016, and those comments are therefore repeated in this year's assessment.

7.3.2 Independence of the NCB

With regard to Hrvatska narodna banka's institutional independence, the Law on HNB needs to be adapted as set out below.

7.3.2.1 Institutional and personal independence

Article 71 of the Law on HNB partially mirrors Article 130 of the Treaty and Article 7 of the Statute. In particular Article 71(2) of the Law on HNB does not expressly prohibit the Croatian Government from seeking to influence the members of Hrvatska narodna banka's decision-making bodies in the performance of their tasks.

[183] Constitution of the Republic of Croatia, OG 5/2014. - Decision of the Constitutional Court No SuP-O- 2014 of 14 January 2014.
[184] Law on Hrvatska narodna banka OG 75/2008 of 01 July 2008. Amendments to the Law on Hrvatska narodna banka OG 54/2013 of 7 May 2013.

In this respect the Law on HNB needs to be adapted to be fully consistent with Article 130 of the Treaty and Article 7 of the Statute[185].

7.3.3 Legal integration of the NCB into the Eurosystem

With regard to the legal integration of Hrvatska narodna banka into the Eurosystem, the Law on HNB needs to be adapted in the respects set out below.

7.3.3.1 International cooperation

Pursuant to Article 104(11) of the Law on HNB, the Hrvatska narodna banka's Council decides on Hrvatska narodna banka's membership of international institutions and organisations. The ECB understands that this power of the Hrvatska narodna banka's Council is without prejudice to the ECB's powers under Article 6(1) of the Statute.

7.3.4 Conclusions

The Law on HNB does not comply with all the requirements for central bank independence. Croatia is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.

7.4 Hungary

7.4.1 Compatibility of national legislation

The following legislation forms the legal basis for the Magyar Nemzeti Bank and its operations:

- The consolidated version of the Fundamental Law of Hungary,[186]
- Law CXXXIX of 2013 on the Magyar Nemzeti Bank (hereinafter the "Law on the MNB").[187]

[185] The ECB has been consulted several times on draft legislation regarding amendments to the Law on HNB, inter alia, concerning the State Office's audit of Hrvatska narodna banka and the Croatian Parliament's vote on Hrvatska narodna banka's Annual Report. In its opinions, the ECB has consistently emphasised that draft legislation must be in line with the principle of central bank independence (see Opinion CON/2016/33, Opinion CON/2016/52 and Opinion CON/2018/17). So far, no draft legislation on amendments to the Law on HNB has been adopted.

[186] Magyarország Alaptörvénye, Magyar Közlöny 2013/163. (X.3.).

[187] 2013. évi CXXXIX. törvény a Magyar Nemzeti Bankról, Magyar Közlöny 2013/158. (IX.26.). Law CXXXIX of 2013 on the Magyar Nemzeti Bank repealed Law CCVIII of 2011 on the Magyar Nemzeti Bank with effect from 1 October 2013. See Opinions CON/2013/56 and CON/2013/71.

There have been no major changes in relation to the points identified in the ECB's Convergence Report of June 2016, and those comments are therefore repeated in this year's assessment. In relation to the Law on the MNB, and the number and combined effects of amendments to the Law on the MNB, which has been amended seven times since the ECB's Convergence Report of June 2016, there are additional points made in this year's assessment.

7.4.2 Independence of the NCB

With regard to the Magyar Nemzeti Bank's independence, the Law on the MNB and Law XXVII of 2008[188] need to be adapted as set out below.

7.4.2.1 Institutional independence

The legislation and institutional framework regarding the Magyar Nemzeti Bank have been changed many times over the course of the past years.[189] The latest recast of the Law on the MNB, which entered into force on 1 October 2013, resulted in the integration of the Hungarian Financial Supervisory Authority (HFSA) into the Magyar Nemzeti Bank as a general legal successor to the HFSA's scope of competence, rights and obligations.[190] Further recent amendments concerned the allocation of new tasks to the Magyar Nemzeti Bank, such as: resolution tasks[191]; supervisory tasks involving the verification of compliance with the new legal measures applicable to consumer loan contracts[192]; mediation of complaints and the initiation of legal proceedings in the public interest.[193] The combination of the changes to the institutional framework of the Magyar Nemzeti Bank and the frequency of changes to the Law on the MNB, not always backed by robust justification for the need to amend the Magyar Nemzeti Bank's institutional framework, adversely affect the organisational and governance stability of the Magyar Nemzeti Bank and impact its institutional independence. The principle of central bank independence requires that a central bank has a stable legal framework to enable it to function.

7.4.2.2 Personal independence

The ECB's Convergence Reports of 2010, 2012, 2014 and 2016 noted that Law XXVII of 2008 specifies the wording of the oath that the members of the Monetary

[188] Law XXVII of 2008 on the oath of certain public officials.

[189] There have been several changes in the institutional framework for the Magyar Nemzeti Bank as identified in the ECB's Convergence Report of June 2016, Chapter 7.4, p. 171, footnote 161. In addition to the changes referred to in the Convergence Report of June 2016, further legislative amendments to the Law on the MNB were introduced by Law XXXI of 2016, Law LIII of 2016, Law LIII of 2017, Law LXIX of 2017, Law CXCI of 2017 Law CXLV of 2017 and Law L of 2017.

[190] See Articles 176 to 183 of the Law on the MNB as well as Opinions CON/2013/56 and CON/2013/71.

[191] Law XXXVII of 2014.

[192] Law XL of 2014.

[193] Law XL of 2014 and Law LXXXV of 2015.

Council – including the Governor – are required to take. Pursuant to Article 9(7), in conjunction with Articles 10(3) and 11(2) of the Law on the MNB which entered into force on 1 October 2013, the Governor and the Deputy Governors of the Magyar Nemzeti Bank must take an oath before Hungary's President, while other members of the Monetary Council take an oath before the Parliament. Law XXVII of 2008 specifies the wording of the oath to be taken by public officials appointed by the Parliament.[194] Therefore, it is not clear whether the Governor and Deputy Governors take the same oath as the other members of the Monetary Council.

The Magyar Nemzeti Bank's Governor acts in a dual capacity as a member of both the Magyar Nemzeti Bank's Monetary Council and the ECB decision-making bodies. The wording of the oath should take into account and reflect the status, obligations and duties of the Governor as a member of the ECB's decision-making bodies. Furthermore, the other members of the Monetary Council are also involved in the performance of ESCB-related tasks. The oath taken should not hinder the Governor, Deputy Governors and other members of the Monetary Council from performing ESCB-related tasks. Law XXVII of 2008 and Articles 9(7), 10(3) and 11(2) of the Law on the MNB need to be adapted in this regard.[195]

In addition, in accordance with Article 152(2) of the Law on the MNB, by way of exception from the general rule laid down in Article 152(1), all employees of the Magyar Nemzeti Bank, including the members of the Monetary Council, may: (1) hold membership of any kind in some but not all of the entities[196] subject to the Magyar Nemzeti Bank's supervisory powers, which fall under the scope of the laws enumerated in Article 39 of the Law on the MNB[197]; (2) have an employment relationship or any other work-related relationship, including by being executive officer or a supervisory board member, in a financial institution in which the Magyar Nemzeti Bank holds shares; and (3) be a supervisory board member of a non-profit business association the purpose of which is the resolution of entities subject to Article 39. In addition, pursuant to Article 153(1) of the Law on the MNB, employees of the Magyar Nemzeti Bank, including the members of the Monetary Council,

[194] Law XXVII of 2008 on the oath of certain public officials. The wording of the oath is: "I, … [name of the person taking the oath], hereby undertake to be faithful to Hungary and to its Fundamental Law, I will comply and ensure compliance with its laws, I will fulfil my office as a … [name of the position] for the benefit of the Hungarian people. [Depending on the belief of the person taking the oath] So help me God!"

[195] Law XXVII of 2008 was amended by Law XIV of 2014, but these changes do not affect the assessment of the Hungarian law laid down in this section.

[196] These entities are voluntary mutual insurance funds, private pension funds, cooperative credit institutions and insurance associations.

[197] These acts are as follows: (a) the Law on voluntary mutual insurance funds; (b) the Law on the Hungarian Export-Import Bank Corporation and the Hungarian Export Credit Insurance Corporation; (c) the Law on credit institutions and financial enterprises; (d) the Law on home savings and loan associations; (e) the Law on mortgage loan companies and mortgage bonds; (f) the Law on private pensions and Private Pension Funds; (g) the Law on the Hungarian Development Bank Limited Company; (h) the Law on credit institutions and financial enterprises; (i) the Law on the capital markets;
(j) the Law on insurance institutions and the insurance business;(k) the Law on the distance marketing of consumer financial services; (l) the Law on occupational retirement pensions and institutions for occupational retirement provision; (m) the Law on investment firms and commodity dealers, and on the regulations governing their activities; (n) the Law on collective investment trusts and their managers, and on the amendment of financial regulations; (o) the Law on reinsurance; (p) the Law on the pursuit of the business of payment services; (q) the Law on insurance against civil liability in respect of the use of motor vehicles; (r) the Law on the central credit information system; (s) the Law on settlement finality in payment and securities settlement systems; (t) the Law on payment service providers.

performing the Magyar Nemzeti Bank's basic tasks can maintain an employment relationship, including by being an executive officer or a supervisory board member, with financial institutions owned by the Magyar Nemzeti Bank. Furthermore, pursuant to Article 153(6) of the Law on the MNB[198], by way of exception from Article 152, Article 153(1) to (5) and Articles 154 to 156 of the Law on the MNB, the members of the Monetary Council may, without being subject to a formal disclosure requirement (unless it amounts to an employment relationship), be an executive officer or a member of a supervisory board of a business association under the majority ownership of the Magyar Nemzeti Bank, as well as a member of the management, board of trustees or supervisory board of a foundation established by the Magyar Nemzeti Bank. On the basis that it gives rise to potential conflicts of interest, the exception provided for in Article 152(2) - in conjunction with Article 153(1) - and Article 153(6) of the Law on the MNB should be removed in relation to the entities subject to the Magyar Nemzeti Bank's supervisory powers that fall under the scope of the laws enumerated in Article 39 of the Law on the MNB, in order to safeguard the personal independence of the members of the Monetary Council. Furthermore, in relation to entities that are not subject to the Magyar Nemzeti Bank's supervisory powers and do not fall under the scope of the laws enumerated in Article 39 of the Law on the MNB, it should be clarified that the memberships or relationships specified in the abovementioned provisions of the Law on the MNB are not permitted if they give rise to a conflict of interest.

In addition, Article 156(7) of the Law on the MNB in conjunction with Article 152(1), sets out post-employment conflict of interest rules for the members of the Monetary Council. It provides the members of the Monetary Council with an exemption from the cooling-off period of six months with regard to any membership or shareholder relationship, employment relationship or work-related contractual relationship, executive officer relationship or supervisory board membership with any of the entities subject to the Magyar Nemzeti Bank's supervisory powers, which fall under the scope of the laws enumerated in Article 39 of the Law on the MNB and in which the Hungarian State or the Magyar Nemzeti Bank has a majority stake.[199] Providing for such an exemption may give rise to potential conflicts of interest for the members of the Monetary Council. In order to safeguard those members' personal independence, the exemption from the post-employment restrictions provided for in Article 156(7) of the Law on the MNB should be removed as regards the entities subject to the Magyar Nemzeti Bank's supervisory powers and should be amended to clarify that such membership is not permitted if it gives rise to a conflict of interest as regards the other entities covered by Article 156(7) of the Law on the MNB.

Article 157 of the Law on the MNB defines the rules that members of the Monetary Council must abide by when submitting their declarations of wealth. The Governor and the Deputy Governors must also follow these rules, by reference to the application of the provisions laid down in Law XXXVI of 2012 on the Parliament governing the declaration of wealth of members of the Parliament and related

[198] As introduced by Law LXXXV of 2015 on amendments to specific acts in order to enhance the development of the system of financial intermediation, 2015. évi LXXXV.

[199] Introduced to Article 156(7) of the Law CXXXIX of 2013 by Article 174 of Law LXXXV of 2015.

proceedings. Pursuant to Article 90(3) of Law XXXVI of 2012, which applies to the members of the Monetary Council by virtue of Article 157(2) of the Law on the MNB, in the case of non-compliance with the obligation to submit a declaration of wealth, the members of the Monetary Council will be prohibited from carrying out their duties and, as a consequence, they will not be entitled to receive their remuneration for the period of non-compliance. The sanction provided for in Article 90(3) of Law XXXVI of 2012 in effect allows the members of the Monetary Council to be temporarily removed from office for grounds other than those pursuant to Article 14.2 of the Statute. The provisions of Article 157(2) of the Law on the MNB should be adapted so that that the members of the Monetary Council may not be dismissed for reasons other than those laid down in Article 14.2 of the Statute.[200]

7.4.2.3 Financial independence

Article 183 read in conjunction with Article 176 of the Law on the MNB provides that on 1 October 2013 all employees of the HFSA are to be employees of the Magyar Nemzeti Bank and that the Magyar Nemzeti Bank is to bear the financial obligations arising from any employment relations which HSFA staff transferred to the Magyar Nemzeti Bank may have had with the HFSA in the past. This provision alone, taken together with the mass redundancy scheme provided for under Article 183(10) of the Law on the MNB and the aim of eliminating positions not essential for the discharge of duties in order to optimise staff management, is incompatible with the Magyar Nemzeti Bank's financial independence and more specifically its autonomy in staff matters. It impedes the Magyar Nemzeti Bank's ability to decide on employing and retaining necessary and qualified staff for the Magyar Nemzeti Bank. See, also, the following Section regarding compatibility with the prohibition on monetary financing.

As noted in the section on institutional independence, recently the Magyar Nemzeti Bank has been entrusted with several new tasks. The legal provisions entrusting the Magyar Nemzeti Bank with several new tasks that require additional human and financial resources within a relatively short period of time may be seen as an instrument to influence the Magyar Nemzeti Bank's ability to fulfil its mandate, both operationally and financially. Therefore, this raises concerns as regards the provisions' compliance with the principle of financial independence. Any allocation of

[200] See paragraphs 2.3 to 2.5 of Opinion CON/2014/8.

new tasks should be supplemented by provisions regarding the necessary resources to carry them out.[201]

7.4.3 Monetary financing and privileged access

Article 36 of the Law on the MNB provides that if circumstances arise which jeopardise the financial system's stability due to a credit institution's operations, the Magyar Nemzeti Bank may extend an emergency loan to such credit institution subject to observing the prohibition on monetary financing in Article 146 of the Law on the MNB. However, it would be useful to specify that such loans are granted independently and at the Magyar Nemzeti Bank's full discretion, which may make such extensions conditional if necessary and against adequate collateral, thus introducing an additional safeguard which should minimise the possibility of the Magyar Nemzeti Bank suffering any loss.

Article 37 of the Law on the MNB provides that on request, the Magyar Nemzeti Bank at its full discretion may provide a loan to the National Deposit Insurance Fund, subject to the prohibition on monetary financing in Article 146 of the Law on the MNB, in urgent and exceptional cases threatening the stability of the financial system as a whole and the smooth completion of cash transactions, the term of which loan may not be longer than three months. Law LXXXV of 2015 extended the scope of Article 37 in order to enable such emergency short-term loan facilities to be provided to the Hungarian Investor Protection Fund, under the same conditions as to the National Deposit Insurance Fund. This provision is compatible with the monetary financing prohibition. As also already clarified in ECB opinions,[202] it may be useful to specify that such loans are extended against adequate collateral, thus introducing an additional safeguard which should minimise the possibility of the Magyar Nemzeti Bank suffering any loss.

The integration of the HFSA into the Magyar Nemzeti Bank took place on 1 October 2013. Based on Articles 176 to 181 of the Law on the MNB, all of the HFSA's assets were transferred to the Magyar Nemzeti Bank. The Magyar Nemzeti Bank also became a general legal successor to all obligations of the HFSA including, inter alia, its contractual relationships, pending procurement procedures, out-of-court redress procedures, tax-related administrative procedures as well as any other type of legal

[201] See paragraph 2.2 of Opinion CON/2014/62 and paragraph 3.4 of Opinion CON/2014/72. It is also important to note that, as introduced by Law LXIX of 2017, the Magyar Nemzeti Bank also acts, within its existing tasks, as a competent authority to implement several delegated acts related to Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (OJ L 173, 12.6.2014, p. 349) and Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012 (OJ L 173, 12.6.2014, p. 84). The Magyar Nemzeti Bank also implements Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds and amending Directives 2008/48/EC and 2014/17/EU and Regulation (EU) No 596/2014 (OJ L 171, 29.6.2016, p. 1), and shall function as a competent authority as referred to in Article 16 of Regulation (EU) 2015/2365 of the European Parliament and of the Council of 25 November 2015 on transparency of securities financing transactions and of reuse and amending Regulation (EU) No 648/2012 (OJ L 337, 23.12.2015, p. 1).

[202] See, for example, paragraph 9.3 of Opinion CON/2011/104.

procedure (including pending administrative legal procedures)[203]. As a consequence, any payment obligation from a legal relationship or a requirement to pay compensation following any judgment handed down by a Hungarian court granting compensation to an individual or entity challenging a prior decision of the HFSA will have to be borne by the Magyar Nemzeti Bank.

Although Article 177(6) of the Law on the MNB provides for compensation by the State to the Magyar Nemzeti Bank for all expenses resulting from the above- mentioned obligations which exceed the assets taken over from the HFSA, the Law on the MNB does not specifically lay down the procedure and deadlines applicable to financing by the State and reimbursement of the Magyar Nemzeti Bank. This can only be considered to be an ex-post financing scheme. The provisions applying to the assignment of the obligations of the HFSA to the Magyar Nemzeti Bank are not accompanied by measures that would fully insulate the Magyar Nemzeti Bank from all financial obligations resulting from any activities and contractual relationships of the HFSA originating prior to the transfer of tasks, and the current provisions of the Law on the MNB involve a time gap between the costs arising and the Hungarian State reimbursing the Magyar Nemzeti Bank, should the expenses incurred at the Magyar Nemzeti Bank exceed the value of assets taken over from the HFSA. Such a scenario would constitute a breach of the prohibition on monetary financing laid down in Article 123 of the Treaty as well as of the principle of financial independence under Article 130. Hence the Magyar Nemzeti Bank must be insulated from all financial obligations resulting from the prior activities or legal relationships of the HFSA.

Article 183 of the Law on the MNB read in conjunction with Article 176 of the Law on the MNB provides that the Magyar Nemzeti Bank bears the financial obligations arising from the employment relationships which HFSA staff transferred to the Magyar Nemzeti Bank may have had with the HFSA in the past. In order to comply with Article 123 of the Treaty, the Magyar Nemzeti Bank should be insulated from all obligations arising out of employment relationships between any new Magyar Nemzeti Bank staff member and the HFSA, in light of the mass redundancy scheme provided for under Article 183(10) of the Law on the MNB.

In addition, the ECB in the 2017 Annual Report[204] addresses some other monetary financing concerns in relation to the activities and operations of the Magyar Nemzeti Bank. In particular, the ECB assessed the establishment and funding of MARK Zrt., an asset management company, by the Magyar Nemzeti Bank as constituting a violation of the monetary financing prohibition that needs to be corrected. The MNB in 2017 has taken corrective actions and no longer owns or controls MARK Zrt., but given that the financial transaction has not yet been fully completed at this juncture, the corrective process cannot be considered as finalised and the case cannot be formally closed. [205]

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[203] See paragraph 3.7 of Opinion CON/2008/83.
[204] Published on the ECB's website.
[205] See Section 9.3 of the 2017 Annual Report.

7.4.4 Single spelling of the euro

In several Hungarian legal acts[206] the name of the single currency is spelled in a way ("euró"), which is inconsistent with EU law. Under the Treaties a single spelling of the word “euro” in the nominative singular case is required in all EU and national legislative provisions, taking into account the existence of different alphabets. The Hungarian legal acts in question should therefore be amended accordingly.[207]

The ECB expects that the correct spelling of the word “euro” will be applied in Hungarian legal acts and the euro changeover law. Only when all national legal acts use the correct spelling of the word “euro” will Hungary comply with the Treaties.

7.4.5 Legal integration of the NCB into the Eurosystem

With regard to the Magyar Nemzeti Bank’s legal integration into the Eurosystem, the Law on the MNB needs to be adapted as set out below.

7.4.5.1 Economic policy objectives

Article 3(2) of the Law on the MNB provides that the Magyar Nemzeti Bank supports, without prejudice to the primary objective of price stability, the maintenance of the stability of the financial intermediary system, the enhancement of its resilience, its sustainable contribution to economic growth and the Government’s general economic policies. This provision is incompatible with Article 127(1) of the Treaty and Article 2 of the Statute as it does not reflect the secondary objective of supporting the general economic policies in the EU.

7.4.5.2 Tasks

Monetary policy

Article 41 of the Fundamental Law of Hungary and Articles 1(2), 4, 9, 16 to 22, 159 and 171 of the Law on the MNB establishing the Magyar Nemzeti Bank’s powers in the field of monetary policy and instruments for the implementation thereof do not recognise the ECB’s powers in this field.

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[206] For example, the Laws on the 2015 general budget in Hungary.

[207] Opinion CON/2006/55.

Collection of statistics

Although Article 4(7) of the Law on the MNB refers to the Magyar Nemzeti Bank's obligation to transfer specific statistical data to the ECB in accordance with Article 5 of the Statute, Article 1(2), as well as Articles 30 and 171(1) of the Law on the MNB establishing the Magyar Nemzeti Bank's powers relating to the collection of statistics do not recognise the ECB's powers in this field.

Official foreign reserve management

Article 1(2), Article 4(3), (4) and (12), Article 9 and Article 159(2) of the Law on the MNB, which provide for the Magyar Nemzeti Bank's powers in the field of foreign reserve management, do not recognise the ECB's powers in this field.

Payment systems

Article 1(2), Article 4(5) and (12), Articles 27 and 28, and Article 171(2) and (3) of the Law on the MNB establishing the Magyar Nemzeti Bank's powers with regard to the promotion of the smooth operation of payment systems do not recognise the ECB's powers in this field.

Issue of banknotes

Article K of the Fundamental Law and Article 1(2), Article 4(2) and (12), Articles 9, 23 to 26 and Article 171(1) of the Law establishing the Magyar Nemzeti Bank's exclusive right to issue banknotes and coins do not recognise the Council's and the ECB's powers in this field.

7.4.5.3 Financial provisions

Appointment of independent auditors

Article 144 of the Law on the MNB providing that the President of the State Audit Office must be consulted before the Magyar Nemzeti Bank's auditor is elected or his or her dismissal is proposed, Article 6(1) of the Law on the MNB, which provides for the shareholder's power to appoint and dismiss the auditor, and Article 15 of the Law on the MNB do not recognise the Council's and the ECB's powers under Article 27.1 of the Statute.

Financial reporting

Article 12(4)(b) of the Law on the MNB and Law C of 2000,[208] in conjunction with Government Decree 221/2000 (XII.19),[209] do not reflect the Magyar Nemzeti Bank's obligation to comply with the Eurosystem's regime for financial reporting of NCB operations, pursuant to Article 26 of the Statute.

7.4.5.4 Exchange rate policy

Article 1(2), 4(4) and (12), Articles 9, 22 and 147 of the Law on the MNB lay down the Government's and the Magyar Nemzeti Bank's respective powers in the area of exchange rate policy. These provisions do not recognise the Council's and the ECB's powers in this field.

7.4.5.5 International cooperation

Article 1(2), 135(5) of the Law on the MNB providing that, upon authorisation by the Government, the Magyar Nemzeti Bank may undertake tasks arising at international financial organisations, unless otherwise provided for by a legislative act, fails to recognise the ECB's powers as far as issues under Article 6 of the Statute are concerned.

7.4.5.6 Miscellaneous

Articles 75 and 76 of the Law on the MNB do not recognise the ECB's powers to impose sanctions.

With regard to Article 132 of the Law on the MNB, which entitles the Magyar Nemzeti Bank to be consulted on draft national legislation related to its tasks, it is noted that consulting the Magyar Nemzeti Bank does not obviate the need to consult the ECB under Articles 127(4) and 282(5) of the Treaty.

As set out in Section 6.5.2.2, Article 9(7) of the Law on the MNB requires the members of the Monetary Council to make an oath in accordance with the wording specified in Article 1 of Law XXVII of 2008. Article 9(7) of the Law on the MNB needs to be adapted to comply with Article 14.3 of the Statute.[210]

[208] A számvitelről szóló törvény, Magyar Közlöny 2000/95. (IX. 21.).

[209] A Magyar Nemzeti Bank éves beszámoló készítési és könyvvezetési kötelezettségének sajátosságairól szóló kormányrendelet, Magyar Közlöny 2000/125. (XII.19.).

[210] See paragraph 3.7 of Opinion CON/2008/83.

7.4.6 Conclusions

The Fundamental Law of Hungary, the Law on the MNB and Law XXVII of 2008 do not comply with all the requirements for central bank independence, the prohibition on monetary financing, and legal integration into the Eurosystem. Other Hungarian legal acts do not comply with the requirements for the single spelling of the euro. Hungary is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.

7.5 Poland

7.5.1 Compatibility of national legislation

The following legislation forms the legal basis for Narodowy Bank Polski and its operations:

- the Polish Constitution,[211]
- the Law on Narodowy Bank Polski (hereinafter the “Law on NBP”),[212]
- the Law on the Bank Guarantee Fund, deposit guarantee system and compulsory restructuring,[213]
- the Law on banking (hereinafter the “Law on banking”),[214]
- the Law on settlement finality in the payment and settlement systems and on the supervision of such systems.[215]

No major new legislation has been enacted in relation to the points identified in the ECB’s Convergence Report of June 2016, and those comments are therefore largely repeated in this year’s assessment.

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[211] Konstytucja Rzeczypospolitej Polskiej of 2 April 1997, Dziennik Ustaw of 1997, No 78, item 483.

[212] Ustawa o Narodowym Banku Polskim of 29 August 1997. Consolidated version published in Dziennik Ustaw of 2017, item 1373.

[213] Ustawa o Bankowym Funduszu Gwarancyjnym, systemie gwarantowania depozytów oraz przymusowej restrukturyzacji of 10 June 2016. Consolidated version published in Dziennik Ustaw of 2017, item 1937, with further amendments.

[214] Ustawa Prawo bankowe of 29 August 1997. Consolidated version published in Dziennik Ustaw of 2017, item 1876, with further amendments.

[215] Ustawa o ostateczności rozrachunku w systemach płatności i systemach rozrachunku papierów wartościowych oraz zasadach nadzoru nad tymi systemami of 24 August 2001. Consolidated version published in Dziennik Ustaw of 2016, item 1224, with further amendments.

7.5.2 Independence of the NCB

With regard to Narodowy Bank Polski's independence, the Polish Constitution, the Law on NBP and the Law on the State Tribunal[216] need to be adapted in the respects set out below.

7.5.2.1 Institutional independence

The Law on NBP does not prohibit Narodowy Bank Polski and members of its decision-making bodies from seeking or taking outside instructions; it also does not expressly prohibit the Government from seeking to influence members of Narodowy Bank Polski's decision-making bodies in situations where this may have an impact on Narodowy Bank Polski's fulfilment of its ESCB-related tasks. In this respect, the Law on NBP needs to be adapted to comply with Article 130 of the Treaty and Article 7 of the Statute. Furthermore, the Polish Constitutional Court has confirmed[217] that, while the Polish Constitution does not expressly lay down the principle of Narodowy Bank Polski's central bank independence, such principle can be implicitly derived from the Constitution's provisions relating to Narodowy Bank Polski. Making explicit provision for this principle in the Polish Constitution on the occasion of a future amendment would increase legal certainty.

Article 11(3) of the Law on NBP, which provides that Narodowy Bank Polski's President represents Poland's interests within international banking institutions and, unless the Council of Ministers decides otherwise, within international financial institutions, needs to be adapted to comply with Article 130 of the Treaty and Article 7 of the Statute.

Article 23(1)(2) of the Law on NBP, which obliges Narodowy Bank Polski's President to forward draft monetary policy guidelines to the Council of Ministers and the Minister for Finance, needs to be adapted to comply with Article 130 of the Treaty and Article 7 of the Statute.

The Supreme Audit Office (NIK), a constitutional body, has wide powers under Article 203(1) of the Polish Constitution to control the activities of all public administrative authorities and Narodowy Bank Polski as regards their legality, economic prudence, efficiency and diligence. The scope of the NIK's control should be clearly defined, should be without prejudice to the activities of Narodowy Bank Polski's independent external auditors,[218] should comply with the prohibition on giving instructions to an NCB and its decision-making bodies and should not interfere with the NCB's ESCB- related tasks. In particular, it should be ensured that when auditing Narodowy Bank Polski, the application by the NIK of the "efficacy criterion" does not extend to an evaluation of Narodowy Bank Polski's activities related to its primary objective of

[216] Ustawa o Trybunale Stanu of 26 March 1982; consolidated version published in Dziennik Ustaw of 2016, item 2050.

[217] Judgment of 16 July 2009 of the Polish Constitutional Court. Kp 4/08.

[218] For the activities of the NCB's independent external auditors see, as an example, Article 27.1 of the Statute.

price stability.[219] Article 203(1) of the Constitution needs to be adapted to comply with Article 130 of the Treaty and Article 7 of the Statute.

7.5.2.2 Personal independence

Article 9(5) of the Law on NBP regulates the dismissal of Narodowy Bank Polski's President by the Sejm (lower house of Parliament), if he or she has:

- been unable to fulfil his or her duties due to prolonged illness,
- been convicted of a criminal offence under a final court sentence,
- submitted an untruthful disclosure declaration, confirmed by a final court judgment,[220]
- been prohibited by the State Tribunal from occupying executive positions or holding posts of particular responsibility in state bodies.[221]

Moreover, under Article 25(3) in conjunction with Article 3 and Article 1(1)(3) of the Law on the State Tribunal, Narodowy Bank Polski's President may also be removed from office if he or she violates the Constitution or a law.[222]

The grounds listed above are in addition to the two grounds for dismissal provided for in Article 14.2 of the Statute. Therefore, Article 9(5) of the Law on NBP and the relevant provisions of the Law on the State Tribunal need to be adapted to comply with Article 14.2 of the Statute.

With regard to security of tenure and grounds for dismissal of other members of Narodowy Bank Polski's decision-making bodies involved in the performance of ESCB-related tasks (i.e. the members of the Management Board, and in particular the First Deputy President, and the members of the Monetary Policy Council), Article 13(5) and Article 17(2b), second sentence, of the Law on NBP provide the following grounds for dismissal:

- an illness which permanently prevents them from performing their responsibilities,
- a conviction for a criminal offence under a final court sentence,

[219] See paragraph 3.6 of Opinion CON/2011/9.

[220] The provision was added with effect from 15 March 2007 by Article 37a of the Law on disclosure of information relating to documents of state security services from the period 1944-1990 (Ustawa o ujawnianiu informacji o dokumentach organów bezpieczeństwa państwa z lat 1944-1990 oraz treści tych dokumentów of 18 October 2006; consolidated version published in Dziennik Ustaw of 2007, No 63, item 425).

[221] The resolution of the Sejm producing an indictment of the President of Narodowy Bank Polski before the State Tribunal results, by operation of law, in suspension of the President from office (Article 11(1), second sentence in connection with Article 1(1)(3) of the Law on the State Tribunal).

[222] The indictment by the Sejm of the President of Narodowy Bank Polski before the State Tribunal results, by operation of law, in suspension of the President from office, see previous footnote.

- submission of an untruthful disclosure declaration as confirmed by a final court judgment,[223]
- non-suspension of membership of a political party or trade union.

The grounds listed above are in addition to the two grounds for dismissal provided for in Article 14.2 of the Statute. Article 13(5) of the Law on NBP therefore needs to be adapted to comply with Article 14.2 of the Statute. Article 14(3) of the Law on NBP, which reaffirms the possibility of dismissal of a member of the Monetary Policy Council of Narodowy Bank Polski for a conviction for a criminal offence, needs also to be adapted to comply with Article 14.2 of the Statute.

The President of Narodowy Bank Polski acts in dual capacity as a member of Narodowy Bank Polski's decision-making bodies and of the relevant decision-making bodies of the ECB. Article 9(3) of the Law on NBP, which specifies the wording of the oath sworn by Narodowy Bank Polski's President, needs to be adapted to reflect the status and the obligations and duties of the President of Narodowy Bank Polski as member of the relevant decision-making bodies of the ECB.

The Law on NBP is silent on the right of national courts to review a decision to dismiss any member, other than the President, of the NCB's decision-making bodies who is involved in the performance of ESCB-related tasks. Even though this right may be available under general Polish law, providing specifically for such a right of review would increase legal certainty.

7.5.3 Confidentiality

Article 23(7) of the Law on NBP specifies instances in which data collected from individual financial institutions, as well as statistical surveys, studies and assessments enabling identification of individual entities, are subject to disclosure by Narodowy Bank Polski to external parties. One such instance covers disclosure to 'unspecified recipients', under "separate applicable provisions".[224] Such disclosure may potentially affect data protected under the ESCB's confidentiality regime and therefore the Law on NBP should be adapted to fully comply with Article 37 of the Statute.[225]

In addition, since NIK has wide powers under Article 203(1) of the Polish Constitution to control the activities of Narodowy Bank Polski, as mentioned in Chapter 7.5.2.1, NIK also has wide access to Narodowy Bank Polski's confidential information and documents. However, pursuant to Article 37 of the Statute in conjunction with Article 130 of the Treaty, NIK's access to Narodowy Bank Polski's confidential information

[223] This provision was added with effect from 15 March 2007 by Article 37a of the Law on disclosure of information relating to documents of state security services from the period 1944-1990 (Ustawa o ujawnianiu informacji o dokumentach organów bezpieczeństwa państwa z lat 1944-1990 oraz treści tych dokumentów of 18 October 2006; consolidated version published in Dziennik Ustaw of 2007, No 63, item 425).

[224] Article 23(7)(3) of the Law on NBP.

[225] See Opinion CON/2008/53.

and documents must be limited to that necessary for the performance of NIK's statutory tasks. Such access must also be without prejudice both to the ESCB's independence and to its confidentiality regime, to which the members of the NCBs' decision-making bodies and staff are subject. In addition, the relevant Polish legislation should be amended to stipulate that NIK shall safeguard the confidentiality of information and documents disclosed by Narodowy Bank Polski to an extent corresponding to that applied by Narodowy Bank Polski.

7.5.4 Monetary financing and privileged access

Article 42(1) in conjunction with Article 3(2)(5) of the Law on NBP provides for Narodowy Bank Polski's powers to grant refinancing credit to banks satisfying specified conditions.[226] In addition, Article 42(3) of the Law on NBP allows Narodowy Bank Polski to grant refinancing credit for the purpose of implementing a bank rehabilitation plan, which is initiated in the event of a bank infringing, or being likely to infringe, certain requirements relating to, among other things, own funds and liquidity ratio.[227] Granting of refinancing credit is in all cases subject to the general rules of the Law on banking, with the modifications resulting from the Law on NBP.[228] Safeguards currently contained in such rules aiming at ensuring timely repayment of the credit do not fully exclude an interpretation that would allow an extension of refinancing credit to a bank undergoing rehabilitation proceedings which then becomes insolvent.[229] More explicit safeguards in relation to all financial institutions receiving liquidity support from Narodowy Bank Polski are needed to avoid incompatibility with the monetary financing prohibition under Article 123 of the Treaty.[230] The Law on NBP should be adapted to make clear that such liquidity support is only temporary and it may not be extended to insolvent financial institutions. Article 220(2) of the Polish Constitution provides that "the budget shall not provide for covering a budget deficit by way of contracting credit obligations to the State's central bank". While this provision prohibits the State from financing its budgetary deficit via Narodowy Bank Polski, the ECB understands that it does not constitute an implementation of Article 123 of the Treaty prohibiting monetary financing, and its aim and function are therefore not identical to those of the said Treaty prohibition. Article 123 of the Treaty, supplemented by Regulation (EC) No 3603/93, is directly applicable, so in general, it is unnecessary to transpose it into national legislation.

226 Narodowy Bank Polski's decision whether to grant refinancing credit is based on its assessment of the bank's ability to repay the principal amount and the interest on time (Article 42(2) of the Law on NBP).

227 Article 142(1) and (2) of the Law on banking.

228 Article 42(7) of the Law on NBP.

229 Under the Law on banking which applies to the provision of refinancing credit by Narodowy Bank Polski, a commercial bank may extend credit to an uncreditworthy borrower, provided that: (i) qualified security is established; and (ii) a recovery programme is instituted, which the crediting bank considers will ensure the borrower's creditworthiness during a specified period (Article 70(2) of the Law on banking). Furthermore, Narodowy Bank Polski may demand early repayment of any refinancing credit if the financial situation of the credited bank has worsened to the extent of putting the timely repayment at risk (Article 42(6) of the Law on NBP).

230 See Opinion CON/2013/5.

7.5.5 Legal integration of the NCB into the Eurosystem

With regard to Narodowy Bank Polski's legal integration into the Eurosystem, the Polish Constitution and the Law on NBP need to be adapted in the respects set out below.

7.5.5.1 Economic policy objectives

Article 3(1) of the Law on NBP provides that Narodowy Bank Polski's primary objective is to maintain price stability, while supporting the economic policies of the Government, insofar as this does not constrain the pursuit of its primary objective. This provision is incompatible with Article 127(1) of the Treaty and Article 2 of the Statute, as it does not reflect the secondary objective of supporting the general economic policies of the Union.

7.5.5.2 Tasks

Monetary policy

Article 227(1) and (6) of the Constitution and Article 3(2)(5), Articles 12, 23 and 38 to 50a and 53 of the Law on NBP, which provide for Narodowy Bank Polski's powers with regard to monetary policy, do not recognise the ECB's powers in this field.

Collection of statistics

Article 3(2)(7) and Article 23 of the Law on NBP, which provides for Narodowy Bank Polski's powers relating to the collection of statistics, do not recognise the ECB's powers in this field.

Official foreign reserve management

Article 3(2)(2) and Article 52 of the Law on NBP, which provide for Narodowy Bank Polski's powers in the field of foreign exchange management, do not recognise the ECB's powers in this field.

Payment systems

Article 3(2)(1) of the Law on NBP, which provides for Narodowy Bank Polski's powers in organising monetary settlements, does not recognise the ECB's powers in this field.

Issue of banknotes

Article 227(1) of the Constitution and Article 4 and Articles 31 to 37 of the Law on NBP, which provide for Narodowy Bank Polski's exclusive powers to issue and withdraw banknotes and coins having the status of legal tender, do not recognise the Council's and the ECB's powers in this field.

7.5.5.3 Financial provisions

Appointment of independent auditors

Article 69(1) of the Law on NBP, which provides for the auditing of Narodowy Bank Polski, does not recognise the Council's and the ECB's powers under Article 27.1 of the Statute. The powers of the NIK to control the activities of Narodowy Bank Polski should be clearly defined by legislation and should be without prejudice to the activities of Narodowy Bank Polski's independent external auditors, as laid down in Article 27.1 of the Statute.

7.5.5.4 Exchange rate policy

Articles 3(2)(3) and 17(4)(2) and Article 24 of the Law on NBP, which provide for Narodowy Bank Polski's power to implement the exchange rate policy set in agreement with the Council of Ministers, do not recognise the Council's and the ECB's powers in this field.

7.5.5.5 International cooperation

Articles 5(1) and 11(3) of the Law on NBP, which provide for Narodowy Bank Polski's right to participate in international financial and banking institutions, do not recognise the ECB's powers in this field.

7.5.5.6 Miscellaneous

Article 9(3) of the Law on NBP, which specifies the wording of the oath sworn by Narodowy Bank Polski's President, needs to be adapted to comply with Article 14.3 of the Statute.

With regard to Article 21(4) of the Law on NBP, which provides for Narodowy Bank Polski's rights to present its opinion on draft legislation concerning the activity of banks and having significance to the banking system, it is noted that consulting Narodowy Bank Polski does not obviate the need to consult the ECB under Articles 127(4) and 282(5) of the Treaty.

7.5.6 Conclusions

The Polish Constitution, the Law on NBP and the Law on the State Tribunal do not comply with all the requirements of central bank independence, confidentiality, the monetary financing prohibition and legal integration into the Eurosystem. Poland is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.[231]

7.6 Romania

7.6.1 Compatibility of national legislation

The following legislation forms the legal basis for Banca Naţională a României and its operations:

- Law No 312/2004 on the Statute of Banca Naţională a României (hereinafter the "Law on BNR").[232]

There have been no changes in relation to the points identified in the ECB's Convergence Report of June 2016 concerning the Law on BNR, and therefore those comments are repeated in this year's assessment.

7.6.2 Independence of the NCB

With regard to Banca Naţională a României's independence, the Law on BNR and other legislation needs to be adapted in the respects set out below.

7.6.2.1 Institutional independence

Article 3(1) of the Law on BNR provides that, when carrying out their tasks, Banca Naţională a României and the members of its decision-making bodies may not seek or take instructions from public authorities or from any other institution or authority. The ECB understands that the provision encompasses both national and foreign institutions in line with Article 130 of the Treaty and Article 7 of the Statute. For legal certainty reasons, the next amendment to the Law on BNR should bring this provision fully in line with Article 130 of the Treaty and Article 7 of the Statute.

Further, Article 3 of the Law on BNR does not expressly prohibit the Government from seeking to influence the members of Banca Naţională a României's decision- making bodies in situations where this may have an impact on Banca Naţională a

[231] For a detailed review of necessary adaptations of the Constitution, the Law on NBP and other laws, see Opinion CON/2011/9.

[232] Published in Monitorul Oficial al României, Part One, No 582, 30.6.2004.

României's fulfilment of its ESCB-related tasks. In this respect the Law on BNR needs to be adapted to be fully consistent with Article 130 of the Treaty and Article 7 of the Statute.

7.6.2.2 Personal independence

Article 33(9) of the Law on BNR provides that an appeal may be brought to the High Court of Cassation and Justice against a decision to recall from office a member of the Board of Banca Naţională a României within 15 days of its publication in Monitorul Oficial al României. The Law on BNR is silent on the jurisdiction of the Court of Justice of the European Union to hear cases with regard to the dismissal of the Governor. The ECB understands that in spite of this silence, Article 14.2 of the Statute applies.

Article 33(7) of the Law on BNR provides that no member of the Board of Banca Naţională a României may be recalled from office for reasons other than or following a procedure other than those provided for in Article 33(6) of the Law on BNR. Article 33(6) of the Law on BNR contains grounds for dismissal which are compatible with those laid down in Article 14.2 of the Statute. Law 161/2003 on certain measures for transparency in the exercise of public dignities, public functions and business relationships and for the prevention and sanctioning of corruption,[233] and Law 176/2010 on the integrity in the exercise of public functions and dignities,[234] define the conflicts of interest and incompatibilities applicable to the Governor and the other members of the Board of Banca Naţională a României and require them to report on their interests and wealth. The ECB understands that the sanctions provided for in these Laws for the breach of such obligations as well as the automatic resignation mechanism in cases of incompatibility[235] do not constitute new grounds for dismissal of the Governor or other members of the Board of Banca Naţională a României in addition to those contained in Article 33 of the Law on BNR. For legal certainty reasons and in line with Article 33 of the Law on BNR, a clarification to this end in the above-mentioned Laws would be welcome.

7.6.2.3 Financial independence

Article 43 of the Law on BNR provides that each month, Banca Naţională a României must transfer to the State budget an 80% share of the net revenues left after deducting expenses relating to the financial year, including provisions for credit risk, and any losses relating to previous financial years that remain uncovered. As noted in Chapter 7.6.4, this arrangement may in certain circumstances amount to an intra-

[233] Published in Monitorul Oficial al României, Part One, No 279, 21.4.2003.

[234] Published in Monitorul Oficial al României, Part One, No 621, 2.9.2010.

[235] According to the relevant provisions of Article 99 of Law 161/2003, if a member of the Board of Banca Naţională a României or an employee occupying a leading position with Banca Naţională a României does not choose within a given period of time between their function and the one which they have declared to be incompatible with their function, they are considered to have resigned from their function and the Parliament takes note of the resignation.

year credit, which in turn may undermine the financial independence of Banca Naţională a României.

A Member State may not put its NCB in a position where it has insufficient financial resources to carry out its ESCB or Eurosystem-related tasks, and also its own national tasks, such as financing its administration and own operations.

Article 43(3) of the Law on BNR also provides that Banca Naţională a României sets up provisions for credit risk in accordance with its rules, after having consulted the Ministry of Public Finance. The ECB notes that NCBs must be free to independently create financial provisions to safeguard the real value of their capital and assets.

Article 43 of the Law on BNR should therefore be adapted, in addition to taking into account the issues highlighted in Chapter 7.6.4, to ensure that such arrangement does not undermine the ability of Banca Naţională a României to carry out its tasks in an independent manner.

Pursuant to Articles 21 and 23 of Law 94/1992 on the organisation and functioning of the Court of Auditors,[236] the Court of Auditors is empowered to control the establishment, management and use of the public sector's financial resources, including Banca Naţională a României's financial resources, and to audit management of the funds of Banca Naţională a României. The scope of audit by the Court of Auditors is further defined in Article 47(2) of the Law on BNR ,which provides that commercial operations performed by Banca Naţională a României, as shown in the revenue and expenditure budget and in the annual financial statements, shall be subject to auditing by the Court of Auditors. As the provisions of Law 94/1992 on the organisation and functioning of the Court of Auditors expressly apply to Banca Naţională a României, in the interests of legal certainty it should be clarified in Romanian legislation that the scope of audit by the Court of Auditors is provided by Article 47(2) of the Law on BNR and is therefore limited to commercial operations performed by Banca Naţională a României.[237]

7.6.3 Confidentiality

Pursuant to Article 52(2) of the Law on BNR, the Governor may release confidential information on the four grounds listed under Article 52(2) of that Law. Under Article 37 of the Statute, professional secrecy is an ESCB-wide matter. Therefore, the ECB assumes that such release is without prejudice to the confidentiality obligations towards the ECB and the ESCB.

[236] Published in Monitorul Oficial al României, Part One, No 238, 3.4.2014.

[237] For the activities of the NCB's independent external auditors see, as an example, Article 27.1 of the Statute.

7.6.4 Monetary financing and privileged access

Articles 6(1) and 29(1) of the Law on BNR expressly prohibit direct purchase on the primary market by Banca Naţională a României of debt instruments issued by the State, central and local public authorities, autonomous public service undertakings, national societies, national companies and other majority State-owned companies. Such prohibition has been extended by Article 6(2) to other bodies governed by public law and public undertakings in Member States. Furthermore, under Article 7(2) of the Law on BNR, Banca Naţională a României is prohibited from granting overdraft facilities or any other type of credit facility to the State, central and local public authorities, autonomous public service undertakings, national societies, national companies and other majority State-owned companies. Article 7(4) extends this prohibition to other bodies governed by public law and public undertakings in Member States. The range of public sector entities referred to in these provisions needs to be extended to be consistent with and fully mirror Article 123 of the Treaty and aligned with the definitions contained in Regulation (EC) No 3603/93.

Pursuant to Article 7(3) of the Law on BNR, majority State-owned credit institutions are exempted from the prohibition on granting overdraft facilities and any other type of credit facility in Article 7(2) and benefit from loans granted by Banca Naţională a României in the same way as any other credit institution eligible under Banca Naţională a României's regulations. The wording of Article 7(3) of the Law on BNR should be aligned with the wording of Article 123(2) of the Treaty, which only exempts publicly owned credit institutions "in the context of the supply of reserves by central banks".

Article 26 of the Law on BNR provides that, to carry out its task of ensuring financial stability, in exceptional cases and only on a case-by-case basis, Banca Naţională a României may grant to credit institutions loans which are unsecured or secured by assets other than assets eligible to collateralise the monetary or foreign exchange policy operations of Banca Naţională a României. Article 26 does not contain sufficient safeguards to prevent such lending from potentially breaching the monetary financing prohibition contained in Article 123 of the Treaty, especially given the risk that such lending could result in the provision of solvency support to a credit institution experiencing financial difficulties, and should be adapted accordingly.

Article 43 of the Law on BNR provides that Banca Naţională a României must transfer to the State budget an 80% share of the net revenues left after deducting expenses relating to the financial year, including provisions for credit risk, and loss related to the previous financial years that remained uncovered. The 80% of the net revenues is transferred monthly before the 25th day of the following month, based on a special statement. The adjustments relating to the financial year are performed by the deadline for submission of the annual balance sheet, based on a rectifying special statement.

This provision is constructed in a way which does not rule out the possibility of an intra- year anticipated profit distribution in circumstances where Banca Naţională a României accumulates profits during the first half of the year but suffers consecutive losses during the second half of the year. Although the State is under an obligation to make adjustments after the closure of the financial year and would therefore have to return any excessive distributions to Banca Naţională a României, this would only happen after the deadline for submission of the annual balance sheet and may therefore be viewed as amounting to an intra-year credit to the State. Article 43 should be adapted to ensure that such an intra-year credit is not possible to rule out the possibility of breaching the monetary financing prohibition in Article 123 of the Treaty.

7.6.5 Legal integration of the NCB into the Eurosystem

With regard to Banca Naţională a României's legal integration into the Eurosystem, the Law on BNR needs to be adapted in the respects set out below.

7.6.5.1 Economic policy objectives

Article 2(3) of the Law on BNR provides that, without prejudice to the primary objective of price stability, Banca Naţională a României must support the State's general economic policy. This provision is incompatible with Article 127(1) of the Treaty, as it does not reflect the secondary objective of supporting the general economic policies of the Union.

7.6.5.2 Tasks

Monetary policy

Article 2(2)(a), Article 5, Articles 6(3) and 7(1), Articles 8, 19 and 20 and Article 33(1)(a) of the Law on BNR, which provide for the powers of Banca Naţională a României in the field of monetary policy and instruments for the implementation thereof, do not recognise the ECB's powers in this field.

Collection of statistics

Article 49 of the Law on BNR, which provides for the powers of Banca Naţională a României relating to the collection of statistics, does not recognise the ECB's powers in this field.

Official foreign reserve management

Articles 2(2)(e) and 9(2)(c) and Articles 30 and 31 of the Law on BNR, which provide for the powers of Banca Naţională a României relating to foreign reserve management, do not recognise the ECB's powers in this field.

Payment systems

Article 2(2)(b), Article 22 and Article 33(1)(b) of the Law on BNR, which provide for the role of Banca Naţională a României in relation to the smooth operation of payment systems, do not recognise the ECB's powers in this field.

Issue of banknotes

Article 2(2)(c) and Articles 12 to 18 of the Law on BNR, which provide for Banca Naţională a României's role in issuing banknotes and coins, do not recognise the Council's and the ECB's powers in this field.

7.6.5.3 Financial provisions

Appointment of independent auditors

Article 36(1) of the Law on BNR, which provides that the annual financial statements of Banca Naţională a României are audited by financial auditors that are legal entities authorised by the Financial Auditors Chamber in Romania and selected by the Board of Banca Naţională a României through a tender procedure, does not recognise the ECB's and the Council's powers under Article 27.1 of the Statute.

Financial reporting

Article 37(3) of the Law on BNR, which provides that Banca Naţională a României establishes the templates for the annual financial statements after having consulted the Ministry of Public Finance, and Article 40 of the Law on BNR, which provides that Banca Naţională a României adopts its own regulations on organising and conducting its accounting, in compliance with the legislation in force and having regard to the advisory opinion of the Ministry of Public Finance, and that Banca Naţională a României registers its economic and financial operations in compliance with its own chart of accounts, also having regard to the advisory opinion of the Ministry of Public Finance, do not reflect Banca Naţională a României's obligation to comply with the Eurosystem's regime for financial reporting of NCB operations, pursuant to Article 26 of the Statute.

7.6.5.4 Exchange rate policy

Article 2(2)(a) and (d), Article 9 and Article 33(1)(a) of the Law on BNR, which empower Banca Naţională a României to conduct exchange rate policy, do not recognise the Council's and the ECB's powers in this field.

Articles 10 and 11 of the Law on BNR, which allow Banca Naţională a României to draw up regulations on monitoring and controlling foreign currency transactions in

Romania and to authorise foreign currency capital operations, transactions on foreign currency markets and other specific operations, do not recognise the Council's and the ECB's powers in this field.

7.6.6 Miscellaneous

With regard to Article 3(2) of the Law on BNR, which entitles Banca Naţională a României to be consulted on draft national legislation, consulting Banca Naţională a României does not obviate the need to consult the ECB under Articles 127(4) and 282(5) of the Treaty.

Article 57 of the Law on BNR does not recognise the ECB's powers to impose sanctions.

Article 4(5) of the Law on BNR entitles Banca Naţională a României to conclude short-term credit arrangements and to perform other financial and banking operations with other entities, including central banks, and provides that such arrangements are possible only if the credit is repaid within one year. The ECB notes that such a limitation is not foreseen in Article 23 of the Statute.

7.6.7 Conclusions

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

7.7 Sweden

7.7.1 Compatibility of national legislation

The following legislation forms the legal basis for Sveriges Riksbank and its operations:

- the Instrument of Government,[238] which forms part of the Swedish Constitution,
- the Law on Sveriges Riksbank,[239]

[238] SFS 1974:152.
[239] SFS 1988:1385.

- the Law on exchange rate policy.[240]

There have been no major changes to the Law on Sveriges Riksbank in relation to the points identified in the ECB's Convergence Report of June 2016, and those comments are therefore largely repeated in this year's assessment.

7.7.2 Independence of the NCB

With regard to Sveriges Riksbank's independence, the Law on Sveriges Riksbank needs to be adapted in the respects set out below.

7.7.2.1 Institutional independence

Article 13 of Chapter 9 of the Instrument of Government states that Sveriges Riksbank is an authority under the Riksdag. Article 2 of Chapter 3 of the Law on Sveriges Riksbank, which prohibits the members of the Executive Board from seeking or taking of instructions, and Article 13 of Chapter 9 of the Instrument of Government, which prohibits any authority from giving instructions to Sveriges Riksbank, do not cover all ESCB-related tasks, as required by Article 130 of the Treaty and Article 7 of the Statute.

Although the explanatory memorandum to the Law on Sveriges Riksbank extends the coverage to all ESCB-related tasks, it would be beneficial if this issue and the relation with Article 13 of Chapter 9 of the Instrument of Government were addressed in the next amendments to the relevant provisions of Swedish legislation.

In addition, pursuant to Article 13(1) of Chapter 8 of the Instrument of Government, the Parliament may direct Sveriges Riksbank in an act of law within its sphere of responsibility under Chapter 9 (Financial power) to adopt provisions concerning its duty to promote a secure and efficient payments system. The ECB understands that this provision only enables the Parliament to assign the adoption of regulations to Sveriges Riksbank within the Sveriges Riksbank's areas of responsibility for promoting secure and efficient payment systems.

Article 3 of Chapter 6 of the Law on Sveriges Riksbank, which establishes the right of the minister appointed by the Swedish Government to be informed prior to Sveriges Riksbank making a monetary policy decision of major importance, could potentially breach the prohibition on giving instructions to the NCBs pursuant to Article 130 of the Treaty and Article 7 of the Statute. Article 3 of Chapter 6 of the Law on Sveriges Riksbank should therefore be adapted accordingly. The Swedish Government has referred the issue to the Parliamentary Committee on Sveriges Riksbank. The Parliamentary Committee on Sveriges Riksbank will investigate how the Swedish Government may continue to be kept informed of monetary policy

[240] SFS 1998:1404.

decisions of major importance without restricting the independence of Sveriges Riksbank.

7.7.2.2 Financial independence

In accordance with Article 3 of Chapter 10 of the Law on Sveriges Riksbank, the General Council of Sveriges Riksbank submits proposals to the Swedish Parliament and the Swedish National Audit Office on the allocation of Sveriges Riksbank's profit. Pursuant to Article 4 of Chapter 10 of the Law on Sveriges Riksbank, the Swedish Parliament then determines the allocation of Sveriges Riksbank's profit. These provisions are supplemented by non-statutory guidelines on profit distribution, which state that Sveriges Riksbank should pay 80% of its profit to the Swedish State, after adjustment for exchange rate and gold valuation effects and based on a five-year average, with the remaining 20% used to increase its own capital. However, these guidelines are not legally binding and there is no statutory provision limiting the amount of profit that may be paid out.

The present arrangements on profit distribution are under review. The Swedish Government has submitted a draft legislative proposal to strengthen the Sveriges Riksbank's financial independence and balance sheet, on which the ECB has reviewed and commented.[241] After receiving extensive comments on the proposal from a number of consultation bodies, the Swedish Government has appointed the Parliamentary Committee on Sveriges Riksbank to further examine the matters addressed in the draft legislative proposal as well as to propose appropriate amendments to the Law on Sveriges Riksbank in order to enhance the financial independence and balance sheet of Sveriges Riksbank. The assignment shall be reported no later than 31 May 2019. However, as the legislation currently stands, it is incompatible with the requirement of central bank independence in Article 130 of the Treaty and Article 7 of the Statute. To safeguard Sveriges Riksbank's financial independence, statutory provisions should be adopted containing clear provisions concerning the limitations applicable to the Swedish Parliament's decisions on Sveriges Riksbank's profit allocation.

7.7.3 Monetary financing prohibition

Article 1(3) of Chapter 8 of the Law on Sveriges Riksbank provides that Sveriges Riksbank may not extend credit or purchase debt instruments directly from the State, another public body or a Union institution. Although the explanatory memorandum to the Law on Sveriges Riksbank, which according to Swedish legal tradition will be closely followed by Swedish courts when interpreting national legislation, states that the coverage is extended to Union bodies and the public sector including public undertakings of other Member States, it would be beneficial if this issue could be

[241] See Opinion CON/2017/17.

addressed when the Law on Sveriges Riksbank is next amended, to bring it fully in line with Article 123 of the Treaty.

In addition, Article 1(4) of Chapter 8 of the Law on Sveriges Riksbank provides that “subject to other provisions in this Law, the Riksbank may also grant credit to and purchase debt instruments from financial institutions owned by the State or another public body”. The wording of Article 1(4) of Chapter 8 of the Law on Sveriges Riksbank should be aligned with the wording of Article 123(2) of the Treaty, which only exempts publicly owned credit institutions from the prohibition on monetary financing in respect of the supply of reserves by central banks; the central bank may not supply reserves to other public financial institutions. In the same vein, the range of public sector entities would need to be made consistent with Article 123(2) of the Treaty, and the ECB suggests, for reasons of legal certainty, inserting a reference to Article 123 of the Treaty in Article 1 of Chapter 8 of the Law on Sveriges Riksbank.

As noted above, the provisions of the Law on the allocation of Sveriges Riksbank’s profit are supplemented by non-statutory guidelines on profit distribution, that are not legally binding, and state that Sveriges Riksbank should pay 80% of its profit to the Swedish State, after adjustment for exchange rate and gold valuation effects and based on a five-year average, with the remaining 20% used to increase its own capital. It is essential for the five-year average rule to be applied in a way which remains consistent with the prohibition on monetary financing under Article 123 of the Treaty, i.e. only as a calculation method and a cap for the NCB’s profit distribution to the State budget. Statutory provisions providing for necessary limitations and ensuring that a breach of the monetary financing prohibition may not occur in this respect should also be adopted. To comply with the monetary financing prohibition, the amount distributed to the State budget pursuant to the applicable profit distribution rules cannot be paid, even partially, from the NCB’s reserve capital. Therefore, profit distribution rules should leave unaffected the NCB’s reserve capital.

7.7.4 Legal integration of the NCB into the Eurosystem

With regard to Sveriges Riksbank’s legal integration into the Eurosystem, the Law on Sveriges Riksbank, the Constitution and the Law on exchange rate policy need to be adapted in the respects set out below.

7.7.4.1 Economic policy objectives

Article 2 of Chapter 1 of the Law on Sveriges Riksbank provides that Sveriges Riksbank’s objective is to maintain price stability. The ECB notes that Article 2 should reflect the ESCB’s secondary objective of supporting the general economic policies of the Union in line with Article 127(1) of the Treaty and Article 2 of the Statute.

Article 2 of Chapter 1 of the Law on Sveriges Riksbank provides that Sveriges Riksbank shall promote a safe and efficient payments system. The ECB notes that insofar as this is a task and not an objective of the Sveriges Riksbank, there is no need to subordinate it to the ESCB's primary and secondary objectives.

7.7.4.2 Tasks

Article 1 of Chapter 1 of the Law on Sveriges Riksbank, which provides that Sveriges Riksbank may only conduct, or participate in, such activities for which it has been authorised by Swedish law, is incompatible with the provisions of the Treaty and the Statute as it does not provide for Sveriges Riksbank's legal integration into the Eurosystem.

Monetary policy

Article 13 of Chapter 9 of the Instrument of Government and Article 2 of Chapter 1 of the Law on Sveriges Riksbank, which establish Sveriges Riksbank's powers in the field of monetary policy, do not recognise the ECB's powers in this field.

Articles 2, 5 and 6 of Chapter 6 of the Law on Sveriges Riksbank, which provide for Sveriges Riksbank's powers in the field of monetary policy, do not recognise the ECB's powers in this field.

Article 6 of Chapter 6 and Articles 1 and 2a of Chapter 11 of the Law on Sveriges Riksbank, concerning the imposition of minimum reserves on financial institutions and the payment of a special fee to the Swedish State in the event of a breach of this requirement, do not recognise the ECB's powers in this field.

Collection of statistics

Article 4(2) and Articles 9, 10 and 11[242] of Chapter 6 of the Law on Sveriges Riksbank, which establish Sveriges Riksbank's powers relating to the collection of statistics, do not recognise the ECB's powers in this field.

Official foreign reserve management

Chapter 7 of the Law on Sveriges Riksbank, and Article 12 of Chapter 9 of the Instrument of Government, which provide for Sveriges Riksbank's powers in the field of foreign reserve management, do not recognise the ECB's powers in this field.

[242] These articles have been introduced in Chapter 6 of the Law on Sveriges Riksbank by amendments which entered into force in June 2014 (SFS 2014:485).

Payment systems

The second sentence of Article 14 of Chapter 9 of the Instrument of Government and Article 2 of Chapter 1 and Article 7 of Chapter 6 of the Law on Sveriges Riksbank, which establish Sveriges Riksbank's powers with regard to the smooth operation of payment systems, do not recognise the ECB's powers in this field.

Issue of banknotes

Article 14 of Chapter 9 of the Instrument of Government and Chapter 5 of the Law on Sveriges Riksbank, which lay down Sveriges Riksbank's exclusive right to issue banknotes and coins, do not recognise the Council's and the ECB's powers in this field.

7.7.4.3 Financial provisions

Appointment of independent auditors

The Law on Sveriges Riksbank does not recognise the Council's and the ECB's powers under Article 27.1 of the Statute.

7.7.4.4 Exchange rate policy

Article 12 of Chapter 9 of the Instrument of Government and Chapter 7 of the Law on Sveriges Riksbank, together with the Law on exchange rate policy, lay down the powers of the Swedish Government and Sveriges Riksbank in the area of exchange rate policy. These provisions do not recognise the Council's and the ECB's powers in this field.

7.7.4.5 International cooperation

Pursuant to Article 6 of Chapter 7 in the Law on Sveriges Riksbank, Sveriges Riksbank may serve as a liaison body in relation to international financial institutions of which Sweden is a member. This provision does not recognise the ECB's powers in this field.

7.7.4.6 Miscellaneous

With regard to Article 4 of Chapter 2 of the Law on Sveriges Riksbank, which provides for the General Council's right to submit consultation opinions on behalf of Sveriges Riksbank within its area of competence, it is noted that consulting Sveriges

Riksbank does not obviate the need to consult the ECB under Articles 127(4) and 282(5) of the Treaty.

As specified in Chapter 2.2.4, the primacy of Union law and rules adopted thereunder also means that national laws on access by third parties to documents may not lead to infringements of the ESCB's confidentiality regime. The ECB understands that the Public Access to Information and Secrecy Act [243] and any other relevant Swedish legislation will permit Sveriges Riksbank to apply it in a manner that ensures compliance with the ESCB's confidentiality regime.

7.7.5 Conclusions

The Law on Sveriges Riksbank, the Constitution and the Law on exchange rate policy do not comply with all the requirements for central bank independence, the monetary financing prohibition and legal integration into the Eurosystem. Sweden is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty. The ECB notes that the Treaty has obliged Sweden to adopt national legislation for integration into the Eurosystem since 1 June 1998. Over the years no legislative action has been taken by the Swedish authorities to remedy the incompatibilities described in this and previous reports. As pointed out above, the Swedish Government has appointed the Parliamentary Committee on Sveriges Riksbank to propose appropriate amendments to the Law on Sveriges Riksbank in order to enhance the financial independence and balance sheet of Sveriges Riksbank. The Parliamentary Committee on Sveriges Riksbank is obliged to report on its conclusions no later than 31 May 2019.

[243] SFS 2009:400.

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For terminology and abbreviations, please refer to the ECB glossary.

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