



EUROPEAN CENTRAL BANK
EUROSYSTEM

Convergence Report

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1 Introduction

Since 1 January 1999 the euro has been introduced in 19 EU Member States; this report examines seven of the eight EU countries that have not yet adopted the single currency. One of the eight countries, Denmark, has notified the Council of the European Union (EU Council) of its intention not to participate in Stage Three of Economic and Monetary Union (EMU).¹ As a consequence, Convergence Reports only have to be provided for Denmark if the country so requests. Given the absence of such a request, this report examines the following countries: Bulgaria, the Czech Republic, Croatia, Hungary, Poland, Romania and Sweden. All seven countries are committed under the Treaty on the Functioning of the European Union (hereinafter the “Treaty”)² to adopt the euro, which implies that they must strive to fulfil all the convergence criteria.

In producing this report, the ECB fulfils its requirement under Article 140 of the Treaty. Article 140 says that at least once every two years, or at the request of an EU Member State with a derogation, the ECB and the European Commission must report to the EU Council “on the progress made by the Member States with a derogation in fulfilling their obligations regarding the achievement of economic and monetary union”. The seven countries under review in this report have been examined as part of the regular two-year cycle. The European Commission has also prepared a report, and both reports are being submitted to the EU Council in parallel.

In this report, the ECB uses the framework applied in its previous Convergence Reports. It examines, for the seven countries concerned, whether a high degree of sustainable economic convergence has been achieved, whether the national legislation is compatible with the Treaties and the Statute of the European System of Central Banks and of the European Central Bank (Statute), and whether the statutory requirements are fulfilled for the relevant national central bank (NCB) to become an integral part of the Eurosystem.

The examination of the economic convergence process is highly dependent on the quality and integrity of the underlying statistics. The compilation and reporting of statistics, particularly government finance statistics, must not be subject to political considerations or interference. EU Member States have been invited to consider the quality and integrity of their statistics as a matter of high priority, to ensure that a proper system of checks and balances is in place when these statistics are compiled, and to apply minimum standards in the domain of statistics. These standards are of the utmost importance in reinforcing the independence, integrity and accountability of the

¹ When the Maastricht Treaty was concluded in 1992, Denmark was granted an exemption clause or “opt-out” under which it does not have to participate in the third stage of EMU and, therefore, introduce the euro.

² Unless otherwise stated, all references in this report to the “Treaty” refer to the Treaty on the Functioning of the European Union, and the references to article numbers reflect the numbering in effect since 1 December 2009. Unless otherwise stated, all references in this report to the “Treaties” refer to both the Treaty on European Union and the Treaty on the Functioning of the European Union. See also the clarification of these terms in the [ECB web glossary](#).

national statistical institutes and in supporting confidence in the quality of government finance statistics (see Chapter 6).

It should be also recalled that, from 4 November 2014 onwards,³ any country whose derogation is abrogated must join the Single Supervisory Mechanism (SSM) at the latest on the date on which it adopts the euro. From then on all SSM-related rights and obligations apply to that country. It is, therefore, of utmost importance that the necessary preparations are made. In particular, the banking system of any Member State joining the euro area, and therefore the SSM, will be subject to a comprehensive assessment.⁴

This report is structured as follows. Chapter 2 describes the framework used for the examination of economic and legal convergence. Chapter 3 provides a horizontal overview of the key aspects of economic convergence. Chapter 4 contains the country summaries, which provide the main results of the examination of economic and legal convergence. Chapter 5 examines in more detail the state of economic convergence in each of the seven EU Member States under review. Chapter 6 provides an overview of the convergence indicators and the statistical methodology used to compile them. Finally, Chapter 7 examines the compatibility of the national legislation of the Member States under review, including the statutes of their NCBs, with Articles 130 and 131 of the Treaty.

³ This is the date when the ECB assumed the tasks conferred on it by Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, Article 33(2).

⁴ See recital 10 of Regulation ECB/2014/17 of the European Central Bank of 16 April 2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities (SSM Framework Regulation).

2 Framework for analysis

2.1 Economic convergence

To examine the state of economic convergence in EU Member States seeking to adopt the euro, the ECB makes use of a common framework for analysis. This common framework, which has been applied in a consistent manner throughout all European Monetary Institute (EMI) and ECB Convergence Reports, is based, first, on the Treaty provisions and their application by the ECB with regard to developments in prices, fiscal balances and debt ratios, exchange rates and long-term interest rates, as well as in other factors relevant to economic integration and convergence. Second, it is based on a range of additional backward and forward-looking economic indicators considered to be useful for examining the sustainability of convergence in greater detail. The examination of the Member State concerned based on all these factors is important to ensure that its integration into the euro area will proceed without major difficulties. Boxes 1 to 5 below briefly outline the legal provisions and provide methodological details on the application of these provisions by the ECB.

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

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

In addition, and to the extent appropriate, a forward-looking perspective is adopted. In this context, particular attention is paid to the fact that the sustainability of favourable economic developments hinges critically on appropriate and lasting policy responses to existing and future challenges. Strong governance, sound institutions and sustainable public finances are also essential for supporting sustainable output growth over the medium to long term. Overall, it is emphasised that ensuring the

sustainability of economic convergence depends on the achievement of a strong starting position, the existence of sound institutions and the pursuit of appropriate policies after the adoption of the euro.

The common framework is applied individually to the seven EU Member States under review. These examinations, which focus on each Member State's performance, should be considered separately, in line with the provisions of Article 140 of the Treaty.

The cut-off date for the statistics included in this Convergence Report was 7 May 2020. The statistical data used in the application of the convergence criteria were provided by the European Commission (see Chapter 6 as well as the tables and charts), in cooperation with the ECB in the case of exchange rates and long-term interest rates. In agreement with the European Commission, the reference period for the price stability criterion is from April 2019 to March 2020. Similarly, the reference period for the long-term interest rate criterion is also from April 2019 to March 2020. For exchange rates, the reference period is from 1 April 2018 to 31 March 2020. Historical data on fiscal positions cover the period up to 2019. Account is also taken of forecasts from various sources, together with the most recent convergence programme of the Member State concerned and other information relevant to a forward-looking examination of the sustainability of convergence. The European Commission's Spring 2020 Economic Forecast⁵ and the Alert Mechanism Report 2020, which are also taken into account in this report, were released on 6 May 2020 and 17 December 2019, respectively. This report was adopted by the General Council of the ECB on 4 June 2020.

This Convergence Report considers the impact of the coronavirus (COVID-19) pandemic on the convergence assessment only to a very limited extent. As it is too early to draw any firm conclusions about how the convergence paths will be affected and whether this effect will materialise in a symmetric or asymmetric way across the relevant countries, detailed analysis will be conducted in the context of the next Convergence Report. In the light of the COVID-19 pandemic, the forward-looking convergence assessment is surrounded by high uncertainty, and the full impact can only be evaluated ex post. Most EU Member States introduced containment measures to bring down the number of infections and also implemented special fiscal, macroprudential, supervisory and monetary policy measures to mitigate the economic impact. The implications for statistical data are also not fully understood at this stage. The heightened uncertainty relates to all convergence criteria. As regards the price stability criterion, there is a high level of uncertainty as to how inflation is going to evolve over the coming months. In particular, the economic downturn brought about by the COVID-19 pandemic could be more protracted or the recovery could be faster than previously expected. Considerable uncertainty surrounds the balance of risks between downward pressures on inflation linked to weaker demand and upward pressures related to supply disruptions. Regarding the fiscal criterion, the COVID-19 pandemic has an impact on the outlook for general government finances, while the key fiscal indicators from 2010 to 2019 are not affected. As regards the fiscal outlook,

⁵ Given the exceptional circumstances and the high level of uncertainty, the European Commission forecasts should be understood as one among several possible scenarios.

the ECB's analysis relies mostly on the European Commission's Spring 2020 Economic Forecast, which, for all countries under review, shows a sharp deterioration in the government balance resulting from the marked deterioration in economic activity and the fiscal measures implemented to mitigate the crisis. Nevertheless, the potential implications of the COVID-19 pandemic for the medium to long-term sustainability of budgetary positions beyond its impact on the latest forecasts are not covered because of the high levels of uncertainty. In particular, the ECB's analysis relies on the European Commission's 2019 Debt Sustainability Monitor, which was released prior to the COVID-19 pandemic. Exchange rate volatility and depreciation pressures on national currencies vis-à-vis the euro increased after the emergence of COVID-19. In order to limit distortions to the overall convergence assessment, the review period for exchange rate developments ends in March 2020. For long-term interest rate developments, April 2020 is excluded from the analysis owing to the impact of the COVID-19 pandemic on financial markets. Extreme levels of uncertainty and volatility in financial markets may cloud the information content of financial market developments and, therefore, introduce potential distortions in the overall assessment of each country's convergence process. In conclusion, a proper analysis of the economic impact of the pandemic on the convergence assessment can only be performed in retrospect.

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

Box 1

Price developments

1. Treaty provisions

Article 140(1), first indent, of the Treaty requires the Convergence Report to examine the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of the following criterion:

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

Article 1 of Protocol (No 13) on the convergence criteria stipulates that:

“The criterion on price stability referred to in the first indent of Article 140(1) of the Treaty on the Functioning of the European Union shall mean that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1½ percentage points that of, at most, the three best performing Member States in terms of price stability. Inflation shall be measured by means of the consumer price index on a comparable basis taking into account differences in national definitions”.

2. Application of Treaty provisions

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

First, with regard to “an average rate of inflation, observed over a period of one year before the examination”, the inflation rate has been calculated using the change in the 12-month average of the HICP in the reference period from April 2019 to March 2020 compared with the previous 12-month average.

Second, the notion of “at most, the three best performing Member States in terms of price stability”, which is used for the definition of the reference value, has been applied by taking the unweighted arithmetic average of the rates of inflation of the following three Member States: Portugal (0.2%), Cyprus (0.4%) and Italy (0.4%). As a result, adding 1½ percentage points to the average rate, the reference value is 1.8%. It should be stressed that under the Treaty a country’s inflation performance is examined in relative terms, i.e. against that of other Member States. The price stability criterion thus takes into account the fact that common shocks (stemming, for example, from global commodity prices) can temporarily drive inflation rates away from central banks’ targets.

In the last five reports, the “outlier” approach was used to deal appropriately with potential significant distortions in individual countries’ inflation developments. A Member State is considered to be an outlier if two conditions are fulfilled: first, a country’s 12-month average inflation rate is significantly below the comparable rates in other Member States; and, second, a country’s price developments have been strongly affected by exceptional factors. In this report, none of the Member States with the lowest inflation rates was identified as an outlier.

Inflation has been measured on the basis of the HICP, which was developed for the purpose of assessing convergence in terms of price stability on a comparable basis (see Section 2 of Chapter 6).

The average rate of HICP inflation over the 12-month reference period from April 2019 to March 2020 is reviewed in the light of the country’s economic performance over the last ten years in terms of price stability. This allows a more detailed examination of the sustainability of price developments in the country under review. In this connection, attention is paid to the orientation of monetary policy, in particular to whether the focus of the monetary authorities has been primarily on achieving and maintaining price stability, as well as to the contribution of other areas of economic policy to this objective. Moreover, the implications of the macroeconomic environment for the achievement of price stability are taken into account. Price developments are examined in the light of supply and demand conditions, focusing on factors such as unit labour costs and import prices. Finally, trends in other relevant price indices are considered. From a forward-looking perspective, a view is provided of prospective inflationary developments in the coming years, including forecasts by major international organisations and market participants. Moreover, institutional and structural aspects relevant for maintaining an environment conducive to price stability after adoption of the euro are discussed.

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

Box 2

Fiscal developments

1. Treaty and other legal provisions

Article 140(1), second indent, of the Treaty requires the Convergence Report to examine the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of the following criterion:

“the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 126(6)”.

Article 2 of Protocol (No 13) on the convergence criteria stipulates that:

“The criterion on the government budgetary position referred to in the second indent of Article 140(1) of the said Treaty shall mean that at the time of the examination the Member State is not the subject of a Council decision under Article 126(6) of the said Treaty that an excessive deficit exists”.

Article 126 sets out the excessive deficit procedure (EDP). In accordance with Article 126(2) and (3), the European Commission prepares a report if a Member State does not fulfil the requirements for fiscal discipline, in particular if:

1. the ratio of the planned or actual government deficit to GDP exceeds a reference value (defined in the Protocol on the EDP as 3% of GDP), unless either:
 - (a) the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively,
 - (b) the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;
2. the ratio of government debt to GDP exceeds a reference value (defined in the Protocol on the EDP as 60% of GDP), unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

In addition, the report prepared by the Commission must take into account whether the government deficit exceeds government investment expenditure and all other relevant factors, including the medium-term economic and budgetary position of the Member State. The Commission may also prepare a report if, notwithstanding the fulfilment of the criteria, it is of the opinion that there is a risk of an excessive deficit in a Member State. The Economic and Financial Committee formulates an opinion on the Commission's report. Finally, in accordance with Article 126(6), the EU Council, on the basis of a recommendation from the Commission and having considered any observations which the Member State concerned may wish to make, decides, acting by qualified majority and excluding the Member State concerned, and following an overall assessment, whether an excessive deficit exists in a Member State.

The Treaty provisions under Article 126 are further clarified by Regulation (EC) No 1467/97⁶ as amended by Regulation (EU) No 1177/2011⁷, which, among other things:

- confirms the equal footing of the debt criterion with the deficit criterion by making the former operational, while allowing for a three-year period of transition for Member States exiting EDPs opened before 2011. Article 2(1a) of the Regulation provides that when it exceeds the reference value, the ratio of the government debt to GDP shall be considered sufficiently diminishing and approaching the reference value at a satisfactory pace if the differential with respect to the reference value has decreased over the previous three years at an average rate of one twentieth per year as a benchmark, based on changes over the last three years for which the data are available. The requirement under the debt criterion shall also be considered to be fulfilled if the required reduction in the differential looks set to occur over a defined three-year period, based on the Commission's budgetary forecast. In implementing the debt reduction benchmark, the influence of the economic cycle on the pace of debt reduction shall be taken into account;
- details the relevant factors that the Commission shall take into account when preparing a report under Article 126(3) of the Treaty. Most importantly, it specifies a series of factors considered relevant in assessing developments in medium-term economic, budgetary and government debt positions (see Article 2(3) of the Regulation and, below, details on the ensuing ECB analysis).

Moreover, the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), which builds on the provisions of the enhanced Stability and Growth Pact, entered into force on 1 January 2013.⁸ Title III (Fiscal Compact) provides, among other things, for a binding fiscal rule aimed at ensuring that the general government budget is balanced or in surplus. This rule is deemed to be respected if the annual structural balance meets the country-specific medium-term objective and does not exceed a deficit – in structural terms – of 0.5% of GDP. If the government debt ratio is significantly below 60% of GDP and risks to long-term fiscal sustainability are low, the medium-term objective can be set at a structural deficit of at most 1% of GDP. The TSCG also includes the debt reduction benchmark rule referred to in Regulation (EU) No 1177/2011, which amended Regulation (EC) No 1467/97. The signatory Member States are required to introduce in their constitution – or equivalent law of higher level than the annual budget law – the stipulated fiscal rules accompanied by an automatic correction mechanism in case of deviation from the fiscal objective.

2. Application of Treaty provisions

For the purpose of examining convergence, the ECB expresses its view on fiscal developments. With regard to sustainability, the ECB examines key indicators of fiscal developments from 2010 to 2019, the outlook and the challenges for general government finances, focusing on the links between deficit and debt developments. Regarding the impact of the COVID-19 pandemic on general government finances, the ECB refers to the Stability and Growth Pact's general escape clause, which was activated on 20 March 2020. In particular, for the preventive arm, Articles 5(1) and 9(1) of Regulation

⁶ Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure (OJ L 209, 2.8.1997, p. 6).

⁷ Council Regulation (EU) No 1177/2011 of 8 November 2011 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure (OJ L 306, 23.11.2011, p. 33).

⁸ The TSCG also applies to those EU Member States with a derogation that have ratified it as from the date when the decision abrogating that derogation takes effect or as from an earlier date if the Member State concerned declares its intention to be bound at such earlier date by all or part of the provisions of the TSCG.

(EC) No 1466/97⁹ state that “in periods of severe economic downturn for the euro area or the Union as a whole, Member States may be allowed temporarily to depart from the adjustment path towards the medium-term budgetary objective ..., provided that this does not endanger fiscal sustainability in the medium term”. For the corrective arm, Articles 3(5) and 5(2) of Regulation (EC) No 1467/97 stipulate that “in the case of a severe economic downturn in the euro area or in the Union as a whole, the Council may also decide, on a recommendation from the Commission, to adopt a revised recommendation under Article 126(7) TFEU provided that this does not endanger fiscal sustainability in the medium term”. The ECB also provides an analysis with regard to the effectiveness of national budgetary frameworks, as referred to in Article 2(3)(b) of Regulation (EC) No 1467/97 and in Directive 2011/85/EU.¹⁰ With regard to Article 126, the ECB, in contrast to the Commission, has no formal role in the EDP. Therefore, the ECB report only states whether the country is subject to an EDP.

With regard to the Treaty provision that a debt ratio of above 60% of GDP should be “sufficiently diminishing and approaching the reference value at a satisfactory pace”, the ECB examines past and future trends in the debt ratio. For Member States in which the debt ratio exceeds the reference value, the ECB provides the European Commission’s latest assessment of compliance with the debt reduction benchmark laid down in Article 2(1a) of Regulation (EC) No 1467/97.

The examination of fiscal developments is based on data compiled on a national accounts basis, in compliance with the European System of Accounts 2010 (ESA 2010) (see Chapter 6). Most of the figures presented in this report were provided by the Commission in April 2020 and include government financial positions from 2010 to 2019 as well as Commission forecasts for 2020-21.

With regard to the sustainability of public finances, the outcome in the reference year, 2019, is reviewed in the light of the performance of the country under review over the past ten years. First, the development of the deficit ratio is investigated. It is useful to bear in mind that the change in a country’s annual deficit ratio is typically influenced by a variety of underlying forces. These influences can be divided into “cyclical effects” on the one hand, which reflect the reaction of deficits to changes in the economic cycle, and “non-cyclical effects” on the other, which are often taken to reflect structural or permanent adjustments to fiscal policies. However, such non-cyclical effects, as quantified in this report, cannot necessarily be seen as entirely reflecting a structural change to fiscal positions, because they include temporary effects on the budgetary balance stemming from the impact of both policy measures and special factors. Indeed, assessing how structural budgetary positions have changed during the COVID-19 pandemic is particularly difficult in view of uncertainty over the level and growth rate of potential output.

As a further step, the development of the government debt ratio in this period is considered, as well as the factors underlying it. These factors are the difference between nominal GDP growth and interest rates, the primary balance and the deficit-debt adjustment. Such a perspective can offer further information on the extent to which the macroeconomic environment, in particular the combination of growth and

⁹ Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies (OJ L 209, 2.8.1997, p.1).

¹⁰ Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States (OJ L 306, 23.11.2011, p. 41).

interest rates, has affected the dynamics of debt. It can also provide more information on the contribution of the structural balance and the cyclical developments, as reflected in the primary balance, and on the role played by special factors, as included in the deficit-debt adjustment. In addition, the structure of government debt is considered, by focusing in particular on the shares of debt with a short-term maturity and foreign currency debt, as well as their development. By comparing these shares with the current level of the debt ratio, the sensitivity of fiscal balances to changes in exchange rates and interest rates can be highlighted.

Turning to a forward-looking perspective, national budget plans and recent forecasts by the European Commission for 2020-21 are considered, and account is taken of the medium-term fiscal strategy, as reflected in the convergence programme. This includes an assessment of the projected attainment of the country's medium-term budgetary objective, as foreseen in the Stability and Growth Pact, as well as of the outlook for the debt ratio on the basis of current fiscal policies. In the context of the COVID-19 pandemic, the general escape clause has been activated and allows deviations from the medium-term budgetary objective as described in Box 2. In addition, long-term challenges to the sustainability of budgetary positions and broad areas for consolidation are emphasised, particularly those related to the issue of unfunded government pension systems in connection with demographic change and to contingent liabilities incurred by the government. The potential implications of the COVID-19 pandemic for the medium to long-term sustainability of budgetary positions beyond its impact on the latest forecasts are not covered because of the high levels of uncertainty. Furthermore, in line with past practice, the analysis described above also covers most of the relevant factors identified in Article 2(3) of Regulation (EC) No 1467/97, as described in Box 2.

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

Box 3

Exchange rate developments

1. Treaty provisions

Article 140(1), third indent, of the Treaty requires the Convergence Report to examine the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of the following criterion:

“the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the euro”.

Article 3 of Protocol (No 13) on the convergence criteria stipulates that:

“The criterion on participation in the Exchange Rate mechanism of the European Monetary System referred to in the third indent of Article 140(1) of the said Treaty shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism on the European Monetary System without severe tensions for at least the last two years before the

examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against the euro on its own initiative for the same period".

2. Application of Treaty provisions

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

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

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

The reference period in this report is from 1 April 2018 to 31 March 2020. All bilateral exchange rates are official ECB reference rates (see Chapter 6).

In addition to ERM II participation and nominal exchange rate developments against the euro over the period under review, evidence relevant to the sustainability of the current exchange rate is briefly reviewed. This is derived from the development of the real effective exchange rates and the current, capital and financial accounts of the balance of payments. The evolution of gross external debt and the net international investment position over longer periods is also examined. The section on exchange rate developments further considers measures of the degree of a country's integration with the euro area. This is assessed in terms of both external trade integration (exports and imports) and financial integration. Finally, the section on exchange rate developments reports, if applicable, whether the country under examination has during the two-year reference period benefited from central bank liquidity assistance or balance of payments support, either bilaterally or multilaterally with the involvement of the IMF and/or the EU. Both actual and precautionary assistance are considered, including access to precautionary financing in the form of, for instance, the IMF's Flexible Credit Line.

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

Box 4

Long-term interest rate developments

1. Treaty provisions

Article 140(1), fourth indent, of the Treaty requires the Convergence Report to examine the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of the following criterion:

“the durability of convergence achieved by the Member State with a derogation and of its participation in the exchange-rate mechanism being reflected in the long-term interest-rate levels”.

Article 4 of Protocol (No 13) on the convergence criteria stipulates that:

“The criterion on the convergence of interest rates referred to in the fourth indent of Article 140(1) of the said Treaty shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than two percentage points that of, at most, the three best performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions”.

2. Application of Treaty provisions

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

First, with regard to “an average nominal long-term interest rate” observed over “a period of one year before the examination”, the long-term interest rate has been calculated as an arithmetic average over the latest 12 months for which HICP data were available. The reference period considered in this report is from April 2019 to March 2020, in line with the reference period for the price stability criterion.

Second, the notion of “at most, the three best performing Member States in terms of price stability”, which is used for the definition of the reference value, has been applied by using the unweighted arithmetic average of the long-term interest rates of the same three Member States included in the calculation of the reference value for the criterion on price stability (see Box 1). Over the reference period considered in this report, the long-term interest rates of the three countries with the lowest inflation rate included in the calculation of the reference value for the price stability criterion were 0.5% (Portugal), 0.8% (Cyprus) and 1.6% (Italy). As a result, the average rate is 0.9% and, adding 2 percentage points, the reference value is 2.9%. Interest rates have been measured on the basis of available harmonised long-term interest rates, which were developed for the purpose of examining convergence (see Chapter 6).

As mentioned above, the Treaty makes explicit reference to the “durability of convergence” being reflected in the level of long-term interest rates. Therefore, developments over the reference period from April 2019 to March 2020 are reviewed against the background of the path of long-term interest rates over the past ten years (or otherwise the period for which data are available) and the main factors underlying differentials vis-à-vis the average long-term interest rate prevailing in the euro area. During the reference period, the average euro area long-term interest rate may have

partly reflected high country-specific risk premia in several euro area countries. Therefore, the euro area AAA long-term government bond yield (i.e. the long-term yield of the euro area AAA yield curve, which includes the euro area countries with an AAA rating) is also used for comparison purposes. As background to this analysis, this report also provides information about the size and development of the financial market. This is based on three different indicators (the outstanding amount of debt securities issued by non-financial corporations, stock market capitalisation and MFI credit to the domestic non-financial private sector), which, together, provide a measure of the size of financial markets.

Finally, Article 140(1) of the Treaty requires this report to take account of several other relevant factors (see Box 5). In this respect, an enhanced economic governance framework in accordance with Article 121(6) of the Treaty entered into force on 13 December 2011 with the aim of ensuring a closer coordination of economic policies and the sustained convergence of EU Member States' economic performances. Box 5 below briefly outlines these legislative provisions and the way in which the above-mentioned additional factors are addressed in the assessment of convergence conducted by the ECB.

Box 5

Other relevant factors

1. Treaty and other legal provisions

Article 140(1) of the Treaty requires that: “The reports of the Commission and the European Central Bank shall also take account of the results of the integration of markets, the situation and development of the balances of payments on current account and an examination of the development of unit labour costs and other price indices”.

In this respect, the ECB takes into account the legislative package on EU economic governance which entered into force on 13 December 2011. Building on the Treaty provisions under Article 121(6), the European Parliament and the EU Council adopted detailed rules for the multilateral surveillance procedure referred to in Articles 121(3) and 121(4) of the Treaty. These rules were adopted “in order to ensure closer coordination of economic policies and sustained convergence of the economic performances of the Member States” (Article 121(3)), in view of the “need to draw lessons from the first decade of functioning of the economic and monetary union and, in particular, for improved economic governance in the Union built on stronger national ownership”.¹¹ The legislative package includes an enhanced surveillance framework (the macroeconomic imbalance procedure or MIP) aimed at preventing excessive macroeconomic and macro-financial imbalances by helping diverging EU Member States to establish corrective plans before divergence becomes entrenched. The MIP, with both preventive and corrective arms, applies to all EU Member States, except those which, being under an international financial assistance programme, are already subject to closer scrutiny coupled with conditionality. The MIP includes an alert mechanism for the early detection of imbalances, based on a transparent scoreboard of indicators with alert thresholds for all EU Member States, combined with economic judgement. This judgement should take into account, among other

¹¹ See recital 2 of Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances (OJ L 306, 23.11.2011, p. 25).

things, nominal and real convergence inside and outside the euro area.¹² When assessing macroeconomic imbalances, this procedure should take due account of their severity and their potential negative economic and financial spillover effects, which aggravate the vulnerability of the EU economy and threaten the smooth functioning of Economic and Monetary Union.¹³

2. Application of Treaty provisions

In line with past practice, the additional factors referred to in Article 140(1) of the Treaty are reviewed in Chapter 5 under the headings of the individual criteria described in Boxes 1 to 4. For completeness, in Chapter 3 the scoreboard indicators are presented for the countries covered in this report (including in relation to the alert thresholds), thereby ensuring the provision of all available information relevant to the detection of macroeconomic and macro-financial imbalances that may be hampering the achievement of a high degree of sustainable convergence as stipulated in Article 140(1) of the Treaty. Notably, EU Member States with a derogation that are subject to an excessive imbalance procedure can hardly be considered as having achieved a high degree of sustainable convergence as stipulated in Article 140(1) of the Treaty.

2.2 Compatibility of national legislation with the Treaties

2.2.1 Introduction

Article 140(1) of the Treaty requires the ECB (and the European Commission) to report, at least once every two years or at the request of a Member State with a derogation, to the Council on the progress made by the Member States with a derogation in fulfilling their obligations regarding the achievement of economic and monetary union. These reports must include an examination of the compatibility between the national legislation of each Member State with a derogation, including the statutes of its NCB, and Articles 130 and 131 of the Treaty and the relevant Articles of the Statute. This Treaty obligation of Member States with a derogation is also referred to as 'legal convergence'.

When assessing legal convergence, the ECB is not limited to making a formal assessment of the letter of national legislation, but may also consider whether the implementation of the relevant provisions complies with the spirit of the Treaties and the Statute. The ECB is particularly concerned about any signs of pressure being put on the decision-making bodies of any Member State's NCB which would be inconsistent with the spirit of the Treaty as regards central bank independence. The ECB also sees the need for the smooth and continuous functioning of the NCBs' decision-making bodies. In this respect, the relevant authorities of a Member State have, in particular, the duty to take the necessary measures to ensure the timely appointment of a successor if the position of a member of an NCB's decision-making

¹² See Article 4(4) of Regulation (EU) No 1176/2011.

¹³ See recital 17 of Regulation (EU) No 1176/2011.

body becomes vacant.¹⁴ The ECB will closely monitor any developments prior to making a positive final assessment concluding that a Member State's national legislation is compatible with the Treaty and the Statute.

Member States with a derogation and legal convergence

Bulgaria, the Czech Republic, Croatia, Hungary, Poland, Romania and Sweden, whose national legislation is examined in this report, each have the status of a Member State with a derogation, i.e. they have not yet adopted the euro. Sweden was given the status of a Member State with a derogation by a decision of the Council in May 1998.¹⁵ As far as the other Member States are concerned, Articles 4¹⁶ and 5¹⁷ of the Acts concerning the conditions of accession provide that each of these Member States shall participate in Economic and Monetary Union from the date of accession as a Member State with a derogation within the meaning of Article 139 of the Treaty.

This report does not cover Denmark, which is a Member State with a special status and which has not yet adopted the euro. Protocol (No 16) on certain provisions relating to Denmark, annexed to the Treaties, provides that, in view of the notice given to the Council by the Danish Government on 3 November 1993, Denmark has an exemption and that the procedure for the abrogation of the derogation will only be initiated at the request of Denmark. As Article 130 of the Treaty applies to Denmark, Denmark's Nationalbank has to fulfil the requirements of central bank independence. The EMI's Convergence Report of 1998 concluded that this requirement had been fulfilled. There has been no assessment of Danish convergence since 1998 due to Denmark's special status. Until such time as Denmark notifies the Council that it intends to adopt the euro, Denmark's Nationalbank does not need to be legally integrated into the Eurosystem and no Danish legislation needs to be adapted.

On 29 March 2017 the United Kingdom notified the European Council of its intention to withdraw from the EU pursuant to Article 50 of the Treaty on European Union. The United Kingdom withdrew from the EU on 31 January 2020 on the basis of the arrangements set out in the Agreement on the withdrawal of the United Kingdom of Great Britain and Northern Ireland from the European Union and the European Atomic Energy Community (hereinafter the "Withdrawal Agreement"). EU law continues to be applicable to and in the United Kingdom in accordance with the terms of the Withdrawal Agreement during a transition period that started on the day of the United

¹⁴ Opinions CON/2010/37 and CON/2010/91.

¹⁵ Council Decision 98/317/EC of 3 May 1998 in accordance with Article 109j(4) of the Treaty (OJ L 139, 11.5.1998, p. 30). Note: The title of Decision 98/317/EC refers to the Treaty establishing the European Community (prior to the renumbering of the Articles of this Treaty in accordance with Article 12 of the Treaty of Amsterdam); this provision has been repealed by the Treaty of Lisbon.

¹⁶ Act concerning the conditions of accession of the Czech Republic, the Republic of Estonia, the Republic of Cyprus, the Republic of Latvia, the Republic of Lithuania, the Republic of Hungary, the Republic of Malta, the Republic of Poland, the Republic of Slovenia and the Slovak Republic and the adjustments to the Treaties on which the European Union is founded (OJ L 236, 23.9.2003, p. 33).

¹⁷ For Bulgaria and Romania, see Article 5 of the Act concerning the conditions of accession of the Republic of Bulgaria and Romania and the adjustments to the treaties on which the European Union is founded (OJ L 157, 21.6.2005, p. 203). For Croatia, see Article 5 of the Act concerning the conditions of accession of the Republic of Croatia and the adjustments to the Treaty on European Union, the Treaty on the Functioning of the European Union and the Treaty establishing the European Atomic Energy Community (OJ L 112, 24.4.2012, p. 21).

Kingdom's withdrawal from the EU and ends on 31 December 2020.¹⁸ However, according to Protocol (No 15) on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland, annexed to the Treaties, the United Kingdom is under no obligation to adopt the euro unless it notifies the Council that it intends to do so. On 30 October 1997 the United Kingdom notified the Council that it did not intend to adopt the euro on 1 January 1999 and this situation has not changed. Pursuant to this notification, certain provisions of the Treaty (including Articles 130 and 131) and of the Statute do not apply to the United Kingdom. Accordingly, there is no current legal requirement to ensure that national legislation (including the Bank of England's statutes) is compatible with the Treaty and the Statute.

The aim of assessing legal convergence is to facilitate the Council's decisions as to which Member States fulfil 'their obligations regarding the achievement of economic and monetary union' (Article 140(1) of the Treaty). In the legal domain, such conditions refer in particular to central bank independence and to the NCBs' legal integration into the Eurosystem.

Structure of the legal assessment

The legal assessment broadly follows the framework of the previous reports of the ECB and the EMI on legal convergence.¹⁹

The compatibility of national legislation is considered in the light of legislation enacted before 24 March 2020.

2.2.2 Scope of adaptation

Areas of adaptation

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

¹⁸ Article 127(1) of the Withdrawal Agreement. See also Article 127(3) and (6), and Article 7(1) of the Withdrawal Agreement. According to Article 128(4) of the Withdrawal Agreement, for the purposes of participation in the institutional arrangements laid down in Articles 282 and 283 of the Treaty and in the Statute (with the exception of Article 21(2) of the Statute), during the transition period the Bank of England shall not be considered to be a national central bank of a Member State.

¹⁹ In particular the ECB's Convergence Reports of May 2018 (on Bulgaria, the Czech Republic, Croatia, Hungary, Poland, Romania and Sweden), June 2016 (on Bulgaria, the Czech Republic, Croatia, Hungary, Poland, Romania and Sweden), June 2014 (on Bulgaria, the Czech Republic, Croatia, Lithuania, Hungary, Poland, Romania and Sweden), June 2013 (on Latvia), May 2012 (on Bulgaria, the Czech Republic, Latvia, Lithuania, Hungary, Poland, Romania and Sweden), May 2010 (on Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania and Sweden), May 2008 (on Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovakia and Sweden), May 2007 (on Cyprus and Malta), December 2006 (on the Czech Republic, Estonia, Cyprus, Latvia, Hungary, Malta, Poland, Slovakia and Sweden), May 2006 (on Lithuania and Slovenia), October 2004 (on the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovakia and Sweden), May 2002 (on Sweden) and April 2000 (on Greece and Sweden), and the EMI's Convergence Report of March 1998.

- compatibility with provisions on the independence of NCBs in the Treaty (Article 130) and the Statute (Articles 7 and 14.2);
- compatibility with provisions on confidentiality (Article 37 of the Statute);
- compatibility with the prohibitions on monetary financing (Article 123 of the Treaty) and privileged access (Article 124 of the Treaty);
- compatibility with the single spelling of the euro required by EU law; and
- legal integration of the NCBs into the Eurosystem (in particular as regards Articles 12.1 and 14.3 of the Statute).

‘Compatibility’ versus ‘harmonisation’

Article 131 of the Treaty requires national legislation to be ‘compatible’ with the Treaties and the Statute; any incompatibility must therefore be removed. Neither the supremacy of the Treaties and the Statute over national legislation nor the nature of the incompatibility affects the need to comply with this obligation.

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

The obligation in Article 131 of the Treaty only covers incompatibility with the Treaties and the Statute. However, national legislation that is incompatible with secondary EU legislation relevant for the areas of adaptation examined in this Convergence Report should be brought into line with such secondary legislation. The primacy of EU law does not affect the obligation to adapt national legislation. This general requirement derives not only from Article 131 of the Treaty but also from the case law of the Court of Justice of the European Union.²⁰

The Treaties and the Statute do not prescribe the manner in which national legislation should be adapted. This may be achieved by referring to the Treaties and the Statute,

²⁰ See, amongst others, *Commission of the European Communities v French Republic*, C-265/95, ECLI:EU:C:1997:595.

or by incorporating provisions thereof and referring to their provenance, or by deleting any incompatibility, or by a combination of these methods.

Furthermore, among other things as a tool for achieving and maintaining the compatibility of national legislation with the Treaties and the Statute, the ECB must be consulted by the EU institutions and by the Member States on draft legislative provisions in its fields of competence, pursuant to Articles 127(4) and 282(5) of the Treaty and Article 4 of the Statute. Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions²¹ expressly requires Member States to take the measures necessary to ensure compliance with this obligation.

2.2.3 Independence of NCBs

As far as central bank independence is concerned, national legislation in the Member States that joined the EU in 2004, 2007 or 2013 had to be adapted to comply with the relevant provisions of the Treaty and the Statute, and be in force on 1 May 2004, 1 January 2007 and 1 July 2013 respectively.²² Sweden had to bring the necessary adaptations into force by the date of establishment of the ESCB on 1 June 1998.

Central bank independence

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

Functional independence

Central bank independence is not an end in itself, but is instrumental in achieving an objective that should be clearly defined and should prevail over any other objective. Functional independence requires each NCB's primary objective to be stated in a clear and legally certain way and to be fully in line with the primary objective of price stability established by the Treaty. It is served by providing the NCBs with the necessary means and instruments for achieving this objective independently of any other authority. The Treaty's requirement of central bank independence reflects the

²¹ OJ L 189, 3.7.1998, p. 42.

²² This also applies to the ESCB's confidentiality regime; see Section 2.2.4 of this Convergence Report.

generally held view that the primary objective of price stability is best served by a fully independent institution with a precise definition of its mandate. Central bank independence is fully compatible with holding NCBs accountable for their decisions, which is an important aspect of enhancing confidence in their independent status. This entails transparency and dialogue with third parties.

As regards timing, the Treaty is not clear about when the NCBs of Member States with a derogation must comply with the primary objective of price stability set out in Articles 127(1) and 282(2) of the Treaty and Article 2 of the Statute. For those Member States that joined the EU after the date of the introduction of the euro in the EU, it is not clear whether this obligation should run from the date of accession or from the date of their adoption of the euro. While Article 127(1) of the Treaty does not apply to Member States with a derogation (see Article 139(2)(c) of the Treaty), Article 2 of the Statute does apply to such Member States (see Article 42.1 of the Statute). The ECB takes the view that the obligation of the NCBs to have price stability as their primary objective runs from 1 June 1998 in the case of Sweden, and from 1 May 2004, 1 January 2007 and 1 July 2013 for the Member States that joined the EU on those dates. This is based on the fact that one of the guiding principles of the EU, namely price stability (Article 119 of the Treaty), also applies to Member States with a derogation. It is also based on the Treaty objective that all Member States should strive for macroeconomic convergence, including price stability, which is the intention behind the regular reports of the ECB and the European Commission. This conclusion is also based on the underlying rationale of central bank independence, which is only justified if the overall objective of price stability has primacy.

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

Institutional independence

The principle of institutional independence is expressly referred to in Article 130 of the Treaty and Article 7 of the Statute. These two articles prohibit the NCBs and members of their decision-making bodies from seeking or taking instructions from EU institutions or bodies, from any government of a Member State or from any other body. In addition, they prohibit EU institutions, bodies, offices or agencies, and the governments of the Member States from seeking to influence those members of the NCBs' decision-making bodies whose decisions may affect the fulfilment of the NCBs' ESCB-related tasks. If national legislation mirrors Article 130 of the Treaty and Article 7 of the Statute, it should reflect both prohibitions and not narrow the scope of their application.²³ The recognition that central banks have such independence does not have the consequence of exempting from every rule of law and to shield them from any kind of legislation.²⁴

²³ Opinion CON/2011/104.

²⁴ See Opinion CON/2019/15 and *Commission v European Central Bank*, C-11/00, ECLI:EU:C:2003:395, paragraphs 134 to 136.

Whether an NCB is organised as a state-owned body, a special public law body or simply a public limited company, there is a risk that influence may be exerted by the owner on its decision-making in relation to ESCB-related tasks by virtue of such ownership.²⁵ Such influence, whether exercised through shareholders' rights or otherwise, may affect an NCB's independence and should therefore be limited by law.

The legal framework for central banking needs to provide a stable and long-term basis for a central bank's functioning. A legal framework that permits frequent changes to the institutional set-up of an NCB, thus affecting its organisational or governance stability, could adversely affect that NCB's institutional independence.²⁶

Prohibition on giving instructions

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

Any involvement of an NCB in the application of measures to strengthen financial stability must be compatible with the Treaty, i.e. NCBs' functions must be performed in a manner that is fully compatible with their functional, institutional, and financial independence so as to safeguard the proper performance of their tasks under the Treaty and the Statute.²⁷ To the extent that national legislation provides for a role of an NCB that goes beyond advisory functions and requires it to assume additional tasks, it must be ensured that these tasks will not affect the NCB's ability to carry out its ESCB-related tasks from an operational and financial point of view.²⁸ Additionally, the inclusion of NCB representatives in collegiate decision-making supervisory bodies or other authorities would need to give due consideration to safeguards for the personal independence of the members of the NCB's decision-making bodies.²⁹

Prohibition on approving, suspending, annulling or deferring decisions

Rights of third parties to approve, suspend, annul or defer an NCB's decisions are incompatible with the Treaty and the Statute as far as ESCB-related tasks are concerned.³⁰

Prohibition on censoring decisions on legal grounds

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

²⁵ Opinion CON/2019/23.

²⁶ Opinions CON/2011/104 and CON/2017/34.

²⁷ Opinion CON/2010/31.

²⁸ Opinion CON/2009/93.

²⁹ Opinion CON/2010/94.

³⁰ Opinion CON/2016/33.

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

Participation by representatives of third parties in an NCB's decision-making body with a right to vote on matters concerning the performance by the NCB of ESCB-related tasks is incompatible with the Treaty and the Statute, even if such vote is not decisive. Such participation even without the right to vote is incompatible with the Treaty and the Statute, if such participation interferes with the performance of ESCB-related tasks by that decision-making bodies or endangers compliance with the ESCB's confidentiality regime.³¹

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

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

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

- this does not result in interference with the independence of the members of the NCB's decision-making bodies;
- the special status of Governors in their capacity as members of the ECB's decision-making bodies is fully respected; and
- confidentiality requirements resulting from the Statute are observed.³²

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

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

Personal independence

The Statute's provision on security of tenure for members of NCBs' decision-making bodies further safeguards central bank independence. NCB Governors are members of the General Council of the ECB and will be members of the Governing Council upon adoption of the euro by their Member States. Article 14.2 of the Statute provides that

³¹ Opinions CON/2014/25 and CON/2015/57.

³² Opinion CON/2018/17.

NCB statutes must, in particular, provide for a minimum term of office of five years for Governors. It also protects against the arbitrary relieving Governors from office by providing that Governors may only be relieved from office if they no longer fulfil the conditions required for the performance of their duties or if they have been guilty of serious misconduct. In such cases, Article 14.2 of the Statute provides for the possibility of recourse to the Court of Justice of the European Union, which has the power to annul the national decision taken to relieve a Governor from office.³³ The suspension of a Governor may effectively amount to relieving from office for the purposes of Article 14.2 of the Statute.³⁴ NCB statutes must comply with this provision as set out below.

Article 130 of the Treaty prohibits national governments and any bodies from influencing the members of NCBs' decision-making bodies in the performance of their tasks. In particular, Member States may not seek to influence the members of the NCB's decision-making bodies by amending national legislation affecting their remuneration, which, as a matter of principle, should apply only for future appointments.³⁵

Minimum term of office for Governors

In accordance with Article 14.2 of the Statute, NCB statutes must provide for a minimum term of office of five years for a Governor. This does not preclude longer terms of office, while an indefinite term of office does not require adaptation of the statutes provided the grounds for the relieving a Governor from office are in line with those of Article 14.2 of the Statute. Shorter periods cannot be justified even if only applied during a transitional period.³⁶ National legislation which provides for a compulsory retirement age should ensure that the retirement age does not interrupt the minimum term of office provided by Article 14.2 of the Statute, which prevails over any compulsory retirement age, if applicable to a Governor.³⁷ When an NCB's statutes are amended, the amending law should safeguard the security of tenure of the Governor and of other members of decision-making bodies who are involved in the performance of ESCB-related tasks.³⁸

Grounds for relieving Governors from office

NCB statutes must ensure that Governors may not be dismissed for reasons other than those mentioned in Article 14.2 of the Statute. The purpose of the requirement under that Article is to prevent the authorities involved in the appointment of Governors, particularly the government or parliament, from exercising their discretion to dismiss a Governor. NCB statutes should either refer to Article 14.2 of the Statute, or incorporate its provisions and refer to their provenance, or delete any incompatibility with the grounds for relieving from office laid down in Article 14.2, or omit any mention

³³ See *Rimšēvičs v Latvia*, C-202/18, ECLI:EU:C:2019:139, paragraph 76.

³⁴ See *Rimšēvičs v Latvia*, C-202/18, ECLI:EU:C:2019:139, paragraph 52, and Opinion CON/2011/9.

³⁵ See, for example, Opinions CON/2010/56, CON/2010/80, CON/2011/104 and CON/2011/106.

³⁶ Opinion CON/2018/23.

³⁷ Opinion CON/2012/89.

³⁸ Opinions CON/2018/17, CON/2019/19 and CON/2019/36.

of grounds for relieving from office (since Article 14.2 is directly applicable).³⁹ Once elected or appointed, Governors may not be relieved from office under conditions other than those mentioned in Article 14.2 of the Statute even if they have not yet taken up their duties. As the conditions under which a Governor may be relieved from office are autonomous concepts of Union law, their application and interpretation do not depend on national contexts.⁴⁰ Ultimately, it is for the Court of Justice of the European Union, in the context of the powers conferred on it by the second subparagraph of Article 14.2 of the Statute, to verify that a decision taken to relieve a Governor of a national central bank from office is justified by sufficient indications that they have engaged in serious misconduct capable of justifying such a measure.⁴¹

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

Applying the same rules for the security of tenure and grounds for relieving of Governors from office to other members of the decision-making bodies of NCBs involved in the performance of ESCB-related tasks will also safeguard the personal independence of those persons.⁴² The provisions of Article 14.2 of the Statute are not restricted to the security of tenure of office to Governors, and Article 130 of the Treaty and Article 7 of the Statute refer to “members of the decision-making bodies” of NCBs, rather than to Governors specifically. This applies in particular where a Governor is “first among equals” with colleagues with equivalent voting rights or where such other members are involved in the performance of ESCB-related tasks.

Right of judicial review

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

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

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

³⁹ Opinion CON/2018/53.

⁴⁰ See Opinion CON/2019/36 and the Opinion of Advocate General Kokott in *Rimšēvičs v Latvia*, C-202/18, ECLI:EU:C:2018:1030, paragraph 77.

⁴¹ See *Rimšēvičs v Latvia*, C-202/18, ECLI:EU:C:2019:139, paragraph 96.

⁴² Opinions CON/2004/35, CON/2005/26, CON/2006/32, CON/2006/44, CON/2007/6, CON/2019/19 and CON/2019/24.

Safeguards against conflicts of interest

Personal independence also entails ensuring that no conflict of interest arises between the duties of members of NCB decision-making bodies involved in the performance of ESCB-related tasks in relation to their respective NCBs (and of Governors in relation to the ECB) and any other functions which such members of decision-making bodies may have and which may jeopardise their personal independence.⁴³ As a matter of principle, membership of a decision-making body involved in the performance of ESCB-related tasks is incompatible with the exercise of other functions that might create a conflict of interest. In particular, members of such decision-making bodies may not hold an office or have an interest that may influence their activities, whether through office in the executive or legislative branches of the state or in regional or local administrations, or through involvement in a business organisation. Particular care should be taken to prevent potential conflicts of interest on the part of non-executive members of decision-making bodies.

Financial independence

The overall independence of an NCB would be jeopardised if it could not autonomously avail itself of sufficient financial resources to fulfil its mandate, i.e. to perform the ESCB-related tasks required of it under the Treaty and the Statute.

Member States may not put their NCBs in a position where they have insufficient financial resources and inadequate net equity⁴⁴ to carry out their ESCB or Eurosystem-related tasks, as applicable. It should be noted that Articles 28.1 and 30.4 of the Statute provide for the possibility of the ECB making further calls on the NCBs to contribute to the ECB's capital and to make further transfers of foreign reserves.⁴⁵ Moreover, Article 33.2 of the Statute provides⁴⁶ that, in the event of a loss incurred by the ECB which cannot be fully offset against the general reserve fund, the ECB's Governing Council may decide to offset the remaining loss against the monetary income of the relevant financial year in proportion to and up to the amounts allocated to the NCBs. The principle of financial independence means that compliance with these provisions requires an NCB to be able to perform its functions unimpaired.

Additionally, the principle of financial independence requires an NCB to have sufficient means not only to perform its ESCB-related tasks but also its national tasks (e.g. supervision of the financial sector, financing its administration and own operations, provision of Emergency Liquidity Assistance⁴⁷).

For all the reasons mentioned above, financial independence also implies that an NCB should always be sufficiently capitalised. In particular, any situation should be avoided whereby for a prolonged period of time an NCB's net equity is below the level of its

⁴³ Opinion CON/2018/23.

⁴⁴ Opinions CON/2014/24, CON/2014/27, CON/2014/56 and CON/2017/17.

⁴⁵ Article 30.4 of the Statute only applies within the Eurosystem.

⁴⁶ Article 33.2 of the Statute only applies within the Eurosystem.

⁴⁷ Opinion CON/2016/55.

statutory capital or is even negative, including where losses beyond the level of capital and the reserves are carried over.⁴⁸ Any such situation may negatively impact on the NCB's ability to perform its ESCB-related tasks but also its national tasks. Moreover, such a situation may affect the credibility of the Eurosystem's monetary policy. Therefore, the event of an NCB's net equity becoming less than its statutory capital or even negative would require that the respective Member State provides the NCB with an appropriate amount of capital at least up to the level of the statutory capital within a reasonable period of time so as to comply with the principle of financial independence. As concerns the ECB, the relevance of this issue has already been recognised by the Council by adopting Council Regulation (EC) No 1009/2000 of 8 May 2000 concerning capital increases of the European Central Bank.⁴⁹ It enabled the Governing Council of the ECB to decide on an actual increase of the ECB's capital to sustain the adequacy of the capital base to support the operations of the ECB;⁵⁰ NCBs should be financially able to respond to such ECB decision.

The concept of financial independence should be assessed from the perspective of whether any third party is able to exercise either direct or indirect influence not only over an NCB's tasks but also over its ability to fulfil its mandate, both operationally in terms of manpower, and financially in terms of appropriate financial resources. The aspects of financial independence set out below are particularly relevant in this respect.⁵¹ These are the features of financial independence where NCBs are most vulnerable to outside influence.

Determination of budget

If a third party has the power to determine or influence an NCB's budget, this is incompatible with financial independence unless the law provides a safeguard clause so that such a power is without prejudice to the financial means necessary for carrying out the NCB's ESCB-related tasks.⁵²

The accounting rules

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

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

⁴⁸ Opinion CON/2018/17.

⁴⁹ OJ L 115, 16.5.2000, p. 1.

⁵⁰ Decision ECB/2010/26 of 13 December 2010 on the increase of the ECB's capital (OJ L 11, 15.1.2011, p. 53).

⁵¹ The main formative ECB opinions in this area are: Opinions CON/2002/16, CON/2003/22, CON/2003/27, CON/2004/1, CON/2006/38, CON/2006/47, CON/2007/8, CON/2008/13, CON/2008/68 and CON/2009/32.

⁵² Opinion CON/2019/12.

Where an NCB's operations are subject to the control of a state audit office or similar body charged with controlling the use of public finances, the scope of the control should be clearly defined by the legal framework,⁵³ should be without prejudice to the activities of the NCB's independent external auditors⁵⁴ and further, in line with the principle of institutional independence, it 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.⁵⁵ The state audit should be done on a non-political, independent and purely professional basis.⁵⁶

Distribution of profits, NCBs' capital and financial provisions

With regard to profit allocation, an NCB's statutes may prescribe how its profits are to be allocated. In the absence of such provisions, decisions on the allocation of profits should be taken by the NCB's decision-making bodies on professional grounds, and should not be subject to the discretion of third parties unless there is an express safeguard clause stating that this is without prejudice to the financial means necessary for carrying out the NCB's ESCB-related tasks as well as national tasks.⁵⁷

Profits may be distributed to the State budget only after any accumulated losses from previous years have been covered⁵⁸ and financial provisions deemed necessary to safeguard the real value of the NCB's capital and assets have been created. Temporary or ad hoc legislative measures amounting to instructions to the NCBs in relation to the distribution of their profits are not permissible.⁵⁹ Similarly, a tax on an NCB's unrealised capital gains would also impair the principle of financial independence.⁶⁰

A Member State may not impose reductions of capital on an NCB without the ex ante agreement of the NCB's decision-making bodies, which must aim to ensure that it retains sufficient financial means to fulfil its mandate under Article 127(2) of the Treaty and the Statute as a member of the ESCB. For the same reason, any amendment to the profit distribution rules of an NCB should only be initiated and decided in close cooperation with the NCB, which is best placed to assess its required level of reserve capital.⁶¹ As regards financial provisions or buffers, NCBs must be free to independently create financial provisions to safeguard the real value of their capital and assets. Member States may also not hamper NCBs from building up their reserve capital to a level which is necessary for a member of the ESCB to fulfil its tasks.⁶²

⁵³ Opinion CON/2019/19.

⁵⁴ For the activities of the independent external auditors of the NCBs see Article 27.1 of the Statute.

⁵⁵ Opinions CON/2011/9, CON/2011/53, CON/2015/57 and CON/2018/17.

⁵⁶ Opinions CON/2015/8, CON/2015/57, CON/2016/24, CON/2016/59 and CON/2018/17.

⁵⁷ Opinions CON/2017/17 and CON/2018/17.

⁵⁸ Opinions CON/2009/85 and CON/2017/17.

⁵⁹ Opinions CON/2009/26 and CON/2013/15.

⁶⁰ Opinions CON/2009/59 and CON/2009/63.

⁶¹ Opinions CON/2009/53, CON/2009/83 and CON/2019/21.

⁶² Opinions CON/2009/26 and CON/2012/69.

Financial liability for supervisory authorities

Most Member States place their financial supervisory authorities within their NCB. This is unproblematic if such authorities are subject to the NCB's independent decision-making. However, if the law provides for separate decision-making by such supervisory authorities, it is important to ensure that decisions adopted by them do not endanger the finances of the NCB as a whole. In such cases, national legislation should enable the NCB to have ultimate control over any decision by the supervisory authorities that could affect an NCB's independence, in particular its financial independence.

Autonomy in staff matters

Member States may not impair an NCB's ability to employ and retain the qualified staff necessary for the NCB to perform independently the tasks conferred on it by the Treaty and the Statute.⁶³ Also, an NCB may not be put into a position where it has limited control or no control over its staff, or where the government of a Member State can influence its policy on staff matters.⁶⁴ Any amendment to the legislative provisions on the remuneration for members of an NCB's decision-making bodies and its employees should be decided in close and effective cooperation with the NCB,⁶⁵ taking due account of its views, to ensure the ongoing ability of the NCB to independently carry out its tasks.⁶⁶ Autonomy in staff matters extends to issues relating to staff pensions. Further, amendments that lead to reductions in the remuneration for an NCB's staff should not interfere with that NCB's powers to administer its own financial resources, including the funds resulting from any reduction in salaries that it pays.⁶⁷

Ownership and property rights

Rights of third parties to intervene or to issue instructions to an NCB in relation to the property held by an NCB are incompatible with the principle of financial independence.

2.2.4 Confidentiality

The obligation of professional secrecy for ECB and NCB staff as well as for the members of the ECB and NCB governing bodies under Article 37 of the Statute may give rise to similar provisions in NCBs' statutes or in the Member States' legislation. The primacy of Union law and rules adopted thereunder also means that national laws on access by third parties to documents should comply with relevant Union law provisions, including Article 37 of the Statute, and may not lead to infringements of the ESCB's confidentiality regime. The access of a state audit office or similar body to an NCB's confidential information and documents must be limited to what is necessary for

⁶³ Opinion CON/2019/19.

⁶⁴ Opinions CON/2008/9, CON/2008/10 and CON/2012/89.

⁶⁵ Opinion CON/2019/19.

⁶⁶ Opinions CON/2010/42, CON/2010/51, CON/2010/56, CON/2010/69, CON/2010/80, CON/2011/104, CON/2011/106, CON/2012/6, CON/2012/86 and CON/2014/7.

⁶⁷ Opinion CON/2014/38.

the performance of the statutory tasks of the body that receives the information and must be without prejudice to the ESCB's independence and the ESCB's confidentiality regime to which the members of NCBs' decision-making bodies and staff are subject.⁶⁸ NCBs should ensure that such bodies protect the confidentiality of information and documents disclosed at a level corresponding to that applied by the NCBs.

2.2.5 Prohibition on monetary financing and privileged access

On the monetary financing prohibition and the prohibition on privileged access, the national legislation of the Member States that joined the EU in 2004, 2007 or 2013 had to be adapted to comply with the relevant provisions of the Treaty and the Statute and be in force on 1 May 2004, 1 January 2007 and 1 July 2013 respectively. Sweden had to bring the necessary adaptations into force by 1 January 1995.

Prohibition on monetary financing

Article 123(1) of the Treaty prohibits overdraft facilities or any other type of credit facility with the ECB or with the NCBs in favour of EU institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States. It also prohibits the purchase directly from these public sector entities by the ECB or NCBs of debt instruments. The Treaty contains one exemption from this monetary financing prohibition: it does not apply to publicly-owned credit institutions which, in the context of the supply of reserves by central banks, must be given the same treatment as private credit institutions (Article 123(2) of the Treaty). Moreover, the ECB and the NCBs may act as fiscal agents for the public sector bodies referred to above (Article 21.2 of the Statute). The precise scope of application of the monetary financing prohibition is further clarified by Council Regulation (EC) No 3603/93 of 13 December 1993 specifying definitions for the application of the prohibitions referred to in Articles 104 and 104b (1) of the Treaty,⁶⁹ according to which the prohibition includes any financing of the public sector's obligations vis-à-vis third parties.

The monetary financing prohibition is of essential importance to ensuring that the primary objective of monetary policy (namely to maintain price stability) is not impeded. Furthermore, central bank financing of the public sector lessens the pressure for fiscal discipline. Therefore the prohibition must be interpreted extensively in order to ensure its strict application, subject only to the limited exemptions contained in Article 123(2) of the Treaty and Regulation (EC) No 3603/93. Thus, even if Article 123(1) of the Treaty refers specifically to 'credit facilities', i.e. with the obligation to repay the funds, the prohibition applies a fortiori to other forms of funding, i.e. without the obligation to repay.

⁶⁸ Opinions CON/2015/8 and CON/2015/57.

⁶⁹ OJ L 332, 31.12.1993, p. 1. Articles 104 and 104b(1) of the Treaty establishing the European Community are now Articles 123 and 125(1) of the Treaty.

The ECB's general stance on the compatibility of national legislation with the prohibition has primarily been developed within the framework of consultations of the ECB by Member States on draft national legislation under Articles 127(4) and 282(5) of the Treaty.⁷⁰

National legislation transposing the monetary financing prohibition

In cases where national legislative provisions mirror Article 123 of the Treaty or Regulation (EC) No 3603/93, they may not narrow the scope of application of the monetary financing prohibition or extend the exemptions available under EU law. For example, national legislation providing for the financing by the NCB of a Member State's financial commitments to international financial institutions (other than the IMF in the capacities provided for in Regulation (EC) No 3603/93)⁷¹ or to third countries is incompatible with the monetary financing prohibition.

Financing of the public sector or of public sector obligations to third parties

National legislation may not require an NCB to finance either the performance of functions by other public sector bodies or the public sector's obligations vis-à-vis third parties. This equally applies to the conferral of new tasks upon NCBs. For this purpose, it is necessary to assess on a case-by-case basis, whether the task to be conferred upon an NCB qualifies as a central bank task or a government task, i.e. a task within the responsibility of the government.⁷² In other words, sufficient safeguards must be in place to ensure that no circumventions of the objective of the monetary financing prohibition occur. The Governing Council has endorsed criteria for determining what may be seen as falling within the scope of a public sector's obligation within the meaning of Regulation (EC) No 3603/93 or, in other words, what constitutes a government task.⁷³ To ensure compliance with the monetary financing prohibition, a new task entrusted to an NCB must be fully and adequately remunerated if it is: (a) not a central bank task or an action that facilitates the performance of a central bank task; or (b) linked to a government task and performed in the government's interest.⁷⁴ Important criteria for qualifying a new task as a government task are: (a) its atypical nature; (b) the fact that it is discharged on behalf of and in the exclusive interest of the government; and (c) its impact on the institutional, financial and personal independence of the NCB. In particular, a task may be qualified as a government task if the performance of the new task meets one of the following conditions: (a) it creates inadequately addressed conflicts of interests with existing central bank tasks; (b) it is disproportionate to the NCB's financial or organisational capacity; (c) it does not fit into the NCB's institutional set-up; (d) it harbours substantial financial risks; and (e) it exposes the members of the NCB decision-making bodies to

⁷⁰ See Convergence Report 2008, page 23, footnote 13, containing a list of formative EMI/ECB opinions in this area adopted between May 1995 and March 2008.

⁷¹ Opinions CON/2013/16, CON/2016/21 and CON/2017/4.

⁷² Such an assessment is not necessary if the task to be conferred on the NCB only complements an existing function of the NCB and does not qualify as a genuinely new task.

⁷³ See, for example, Opinion CON/2016/54.

⁷⁴ Opinions CON/2011/30, CON/2015/36 and CON/2015/46.

political risks that are disproportionate and that may also negatively impact on them in terms of their personal independence.⁷⁵

Some of the new tasks conferred on NCBs that the ECB considered to be government tasks are: (a) tasks relating to financing resolution funds or financial arrangements as well as those relating to deposit guarantee or investor compensation schemes;⁷⁶ (b) tasks relating to the establishment of a central register of bank account numbers;⁷⁷ (c) tasks of a credit mediator;⁷⁸ (d) tasks relating to the collection, maintenance and processing of data that supports the calculation of insurance premium transfers;⁷⁹ (e) tasks relating to the protection of competition in the mortgage loan market;⁸⁰ (f) tasks relating to the provision of resources to bodies that are independent of the NCBs and operate as an extension of the government;⁸¹ (g) tasks of an information authority for the purposes of facilitating cross-border debt recovery in civil and commercial matters;⁸² (h) tasks relating to the establishment of an insurance claims database,⁸³ and (i) tasks relating to national defence preparedness going beyond the internal contingency planning tasks of a central bank.⁸⁴ By contrast, central bank tasks may be, inter alia, supervisory tasks or tasks relating to those supervisory tasks, such as those relating to consumer protection in the area of financial services⁸⁵ or compliance of credit institutions with loan restructuring requirements,⁸⁶ supervision over credit-acquiring companies⁸⁷ or financial leasing companies,⁸⁸ supervision of consumer credit providers and intermediaries,⁸⁹ licensing and supervision of microcredit providers,⁹⁰ supervision of credit reference agencies,⁹¹ supervision of administrators of interest rate benchmarks,⁹² supervisory tasks to ensure compliance with Union legislation in the field of investment services and products,⁹³ tasks relating to the oversight of payment schemes,⁹⁴ tasks relating to the application and enforcement of Union legislation concerning payment accounts,⁹⁵ administrative

⁷⁵ Opinion CON/2015/22.

⁷⁶ See the section entitled 'Financial support for resolution funds or financial arrangements and deposit insurance or investor compensation schemes' for some specific cases.

⁷⁷ Opinions CON/2015/36, CON/2015/46, CON/2016/49, CON/2016/57 and CON/2018/57.

⁷⁸ Opinion CON/2015/12.

⁷⁹ Opinion CON/2016/45.

⁸⁰ Opinion CON/2016/54.

⁸¹ Opinion CON/2017/19.

⁸² Opinion CON/2017/32.

⁸³ Opinion CON/2018/43.

⁸⁴ Opinion CON/2020/2.

⁸⁵ Opinions CON/2007/29, CON/ 2016/31, CON/2017/3 and CON/2017/12.

⁸⁶ Opinion CON/2019/27.

⁸⁷ Opinion CON/2015/45.

⁸⁸ Opinion CON/2016/31.

⁸⁹ Opinions CON/2015/54, CON/2016/34 and CON/2017/3.

⁹⁰ Opinion CON/2019/07.

⁹¹ Opinion CON/2019/02.

⁹² Opinion CON/2017/52.

⁹³ Opinions CON/2018/2 and CON/2018/5.

⁹⁴ Opinion CON/2016/38.

⁹⁵ Opinion CON/2017/2.

resolution tasks⁹⁶, or tasks relating to the operation and management of credit registers.⁹⁷

In addition, no bridge financing may be provided by an NCB to enable a Member State to honour its obligations in respect of State guarantees of bank liabilities.⁹⁸ Also, the distribution of central bank profits which have not been fully realised, accounted for and audited does not comply with the monetary financing prohibition. 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. Moreover, when NCB assets are transferred to the State, they must be remunerated at market value and the transfer should take place at the same time as the remuneration.⁹⁹

Similarly, intervention in the performance of other Eurosystem tasks, such as the management of foreign reserves, by introducing taxation of theoretical and unrealised capital gains is not permitted since this would result in a form of central bank credit to the public sector through the advanced distribution of future and uncertain profits.¹⁰⁰

Assumption of public sector liabilities

National legislation which requires an NCB to take over the liabilities of a previously independent public body, as a result of a national reorganisation of certain tasks and duties (for example, in the context of a transfer to the NCB of certain supervisory tasks previously carried out by the state or independent public authorities or bodies), without fully insulating the NCB from all financial obligations resulting from the prior activities of such a body, would be incompatible with the monetary financing prohibition.¹⁰¹ Along the same lines, national legislation that requires an NCB to obtain approval from the government prior to taking resolution actions under a broad range of circumstances, but which does not limit the NCB's liability to its own administrative acts, would be incompatible with the monetary financing prohibition.¹⁰² In the same vein, national legislation that requires an NCB to pay compensation for damages, to the extent that it results in that NCB assuming the liability of the state, would not be in line with the monetary financing prohibition.¹⁰³

Financial support for credit and/or financial institutions

National legislation which provides for financing by an NCB, granted independently and at their full discretion, of credit institutions other than in connection with central banking tasks (such as monetary policy, payment systems or temporary liquidity

⁹⁶ This is further qualified under the sub-section below on 'Financial support for resolution funds or financial arrangements and for deposit insurance or investor compensation schemes'.

⁹⁷ Opinion CON/2016/42.

⁹⁸ Opinion CON/2012/4.

⁹⁹ Opinions CON/2011/91 and CON/2011/99.

¹⁰⁰ Opinions CON/2009/59 and CON/2009/63.

¹⁰¹ Opinion CON/2013/56.

¹⁰² Opinion CON/2015/22.

¹⁰³ Opinion CON/2019/20.

support operations), in particular the support of insolvent credit and/or other financial institutions, would be incompatible with the monetary financing prohibition.

This applies, in particular, to the support of insolvent credit institutions. The rationale is that by financing an insolvent credit institution, an NCB would be assuming a government task.¹⁰⁴ The same concerns apply to the Eurosystem financing of a credit institution which has been recapitalised to restore its solvency by way of a direct placement of state-issued debt instruments where no alternative market-based funding sources exist (hereinafter “recapitalisation bonds”), and where such bonds are to be used as collateral. In such case of a state recapitalisation of a credit institution by way of direct placement of recapitalisation bonds, the subsequent use of the recapitalisation bonds as collateral in central bank liquidity operations raises monetary financing concerns.¹⁰⁵ Emergency liquidity assistance, granted by an NCB independently and at its full discretion to a solvent credit institution on the basis of collateral security in the form of a State guarantee, has to meet the following criteria: (i) it must be ensured that the credit provided by the NCB is as short term as possible; (ii) there must be systemic stability aspects at stake; (iii) there must be no doubts as to the legal validity and enforceability of the State guarantee under applicable national law; and (iv) there must be no doubts as to the economic adequacy of the State guarantee, which should cover both principal and interest on the loans.¹⁰⁶

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

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

While administrative resolution tasks are generally considered as related to those referred to in Article 127(5) of the Treaty, the financing of any resolution fund or financial arrangement is not in line with the monetary financing prohibition.¹⁰⁷ Where an NCB acts as resolution authority, it should not, under any circumstances, assume or finance any obligation of either a bridge institution or an asset management vehicle.¹⁰⁸ To this end, national legislation should clarify that the NCB will not assume or finance any of these entities’ obligations.¹⁰⁹

The Deposit Guarantee Schemes Directive¹¹⁰ and the Investor Compensation Schemes Directive¹¹¹ provide that the costs of financing deposit guarantee schemes and investor compensation schemes must be borne, respectively, by credit institutions and investment firms themselves. National legislation which provides for the financing

¹⁰⁴ Opinion CON/2013/5.

¹⁰⁵ Opinions CON/2012/50, CON/2012/64, and CON/2012/71.

¹⁰⁶ Opinion CON/2012/4, footnote 42 referring to further relevant Opinions in this field. See also Opinions CON/2016/55 and CON/2017/1.

¹⁰⁷ Opinions CON/2015/22, CON/2016/28 and CON/2019/16.

¹⁰⁸ Opinions CON/2011/103, CON/2012/99, CON/2015/3 and CON/2015/22.

¹⁰⁹ Opinions CON/2015/33, CON/2015/35 and CON/2016/60.

¹¹⁰ Recital 27 of Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes (OJ L 173, 12.6.2014, p. 149).

¹¹¹ Recital 23 of Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor-compensation schemes (OJ L 84, 26.3.1997, p. 22).

by an NCB of a national deposit insurance scheme for credit institutions or a national investor compensation scheme for investment firms would be compatible with the monetary financing prohibition only if it were short term, addressed urgent situations, systemic stability aspects were at stake, and decisions were at the NCB's discretion.¹¹² To this end, inserting references to Article 123 of the Treaty in national legislation should be considered. When exercising its discretion to grant a loan, the NCB must ensure that it is not de facto taking over a government task.¹¹³ In particular, central bank support for deposit guarantee schemes should not amount to a systematic pre-funding operation.¹¹⁴

Fiscal agency function

Article 21.2 of the Statute establishes that the 'ECB and the national central banks may act as fiscal agents' for 'Union institutions, bodies, offices or agencies, central governments, regional local or other public authorities, other bodies governed by public law, or public undertakings of Member States.' The purpose of Article 21.2 of the Statute is, following transfer of the monetary policy competence to the Eurosystem, to clarify that NCBs may continue to provide the fiscal agent service traditionally provided to governments and other public entities without infringing the monetary financing prohibition. In addition, Regulation (EC) No 3603/93 establishes a number of explicit and narrowly drafted exemptions from the monetary financing prohibition relating to the fiscal agency function, as follows: (i) intra-day credits to the public sector are permitted provided that they remain limited to the day and that no extension is possible;¹¹⁵ (ii) crediting the public sector's account with cheques issued by third parties before the drawee bank has been debited is permitted if a fixed period of time corresponding to the normal period for the collection of cheques by the NCB concerned has elapsed since receipt of the cheque, provided that any float which may arise is exceptional, is of a small amount and averages out in the short term;¹¹⁶ and (iii) the holding of coins issued by and credited to the public sector is permitted where the amount of such assets remains at less than 10 % of coins in circulation.¹¹⁷

National legislation on the fiscal agency function should be compatible with EU law in general, and with the monetary financing prohibition in particular.¹¹⁸ Taking into account the express recognition in Article 21.2 of the Statute of the provision of fiscal agency services, which is a legitimate function traditionally performed by NCBs, the provision by central banks of fiscal agency services complies with the monetary financing prohibition, provided that such services remain within the field of the fiscal agency function and do not constitute central bank financing of public sector obligations vis-à-vis third parties or central bank crediting of the public sector outside the narrowly defined exceptions specified in Regulation (EC) No 3603/93.¹¹⁹ National legislation that enables an NCB to hold government deposits and to service

¹¹² Opinions CON/2015/40 and CON/2016/60.

¹¹³ Opinions CON/2011/83 and CON/2015/52.

¹¹⁴ Opinion CON/2011/84.

¹¹⁵ Article 4 of Regulation (EC) No 3603/93 and Opinion CON/2013/2.

¹¹⁶ Article 5 of Regulation (EC) No 3603/93.

¹¹⁷ Article 6 of Regulation (EC) No 3603/93.

¹¹⁸ Opinion CON/2013/3.

¹¹⁹ Opinions CON/2009/23, CON/2009/67 and CON/2012/9.

government accounts does not raise concerns about compliance with the monetary financing prohibition as long as such provisions do not enable the extension of credit, including overnight overdrafts. However, there would be a concern about compliance with the monetary financing prohibition if, for example, national legislation were to enable the remuneration of deposits or current account balances above, rather than at or below, market rates. Remuneration that is above market rates constitutes a de facto credit, contrary to the objective of the prohibition on monetary financing, and might therefore undermine the prohibition's objectives. It is essential for any remuneration of an account to reflect market parameters and it is particularly important to correlate the remuneration rate of the deposits with their maturity.¹²⁰ Moreover, the provision without remuneration by an NCB of fiscal agent services does not raise monetary financing concerns, provided they are core fiscal agent services.¹²¹

Prohibition on privileged access

Article 124 of the Treaty provides that '[a]ny measure, not based on prudential considerations, establishing privileged access by Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States to financial institutions, shall be prohibited.' As with the monetary financing prohibition, the prohibition of privileged access aims to encourage the Member States to follow a sound budgetary policy, not allowing monetary financing of public deficits or privileged access by public authorities to the financial markets to lead to excessively high levels of debt or excessive Member State deficits.¹²²

Under Article 1(1) of Council Regulation (EC) No 3604/93,¹²³ privileged access is understood as any law, regulation or other binding legal instrument adopted in the exercise of public authority which: (a) obliges financial institutions to acquire or to hold liabilities of EU institutions or bodies, central governments, regional, local or other public authorities, other bodies governed by public law or public undertakings of Member States, or (b) confers tax advantages that only benefit financial institutions or financial advantages that do not comply with the principles of a market economy, in order to encourage those institutions to acquire or hold such liabilities.

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

¹²⁰ See, among others, Opinions CON/2010/54, CON/2010/55 and CON/2013/62.

¹²¹ Opinion CON/2012/9.

¹²² See, to that effect, *Smaranda Bara and Others v Casa Națională de Asigurări de Sănătate and Others*, C-201/14, ECLI:EU:C:2015:638, paragraph 22; and *Peter Gauweiler and Others v Deutscher Bundestag*, C-62/14, ECLI:EU:C:2015:400, paragraph 100.

¹²³ Council Regulation (EC) No 3604/93 of 13 December 1993 specifying definitions for the application of the prohibition of privileged access referred to in Article 104a of the Treaty [establishing the European Community] (OJ L 332, 31.12.1993, p. 4). Article 104a of the Treaty establishing the European Community is now Article 124 of the Treaty.

prohibition on privileged access.¹²⁴ Member States' legislation in this area may not establish such privileged access.

Article 2 of Regulation (EC) No 3604/93 defines 'prudential considerations' as those which underlie national laws, regulations or administrative actions based on, or consistent with, EU law and designed to promote the soundness of financial institutions so as to strengthen the stability of the financial system as a whole and the protection of the customers of those institutions. Prudential considerations seek to ensure that banks remain solvent with regard to their depositors.¹²⁵ In the area of prudential supervision, EU secondary legislation has established a number of requirements to ensure the soundness of credit institutions.¹²⁶ A 'credit institution' has been defined as an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account.¹²⁷ Additionally, credit institutions, commonly referred to as 'banks', require an authorisation by a competent Member State authority to provide services.¹²⁸

Although minimum reserves might be seen as a part of prudential requirements, they are part of an NCB's operational framework and used as a monetary policy tool in most economies, including in the euro area.¹²⁹ In this respect, paragraph 2 of Annex I to Guideline ECB/2014/60¹³⁰ states that the Eurosystem's minimum reserve system primarily pursues the aims of stabilising the money market interest rates and creating (or enlarging) a structural liquidity shortage.¹³¹ The ECB requires credit institutions established in the euro area to hold the required minimum reserves (in the form of deposits) on account with their NCB.¹³²

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

¹²⁴ Article 3(2) of and recital 10 of Regulation (EC) No 3604/93.

¹²⁵ Opinion of Advocate General Elmer in *Société civile immobilière Parodi v Banque H. Albert de Bary et Cie.*, C-222/95, ECLI:EU:C:1997:345, paragraph 24.

¹²⁶ Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.06.2013, p. 1) and Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.06.2013, p. 338).

¹²⁷ Article 4(1)(1) of Regulation (EU) No 575/2013.

¹²⁸ Article 8 of Directive 2013/36/EU.

¹²⁹ This is supported by Article 3(2) and recital 9 of Regulation (EC) No 3604/93.

¹³⁰ Guideline (EU) 2015/510 of the European Central Bank of 19 December 2014 on the implementation of the Eurosystem monetary policy framework (General Documentation Guideline) (ECB/2014/60) (OJ L 91, 2.4.2015, p. 3).

¹³¹ The higher the reserve requirement is set, the fewer funds banks will have to loan out, leading to lower money creation.

¹³² See: Article 19 of the Statute; Council Regulation (EC) No 2531/98 of 23 November 1998 concerning the application of minimum reserves by the European Central Bank (OJ L 318, 27.11.1998, p. 1); Regulation (EC) No 1745/2003 of the European Central Bank of 12 September 2003 on the application of minimum reserves (ECB/2003/9) (OJ L 250, 2.10.2003, p. 10); and Regulation (EU) No 1071/2013 of the European Central Bank of 24 September 2013 concerning the balance sheet of the monetary financial institutions sector (ECB/2013/33) (OJ L 297, 7.11.2013, p. 1).

2.2.6 Single spelling of the euro

Article 3(4) of the Treaty on European Union lays down that the ‘Union shall establish an economic and monetary union whose currency is the euro’. In the texts of the Treaties in all the authentic languages written using the Roman alphabet, the euro is consistently identified in the nominative singular case as ‘euro’. In the Greek alphabet text, the euro is spelled ‘ευρώ’ and in the Cyrillic alphabet text the euro is spelled ‘евро’.¹³³ Consistent with this, Council Regulation (EC) No 974/98 of 3 May 1998 on the introduction of the euro¹³⁴ makes it clear that the name of the single currency must be the same in all the official languages of the EU, taking into account the existence of different alphabets. The Treaties thus require a single spelling of the word ‘euro’ in the nominative singular case in all EU and national legislative provisions, taking into account the existence of different alphabets.

In view of the exclusive competence of the EU to determine the name of the single currency, any deviations from this rule are incompatible with the Treaties and should be eliminated¹³⁵. While this principle applies to all types of national legislation, the assessment in the country chapters focuses on the NCBs’ statutes and the euro changeover laws.

2.2.7 Legal integration of NCBs into the Eurosystem

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

The main areas examined in this report are those in which statutory provisions may hinder NCBs’ compliance with the Eurosystem’s requirements. These include provisions (i) that could prevent NCBs from taking part in implementing the single monetary policy, as defined by the ECB’s decision-making bodies, or (ii) that could

¹³³ The ‘Declaration by the Republic of Latvia, the Republic of Hungary and the Republic of Malta on the spelling of the name of the single currency in the Treaties’, annexed to the Treaties, states that; ‘Without prejudice to the unified spelling of the name of the single currency of the European Union referred to in the Treaties as displayed on banknotes and on coins, Latvia, Hungary and Malta declare that the spelling of the name of the single currency, including its derivatives as applied throughout the Latvian, Hungarian and Maltese text of the Treaties, has no effect on the existing rules of the Latvian, Hungarian or Maltese languages’.

¹³⁴ OJ L 139, 11.5.1998, p. 1.

¹³⁵ Opinion CON/2012/87.

hinder a Governor from fulfilling their duties as a member of the ECB's Governing Council, or (iii) that do not respect the ECB's prerogatives, or (iv) that do not recognise that the exclusive competence for ESCB-related tasks in Member States whose currency is the euro is irrevocably conferred on the Union,¹³⁶ or (v) pursuant to which NCBs in the performance of their ESCB-related tasks are bound by decisions of national authorities that conflict with legal acts of the ECB. Distinctions are made between economic policy objectives, tasks, financial provisions, exchange rate policy and international cooperation. Finally, other areas where NCBs' statutes may need to be adapted are mentioned.

Economic policy objectives

The full integration of an NCB into the Eurosystem requires its statutory objectives to be compatible with the ESCB's objectives, as laid down in Article 2 of the Statute. Among other things, this means that statutory objectives with a 'national flavour' – for example, where statutory provisions refer to an obligation to conduct monetary policy within the framework of the general economic policy of the Member State concerned – need to be adapted. Furthermore, an NCB's secondary objectives must be consistent and not interfere with its obligation to support the general economic policies in the EU with a view to contributing to the achievement of the objectives of the EU as laid down in Article 3 of the Treaty on European Union, which is itself an objective expressed to be without prejudice to maintaining price stability.¹³⁷

Tasks

The tasks of an NCB of a Member State whose currency is the euro are predominantly determined by the Treaty and the Statute, given that NCB's status as an integral part of the Eurosystem. In order to comply with Article 131 of the Treaty, provisions on tasks in an NCB's statutes therefore need to be compared with the relevant provisions of the Treaty and the Statute, and any incompatibility must be removed.¹³⁸ This applies to any provision that, after adoption of the euro and integration into the Eurosystem, constitutes an impediment to carrying out ESCB-related tasks and in particular to provisions which do not respect the ESCB's powers under Chapter IV of the Statute.

Any national legislative provisions relating to monetary policy must recognise that the EU's monetary policy is to be carried out through the Eurosystem.¹³⁹ An NCB's statutes may contain provisions on monetary policy instruments. Such provisions should be comparable to those in the Treaty and the Statute, and any incompatibility must be removed in order to comply with Article 131 of the Treaty.

¹³⁶ Opinion CON/2020/2.

¹³⁷ Opinions CON/2010/30 and CON/2010/48.

¹³⁸ See, in particular, Articles 127 and 128 of the Treaty and Articles 3 to 6 and 16 of the Statute.

¹³⁹ First indent of Article 127(2) of the Treaty.

Monitoring fiscal developments is a task that an NCB carries out on a regular basis to assess properly the stance to be taken in monetary policy. NCBs may also present their views on relevant fiscal developments on the basis of their monitoring activity and the independence of their advice, with a view to contributing to the proper functioning of the European Monetary Union. The monitoring of fiscal developments by an NCB for monetary policy purposes should be based on the full access to all relevant public finance data. Accordingly, the NCBs should be granted unconditional, timely and automatic access to all relevant public finance statistics. However, an NCB's role should not go beyond monitoring activities that result from or are linked – directly or indirectly – to the discharge of their monetary policy mandate.¹⁴⁰ A formal mandate for an NCB to assess forecasts and fiscal developments implies a function for the NCB in (and a corresponding responsibility for) fiscal policymaking which may risk undermining the discharge of the Eurosystem's monetary policy mandate and the NCB's independence.¹⁴¹

In the context of the national legislative initiatives to address the turmoil in the financial markets, the ECB has emphasised that any distortion in the national segments of the euro area money market should be avoided, as this may impair the implementation of the single monetary policy. In particular, this applies to the extension of State guarantees to cover interbank deposits.¹⁴²

Member States must ensure that national legislative measures addressing liquidity problems of businesses or professionals, for example their debts to financial institutions, do not have a negative impact on market liquidity. In particular, such measures may not be inconsistent with the principle of an open market economy, as reflected in Article 3 of the Treaty on European Union, as this could hinder the flow of credit, materially influence the stability of financial institutions and markets and therefore affect the performance of Eurosystem tasks.¹⁴³

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

¹⁴⁰ Opinions CON/2012/105, CON/2013/90 and CON/2013/91.

¹⁴¹ For example, national legislative provisions transposing Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States (OJ L 306, 23.11.2011, p. 41). See Opinions CON/2013/90 and CON/2013/91.

¹⁴² Opinions CON/2009/99, CON/2011/79 and CON/2017/1.

¹⁴³ Opinion CON/2010/8.

currency and be incompatible with the requirements of Eurosystem legal integration.¹⁴⁴

With regard to foreign reserve management,¹⁴⁵ any Member State that has adopted the euro and which does not transfer its official foreign reserves¹⁴⁶ to its NCB is in breach of the Treaty. In addition, any right of a third party – for example, the government or parliament – to influence an NCB's decisions with regard to the management of the official foreign reserves would be inconsistent with the third indent of Article 127(2) of the Treaty. Furthermore, NCBs have to provide the ECB with foreign reserve assets in proportion to their shares in the ECB's subscribed capital. This means that there must be no legal obstacles to NCBs transferring foreign reserve assets to the ECB.

With regard to statistics, although regulations adopted under Article 34.1 of the Statute in the field of statistics do not confer any rights or impose any obligations on Member States that have not adopted the euro, Article 5 of the Statute, which concerns the collection of statistical information, applies to all Member States, regardless of whether they have adopted the euro. Accordingly, Member States whose currency is not the euro are under an obligation to design and implement, at national level, all measures they consider appropriate to collect the statistical information needed to fulfil the ECB's statistical reporting requirements and to make timely preparations in the field of statistics in order for them to become Member States whose currency is the euro.¹⁴⁷ National legislation laying down the framework for cooperation between the NCBs and national statistical offices should guarantee the NCBs' independence in the performance of their tasks within the ESCB's statistical framework.¹⁴⁸

Financial provisions

The financial provisions in the Statute comprise rules on financial accounts,¹⁴⁹ auditing,¹⁵⁰ capital subscription,¹⁵¹ the transfer of foreign reserve assets¹⁵² and the allocation of monetary income.¹⁵³ NCBs must be able to comply with their obligations under these provisions and therefore any incompatible national provisions must be repealed.

¹⁴⁴ Opinion CON/2008/34.

¹⁴⁵ Third indent of Article 127(2) of the Treaty.

¹⁴⁶ With the exception of foreign-exchange working balances, which Member State governments may retain pursuant to Article 127(3) of the Treaty.

¹⁴⁷ Opinion CON/2013/88.

¹⁴⁸ Opinions CON/2015/5 and CON/2015/24.

¹⁴⁹ Article 26 of the Statute.

¹⁵⁰ Article 27 of the Statute.

¹⁵¹ Article 28 of the Statute.

¹⁵² Article 30 of the Statute.

¹⁵³ Article 32 of the Statute.

Exchange rate policy

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

International cooperation

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

Miscellaneous

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

3 The state of economic convergence

This chapter provides a horizontal overview. Some factors relevant for the overall assessment are not covered here, but in Chapters 4 and 5.

As regards compliance with the convergence criteria, limited progress has been made since the ECB's 2018 Convergence Report (see Table 3.1). In five of the seven countries examined in the report, HICP inflation is above the reference value, as compared to only two countries in 2018. Since May 2018, the 12-month averages of long-term interest rate differentials versus the euro area have continued to decline in three of the seven countries considered in the report and only one country remains above the reference value, compared to two countries in 2018. While none of the countries participates in the exchange rate mechanism (ERM II), two countries have expressed the intention to seek inclusion of their currencies in ERM II. The currencies of some countries examined in this report have experienced sizeable fluctuations against the euro over the last few years. Some progress has been made on reducing fiscal imbalances in most of the countries, with one notable exception.

Table 3.1

Overview table of economic indicators of convergence

		Price stability		Government budgetary developments and projections			Exchange rate		Long-term interest rate ⁶⁾
		HICP inflation ¹⁾	Country in excessive deficit ^{2), 3)}	General government surplus (+)/ deficit (-) ⁴⁾	General government debt ⁴⁾	Currency participating in ERM II ³⁾	Exchange rate vis-à-vis the euro ⁵⁾		
Bulgaria	2018	2.6	No	2.0	22.3	No	0.0	0.9	
	2019	2.5	No	2.1	20.4	No	0.0	0.4	
	2020	2.6	No	-2.8	25.5	No	0.0	0.3	
Czech Republic	2018	2.0	No	0.9	32.6	No	2.6	2.0	
	2019	2.6	No	0.3	30.8	No	-0.1	1.5	
	2020	2.9	No	-6.7	38.7	No	0.2	1.5	
Croatia	2018	1.6	No	0.2	74.7	No	0.6	2.2	
	2019	0.8	No	0.4	73.2	No	0.0	1.3	
	2020	0.9	No	-7.1	88.6	No	-1.0	0.9	
Hungary	2018	2.9	No	-2.1	70.2	No	-3.1	3.1	
	2019	3.4	No	-2.0	66.3	No	-2.0	2.5	
	2020	3.7	No	-5.2	75.0	No	-4.3	2.3	
Poland	2018	1.2	No	-0.2	48.8	No	-0.1	3.2	
	2019	2.1	No	-0.7	46.0	No	-0.8	2.3	
	2020	2.8	No	-9.5	58.5	No	-0.6	2.2	
Romania	2018	4.1	No	-2.9	34.7	No	-1.9	4.7	
	2019	3.9	No	-4.3	35.2	No	-2.0	4.5	
	2020	3.7	Yes	-9.2	46.2	No	-1.1	4.4	
Sweden	2018	2.0	No	0.8	38.8	No	-6.5	0.7	
	2019	1.7	No	0.5	35.1	No	-3.2	0.0	
	2020	1.6	No	-5.6	42.6	No	-0.8	-0.1	
Reference value ⁷⁾		1.8		-3.0	60.0			2.9	

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

1) Average annual percentage change. Data for 2020 refer to the period from April 2019 to March 2020.

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

3) The information for 2020 refers to the period up to the cut-off date for statistics (7 May 2020).

4) As a percentage of GDP. Data for 2020 are taken from the European Commission's Spring 2020 Economic Forecast.

5) Annual percentage change. A positive (negative) number denotes appreciation (depreciation) vis-à-vis the euro. Data for 2020 refer to the period from 1 January 2020 to 31 March 2020.

6) Average annual interest rate. Data for 2020 refer to the period from April 2019 to March 2020.

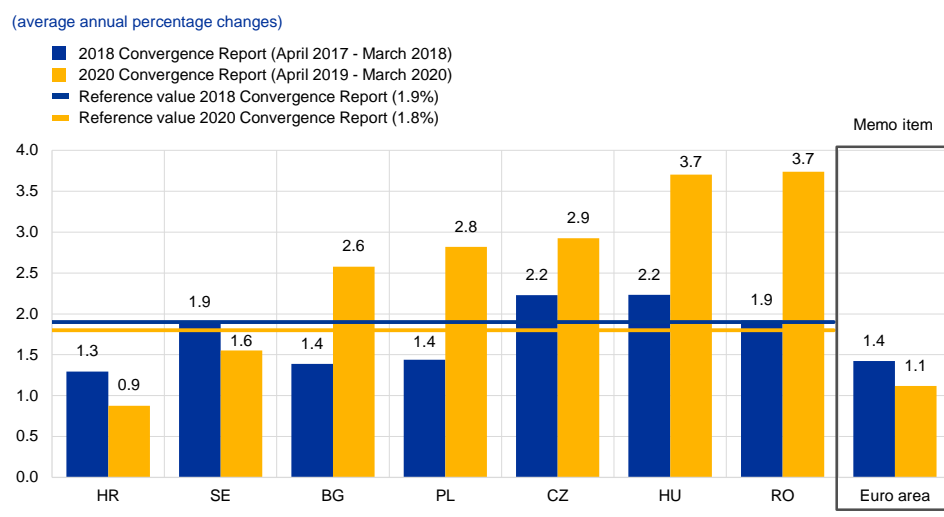
7) The reference values for HICP inflation and long-term interest rates refer to the period from April 2019 to March 2020; for the general government balance and debt, the reference values are defined in Article 126 of the Treaty on the Functioning of the European Union and the related Protocol (No 12) on the excessive deficit procedure.

The economic situation in most of the seven countries examined in this report remained broadly robust between the publication of the previous Convergence Report and the start of the coronavirus (COVID-19) crisis in the first quarter of 2020. Despite the deteriorating external environment, especially since 2019, robust domestic demand has continued to support economic activity in most cases. Domestic demand has been mainly supported by sustained growth in employment and wages, as well as accommodative monetary and fiscal policies in a number of countries. Labour market conditions have become increasingly tight in most cases. In some countries labour shortages were also influenced by a loss of working age population through net emigration. In all countries, further progress has been made towards

correcting external imbalances and reducing dependence on external funding. This has enhanced the resilience of most of the countries under review. However, significant vulnerabilities of various kinds still persist, though to differing degrees depending on the country. If not adequately tackled in the countries with lower GDP per capita, such vulnerabilities are likely to slow their convergence process over the long term. However, since the beginning of 2020, the economic environment has dramatically deteriorated owing to the COVID-19 outbreak. Economic activity has slowed down markedly in all countries under review and even contracted in some countries. The national authorities have taken major fiscal, macroprudential, supervisory and monetary policy measures to offset the economic damage wrought by COVID-19.

Regarding the price stability criterion, the 12-month average inflation rate was above the reference value of 1.8% in five of the seven countries examined in the report (see Chart 3.1). Bulgaria, Poland, Romania, the Czech Republic and Hungary recorded inflation rates well above the reference value, while it was below the reference rate in Sweden and well below in Croatia. In view of the COVID-19 pandemic, there is a high level of uncertainty as to how these rates are going to develop over the coming months. In the 2018 Convergence Report, the Czech Republic and Hungary were the only countries that recorded inflation rates above the applicable reference value at that time, which was 1.9%.

Chart 3.1
HICP inflation

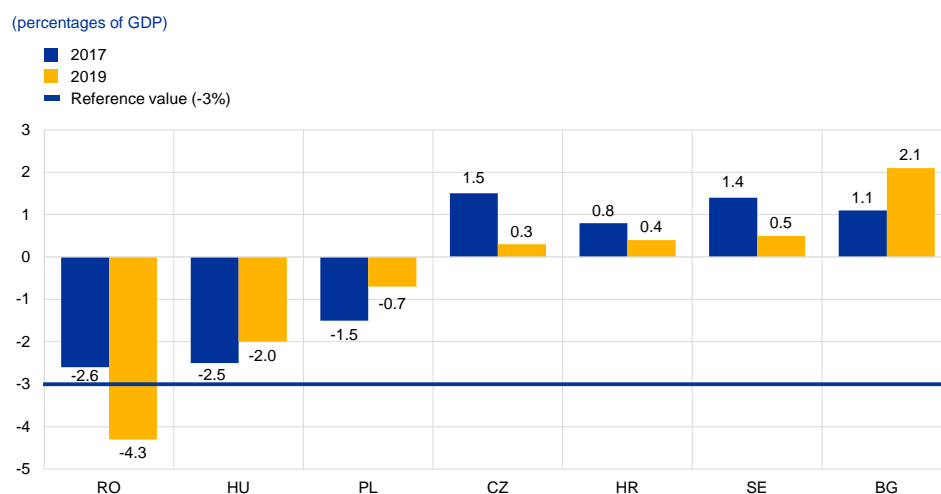


Source: Eurostat.

At the time of publication of this report, one country is subject to an excessive deficit procedure, whereas none were at the time of the previous report. Nevertheless, as a consequence of the COVID-19 pandemic, a strong deterioration of budgetary positions is expected in all countries in 2020. All of the countries under review, apart from Romania, were below the 3% deficit reference value in 2019. Bulgaria, Croatia, the Czech Republic and Sweden posted a surplus in 2019. In Romania, the deficit has deteriorated sharply since the 2018 Convergence Report, rising from 2.6% of GDP in 2017 to 4.3% of GDP in 2019 (see Chart 3.2), and

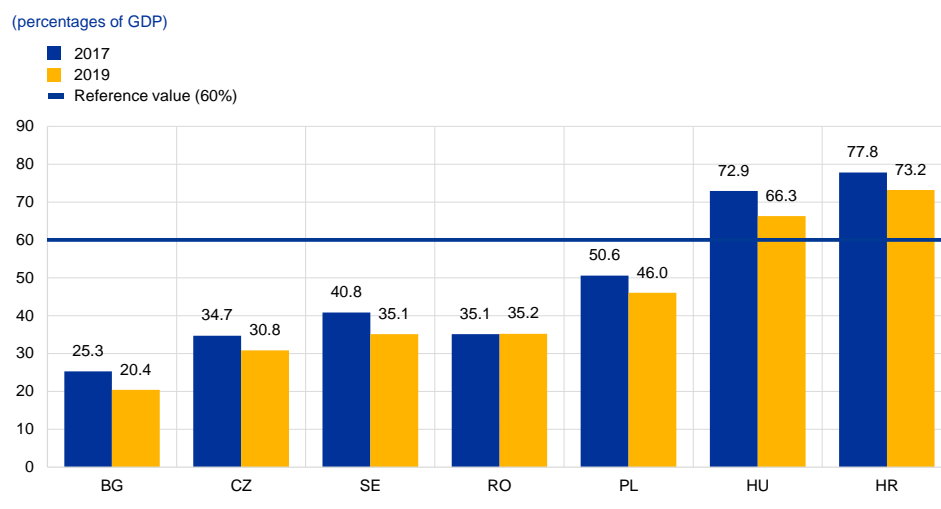
an excessive deficit procedure was opened in April 2020. In 2020, as a consequence of the COVID-19 pandemic, the deficit-to-GDP ratio is expected to stand above the 3% reference value in all countries, with the exception of Bulgaria, according to the European Commission’s Spring 2020 Economic Forecast. Under the conventional no-policy change assumption (assuming the fiscal measures implemented to mitigate the crisis are temporary), as of 2021 the headline deficits are expected to decline notably in all countries under review except Romania (and to below the 3% of GDP reference value in Bulgaria, Sweden and Croatia). Regarding the debt criterion, in Poland, the debt ratio was below 50% of GDP in 2019. In the Czech Republic, Romania and Sweden, the debt ratio was between 30% and 40% of GDP, while in Bulgaria, it was slightly above 20% of GDP (see Chart 3.3). Croatia and Hungary were the only countries with a general government debt-to-GDP ratio above the 60% reference value in 2019, as was also the case in 2017. In both countries the debt ratios were on a diminishing trajectory from 2015 to 2019 and were approaching 60% of GDP at a satisfactory pace until the end of 2019. However, the COVID-19 pandemic is expected to lead to rising debt ratios in all the countries under review in 2020, according to the European Commission’s Spring 2020 Economic Forecast.

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



Source: Eurostat.
Note: Data for 2017 have been revised slightly since the 2018 Convergence Report.

Chart 3.3
General government gross debt



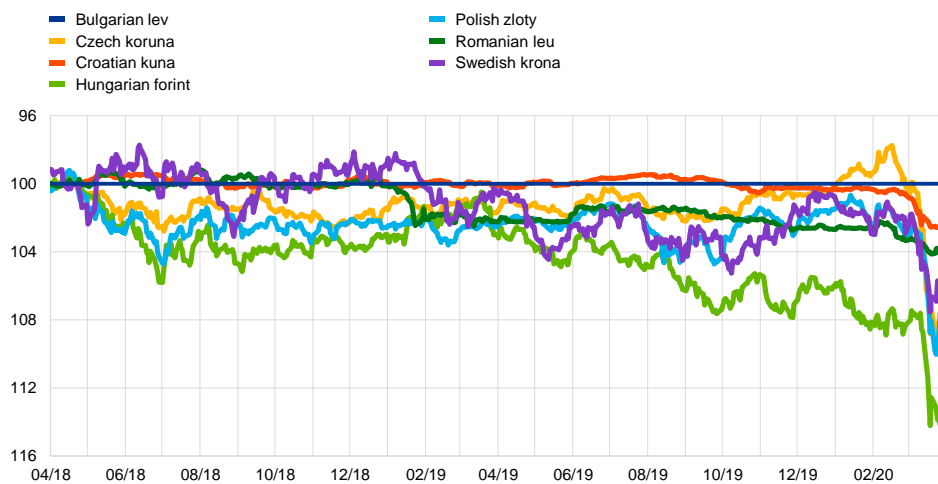
Source: Eurostat.
Note: Data for 2017 have been revised slightly since the 2018 Convergence Report.

As regards the exchange rate criterion, none of the countries under review is participating in ERM II at the time of publication of this report. However, the Bulgarian and Croatian authorities have expressed their intention to seek inclusion of the lev and the kuna in ERM II. In July 2018, the Finance Ministers of the euro area countries, the ECB, and the representatives of the Danish Minister of Finance and of the Governor of Danmarks Nationalbank welcomed the intention of the Bulgarian authorities to put in place the necessary elements for successful participation in ERM II. Similarly, in July 2019, the Finance Ministers of the euro area countries and Denmark, the ECB, and the representative of the Governor of Danmarks Nationalbank welcomed the intention of the Croatian authorities to put in place the necessary elements for successful participation in ERM II. In this respect, both Bulgaria and Croatia have made a number of commitments in policy areas which are of particular relevance for smooth participation in ERM II. Turning to exchange rate developments, in most of the countries under review, the exchange rate exhibited relatively high volatility over most of the reference period, until February 2020. The exceptions were Bulgaria, which has a currency board vis-à-vis the euro, Croatia, which operates a tightly managed float, and, to a lesser extent, Romania. Until February 2020, the Hungarian forint and, to a lesser degree, the Romanian leu and the Swedish krona depreciated against the euro, while the Polish zloty remained virtually unchanged and the Czech koruna appreciated (see Chart 3.4). From March 2020 onwards, following the outbreak of the coronavirus in Europe and its impact on economic activity and global financial markets, the currencies of all the countries examined in this report, except the Bulgarian lev, experienced significant depreciation pressures.

Chart 3.4

Bilateral exchange rates vis-à-vis the euro

(index: average of April 2018 = 100; daily data; 1 April 2018 – 31 March 2020)



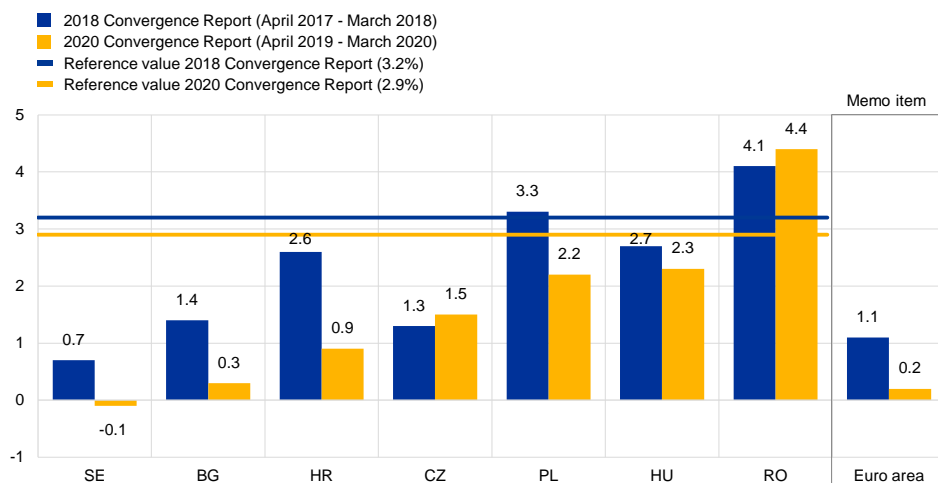
Source: ECB.
 Note: An upward (downward) movement indicates appreciation (depreciation) of the currency.

With regard to the convergence of long-term interest rates, only one of the seven countries under review recorded long-term interest rates above the reference value, which was 2.9% (see Chart 3.5). Interest rates were above the reference value in Romania, while the lowest values were recorded in Bulgaria and Sweden. By comparison, in the 2018 Convergence Report, the long term interest rate was above the reference value, which at the time was 3.2%, in both Poland and Romania.

Chart 3.5

Long-term interest rates

(percentages, annual average)



Sources: Eurostat and ECB.

When considering compliance with the convergence criteria, sustainability is essential. Convergence must be achieved on a lasting basis and not just at a given

point in time. The first decade of Economic and Monetary Union (EMU) showed that weak fundamentals, an excessively loose macroeconomic stance at the country level and overly optimistic expectations about convergence in real incomes pose risks not only for the countries concerned but also for the smooth functioning of the euro area as a whole. Compliance with the numerical convergence criteria at a point in time is, by itself, not a guarantee of smooth membership of the euro area. Countries joining the euro area should thus demonstrate the sustainability of their convergence processes and their capacity to live up to the permanent commitments which euro adoption represents. This is in the country's own interest, as well as in the interest of the euro area.

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

3.1 The price stability criterion

In March 2020 five of the seven countries under review recorded a 12-month average inflation rate above the reference value of 1.8% for the price stability criterion. Inflation accelerated in the euro area in 2018, before significantly decelerating in 2019, mainly owing to lower energy prices and a slowdown in economic activity. In contrast, in most countries examined in the report, inflation continued accelerating or remained relatively elevated, mainly driven by robust domestic demand. As a result, Bulgaria, Poland, Romania, the Czech Republic and Hungary recorded inflation rates well above the reference value, while they were below the reference value in Sweden and well below in Croatia. Inflation slowed down in most countries under review at the beginning of 2020, albeit to different degrees, mainly owing to a lower oil price.

Over the past ten years, both the average rate and the volatility of inflation have varied significantly across the countries examined. Over this period, Romania and Hungary recorded an average HICP inflation rate well above 2%. In the Czech Republic and Poland, the average inflation rate was closer to 1.5%. In Bulgaria,

Croatia and Sweden, inflation has been on average only slightly above 1.0% over the past ten years. During this period, price dynamics were particularly volatile in Bulgaria, Hungary, Croatia, Poland and Romania, as inflation in these countries fluctuated over a relatively wide range. Sweden recorded the lowest volatility in inflation rates. Although some progress has been made towards convergence over the last decade, inflation differentials over the reference period from April 2019 to March 2020 increased in most countries under review.

Longer-term price developments mirrored a more volatile macroeconomic environment in many countries. In 2010, in most of the countries under review, price developments became more heterogeneous, partly reflecting differences in the strength of the economic recovery and country-specific measures related to administered prices following the abrupt economic downturn. In 2013 inflation embarked on a downward trend in all countries under review, reaching historical lows and often even negative rates. This broad-based movement mainly reflected developments in global commodity prices, low imported inflationary pressures and persistent spare capacity in some countries. The developments in global commodity prices have had a particularly pronounced impact on the central and eastern European economies, given the relatively large weights of energy and food in their HICP baskets. In some of the countries under review, cuts in administered prices and indirect taxes or a strengthening of the nominal effective exchange rate also exerted downward pressure on inflation. Against this backdrop, monetary policy conditions have been loosened considerably. From 2017 onwards, inflation significantly accelerated, owing to the strengthening of economic activity, mainly driven by solid domestic demand and rising energy and commodity prices. In 2019 and at the beginning of 2020, despite external headwinds and lower energy prices, inflation remained elevated in most countries considered in the report, driven by robust domestic demand, increasingly tight labour market conditions and food prices. At the same time, monetary and fiscal policies have remained accommodative or very accommodative in most countries.

Inflation is expected to decline in the coming years in most of the countries under review, albeit remaining relatively high in some of them. In the current exceptional circumstances, the forecasts are subject to an unusual level of uncertainty. Over the longer term, there are concerns regarding the sustainability of inflation convergence in most of the countries examined. According to the European Commission's Spring 2020 Economic Forecast, inflation is expected to decline in most of the countries over the forecast horizon, with the exception of Poland. The international environment in particular has further deteriorated in 2020 owing to the COVID-19 pandemic. The balance between downward pressures on inflation linked to weaker demand and upward pressures related to supply disruptions, in particular on food prices, which have a significant weight in the HICP baskets of some countries under review, is surrounded by considerable uncertainty. In 2020 deflationary pressures are also expected to be supported by the sharp decline in oil prices. However, inflation is expected to remain above 1.8% in the Czech Republic, Hungary, Poland and Romania over the forecast horizon. The risks to the inflation outlook are broadly balanced in all the countries under review, except in Poland, where they are tilted to the downside. Upside risks

mainly relate to a faster than expected recovery from the economic downturn brought about by the COVID-19 pandemic, while a more protracted economic downturn constitutes a significant downside risk for the inflation outlook. Looking further ahead, in many of the central and eastern European countries under review, the catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area, since GDP per capita and price levels are still significantly lower than in the euro area, unless counteracted by an appreciation of the nominal exchange rate in some countries.

An environment that is conducive to sustainable price stability in, among others, the countries covered in this report requires stability-oriented economic policies, structural reforms and measures to safeguard financial stability.

Achieving or maintaining an environment supportive of price stability will crucially depend on the implementation of further structural reforms. In particular, wage increases should reflect labour productivity growth at firm level and take into account labour market conditions and developments in competitor countries. In addition, continued reform effort is needed to further improve the functioning of labour and product markets and maintain favourable conditions for economic expansion and employment growth. To that end, measures to support stronger governance and further improvements in the quality of institutions are essential in the central and eastern European economies. Given the limited room for manoeuvre for monetary policy under the tightly managed exchange rate regime in Croatia and the currency board framework in Bulgaria, and with a view to a smooth transition to and participation in ERM II, it is imperative that other policy areas support the capacity of these economies to maintain price stability, cope with country-specific shocks and avoid the build-up of macroeconomic imbalances. Financial sector and supervisory policies should be aimed at further safeguarding financial stability. In order to further bolster confidence in the financial system, the national competent authorities should continue to improve their supervisory practices by, among other things, 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.

3.2 The government budgetary position criterion

At the time of publication of this report, one country is subject to an excessive deficit procedure, whereas in 2018 none of the countries under review was subject to such a procedure. Since 2018, the deficit in Romania has sharply deteriorated, and it exceeded the 3% of GDP reference value in 2019. An excessive deficit procedure was opened in April 2020 with a deadline for correction of 2022. All other countries posted surpluses or fiscal deficit-to-GDP ratios below the reference value in 2019. There were deficits of 2.0% of GDP in Hungary and 0.7% of GDP in Poland, while the Czech Republic, Croatia and Sweden posted small surpluses of 0.3%, 0.4% and 0.5% of GDP, respectively, and Bulgaria had a surplus slightly above 2.0% of GDP.

Between 2017 and 2019 the fiscal balance deteriorated in most of the countries covered in this report, with the exception of Bulgaria, Hungary and Poland,

where it improved. In Romania, Croatia, the Czech Republic and Sweden, the deterioration in the headline balance can mainly be explained by the loosening fiscal stance, partially offset by more favourable macroeconomic developments. In Poland and Hungary, good macroeconomic conditions contributed to a reduction in the headline deficit-to-GDP ratio.

For 2020, as a consequence of the COVID-19 pandemic, the European Commission forecasts that the deficit-to-GDP ratio will be above the 3% reference value in all the countries with the exception of Bulgaria. The sharp deterioration in the government balance is projected to result from the strong decline in economic activity and the fiscal measures implemented to mitigate the crisis. The fiscal balance is projected to deteriorate by around 3 percentage points in Hungary, by around 5 percentage points in Bulgaria and Romania, by 6 to 7 percentage points in the Czech Republic and Sweden, by 7.5 percentage points in Croatia, and by around 9 percentage points in Poland.

In 2019, in Croatia and Hungary, the debt ratio was above 60% of GDP, while in the other countries under review the debt levels were below or well below this threshold (see Table 3.1 and Chart 3.3). Between 2017 and 2019, the government debt-to-GDP ratio decreased in all countries under review, with the exception of Romania, where it virtually stabilised. The debt ratio fell by 6.6 percentage points in Hungary, 5.7 percentage points in Sweden, 4.9 percentage points in Bulgaria, 4.7 percentage points in Poland, 4.5 percentage points in Croatia and 3.9 percentage points in the Czech Republic. Taking a longer perspective, between 2010 and 2019 the government debt-to-GDP ratio increased strongly in Croatia (by 15.4 percentage points) and significantly in Romania (by 5.6 percentage points) and Bulgaria (by 5.0 percentage points), while in the other countries the ratio declined.

For 2020, as a consequence of the COVID-19 pandemic, the European Commission projects an upward path for the debt ratios in all countries. The Commission's projections also indicate that the debt ratio will remain below or well below the 60% reference value in all countries in 2020, with the exception of Croatia and Hungary.

Looking ahead, and leaving aside the policy measures taken to address the COVID-19 pandemic, it is essential for the countries examined to achieve and/or maintain sound and sustainable fiscal positions. Romania, which breached the deficit ratio threshold in 2019, should ensure compliance with the rules of the Stability and Growth Pact and correct its excessive deficit by 2022. Moreover, countries whose debt-to-GDP ratio exceeds the reference value should ensure that the ratio is declining sufficiently, in accordance with the provisions of the Pact, while taking the COVID-19 pandemic into account. Further consolidation would also make it easier to deal with the budgetary challenges related to adverse demographic developments and to build the buffers needed to allow automatic stabilisers to work. Strong national fiscal frameworks that are fully in line with EU rules and implemented effectively should support fiscal consolidation and limit slippages in public expenditure, while helping to prevent a re-emergence of macroeconomic imbalances. Overall, fiscal strategies should be consistent with comprehensive structural reforms to increase potential growth and employment.

3.3 The exchange rate criterion

At the time of publication of this report, none of the countries under review is participating in ERM II. The seven countries operate under different exchange rate regimes. However, in July 2018 and July 2019, respectively, the Bulgarian and the Croatian authorities expressed their intention to seek inclusion of the lev and the kuna in ERM II, and the related processes have made significant progress in the meantime.

The Bulgarian lev remained fixed at 1.95583 levs to the euro within the framework of a currency board arrangement during the reference period. This exchange rate regime operates in an environment of mostly low short-term interest rate differentials vis-à-vis the euro area.

The Croatian kuna and the Romanian leu traded under exchange rate regimes involving – to different degrees – a managed float vis-à-vis the euro. In the case of the Croatian kuna, this was reflected in very low exchange rate volatility and low short-term interest rate differentials vis-à-vis the euro area. The exchange rate of the Romanian leu against the euro showed a low degree of volatility, with short-term interest rate differentials vis-à-vis the euro area remaining relatively high throughout the reference period. With the emergence of financial market tensions following the intensification of the COVID-19 pandemic in March 2020, however, both currencies came under depreciation pressure.

All the other currencies traded under flexible exchange rate regimes, most of them amid high exchange rate volatility, particularly after the emergence of financial market tensions following the intensification of the COVID-19 pandemic in March 2020. Short-term interest rate differentials vis-à-vis the euro area were small in Sweden and Hungary, but relatively large in Poland and the Czech Republic. Sveriges Riksbank maintained a swap agreement with the ECB which, as it helped to reduce financial vulnerabilities, may also have had an impact on exchange rate developments over the reference period.

3.4 The long-term interest rate criterion

Over the reference period, only one of the seven countries under review recorded an average long-term interest rate in the reference period from April 2019 to March 2020 that was above the 2.9% reference value. In Sweden, the average long-term interest rate was slightly negative at -0.1%. In Bulgaria it was 0.3%, while in the Czech Republic and Croatia average long-term interest rates were 1.5% and 0.9%, respectively. In Hungary and Poland, interest rates stabilised at levels below 2.5%, while in Romania the average long-term interest rate was above the 2.9% reference value at 4.4%. Following the emergence of financial market tensions owing to the intensification of the COVID-19 pandemic at the end of the reference period in March 2020, the central banks of Croatia, Hungary, Poland and Romania announced, and in some cases implemented, government bond purchase programmes. Sweden announced an increase in the total envelope of its debt securities purchase programme, which also includes government bonds.

Since the 2018 Convergence Report, the dynamics of long-term interest rate spreads vis-à-vis the euro area average have been rather heterogeneous across the countries under review. This heterogeneity reflects differences in both the cyclical position and the financial markets' assessment of the countries' external and internal vulnerabilities, including developments in budgetary performance and the prospects for sustainable convergence. In one of the seven countries under review, Sweden, the interest rate differential is negative, while in Bulgaria the differential is zero. Sweden is a modern and developed economy whose financial system is already highly integrated with the euro area, while in Bulgaria the banking system is predominantly owned by euro area-based banks and the central bank operates a currency board arrangement, which de facto imports euro area monetary conditions. In Croatia, continuous fiscal consolidation over recent years helped to lower the interest rate differential vis-à-vis the euro area to around 80 basis points by the end of the reference period. In the Czech Republic, Hungary and Poland, the differential ranges from 110 to 220 basis points, mainly because of higher inflation and faster real GDP growth. Romania is the only country where the interest rate differential is significant. It stood at around 440 basis points at the end of the reference period, after increasing for three years as a reflection of both domestic and external imbalances.

3.5 Other relevant factors

According to the European Commission, most of the countries under review have made progress in addressing imbalances in their economies, albeit to different degrees. The European Commission's in-depth reviews, the results of which were published on 26 February 2020, concluded that Croatia, Romania and Sweden were experiencing macroeconomic imbalances. However, Bulgaria was no longer assessed as experiencing macroeconomic imbalances. As regards Croatia, the Commission found that imbalances are linked to high levels of public, private and external debt. These stock imbalances started receding with the economic recovery. For Romania, the Commission found that vulnerabilities linked to cost competitiveness losses and a widening current account deficit persist in the context of a strongly expansionary fiscal policy and will increase if current trends are not reversed. In the case of Sweden, the Commission found that, notwithstanding the recent correction, house prices remain at historically high levels, while household debt is continuing to grow. Although the European Commission classified the other countries under review as having no imbalances, those countries also face various challenges.

The external positions of most of the countries have stabilised in recent years. The macroeconomic imbalance procedure (MIP) scoreboard shows that three-year average current account balances remained in surplus in 2018 and 2019 (see Table 3.2) in almost all the countries under review, with the exception of Poland, which recorded a modest deficit, and Romania, where the deficit increased further.

In almost all the countries under review, negative net international investment positions as a share of GDP have diminished, but remain at high levels. The net foreign liabilities of the central and eastern European countries are mainly in foreign direct investment, which is assessed as constituting a more stable form of financing. In

2019 the net international investment position was beyond the indicative threshold of -35% of GDP in four of the seven countries under review. Net foreign liabilities were smallest in the Czech Republic (20.7% of GDP), while Sweden recorded a positive net international investment position (20.9% of GDP).

In terms of price and cost competitiveness, between 2016 and 2019

HICP-deflated real effective exchange rates appreciated to different degrees in most of the countries examined, with Sweden being the only exception. The three-year growth rate of unit labour costs, which in the pre-crisis years stood at very high levels in almost all of the countries, has started to increase again and in four of the seven countries examined in this report exceeded – in some cases to a very significant extent – the indicative threshold of 12%. It was particularly high in Romania, where the three-year growth rate of unit labour costs reached 24.9% in 2019. Over the five-year period from 2015 to 2019, significant gains in export market shares were recorded in all countries except Sweden, albeit slowing over time.

House prices continued to increase in all countries under review except

Sweden. House prices increased at a faster pace, close to or beyond the indicative threshold of 6%, in all countries except Bulgaria and Sweden. While house prices started a downward correction in Sweden after strong increases in previous years, partly owing to supply-side bottlenecks and historically low interest rates, house prices continued to increase very strongly and beyond the indicative threshold in the Czech Republic and, in particular, Hungary, also fuelled by the low level of interest rates.

Table 3.2

Scoreboard for the surveillance of macroeconomic imbalances

Table 3.2a – External imbalances and competitiveness indicators

		Current account balance ¹⁾	Net international investment position ²⁾	Real effective exchange rate, HICP-deflated ³⁾	Export market share ⁴⁾	Nominal unit labour costs ⁵⁾
Bulgaria	2017	2.3	-43.3	-3.3	20.6	13.5
	2018	2.7	-36.8	3.9	13.6	18.3
	2019	3.0	-31.6	4.5	13.7	18.9
Czech Republic	2017	1.1	-25.0	5.3	8.7	5.9
	2018	1.2	-24.8	11.0	11.5	13.7
	2019	0.6	-20.7	8.7	5.4	14.9
Croatia	2017	2.9	-65.6	0.1	23.4	-3.9
	2018	2.5	-57.9	4.2	23.0	-2.1
	2019	2.6	-51.0	1.5	21.2	2.5
Hungary	2017	3.1	-55.1	0.0	11.0	9.1
	2018	2.3	-51.6	2.0	8.9	12.4
	2019	0.5	-47.9	0.3	6.2	14.6
Poland	2017	-0.3	-61.2	-3.5	28.1	4.1
	2018	-0.5	-55.6	0.1	25.8	7.8
	2019	-0.2	-49.8	2.8	23.7	8.2
Romania	2017	-1.6	-47.4	-5.6	38.5	15.4
	2018	-2.8	-43.7	-0.7	24.1	29.6
	2019	-3.9	-43.1	0.2	18.4	24.9
Sweden	2017	3.6	1.4	-5.5	-4.4	3.9
	2018	2.8	8.0	-4.0	-6.4	7.6
	2019	2.9	20.9	-8.3	-5.3	7.9
Threshold		-4.0/+6.0	-35.0	+/-11.0	-6.0	+12.0

Table 3.2b – Internal imbalances and unemployment indicators

		Internal imbalances					Unemployment indicators			
		House prices, consumption-deflated ¹⁾	Private sector credit flow, consolidated ²⁾	Private sector debt, consolidated ²⁾	Financial sector liabilities ⁶⁾	General government debt ²⁾	Unemployment rate ⁷⁾	Activity rate ⁸⁾	Long-term unemployment ⁸⁾	Youth unemployment ⁸⁾
Bulgaria	2017	5.3	4.1	99.0	7.0	25.3	7.6	2.3	-3.5	-11.0
	2018	4.5	3.9	95.0	6.7	22.3	6.3	2.2	-2.6	-9.1
	2019	4.0	.	.	.	20.4	5.2	4.6	-2.1	-8.3
Czech Republic	2017	9.1	4.2	67.3	22.9	34.7	4.0	2.4	-1.6	-7.9
	2018	6.2	5.3	70.7	7.4	32.6	3.0	2.5	-1.7	-5.9
	2019	6.0	.	.	.	30.8	2.4	1.7	-1.1	-4.9
Croatia	2017	2.9	1.5	97.9	3.9	77.8	13.5	0.3	-5.5	-17.9
	2018	4.6	2.3	94.0	4.5	74.7	10.9	-0.6	-6.8	-18.5
	2019	8.1	.	.	.	73.2	8.8	0.9	-4.3	-14.9
Hungary	2017	9.3	0.7	70.8	-7.6	72.9	5.4	4.2	-2.0	-9.7
	2018	10.9	4.1	69.8	-9.2	70.2	4.3	3.3	-1.7	-7.1
	2019	10.8	3.4	67.4	10.4	66.3	3.8	2.5	-1.3	-1.5
Poland	2017	1.8	2.9	76.5	6.5	50.6	6.2	1.7	-2.3	-9.0
	2018	5.0	3.2	75.8	2.8	48.8	5.0	2.0	-1.9	-9.0
	2019	6.6	.	.	.	46.0	4.0	1.8	-1.5	-7.8
Romania	2017	3.3	1.7	50.9	8.1	35.1	5.9	1.6	-0.8	-5.6
	2018	1.3	1.9	47.4	3.3	34.7	5.0	1.7	-1.1	-5.4
	2019	-1.7	.	.	.	35.2	4.3	3.0	-1.3	-3.9
Sweden	2017	4.8	13.3	199.0	6.9	40.8	7.0	1.0	-0.2	-5.0
	2018	-3.1	9.1	202.2	-2.6	38.8	6.7	1.0	-0.4	-2.9
	2019	0.6	10.0	205.1	10.4	35.1	6.6	0.9	-0.3	1.3
Threshold		+6.0	+14.0	+133.0	+16.5	+60.0	+10.0	-0.2	0.5	2.0

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

Note: This table includes data available as at 7 May 2020, i.e. the cut-off date for this report, and therefore differs from the scoreboard published in the Alert Mechanism Report of November 2019.

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

2) As a percentage of GDP.

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

4) Five-year percentage change.

5) Three-year percentage change.

6) Year-on-year percentage change.

7) Three-year average.

8) Three-year percentage point change.

A relatively long period of credit expansion prior to the financial crisis left the private non-financial sector with high – though moderately declining – levels of accumulated debt in some of the countries under review. This continues to constitute a key vulnerability in such countries, although private credit growth has moderated and does not exceed the indicative threshold of 14% in any of the countries under review. However, Sweden continued to record a particularly high stock of private sector debt, exceeding 200% of GDP in 2019.

Financial sector policies in the countries under review should be aimed at ensuring that the financial sector makes a sound contribution to economic growth and price stability, and supervisory policies should be geared towards stabilising the supervisory framework, which is a precondition for joining the Single Supervisory Mechanism (SSM). In order to further support confidence in the financial system, the national competent authorities should continue to improve their

supervisory practices, inter alia by following the applicable recommendations of the relevant international and European bodies and by closely collaborating with national supervisors of other EU countries within the supervisory colleges.

The adjustment process following the financial crisis resulted in relatively high levels of unemployment in some of the countries under review, but unemployment has been on a declining path in more recent years.

Over the review period, the unemployment rate has declined further in most countries and remains below the indicative threshold of 10% in all reviewed countries. While unemployment remains high in Croatia, despite declining substantially, partly on account of a significant reduction in long-term and, in particular, youth unemployment, Hungary, the Czech Republic and Poland have recorded historically low unemployment rates and some countries are increasingly facing labour shortages in certain segments of the labour market.

The strength of the institutional environment is another important factor in the analysis of the sustainability of economic integration and convergence.

Low quality of institutions and weak governance may reflect, for example, weaknesses in the business environment, an inefficient public administration, tax evasion, corruption, a lack of social inclusion, a lack of transparency, a lack of judicial independence and/or poor access to online services. In several central and eastern European countries, enhancing institutional quality would contribute to removing the existing rigidities and impediments to the efficient use and allocation of production factors, thereby strengthening long-term growth capacity. By hampering potential output growth, a weak institutional environment may also undermine a country's debt-servicing ability and make economic adjustment more difficult. It may also affect a country's ability to implement necessary policy measures.

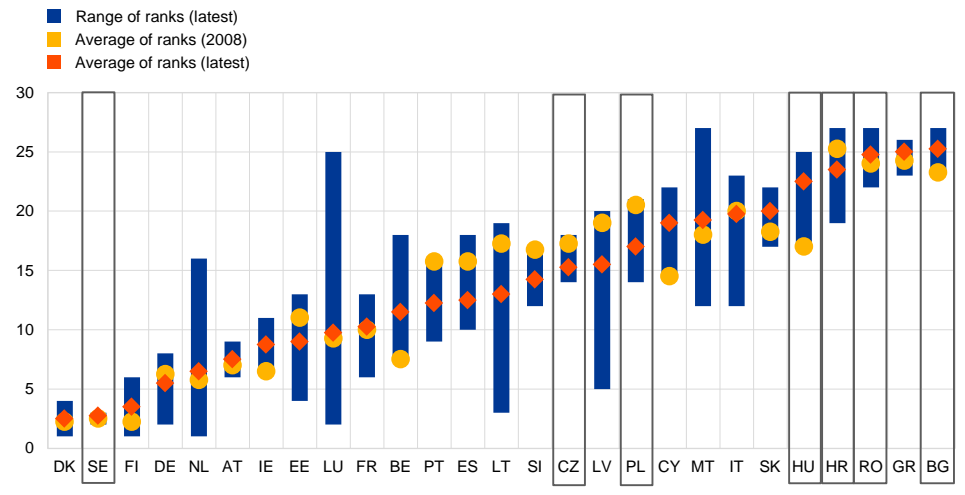
Except in Sweden, the quality of institutions and governance is relatively weak in all the countries under review – especially in Bulgaria, Romania, Croatia and Hungary.

This can pose risks for economic resilience and the sustainability of convergence. Specific institutional indicators broadly confirm an overall picture of poor quality institutions and governance in most countries, although with some notable

differences (see Charts 3.6 and 3.7).¹⁵⁴ In this respect, Bulgaria, Romania, Croatia and Hungary are among the countries facing the greatest challenges within the EU.

Chart 3.6

Overview of EU country rankings in terms of institutional quality

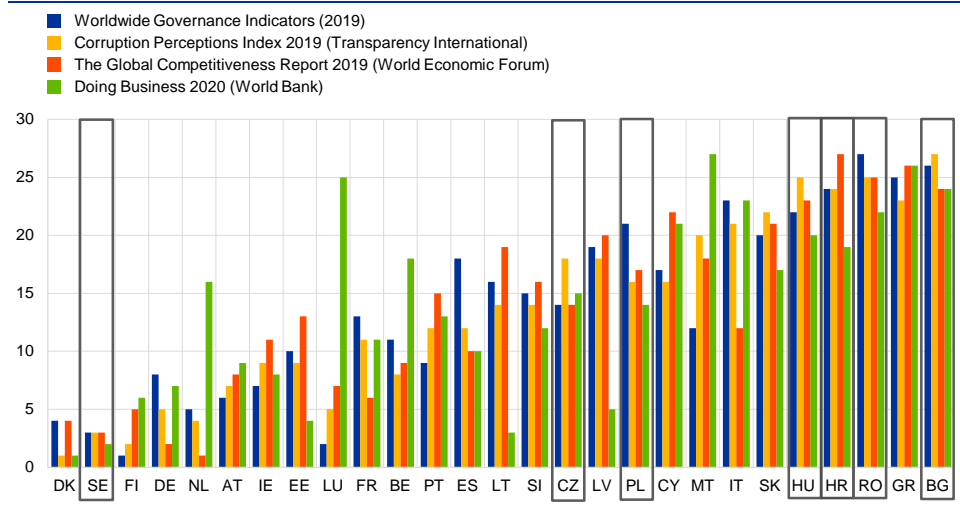


Sources: Worldwide Governance Indicators 2019, The Global Competitiveness Report 2019 (World Economic Forum), Corruption Perceptions Index 2019 (Transparency International) and Doing Business 2020 (World Bank).
 Notes: Countries are ranked from one (best performing in the EU) to 27 (worst performing in the EU) and ordered according to their average position in the latest rankings. In the Doing Business report, Malta has only been covered since the 2013 report and Cyprus only since 2010.

¹⁵⁴ Measuring institutional quality remains difficult and fraught with controversy. On one hand, perception-based indicators can have some merit when compared with more “objective” indicators. One advantage of perception-based surveys rests in their catch-all nature, whereas more specific measures may provide highly distorted information. Also, while the absolute value of perception-based indicators may be questionable, they are useful for cross-country comparisons, unless it is clear that there is a systematic bias against one or more specific countries. Moreover, “objective” indicators that are based solely on the content of laws, but not on detailed knowledge of their actual implementation, can be misleading. Furthermore, as no institutional model may be presumed to be preferable ex ante, perception-based surveys may prevent the emergence of measurement biases when gauging the various dimensions of economic governance directly. On the other hand, perception-based surveys also produce distortions. For instance, they may be heavily influenced by a recent episode or poorly designed questions. Given the respective weaknesses and comparative advantages of perception-based (e.g. corruption) and more objective (e.g. doing business) institutional indicators, Charts 3.6 and 3.7 present both types of indicators. Moreover, as regards EU countries, the institutional focus has only gained analytical and policy prominence in recent years. There is thus, generally speaking, still ample scope for measurement improvements. Finally, cross-country approaches to an issue as complex as institutional quality or good governance are necessarily somewhat insufficient and clearly need to be complemented with more country-specific and longer-term assessments. At the same time, measurement difficulties should not lead to a down-playing of these crucially important determinants of long-term prosperity, social fairness and well-being.

Chart 3.7

EU country rankings in terms of institutional quality by individual indicator



Sources: Worldwide Governance Indicators 2019, The Global Competitiveness Report 2019 (World Economic Forum), Corruption Perceptions Index 2019 (Transparency International) and Doing Business 2020 (World Bank).
 Note: Countries are ranked from one (best performing in the EU) to 27 (worst performing in the EU) and ordered according to their average position in the latest rankings.

Wide-ranging structural reforms are required in most of the countries under review to improve economic growth and competitiveness. Improving local institutions, governance and the business environment, along with further progress in the reform and privatisation of state-owned enterprises and the efficient absorption of EU funds, would help to speed up productivity growth. This would in turn contribute to increasing competition in key regulated sectors (e.g. energy and transport), lowering barriers to entry and encouraging much-needed private investment.

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

4 Country summaries

4.1 Bulgaria

In March 2020 the 12-month average rate of HICP inflation in Bulgaria was 2.6%, i.e. well above the reference value of 1.8% for the criterion on price stability. In the light of the coronavirus (COVID-19) pandemic, there is a high level of uncertainty as to how this rate is going to evolve over the coming months. The national authorities have taken major fiscal and macroprudential policy measures to offset the economic damage wrought by the COVID-19 pandemic. Over the past ten years this rate has fluctuated within a relatively wide range, from -1.7% to 3.8%, and the average for that period was subdued, standing at 1.1%. Looking ahead, there are concerns regarding the sustainability of inflation convergence in Bulgaria over the longer term, also taking into account the marked increase in unit labour costs, in particular in the period 2017-18. 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.

Bulgaria's general government budget balance and debt complied with the Maastricht criteria in 2019 but a significant deterioration of the fiscal situation is expected in 2020-21. Bulgaria has been subject to the preventive arm of the Stability and Growth Pact since 2012. From 2012 to 2019 Bulgaria comfortably met both the deficit (with one exception in 2014) and the debt criteria. For 2020, however, the European Commission's Spring 2020 Economic Forecast foresees a sharp worsening of the fiscal positions resulting from the combined effect of the marked deterioration in economic activity and the fiscal measures implemented to mitigate the crisis. The Commission's 2019 Debt Sustainability Monitor, which was released prior to the COVID-19 pandemic, indicated that Bulgaria faced low risks to fiscal sustainability over the medium and long run. Leaving aside the policy measures to address the COVID-19 pandemic, prudent and growth-friendly fiscal policies remain essential for safeguarding sound public finances in the future.

In the two-year reference period from 1 April 2018 to 31 March 2020, the Bulgarian lev did not participate in ERM II, but its exchange rate was fixed at 1.95583 levs per euro within the framework of a currency board. Over the past ten years Bulgaria's combined current and capital account balance has improved and the country's net foreign liabilities have declined markedly. On 29 June 2018 the Bulgarian authorities expressed their intention to seek inclusion of the Bulgarian lev in ERM II. On 12 July 2018 the finance ministers of the euro area countries, the ECB, and the representatives of the Minister of Finance of Denmark and of the Governor of Denmark's Nationalbank welcomed the intention of the Bulgarian authorities to put in place the necessary elements for successful participation in ERM II. Bulgaria made a number of commitments in policy areas which are of high relevance for a smooth transition to, and participation in, ERM II. These commitments relate to banking

supervision, other financial sector issues and institutional quality and governance. The ECB and the European Commission are monitoring the effective implementation of these commitments, acting within their respective areas of competence as provided for by the Treaties and secondary legislation.

Over the reference period from April 2019 to March 2020, long-term interest rates in Bulgaria stood at 0.3% on average and were thus well below the 2.9% reference value for the interest rate convergence criterion. Long-term interest rates in Bulgaria have decreased since 2010, with 12-month average rates declining from above 7% to below 0.5%.

Achieving an environment that is conducive to sustainable convergence in Bulgaria requires stability-oriented economic policies and wide-ranging structural reforms. As regards macroeconomic imbalances, the Commission did not select Bulgaria for an in-depth review in its Alert Mechanism Report 2020. The sustainability of convergence and economic resilience would benefit from wide-ranging structural reforms to enhance structural resilience, the business environment, financial stability, institutional quality and governance. In the banking supervision sphere, on 18 July 2018 the relevant Bulgarian authorities sent an application to establish close cooperation with the ECB under the Single Supervisory Mechanism, in view of ERM II participation. In line with the related procedure, on 26 July 2019 the ECB published the results of the comprehensive assessment of six Bulgarian banks. This assessment identified follow-up measures to be implemented within nine months of the date of publication – these are a requirement for two banks.

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

4.2 Czech Republic

In March 2020 the 12-month average rate of HICP inflation in the Czech Republic was 2.9%, i.e. well above the reference value of 1.8% for the criterion on price stability.

In the light of the coronavirus (COVID-19) pandemic, there is a high level of uncertainty as to how this rate is going to evolve over the coming months. The national authorities have taken major fiscal, macroprudential and monetary policy measures to offset the economic damage wrought by the COVID-19 pandemic. Over the past ten years this rate has fluctuated within a range from 0.2% to 3.6%, and the overall average for that period was moderate, standing at 1.6%. Looking ahead, there are concerns regarding the sustainability of inflation convergence in the Czech Republic over the longer term. 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 significantly 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.

The Czech Republic's general government budget balance and debt complied with the Maastricht criteria in 2019. Nevertheless, as a consequence of the COVID-19 pandemic, a marked deterioration of the budgetary position is expected in 2020-21.

The Czech Republic has been subject to the preventive arm of the Stability and Growth Pact since 2014. In the subsequent period to 2019, the deficit and debt criteria were comfortably met. However, the European Commission's Spring 2020 Economic Forecast foresees a sharp deterioration in the fiscal positions resulting from the combined effect of the marked deterioration in economic activity and the fiscal measures implemented to mitigate the crisis. The Commission's 2019 Debt Sustainability Monitor, which was released prior to the COVID-19 pandemic, suggested that the fiscal risk was low over the short and medium term, but population ageing implied risks over the long term. Leaving aside the policy measures to address the COVID-19 pandemic, a prudent fiscal policy is essential for safeguarding sound public finances in the future.

In the two-year reference period from 1 April 2018 to 31 March 2020, the Czech koruna did not participate in ERM II, but traded under a flexible exchange rate regime.

Following the discontinuation of the exchange rate floor in 2017, the Czech koruna exhibited a relatively high degree of volatility against the euro over the two-year reference period. On 31 March 2020 the exchange rate stood at 27.312 korunas per euro, 7.7% weaker than its average level in April 2018. Over the past ten years the combined current and capital account balance has improved, while the country's net foreign liabilities have declined.

Over the reference period from April 2019 to March 2020, long-term interest rates in the Czech Republic stood at 1.5% on average and thus remained below the 2.9% reference value for the interest rate convergence criterion.

Long-term interest rates in the Czech Republic have decreased since 2010, with 12-month average rates declining from almost 5% to 1.5%.

Achieving an environment that is conducive to sustainable convergence requires conducting price stability-oriented economic policies, including targeted structural reforms that are geared to ensuring macroeconomic stability.

With regard to macroeconomic imbalances, the European Commission did not select the Czech Republic for an in-depth review in its Alert Mechanism Report 2020. Nevertheless, the targeted structural reforms, with regard to labour and product market policies as well as the business environment, need to be stepped up in order to address structural weaknesses which may hinder growth prospects. 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.

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

4.3 Croatia

In March 2020 the 12-month average rate of HICP inflation in Croatia was 0.9%, i.e. well below the reference value of 1.8% for the criterion on price stability. In the light of the coronavirus (COVID-19) pandemic, there is a high level of uncertainty as to how this rate is going to evolve over the coming months. The national authorities have taken major fiscal and monetary policy measures to offset the economic damage wrought by the COVID-19 pandemic. Over the past ten years this rate has fluctuated within a relatively wide range, from -0.8% to 4.0%, and the average for that period was subdued, standing at 1.2%. Looking ahead, there are concerns regarding the sustainability of inflation convergence in Croatia over the longer term. The catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area, since 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.

Croatia's general government budget balance complied with the Maastricht criterion in 2019, while its debt ratio was above the reference value, although it diminished from 2015 to 2019. Nevertheless, as a consequence of the COVID-19 pandemic, a notable deterioration in the budget position and a marked increase in the debt ratio are expected in 2020-21. Croatia was subject to the corrective arm of the Stability and Growth Pact from 2014, and exited the excessive deficit procedure in June 2017. In the subsequent period to 2019, the deficit criterion was comfortably met, and the debt ratio declined. For 2020, however, the European Commission's Spring 2020 Economic Forecast foresees a sharp deterioration of the fiscal positions resulting from the combined effect of the marked deterioration in economic activity and the fiscal measures implemented to mitigate the crisis. The Commission's 2019 Debt Sustainability Monitor, which was released prior to the COVID-19 pandemic, suggested that Croatia faced a low debt sustainability risk over the medium and long term. Over the long term, while Croatia appeared to be at low risk owing to the projected decrease in age-related spending, the projected marked decline in the benefit ratio raised concerns about the adequacy of the pension system. Leaving aside the policy measures to address the COVID-19 pandemic, a prudent fiscal policy that further enhances the efficiency of both revenue and expenditure, should put the debt ratio on a long-lasting downward path.

In the two-year reference period from 1 April 2018 to 31 March 2020, 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 exchange rate of the Croatian kuna against the euro exhibited, on average, a very low degree of volatility over the reference period. On 31 March 2020 the exchange rate stood at 7.6255 kuna per euro, 2.8% weaker than its average level in April 2018. Croatia's combined current and capital account balance has improved over the past ten years and the country's net foreign liabilities have declined, but remain very high. On 4 July 2019 the Croatian authorities expressed their intention to seek inclusion of the Croatian kuna in ERM II and announced an action plan detailing the reforms the country intends to implement before participating in ERM II. On 8 July 2019 the

finance ministers of the euro area countries and Denmark, the ECB, and the representative of the Governor of Denmark's Nationalbank welcomed the intention of the Croatian authorities to put in place the necessary elements for successful participation in ERM II. Croatia made a number of commitments in policy areas which are of high relevance for a smooth transition to, and participation in, ERM II. In addition to banking supervision, these commitments relate to the country's macroprudential framework, its anti-money-laundering framework, the collection, production and dissemination of statistics, public sector governance and reducing the financial and administrative burden. The ECB and the European Commission are monitoring the effective implementation of these commitments, acting within their respective areas of competence as provided for by the Treaties and secondary legislation.

Over the reference period from April 2019 to March 2020, long-term interest rates in Croatia stood at 0.9% on average and thus remained well below the 2.9% reference value for the interest rate convergence criterion. Long-term interest rates in Croatia have decreased since 2010, with 12-month average rates declining from slightly below 7% to around 1.0%.

Achieving an environment that is conducive to sustainable convergence in Croatia requires stability-oriented economic policies and wide-ranging structural reforms. With regard to macroeconomic imbalances, the European Commission selected Croatia for an in-depth review in its Alert Mechanism Report 2020 and concluded that Croatia is experiencing macroeconomic imbalances. Croatia would benefit from structural reforms aimed at improving the institutional and business environment, boosting competition in the product markets, reducing mismatches in the labour market and labour supply constraints, and enhancing the efficiency of the public administration and the judicial system. In the banking supervision sphere, on 27 May 2019 the relevant Croatian authorities sent an application to establish close cooperation with the ECB under the Single Supervisory Mechanism, in view of ERM II participation.

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

4.4 Hungary

In March 2020 the 12-month average rate of HICP inflation in Hungary was 3.7%, i.e. well above the reference value of 1.8% for the criterion on price stability. In

the light of the coronavirus (COVID-19) pandemic, there is a high level of uncertainty as to how this rate is going to evolve over the coming months. The national authorities have taken major fiscal, macroprudential and monetary policy measures to offset the economic damage wrought by the COVID-19 pandemic. Over the past ten years this rate has fluctuated within a relatively wide range, from -0.3% to 5.7%, and the average for that period was elevated, standing at 2.5%. Looking ahead, there are concerns regarding the sustainability of inflation convergence in Hungary over the longer term. The catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area, 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.

Hungary's general government budget balance complied with the Maastricht criterion in 2019, whereas its debt ratio was above the reference value, although it diminished from 2012 to 2019. Nevertheless, as a consequence of the COVID-19 pandemic, a notable deterioration in the budget position and a significant increase in the debt ratio are expected in 2020-21. Hungary has been subject to the preventive arm of the Stability and Growth Pact since 2013, and a significant deviation procedure since 2018. The European Commission's Spring 2020 Economic Forecast points to a sharp worsening of the fiscal positions in 2020 resulting from the combined effect of the marked deterioration in economic activity and the fiscal measures implemented to mitigate the crisis. The Commission's 2019 Debt Sustainability Monitor, which was released prior to the COVID-19 pandemic, indicated that Hungary was at low risk of fiscal stress over the short and medium term but at medium risk over the long term. Population ageing posed a challenge to the sustainability of public finances. Leaving aside the policy measures to address the COVID-19 pandemic, a prudent fiscal policy is essential for safeguarding sound public finances in the future.

In the two-year reference period from 1 April 2018 to 31 March 2020, the Hungarian forint did not participate in ERM II, but traded under a flexible exchange rate regime. The exchange rate of the Hungarian forint against the euro exhibited, on average, a relatively high degree of volatility over the reference period. On 31 March 2020 the exchange rate stood at 360.02 forints per euro, 15.5% weaker than its average level in April 2018. Over the past ten years Hungary's current and capital account has consistently remained in surplus. This has contributed to some reduction in the country's net foreign liabilities, which nevertheless remain very high.

Over the reference period from April 2019 to March 2020, long-term interest rates in Hungary were 2.3% on average and thus remained below the 2.9% reference value for the interest rate convergence criterion. Long-term interest

rates in Hungary have been on a downward path since 2010, with 12-month average rates declining from 9% to below 3%.

Achieving an environment that is conducive to sustainable convergence in Hungary requires stability-oriented economic policies and wide-ranging structural reforms. With regard to macroeconomic imbalances, the European Commission did not select Hungary for an in-depth review in its Alert Mechanism Report 2020. However, Hungary would benefit from structural reforms aimed at improving the quality of public institutions and administration as well as from implementing adequate product and labour market policies. 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.

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

4.5 Poland

In March 2020 the 12-month average rate of HICP inflation in Poland was 2.8%, i.e. well above the reference value of 1.8% for the criterion on price stability. In

the light of the coronavirus (COVID-19) pandemic, there is a high level of uncertainty as to how this rate is going to evolve over the coming months. The national authorities have taken major fiscal, macroprudential and monetary policy measures to offset the economic damage wrought by the COVID-19 pandemic. Over the past ten years this rate has fluctuated within a relatively wide range, from -0.7% to 4.1% while the average for that period was moderate, standing at 1.5%. Looking ahead, there are concerns regarding the sustainability of inflation convergence in Poland over the longer term. The catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area, since GDP per capita and price levels are still significantly 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.

Poland's general government budget balance and debt complied with the Maastricht criteria in 2019. However, as a consequence of the COVID-19 pandemic, a marked deterioration in the budget position and a marked increase in the debt ratio are expected in 2020-21. Poland has been subject to the preventive

arm of the Stability and Growth Pact since 2015. In the subsequent period to 2019, the deficit criterion was met and the debt ratio declined. In 2020, the European Commission's Spring 2020 Economic Forecast foresees a sharp deterioration of the fiscal position resulting from the combined effect of the marked deterioration in economic activity and the fiscal measures implemented to mitigate the crisis. The Commission's 2019 Debt Sustainability Monitor, which was released prior to the COVID-19 pandemic, suggested that Poland faced low risks to fiscal sustainability in the medium and long run. Nevertheless, the adequacy of the pension system needed to be ensured, preventing the benefit ratio from dropping substantially in the medium and long term. Leaving aside the policy measures to address the COVID-19 pandemic, a prudent fiscal policy is essential for safeguarding sound public finances in the future.

In the two-year reference period from 1 April 2018 to 31 March 2020, the Polish zloty did not participate in ERM II, but traded under a flexible exchange rate regime. The exchange rate of the Polish zloty against the euro exhibited, on average,

a relatively high degree of volatility over the reference period. On 31 March 2020 the exchange rate stood at 4.5506 zlotys per euro, 8.5% weaker than its average level in April 2018. Poland's combined current and capital account balance has improved over the past ten years, while the country's net foreign liabilities remain very high, although in decline since 2017 and consisting mostly of net direct investment liabilities.

Over the reference period from April 2019 to March 2020, long-term interest rates in Poland stood at 2.2% on average and were thus below the reference value of 2.9% for the interest rate convergence criterion. Long-term interest rates

in Poland have decreased since 2010, with 12-month average rates declining from approximately 6% to around 2%.

Achieving an environment that is conducive to sustainable convergence in Poland requires stability-oriented economic policies, policy measures safeguarding financial stability and targeted structural reforms. With regard to macroeconomic imbalances, the European Commission did not select Poland for an in-depth review in its Alert Mechanism Report 2020. It is essential to preserve the currently strong financial position of the banking sector in order to maintain foreign investors' confidence and ensure its sound contribution to economic growth, which should be supported by well targeted structural reforms aimed at reducing frictions in labour markets, enhancing competition in product markets and speeding up innovation, privatisation and infrastructure modernisation. 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.

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

4.6 Romania

In March 2020 the 12-month average rate of HICP inflation in Romania was 3.7%, i.e. well above the reference value of 1.8% for the criterion on price stability. In

the light of the coronavirus (COVID-19) pandemic, there is a high level of uncertainty as to how this rate is going to evolve over the coming months. The national authorities have taken major fiscal, macroprudential and monetary policy measures to offset the economic damage wrought by the COVID-19 pandemic. Over the past ten years this rate has fluctuated within a relatively wide range, from -1.7% to 7.8%, and the average for that period was elevated, standing at 2.7%. Looking ahead, there are serious concerns regarding the sustainability of inflation convergence in Romania over the longer term. The catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area, since 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.

While Romania's debt complied with the Maastricht debt criterion, its government deficit breached the 3% reference value in 2019; an excessive deficit procedure was thus launched in April 2020, under which the country was required to rectify its excessive deficit by 2022 at the latest. From June 2017

Romania was subject to a significant deviation procedure under the preventive arm of the Stability and Growth Pact, and since April 2020 it has been subject to an excessive deficit procedure under the corrective arm. The authorities repeatedly failed to take effective action in correcting the significant deviation from the adjustment path toward the medium-term budgetary objective; the structural balance deviated by a significant and increasing margin from 2016. According to the European Commission's Spring 2020 Economic Forecast, the budget deficit is projected to deteriorate markedly, with an increasing margin vis-à-vis the 3% of GDP reference value. The sharp worsening of the headline budget and structural balances is driven by the marked deterioration in economic activity and the fiscal measures implemented to mitigate the COVID-19 crisis and by the significant increase in old age pensions resulting from the new pension law passed in summer 2019. These also drive the upward trend in the debt ratio. The Commission's 2019 Debt Sustainability Monitor, which was released prior to the COVID-19 pandemic, pointed to high sustainability risks in the medium and long term, largely driven by the deterioration in the forecast structural primary balance and the increase in age-related expenditure. Leaving aside the policy measures to address the COVID-19 pandemic, further reforms in these areas are required and significant consolidation measures will be necessary to correct the excessive deficit situation and to safeguard the sustainability of public finances.

In the two-year reference period from 1 April 2018 to 31 March 2020, the Romanian leu did not participate in ERM II, but traded under a flexible exchange rate regime involving a managed floating of the currency's exchange rate. The

exchange rate of the Romanian leu against the euro exhibited, on average, a low degree of volatility over the reference period. On 31 March 2020 the exchange rate stood at 4.8283 lei per euro, i.e. 3.7% weaker than its average level in April 2018.

Romania's current and capital account has improved over the past ten years, and the country's net foreign liabilities have declined, but remain high.

Over the reference period from April 2019 to March 2020, long-term interest rates in Romania stood at 4.4% on average and were thus above the 2.9% reference value for the interest rate convergence criterion. Long-term interest rates in Romania have decreased since 2010, with 12-month average rates declining from slightly less than 10% to around 4.5%.

Achieving an environment that is conducive to sustainable convergence in Romania requires stability-oriented economic policies and wide-ranging structural reforms. With regard to macroeconomic imbalances, the European Commission selected Romania for an in-depth review in its Alert Mechanism Report 2020 to be conducted in early 2020. There is considerable scope and a need for measures aimed at improving the institutional and business environment, boosting investment and competition in product markets, reducing sizeable skill mismatches and shortages as well as increasing the activity rate of the labour force to decrease labour market tensions, and enhancing both the quality and efficiency of the public administration and the judicial system, in particular after the reversal of progress in important areas such as the fight against corruption. Significant efforts should also be made to improve Romania's absorption of EU funds. 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.

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

4.7 Sweden

In March 2020 the 12-month average rate of HICP inflation in Sweden was 1.6%, i.e. below the reference value of 1.8% for the criterion on price stability. In the light of the coronavirus (COVID-19) pandemic, there is a high level of uncertainty as to how this rate is going to evolve over the coming months. The national authorities have taken major fiscal, macroprudential and monetary policy measures to offset the economic damage wrought by the COVID-19 pandemic. Over the past ten years this rate has fluctuated within a relatively narrow range from 0.2% to 2.1%, and the average for that period was subdued, standing at 1.2%. Sweden's GDP per capita is already above the euro area level. Looking ahead, monetary policy and the stability-oriented institutional framework should continue to support the achievement of price stability in Sweden.

Sweden's general government budget balance and debt ratio complied with the Maastricht criteria in 2019, but are expected to deteriorate notably in 2020 on account of the COVID-19 pandemic. From 1998 to 2019, Sweden was not subject to an excessive deficit procedure. According to the European Commission's Spring 2020 Economic Forecast, Sweden's budget balance is projected to deteriorate markedly in 2020 to a deficit of 5.6% of GDP on account of the macroeconomic effects of the COVID-19 pandemic and related fiscal policy measures. It is expected to return to below the 3% reference value in 2021. The debt-to-GDP-ratio is also projected to increase markedly, but to remain below the 60% reference value. The Commission's 2019 Debt Sustainability Monitor, which was released prior to the COVID-19 pandemic, suggested that Sweden faced low risks over the medium and long term owing to its still low debt level. Leaving aside the policy measures to address the COVID-19 pandemic, continued compliance with the medium-term objective over the coming years would ensure that the track record of sound public finances is further enhanced.

In the two-year reference period from 1 April 2018 to 31 March 2020, the Swedish krona did not participate in ERM II, but traded under a flexible exchange rate regime. The exchange rate of the Swedish krona against the euro exhibited, on average, a relatively high degree of volatility over the reference period, following overall a depreciating trend. On 31 March 2020 the exchange rate stood at 11.0613 kronor per euro, 6.6% weaker than its average level in April 2018. Over the past ten years Sweden has recorded large current account surpluses and since 2015 its net international investment position has been positive.

Over the reference period from April 2019 to March 2020, long-term interest rates in Sweden stood at -0.1% on average and thus remained well below the 2.9% reference value for the interest rate convergence criterion. Long-term interest rates in Sweden have decreased since 2010, with 12-month average rates declining from above 3% to around 0%.

Maintaining an environment that is conducive to sustainable convergence in Sweden requires the continuation of stability-oriented economic policies, targeted structural reforms and measures to safeguard financial stability. With regard to macroeconomic imbalances, the European Commission concluded in its

Alert Mechanism Report 2020 that Sweden is still experiencing macroeconomic imbalances. Against this backdrop, further steps are needed to address the risks to macroeconomic stability arising from historically high house prices and the associated high level of household indebtedness. 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.

Swedish law does not comply with all the requirements for central bank independence, the monetary financing prohibition and legal integration into the Eurosystem. Sweden is an EU Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty. Pursuant to the Treaty, Sweden has been under the obligation to adopt national legislation with a view to integration into the Eurosystem since 1 June 1998. As yet no legislative action has been taken by the Swedish authorities to remedy the incompatibilities described in this and previous reports.

5 Examination of economic convergence in individual countries

5.1 Bulgaria

5.1.1 Price developments

In March 2020 the 12-month average rate of HICP inflation in Bulgaria was 2.6%, i.e. well above the reference value of 1.8% for the criterion on price stability (see Chart 5.1.1). In the light of the coronavirus (COVID-19) pandemic, there is a high level of uncertainty as to how this rate is going to evolve 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 3.8%, and the average for that period was subdued, standing at 1.1%. 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. HICP inflation increased further in 2018 and 2019, chiefly driven by food and services prices (see Table 5.1.1).

In the first quarter of 2020 the average annual rate of HICP inflation stood at 3.0%. In addition to strong domestic demand on the back of strong wage growth, hikes in the prices of food and services exerted significant upward pressure on overall HICP inflation.

The national authorities have taken major fiscal and macroprudential policy measures to offset the economic damage wrought by the COVID-19 pandemic. The governmental measures include an upward revision of the budget balance target to a deficit of 3.1% of GDP for 2020, and the approval of an increase in new debt issuances. Българска народна банка (Bulgarian National Bank) approved a private loan instalment moratorium for up to six months and announced a package of other measures, including measures aimed at further strengthening the capital and the liquidity position of banks as well as the annulment of the scheduled increases of the countercyclical capital buffer for banks.

Inflation is expected to decrease in the coming years. However, in the current exceptional circumstances, the forecasts are subject to an unusual level of uncertainty. Over the longer term there are concerns about the sustainability of inflation convergence in Bulgaria. According to the European Commission's Spring

2020 Economic Forecast, the average annual rate of inflation will decrease to around 1.1% in 2020 and 2021, respectively. This outlook is based on the expectation that economic activity will fall significantly in 2020 and then recover partially in 2021, driven by private consumption. Given the COVID-19 outbreak, considerable uncertainty surrounds the balance between downward pressures on inflation (linked to weaker demand) and upward pressures related to supply disruptions (in particular on food prices, which have a significant weight in the HICP basket). In 2020 deflationary pressures are also supported by the sharp decline in oil prices. The risks to the medium-term inflation outlook are broadly balanced. Upside risks mainly relate to a faster than expected recovery from the economic downturn brought about by the COVID-19 pandemic, while a more protracted economic downturn constitutes a significant downside risk for the inflation outlook. Looking further ahead, there are concerns regarding the sustainability of inflation convergence in Bulgaria over the longer term, also taking into account the marked increase in unit labour costs, in particular in the period 2017-18. 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, Bulgaria has opted for a currency board arrangement and aims at participating in ERM II, therefore 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 potential country-specific shocks and macroeconomic imbalances. This is also of utmost importance for a smooth transition to, and participation in, ERM II. 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, which started to decline in 2019, 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 did not select Bulgaria for an in-depth review in its Alert Mechanism Report 2020.

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

Prudent supervisory policies of Българска народна банка (Bulgarian National Bank) have resulted in a stronger banking sector which is well capitalised and liquid. Given favourable economic conditions, increasing wages and improving profits until the beginning of 2020, bank credit to the private sector, in particular in the segment of loans to households, started growing at rates above those witnessed in recent years, after a long period of growth that was sluggish and even negative for some periods in the years after the global financial crisis.. The accumulation of cyclical risks related to strong mortgage credit growth and increasing house prices has been closely monitored. Against the background of the COVID-19 outbreak and in order to preserve the stability of the banking system and strengthen its flexibility, in March 2020 the Българска народна банка (Bulgarian National Bank) Governing Council announced its decision to cancel the additional increases in the countercyclical capital buffer scheduled for 2020 and 2021. Following Bulgaria's request to establish close cooperation between Българска народна банка and the European Central Bank in July 2018, the ECB conducted a comprehensive assessment, comprising an asset quality review and a stress-testing exercise, of six Bulgarian banks. The results of the Comprehensive Assessment were published on 26 July 2019. Follow-up measures, to be implemented within nine months of the date of publication, are required for two banks, namely First Investment Bank and Investbank. The ECB will take a decision on the possible establishment of close cooperation with Българска народна банка based on the comprehensive assessment and the legal assessment. The national competent authorities shall maintain 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 budget balance and debt complied with the Maastricht criteria in 2019.

In the reference year 2019 the general government budget recorded a surplus of 2.1% of GDP, thus comfortably meeting the 3% deficit reference value. The general government gross debt-to-GDP ratio was 20.4%, well below the 60% reference value (see Table 5.1.2). Compared with the previous year, the general government surplus increased slightly, by 0.1 percentage points, and the debt ratio declined by 1.9 percentage points.

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 in 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 in June 2012. In the subsequent period to 2019, general government debt was well below the 60% of GDP reference value, and the general government balance breached the reference value only in 2014, reaching a deficit of

5.4% of GDP, mostly as a result of the one-off capital transfer (amounting to around 3% 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. Considering the excess over the reference value to be both exceptional and temporary, the European Commission concluded that opening an excessive deficit procedure was not warranted.

Both cyclical and non-cyclical factors contributed to the improvement in the budget balance over 2015-19. The fiscal consolidation that took place was mainly due to the unwinding of the 2014 one-off capital transfer, restraint in public spending and favourable macroeconomic conditions. The prudent fiscal policy allowed Bulgaria to record a structural surplus, which peaked at 1.1% of GDP in 2019.

The government debt-to-GDP ratio remained well below the 60% reference value over the past decade. The debt ratio increased notably, from 13.7% in 2009 to 29.3% of GDP in 2016, on the back of primary deficits and, to a lesser extent, unfavourable interest-growth differentials. From 2017 to 2019, primary surpluses and favourable interest-growth differentials made a major contribution to the debt ratio reduction. Regarding contingent liabilities, potential risks pertained mainly to contingent liabilities stemming from state-owned enterprises.

In the presence of a long-standing 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. Taking into account the low 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 (81.0% in 2019), although almost entirely denominated in euro, which is the anchor currency of Bulgaria's currency board framework. Fiscal balances are thus insensitive to changes in exchange rates other than the euro/lev exchange rate, which is fixed under the currency board.

As a consequence of the COVID-19 pandemic the European Commission's Spring 2020 Economic Forecast predicts a notable deterioration in the budget balance and a significant increase in public debt. According to the European Commission's Spring 2020 Economic Forecast, even though the headline balance is expected to temporarily worsen to a deficit of 2.8% of GDP in 2020, it will remain slightly below the 3% deficit reference value. The foreseen deterioration of the general government balance stems from the worsening macroeconomic outlook and the fiscal measures implemented to mitigate the adverse effects of the crisis. The budget balance is projected to improve in 2021 and to reach a deficit of 1.8% of GDP. Over 2020-21, the structural deficit is expected to stand above the medium-term objective (a structural deficit of 1% of GDP). Nevertheless, in the context of the COVID-19 pandemic, the Stability and Growth Pact's general escape clause provides that "in periods of severe economic downturn for the euro area or the Union as a whole, Member States may be allowed temporarily to depart from the adjustment path towards the medium-term budgetary objective..., provided that this does not endanger

fiscal sustainability in the medium term".¹⁵⁵ In 2020 the debt ratio is projected to increase by around 5 percentage points to 25.5% of GDP and remain at this level over the forecast horizon. The 2020 headline deficit presented in the 2020 convergence programme is in line with the European Commission's Spring 2020 Economic Forecast, while the projected debt ratio is above the European Commission's value.

Bulgaria's strengthened fiscal framework has helped it to achieve a sound fiscal position, but there is still scope for further improvement. The large number of fiscal rules mitigates the risk of increasing debt, but in practice they are complex to implement and therefore need to be streamlined. The mandate of the Fiscal Council has been strengthened; further improvements in the areas of its technical and administrative capacities are nevertheless still needed. Progress made in tax collection and the reduction of the informal economy has contributed to significant growth in tax revenues, and further progress should be pursued. Additionally, Bulgaria has recently improved its corporate governance framework for state-owned enterprises and launched a spending review project in 2018. Efficiency gains in current public spending would free additional resources to increase both the quantity and quality of the stock of public capital.

The European Commission's 2019 Debt Sustainability Monitor, which was released prior to the COVID-19 pandemic, suggested that Bulgaria faced low risks to fiscal sustainability over the medium and long run. The European Commission's 2019 Debt Sustainability Monitor found that Bulgaria faced low fiscal sustainability risks over the medium and long term, thanks to its favourable initial budgetary position and low debt ratio.¹⁵⁶ ¹⁵⁷ These two factors helped to mitigate the notable increase in age-related public expenditure by 2.3 percentage points of GDP over the period 2016-70 according to the reference scenario from the 2018 Ageing Report prepared by the Ageing Working Group (AWG) of the EU's Economic Policy Committee,¹⁵⁸ from a level of 18.5% of GDP in 2016. In the AWG's risk scenario, the increase in costs was even higher and amounted to 4.1 percentage points of GDP, owing to a larger rise in healthcare and in long-term care spending (by respectively 1.0 and 0.9 percentage points of GDP in comparison with the baseline scenario). These projections signalled a need for further reforms in order to enhance the long-term sustainability of public finances.

Looking ahead, and leaving aside the policy measures to address the COVID-19 pandemic, a prudent fiscal policy needs to be maintained despite the low level of public debt. A consistent and prudent fiscal policy will ensure that Bulgaria continues to comply with the Stability and Growth Pact and maintains buffers to alleviate adverse shocks. Moreover, there is scope for a more growth-friendly tax system and policies and a more cost-effective provision of healthcare services.

¹⁵⁵ For more details, see Box 2 in the Framework for analysis.

¹⁵⁶ As explained in the Framework for analysis, the potential implications of the COVID-19 pandemic for the medium to long-term sustainability of budgetary positions beyond its impact on the latest forecasts are not covered because of the high levels of uncertainty.

¹⁵⁷ 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.

¹⁵⁸ European Commission and Economic Policy Committee, "The 2018 Ageing Report: Economic & Budgetary Projections for the 28 EU Member States (2016-2070)", *European Economy Institutional Paper*, No 079, European Commission, 2018.

Safeguarding and extending the current reductions in tax collection gaps, further reducing the informal economy and increasing spending efficiency are all essential measures for preserving medium-term fiscal sustainability.

5.1.3 Exchange rate developments

In the two-year reference period from 1 April 2018 to 31 March 2020, 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. On 29 June 2018 the Bulgarian authorities expressed their intention to seek inclusion of the Bulgarian lev in ERM II. On 12 July 2018 the finance ministers of the euro area countries, the ECB, and the representatives of the Minister of Finance of Denmark and of the Governor of Danmarks Nationalbank welcomed the intention of the Bulgarian authorities to put in place the necessary elements for successful participation in ERM II. Bulgaria made a number of commitments in policy areas which are of high relevance for a smooth transition to, and participation in, ERM II. These commitments relate to banking supervision, other financial sector issues and institutional quality and governance. The ECB and the European Commission are monitoring the effective implementation of these commitments, acting within their respective areas of competence as provided for by the Treaties and secondary legislation.

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 combined current and capital account balance has improved significantly over the past ten years and the country's net foreign liabilities have declined markedly (see Table 5.1.3). After recording a small surplus in 2011, the combined current and capital account improved further in recent years. 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 2.5% in 2018 and 5.5% in 2019. 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 2.1% of GDP from 2015 to 2019, while the balance on other investment recorded net outflows. Gross external debt decreased substantially from 80.7% of GDP in 2015 to 62.2% in 2019. At the same time the country's net international investment position improved markedly from -61.8% of GDP in 2015 to -31.6% of GDP in 2019. 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 2019 exports of goods and services to the euro area constituted 44.7% of total exports, with the corresponding figure for imports standing at 42.4%. In 2019 the share of the euro area in Bulgaria's stock of direct investment liabilities stood at 65.7% and its share in the country's stock of portfolio investment liabilities was 67.7%. The share of Bulgaria's stock of foreign assets invested in the euro area amounted to 50.4% in the case of direct investment and 43.6% for portfolio investment in 2019.

5.1.4 Long-term interest rate developments

Over the reference period from April 2019 to March 2020, long-term interest rates in Bulgaria continued to decrease and stood at 0.3% on average, well below the 2.9% reference value for the interest rate convergence criterion (see Chart 5.1.5).

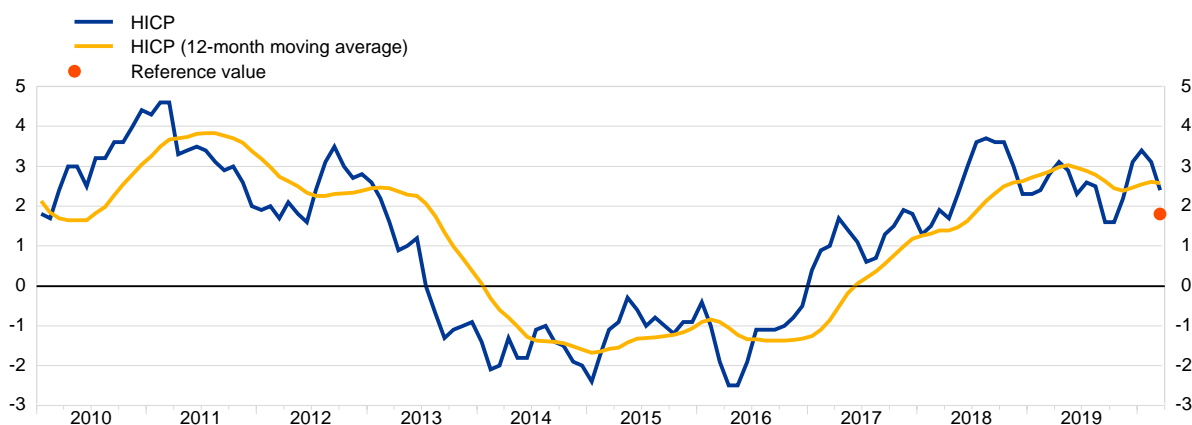
Long-term interest rates in Bulgaria declined from 7.2% in January 2010 to 0.2% in March 2020. After the onset of the financial crisis, both the base interest rate - the reference interest rate calculated as the simple monthly average of the values of the LEONIA index (LEv OverNight Interest Average) - and long-term interest rates declined significantly between 2009 and 2010. Thereafter, the continuous decline in Bulgarian long-term interest rates was driven initially by the gradual compression in risk premia resulting from the lower macro-financial risk perceived by financial markets and the significant improvement in the liquidity conditions of banks. For most of the period since mid-2010 other factors, such as relatively weak private credit demand until 2015, low interest rates in the euro area, Bulgarian banks' demand for government debt securities in the context of a limited supply of debt securities, and a high private savings rate, have contributed to the declining trend in long-term interest rates. Recently, global trade tensions have also exerted some downward pressure on Bulgarian long-term interest rates. As a result, the long-term interest rate in Bulgaria stood at a historical low of 0.2% in March 2020 (see Chart 5.1.5). 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 credit default swap spreads – which fell from over 200 basis points in early 2010 to below 70 basis points in March 2020. Bulgaria's government debt is rated investment grade by all 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 was zero in March 2020. In the early stages of the financial crisis, the interest rate differential narrowed gradually owing to the combination of the decline in Bulgarian long-term interest rates and the increase in euro area average rates. By the end of 2012 the differential stood at around less than half a percentage point (see Chart 5.1.6). Thereafter, stable rates in Bulgaria, combined with declining euro area average rates, led to some widening of that differential, which peaked in November 2014 at 1.9 percentage points, before declining and bottoming out at 0.7 percentage points in June 2015. Between June 2015 and October 2016 the differential fluctuated between 1.1 and 1.8 percentage points. From late 2016 the differential declined steadily and, after remaining in negative territory for more than one year owing to heightened political and economic uncertainty in some euro area countries, it turned slightly positive in mid-2019. Since then it has declined gradually to stand at 0.0% in March 2020 (+ 0.6% vis-à-vis the euro area AAA yield).

Capital markets in Bulgaria are smaller and much less developed than in the euro area (see Table 5.1.4). In the past few years only a few indications have emerged of any significant deepening of capital markets compared with early 2010. In recent years stock market capitalisation, as a percentage of GDP, has increased from an average of 13.1% of GDP over the period 2010-14 to 23.5% in 2019. Market-based debt financing of domestic MFIs has remained quite constant since 2010, 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 3.1% of GDP over the period 2015-19, up from 2.0% of GDP over the period 2010-14. In 2019 the Bulgarian banking system relied only to a very small extent on euro area banks for its funding needs. Euro area banks' claims on Bulgarian banks remained at historically low levels of 3.3% in 2019, in line with the post-2015 annual average and well below the 2010-14 average. The degree of financial intermediation remains quite low in Bulgaria compared with the euro area average, even if it is comparable to that of peer countries in the region. MFI credit to non-government residents stood at 53.8% of GDP in 2019, less than 13 percentage points down from its average in the period 2010-14. At the end of 2019 foreign-owned banks continued to play a major role in the banking system in Bulgaria, accounting for more than 75% of total banking assets. The banking system is largely funded by resident private non-financial sector deposits (around 83% of total liabilities). The banking system's assets vis-à-vis the non-financial private sector were dominated by loans, 65% of which were denominated in local currency.

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 2019 to March 2020 is the unweighted arithmetic average of the annual percentage changes in the HICP for Portugal, Cyprus and Italy plus 1.5 percentage points. The reference value is 1.8%.

Table 5.1.1 Measures of inflation and related indicators
(annual percentage changes, unless otherwise indicated)

	2010-2019 ¹⁾	2010-2014 ¹⁾	2015-2019 ¹⁾	2015	2016	2017	2018	2019	2020 ²⁾	2021 ²⁾
Measures of inflation										
HICP	1.1	1.5	0.8	-1.1	-1.3	1.2	2.6	2.5	1.1	1.1
HICP excluding unprocessed food and energy	0.9	1.0	0.8	-0.3	-0.4	0.3	2.1	2.5	2.0	1.3
HICP at constant tax rates ³⁾	1.0	1.3	0.6	-1.1	-1.5	1.0	2.4	2.4	-	-
CPI	1.6	1.8	1.4	-0.1	-0.8	2.1	2.8	3.1	1.1	1.1
Private consumption deflator	1.6	1.3	1.8	1.6	0.4	3.2	2.0	2.0	0.0	2.0
GDP deflator	2.6	1.7	3.5	2.4	2.5	3.9	4.0	4.7	0.5	2.4
Producer prices ⁴⁾	2.6	3.7	1.5	-1.7	-2.8	4.2	4.1	3.8	-	-
Related indicators										
Real GDP growth	2.3	1.1	3.6	4.0	3.8	3.5	3.1	3.4	-7.2	6.0
GDP per capita in PPS ⁵⁾ (euro area = 100)	44.2	42.4	46.3	44.6	45.9	46.9	48.0	.	-	-
Comparative price levels (euro area = 100)	48.5	49.0	48.0	47.1	47.0	48.6	49.1	.	-	-
Output gap ⁶⁾	0.1	-1.1	1.4	-0.8	0.5	1.5	2.2	3.4	-5.0	-0.7
Unemployment rate (%) ⁷⁾	9.1	11.7	6.5	9.2	7.6	6.2	5.2	4.2	7.0	5.8
Unit labour costs, whole economy	4.6	4.7	4.4	1.9	2.4	8.7	6.3	3.0	8.6	-3.1
Compensation per employee, whole economy	7.6	7.8	7.5	5.6	5.8	10.5	9.7	6.1	3.4	2.3
Labour productivity, whole economy	2.9	2.9	3.0	3.6	3.3	1.7	3.2	3.0	-4.8	5.6
Imports of goods and services deflator	1.8	3.4	0.2	-2.6	-5.1	6.7	1.9	0.4	-3.0	2.6
Nominal effective exchange rate ⁸⁾	0.6	0.1	1.1	-2.2	2.2	1.8	3.6	0.4	-	-
Money supply (M3) ⁹⁾	8.6	8.6	8.5	8.2	7.2	8.5	8.6	10.1	-	-
Lending from banks ¹⁰⁾	4.3	2.4	6.2	-0.2	3.4	7.8	9.9	10.6	-	-
Stock prices (SOFIX) ¹¹⁾	33.0	22.2	8.8	-11.7	27.2	15.5	-12.3	-4.4	-	-
Residential property prices	1.1	-3.8	6.2	2.8	7.0	8.7	6.6	6.0	-	-

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 Refinitiv 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 2020 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).

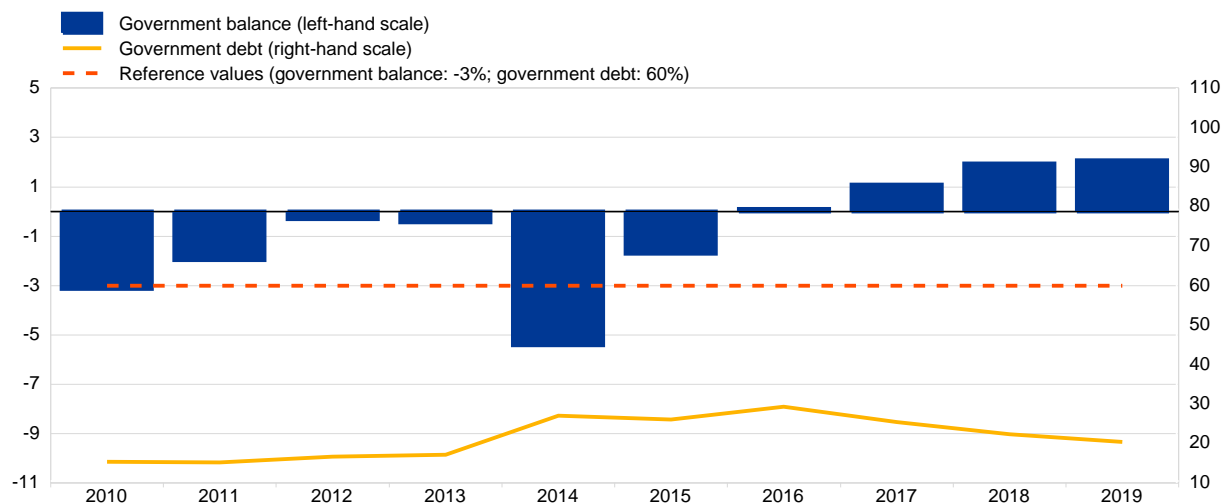
9) The series includes repurchase agreements with central counterparties.

10) 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)

	2010-2019 ¹⁾	2010-2014 ¹⁾	2015-2019 ¹⁾	2015	2016	2017	2018	2019	2020 ²⁾	2021 ²⁾
Government balance	-0.8	-2.3	0.7	-1.7	0.1	1.1	2.0	2.1	-2.8	-1.8
Total revenue	36.1	34.9	37.3	38.7	35.1	36.0	38.5	38.4	39.3	38.3
Current revenue	34.5	33.1	35.9	34.7	34.5	35.0	37.7	37.5	38.3	37.3
Direct taxes	5.3	4.9	5.7	5.4	5.6	5.7	5.8	5.9	5.6	5.3
Indirect taxes	14.9	14.6	15.3	15.5	15.4	15.0	15.0	15.4	15.6	15.2
Net social contributions	7.7	7.1	8.3	7.8	7.7	8.3	8.7	8.9	9.4	8.9
Other current revenue ³⁾	6.6	6.5	6.7	6.0	5.9	6.0	8.2	7.2	7.7	7.8
Capital revenue	1.6	1.8	1.5	4.0	0.6	1.1	0.8	0.9	0.9	1.0
Total expenditure	36.9	37.2	36.6	40.4	35.0	34.9	36.6	36.3	42.0	40.2
Current expenditure	32.0	31.9	32.0	33.2	30.9	31.5	32.5	32.0	37.3	35.4
Compensation of employees	9.3	9.1	9.4	9.3	8.9	9.2	9.5	10.3	12.1	11.7
Social benefits	13.5	13.5	13.5	13.9	13.7	13.4	13.0	13.5	15.2	13.9
Interest payable	0.8	0.8	0.8	0.9	0.9	0.8	0.7	0.6	0.6	0.7
Other current expenditure ⁴⁾	8.4	8.5	8.3	9.1	7.4	8.2	9.3	7.7	9.4	9.1
Capital expenditure	4.9	5.3	4.6	7.2	4.0	3.4	4.0	4.3	4.8	4.8
of which: Investment	3.9	4.2	3.6	6.6	2.7	2.3	3.1	3.2	3.7	3.7
Cyclically adjusted balance	-0.8	-1.9	0.3	-1.5	-0.1	0.7	1.3	1.1	-1.3	-1.6
One-off and temporary measures	-0.3	-0.7	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Structural balance ⁵⁾	-0.5	-1.3	0.3	-1.4	-0.1	0.7	1.3	1.1	-1.3	-1.6
Government debt	21.5	18.3	24.7	26.0	29.3	25.3	22.3	20.4	25.5	25.4
Average residual maturity (in years)	7.0	6.5	7.5	8.3	7.8	7.5	7.1	6.9	.	.
In foreign currencies (% of total)	78.5	76.7	80.2	79.0	81.0	78.4	81.7	81.0	.	.
of which: Euro	69.9	60.7	79.0	77.4	79.8	77.3	80.7	80.1	.	.
Domestic ownership (% of total)	52.4	50.2	54.6	52.6	52.0	56.5	55.6	56.1	.	.
Medium and long-term maturity (% of total) ⁶⁾	96.8	94.0	99.7	99.1	99.7	99.9	100.0	99.9	.	.
of which: Variable interest rate (% of total)	13.5	19.2	7.8	9.3	11.6	8.4	5.2	4.7	.	.
Deficit-debt adjustment	1.0	0.8	1.1	-1.2	5.0	-0.8	0.6	1.9	.	.
Net acquisitions of main financial assets	0.2	0.0	0.5	-2.5	6.3	-0.9	0.1	-0.7	.	.
Currency and deposits	0.2	-0.2	0.6	-2.0	5.8	-0.8	0.2	-0.4	.	.
Debt securities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	.	.
Loans	0.1	0.1	0.0	-0.4	0.6	0.0	0.0	0.0	.	.
Equity and investment fund shares or units	0.0	0.0	-0.1	0.0	-0.1	0.0	-0.1	-0.4	.	.
Revaluation effects on debt	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0	.	.
of which: Foreign exchange holding gains/losses	0.1	0.1	0.0	0.1	0.0	0.0	0.0	0.0	.	.
Other ⁷⁾	0.7	0.9	0.6	1.2	-1.4	0.1	0.5	2.6	.	.
Convergence programme: government balance	-	-	-	-	-	-	-	-	-3.1	.
Convergence programme: structural balance	-	-	-	-	-	-	-	-	.	.
Convergence programme: government debt	-	-	-	-	-	-	-	-	28.5	.

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 2020 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.

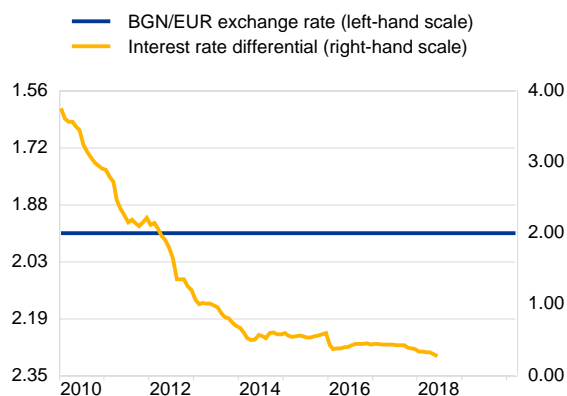
6) Original maturity of more than one year.

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 ¹⁾

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

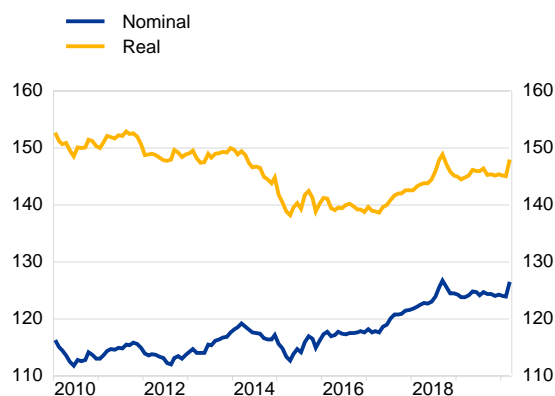


Sources: National data and ECB calculations.

1) The interest rate differential is calculated against SOFIBOR. Production of SOFIBOR reference rate was discontinued by the national central bank as of 1 July 2018; a comparable rate is not currently available.

Chart 5.1.4 Effective exchange rates ²⁾

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



Source: ECB.

2) 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)

	2010-2019 ¹⁾	2010-2014 ¹⁾	2015-2019 ¹⁾	2015	2016	2017	2018	2019	2020 ²⁾	2021 ²⁾
Balance of payments										
Current account and capital account balance ³⁾	2.8	1.4	4.2	3.2	5.4	4.5	2.5	5.5	4.7	6.8
Current account balance	1.2	0.1	2.4	0.1	3.2	3.5	1.4	4.0	3.3	5.4
Goods	-5.4	-7.8	-3.1	-5.7	-2.0	-1.5	-3.3	-2.8	.	.
Services	6.3	6.3	6.3	6.7	7.0	5.8	5.9	6.2	.	.
Primary income	-3.6	-3.0	-4.2	-4.5	-5.1	-4.4	-4.4	-2.8	.	.
Secondary income	3.9	4.5	3.4	3.6	3.3	3.5	3.2	3.4	.	.
Capital account balance	1.6	1.3	1.8	3.1	2.2	1.0	1.1	1.5	.	.
Combined direct and portfolio investment balance ³⁾	-1.2	-1.8	-0.5	-5.3	-2.4	2.5	1.3	1.3	.	.
Direct investment	-2.2	-2.2	-2.1	-4.1	-1.1	-2.5	-1.3	-1.3	.	.
Portfolio investment	1.0	0.4	1.5	-1.3	-1.3	5.0	2.6	2.6	.	.
Other investment balance	2.9	2.3	3.4	5.0	4.5	2.2	1.6	3.9	.	.
Reserve assets	2.4	1.5	3.3	8.2	7.1	-0.2	2.4	-0.9	.	.
Exports of goods and services	62.5	60.0	65.0	64.0	64.1	67.3	65.9	63.6	.	.
Imports of goods and services	61.6	61.4	61.7	63.0	59.1	62.9	63.2	60.1	.	.
Net international investment position ⁴⁾	-62.0	-79.7	-44.3	-61.8	-47.9	-43.3	-36.8	-31.6	.	.
Gross external debt ⁴⁾	83.0	94.2	71.8	80.7	78.5	71.8	65.9	62.2	.	.
Trade with the euro area ⁵⁾										
Exports of goods and services	42.9	42.3	43.5	42.8	43.2	42.4	44.6	44.7	.	.
Imports of goods and services	42.3	41.7	42.9	43.0	43.9	42.9	42.4	42.4	.	.
Investment position with the euro area ⁵⁾										
Direct investment assets ⁴⁾	50.7	53.0	48.4	49.5	49.2	46.2	46.9	50.4	.	.
Direct investment liabilities ⁴⁾	66.5	67.2	65.8	65.6	65.8	65.9	65.7	65.7	.	.
Portfolio investment assets ⁴⁾	47.0	47.0	47.1	55.7	51.1	44.1	41.2	43.6	.	.
Portfolio investment liabilities ⁴⁾	74.9	77.1	72.7	64.8	72.1	79.6	79.2	67.7	.	.

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 2020 Economic Forecast.

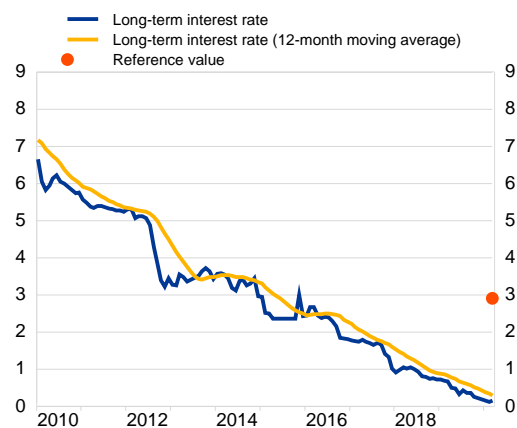
3) Differences between totals and the sum of their components are due to rounding.

4) End-of-period outstanding amounts.

5) As a percentage of the total.

Bulgaria - Long-term interest rate developments

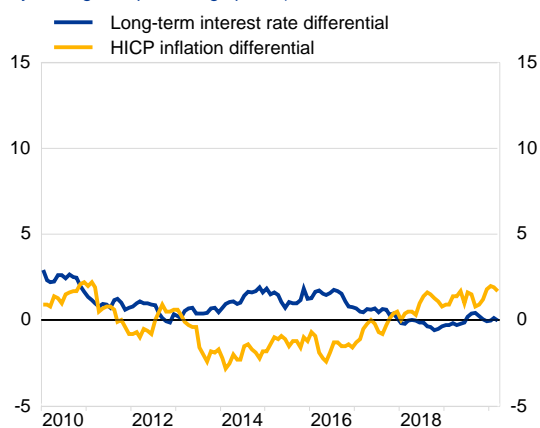
Chart 5.1.5 Long-term interest rate ¹⁾
(monthly averages in percentages)



Sources: European System of Central Banks and ECB calculations.

1) The basis of the calculation of the reference value for the period from April 2019 to March 2020 is the unweighted arithmetic average of the interest rate levels in Portugal, Cyprus and Italy plus 2 percentage points. The reference value is 2.9%.

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)

	2010-2019 ¹⁾	2010-2014 ¹⁾	2015-2019 ¹⁾	2016	2017	2018	2019	Apr. 2019 to Mar. 2020	Memo item: euro area 2019
Long-term interest rates									
Bulgaria ²⁾	3.0	4.5	1.5	2.3	1.6	0.9	0.4	0.3	-
Euro area ^{2), 3)}	2.2	3.4	0.9	0.9	1.1	1.1	0.4	0.2	-
Euro area AAA par curve, ten-year residual maturity ^{2), 3)}	1.3	2.3	0.3	0.2	0.4	0.5	-0.2	-0.3	-
Indicators of financial development and integration									
Debt securities issued by financial corporations ⁴⁾	1.1	1.1	1.1	1.1	1.3	1.0	1.1	-	66.7
Debt securities issued by non-financial corporations ⁵⁾	2.6	2.0	3.1	4.1	3.4	2.8	2.6	-	11.8
Stock market capitalisation ⁶⁾	15.5	13.1	17.8	8.7	23.1	24.4	23.5	-	67.7
MFI credit to non-government residents ⁷⁾	60.1	66.4	53.8	53.7	52.2	53.0	53.8	-	107.4
Claims of euro area MFIs on resident MFIs ⁸⁾	7.5	11.7	3.3	3.0	2.9	3.2	3.3	-	26.1

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 (excluding the national central bank) 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 market values.

7) MFI (excluding national central bank) credit to domestic non-MFI residents other than general government. Credit comprises 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 2020 the 12-month average rate of HICP inflation in the Czech Republic was 2.9%, i.e. well above the reference value of 1.8% for the criterion on price stability (see Chart 5.2.1). In the light of the coronavirus (COVID-19) pandemic, there is a high level of uncertainty as to how this rate is going to evolve 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 3.6%, and the overall average for that period was moderate, standing at 1.6%. Following a significant decline between 2008 and 2010, HICP inflation gradually increased over the period 2010-12 driven by a rebound in global commodity prices, together with hikes in administered prices and the value added tax rate. 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 second half of the decade the Czech economy has returned to a path of solid growth. This robust performance has been exerting appreciation pressures 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. 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 a sequence of hikes in Česká národní banka's interest rates. Inflation decelerated in the second half of 2018, as growth in energy prices was offset by the moderation in food prices. HICP inflation significantly increased in 2019, from 2% in January to 3.2% in December, mainly due to core inflation, although faster growth in administered prices and in food prices also played a role. Within core inflation, non-tradables prices continued to rise markedly, driven by a persistently strong domestic demand amid continued buoyant wage growth.

In the first quarter of 2020 the average annual rate of HICP inflation remained above the target at 3.7%. Government measures boosting household consumption, in a context of protracted buoyant economic activity, are behind the observed developments. At the same time, robust wage growth as a result of tight labour market conditions and significant skills shortages continued to be a source of inflationary pressure.

The national authorities have taken major fiscal, macroprudential and monetary policy measures to offset the economic damage wrought by the COVID-19 pandemic.

In order to support economic activity amid closures of several segments of services and industries, the Government adopted a number of measures, including interest-free credit lines and government guarantees to affected businesses, tax suspensions, and direct labour income support. Similarly, Česká národní banka reacted by cutting all key interest rates – by 0.5 percentage points on 16 March, by 0.75 percentage points on 26 March, and by a further 0.75 percentage points in May 2020 – while also lowering the countercyclical capital buffer rate.

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; since then, it has been followed by a sequence of hikes in Česká národní banka's interest rates (two in 2017, five in 2018, one in 2019 and one further increase in February 2020), although reversed in March 2020 as a result of the coronavirus outbreak.

Inflation in the Czech Republic is expected to decelerate significantly over the forecast horizon, falling to below 2%. However, in the current exceptional circumstances, the forecasts are subject to an unusual level of uncertainty.

According to the European Commission's Spring 2020 Economic Forecast, following a 2.6% increase in 2019, the average annual rate of HICP inflation will decelerate to 2.3% in 2020 and further to 1.9% in 2021. Given the COVID-19 outbreak, considerable uncertainty surrounds the balance between downward pressures on inflation (linked to weaker demand) and upward pressures related to supply disruptions (in particular on food prices, which have a significant weight in the HICP basket). In 2020 deflationary pressures are also supported by the sharp decline in oil prices. The risks to the inflation outlook are broadly balanced. Upside risks mainly relate to a faster than expected recovery from the economic downturn brought about by the COVID-19 pandemic, while a more protracted economic downturn constitutes a significant downside risk for the inflation outlook. 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 the 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 Research and Development (R&D) and innovation. Moreover, the skill mismatch needs to be addressed by improving vocational education and training, and by further 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 2020.

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 the short term, the priority for national authorities is to safeguard financial stability in view of the COVID-19 outbreak. However, the risk of a continued spiral between housing prices and property purchase loans poses a challenge in the medium term. Despite being still rather contained, housing vulnerabilities in the residential real estate sector represent a source of systemic risk to financial stability, with potentially serious negative consequences for the real economy. In December 2015 Česká národní banka set a countercyclical capital buffer rate for domestic exposures of 0.5% for the first time. Up to early 2020, the domestic economy 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, to 1.25% with effect from 1 January 2019, to 1.5% with effect from 1 July 2019 and to 1.75% with effect from 1 January 2020. Shortly after the outbreak of the COVID-19 pandemic, the countercyclical capital buffer rate was lowered to 1% with effect from 1 April 2020. 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 general government budget balance and debt complied with the Maastricht criteria in 2019. In the reference year 2019 the general government budget balance recorded a surplus of 0.3% of GDP, thus comfortably meeting the 3% deficit reference value. The general government gross debt-to-GDP ratio was 30.8%, i.e. well below the 60% reference value (see Table 5.2.2). Compared with the previous year the government balance-to-GDP ratio declined by 0.7 percentage points, while the debt-to-GDP ratio decreased by 1.8 percentage points.

With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2019.

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 in 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 in June 2014. In the subsequent period to 2019, the Czech Republic comfortably met its medium-term objective of a structural deficit of no more than 1% of GDP.

The reduction in 2018-19 in the government surplus was driven mostly by structural factors. Following a significant reduction in the nominal deficit after the global financial crisis, the government balance peaked at a surplus of 1.5% of GDP in 2017, which decreased to 0.3% in 2019. This surplus reduction was mainly driven by a deterioration in the structural balance by 1.4 percentage points of GDP over the period 2018-19. The wage and social expenditure increases that were legislated for 2018 and 2019 were not fully offset by buoyant tax receipts.

The debt-to-GDP ratio followed a declining path in the period 2014-19, remaining well below the 60% reference value. The debt ratio decreased by 14.1 percentage points from its peak value of 44.9% of GDP in 2013, to 30.8% of GDP in 2019. The reduction was mostly driven by primary surpluses and favourable interest-growth differentials. More recently (in the period 2017-19), unfavourable deficit-debt adjustments (stemming from the accumulation of deposit reserves) slowed the reduction of the debt ratio.

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 (1.2% in 2019 – 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 (11.4% in 2019); it is mostly denominated in euro (97% of foreign-denominated debt). Considering also the size of the debt ratio, fiscal balances are relatively insensitive to changes in exchange rates. The share of debt denominated in foreign currencies has been on a decreasing path and stands well below the 2010-14 average (21.8%), pointing to a decline in exchange-rate related vulnerabilities.

As a consequence of the COVID-19 pandemic, the European Commission's Spring 2020 Economic Forecast foresees a significant deterioration in the budget balance and a significant increase in the debt ratio. According to the European Commission's forecast, the headline balance is projected to be a deficit of 6.7% of GDP in 2020 and of 4.0% in 2021. The sharp deterioration in the government balance results from the marked deterioration in economic activity and the fiscal measures implemented to mitigate the crisis. Over 2020-21, the structural deficit is

projected to stand above the medium-term objective.¹⁵⁹ Nevertheless, in the context of the COVID-19 pandemic, the Stability and Growth Pact's general escape clause provides that "in periods of severe economic downturn for the euro area or the Union as a whole, Member States may be allowed temporarily to depart from the adjustment path towards the medium-term budgetary objective..., provided that this does not endanger fiscal sustainability in the medium term".¹⁶⁰ Regarding the debt ratio, the European Commission forecasts a significant increase by around 7.9 percentage points in 2020, followed by a smaller increase in 2021, to reach 39.9% of GDP, i.e. around 5 percentage points below the peak reached in 2013.

The Czech Republic's new fiscal governance framework is applied effectively but further progress remains warranted. The national legislation implementing the EU Directive on requirements for budgetary frameworks was adopted in 2017. Since then, the Fiscal Council has become operational and issued reports on long-term sustainability and on compliance with the budgetary rules. Nevertheless, coordination among the various levels of general government remains low and should be further enhanced. Regarding tax compliance, tax collection has benefited from the implementation of several measures, in particular the electronic registration of sales. Policies aimed at improving tax collection should be continued.

The European Commission's 2019 Debt Sustainability Monitor, which was released prior to the COVID-19 pandemic, suggested that the Czech Republic faced medium risk over the long term, mostly on account of projected adverse demographic developments. The European Commission's 2019 Debt Sustainability Monitor foresaw low risks over the short and medium term, mostly owing to the favourable initial budgetary position and the relatively low public debt level.¹⁶¹ Over the long term, sustainability risks were seen at a medium level,¹⁶² because of the significant increase in age-related costs. Indeed, according to the 2018 Ageing Report prepared by the Ageing Working Group (AWG) of the EU's Economic Policy Committee,¹⁶³ the Czech Republic would record a significant rise in age-related expenditure (6.2 percentage points of GDP by 2070), in the AWG's reference scenario, from a level of 18.2% of GDP in 2016. In the AWG's risk scenario, the increase was projected to be 7.8 percentage points of GDP, which was significantly above the EU average. All these factors suggested that reforms of the pension, health and long-term care systems were necessary to improve the long-term sustainability of public finances.

Looking ahead and leaving aside the policy measures to address the COVID-19 pandemic, a prudent fiscal policy as well as further structural reforms are

¹⁵⁹ As of January 2020 Czech Republic's medium-term objective changed from a structural deficit of 1% of GDP to a structural deficit of 0.75% of GDP.

¹⁶⁰ For more details, see Box 2 in the Framework for analysis.

¹⁶¹ As explained in the Framework for analysis, the potential implications of the COVID-19 pandemic for the medium to long-term sustainability of budgetary positions beyond its impact on the latest forecasts are not covered because of the high levels of uncertainty.

¹⁶² 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.

¹⁶³ European Commission and Economic Policy Committee, "The 2018 Ageing Report: Economic & Budgetary Projections for the 28 EU Member States (2016-2070)", *European Economy Institutional Paper*, No 079, European Commission, 2018.

needed to safeguard the sustainability of public finances. A consistent and prudent fiscal policy will ensure that Czech Republic continues to comply with the Stability and Growth Pact and maintains buffers to alleviate adverse shocks. Over the longer term, to reduce the weight of mandatory expenditure, comprehensive and determined structural reforms are needed, focusing on the pension and healthcare systems. Moreover, there is scope for an improvement of taxation, in particular by reducing the labour tax wedge for lower-wage earners.

5.2.3 Exchange rate developments

In the two-year reference period from 1 April 2018 to 31 March 2020, the Czech koruna did not participate in ERM II, but traded under a flexible exchange rate regime (see Chart 5.2.3). Over the reference period the Czech currency mostly traded weaker than its April 2018 average exchange rate against the euro of 25.365 korunas per euro, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate. On 31 March 2020 the exchange rate stood at 27.312 korunas per euro, i.e. 7.7% weaker than its average level in April 2018. During the reference period the maximum upward deviation from this benchmark was 2.3%, while the maximum downward deviation amounted to 9.6%. Over the past ten years the exchange rate of the Czech koruna against the euro has depreciated by 7.9%.

The Czech koruna exhibited a relatively high degree of volatility against the euro over the two-year reference period. Following the discontinuation of the exchange rate floor in 2017, between April 2018 and July 2018 the exchange rate depreciated, after which it fluctuated within a relatively narrow range until September 2019. Thereafter, the currency strengthened until mid-February 2020, when it started to depreciate significantly amid heightened volatility in global financial markets due to the intensification of the coronavirus (COVID-19) crisis. Over the reference period short-term interest rate differentials against the three-month EURIBOR were relatively large, widening from mid-2018 onwards.

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 to appreciate again. 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 combined current and capital account balance 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 2010-14, the current and capital account turned into a surplus, mainly as a result of improvements in the goods and services balance on account of strengthening exports, which however narrowed to 0.6% of GDP in 2018 and turned slightly negative in 2019. On the financing side, the Czech Republic continued to be a recipient of net inflows of direct investment in 2018 and 2019, which was however more than offset by net outflows of other investment

together with an increase in reserve assets. Against this background, the country's gross external debt, which had increased from 68.5% of GDP in 2015 to 89.1% of GDP in 2017, decreased to 82.7% of GDP in 2018 and further to 78.3% in 2019, while its net international investment position improved from -25.8% of GDP in 2017 to -24.7% of GDP in 2018 and -20.9% in 2019.

The Czech economy is well integrated with the euro area through trade and investment linkages. In 2019 exports of goods and services to the euro area constituted 61.9% of total exports, while the corresponding figure for imports was 51.7%. In 2019 the share of the euro area in the Czech Republic's stock of inward direct investment stood at 80.4%, and its share in the country's stock of portfolio investment liabilities was 68.4%. The share of the Czech Republic's stock of foreign assets invested in the euro area amounted to 74.3% in the case of direct investment and 69.2% for portfolio investment in 2019.

5.2.4 Long-term interest rate developments

Over the reference period from April 2019 to March 2020, long-term interest rates in the Czech Republic stood at 1.5% on average and thus remained below the 2.9% reference value for the interest rate convergence criterion (see Chart 5.2.5).

Long-term interest rates in the Czech Republic decreased from above 4% at the start of 2010 to 1.3% at the end of the reference period. From 2010 the long-term interest rates in the Czech Republic declined almost continuously until 2015. The only exception was a period of stability between 2011 and 2012, when downward pressures on the interest rates owing to domestic factors were offset by higher risk premia originating in the euro area sovereign debt crisis, as indicated by the sharp increase in credit default spreads in those years. Between 2012 and 2015 long-term interest rates in the Czech Republic continued to decline, also because Česká národní banka maintained a highly accommodative monetary policy, as the economic recovery that started in 2013 did not push up inflation until 2017. In 2018 long-term interest rates increased, reflecting global developments and an acceleration of economic growth combined with an expected rise in inflation, mainly related to overheating in the domestic labour market. At the start of 2019 long-term interest rates started to decline owing to signs of weakness in the global economic outlook, higher risk aversion related to the US-China trade dispute and a possible disorderly Brexit process. From mid-2017 to early 2020 Česká národní banka tightened its monetary policy stance and raised its main policy rate from 0.25% in August 2017 to 2.25% in February 2020. However, in the light of the disinflationary impact of the coronavirus (COVID-19) pandemic, which contributed to a 20 basis point drop in the long-term interest rate in March 2020, Česká národní banka cut its interest rates twice in March and once in May 2020, cumulatively by 2.0 percentage points. In recent months credit default swap spreads for Czech government debt have fluctuated within a range of 50 to 70 basis points. The Czech Republic's government debt is rated investment grade by all three main rating agencies (Moody's: Aa3; S&P: AA-; Fitch: AA-).

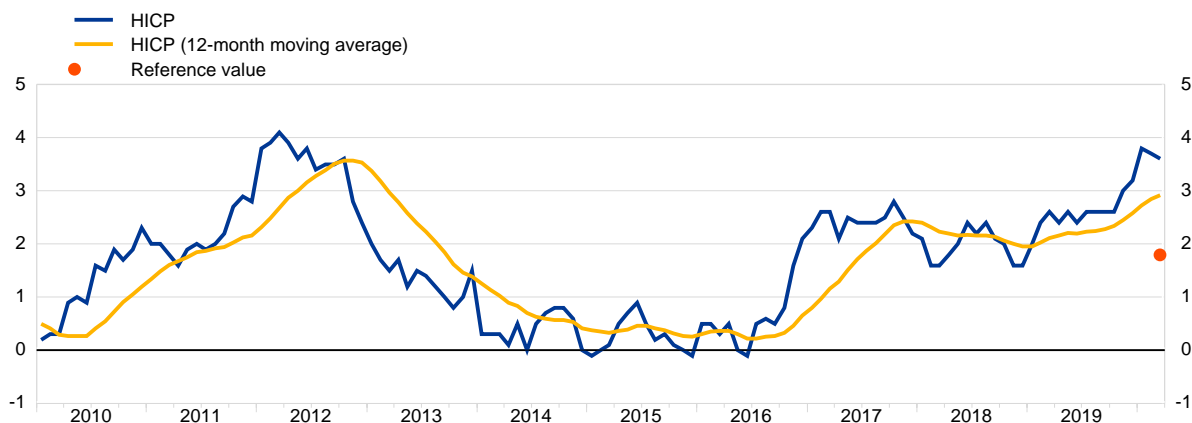
The Czech Republic's long-term interest rate differential vis-à-vis the euro area average turned positive at the end of 2017 for the first time since 2011 and has gradually increased further until March 2020, when it narrowed significantly.

Over the past ten years the dynamics of the Czech long-term interest rate differential vis-à-vis the average euro area long-term interest rate can be divided into two distinct phases. In the first phase during the euro area sovereign debt crisis that started in 2010, long-term interest rates in the Czech Republic declined more rapidly than euro area average rates, and the differential bottomed out at -1.5 percentage points in August 2012. The decline in risk premia on euro area sovereign debt that occurred later in 2012 and contributed to driving down euro area yields was the impulse for the second phase, which consisted of a gradual increase in the long-term interest rate differential up to the end of 2017. After stabilising in 2018 the long-term interest rate differential increased further, reflecting the opening of an inflation differential in favour of the Czech Republic. In March 2020 the interest rate differential dropped from its February 2020 value at 1.1 percentage points (1.8 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 10.5% at the end of 2019. Outstanding debt securities issued by non-financial institutions (a measure of market-based indebtedness) have stabilised around post-2015 yearly averages at 6.6% of GDP in 2019. In the same vein, debt securities issued by financial institutions have continuously declined since 2016, to stand at around 9.5% of GDP in 2019. Financial intermediation, as measured by MFI credit to non-government residents, stood at 55.5% of GDP in 2019, which is still only slightly more than half of the euro area average. However, in recent years the ability of the Czech Republic's banking sector to obtain funding from the euro area banks stabilised at high levels, as claims of euro area MFIs on resident MFIs reached 25% of the total liabilities of domestic MFIs in 2019. 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 2019 to March 2020 is the unweighted arithmetic average of the annual percentage changes in the HICP for Portugal, Cyprus and Italy plus 1.5 percentage points. The reference value is 1.8%.

Table 5.2.1 Measures of inflation and related indicators
(annual percentage changes, unless otherwise indicated)

	2010-2019 ¹⁾	2010-2014 ¹⁾	2015-2019 ¹⁾	2015	2016	2017	2018	2019	2020 ²⁾	2021 ²⁾
Measures of inflation										
HICP	1.7	1.7	1.6	0.3	0.6	2.4	2.0	2.6	2.3	1.9
HICP excluding unprocessed food and energy	1.5	1.3	1.7	0.8	1.2	2.6	1.8	2.3	2.1	2.0
HICP at constant tax rates ³⁾	1.3	1.0	1.5	0.1	0.4	2.6	1.9	2.6	-	-
CPI	1.7	1.7	1.7	0.3	0.7	2.5	2.1	2.8	2.3	1.9
Private consumption deflator	1.4	1.2	1.6	0.1	0.5	2.4	2.3	3.0	2.0	1.6
GDP deflator	1.4	0.8	2.0	1.2	1.3	1.4	2.6	3.5	1.4	1.6
Producer prices ⁴⁾	0.9	1.8	0.0	-3.2	-3.3	1.8	2.0	2.6	-	-
Related indicators										
Real GDP growth	2.3	1.1	3.5	5.3	2.5	4.4	2.8	2.6	-6.2	5.0
GDP per capita in PPS ⁵⁾ (euro area = 100)	80.4	77.9	83.5	82.0	82.4	84.1	85.5	.	-	-
Comparative price levels (euro area = 100)	67.1	68.0	66.0	63.3	64.6	66.9	69.4	.	-	-
Output gap ⁶⁾	-0.2	-1.7	1.3	0.2	0.1	1.8	2.1	2.0	-5.2	-2.6
Unemployment rate (%) ⁷⁾	5.0	6.8	3.2	5.1	4.0	2.9	2.2	2.0	5.0	4.2
Unit labour costs, whole economy	2.1	0.9	3.3	-0.8	3.1	3.6	6.5	4.2	5.9	0.0
Compensation per employee, whole economy	3.8	2.0	5.5	3.0	4.0	6.4	8.0	6.2	2.5	4.2
Labour productivity, whole economy	1.6	1.1	2.2	3.8	0.8	2.8	1.5	1.9	-3.2	4.2
Imports of goods and services deflator	0.5	2.0	-1.0	-1.7	-3.4	0.4	-0.6	0.6	0.4	0.1
Nominal effective exchange rate ⁸⁾	0.1	-1.4	1.6	-2.3	2.8	3.6	4.6	-0.5	-	-
Money supply (M3) ⁹⁾	5.8	3.8	7.8	8.3	6.7	11.2	6.2	6.5	-	-
Lending from banks ¹⁰⁾	5.9	4.6	7.3	7.2	9.1	7.6	7.3	5.5	-	-
Stock prices (PX Index) ¹¹⁾	-0.1	-15.3	17.8	1.0	-3.6	17.0	-8.5	13.1	-	-
Residential property prices	3.9	-0.2	8.1	4.0	7.2	11.7	8.6	9.2	-	-

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 Refinitiv 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 2020 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).

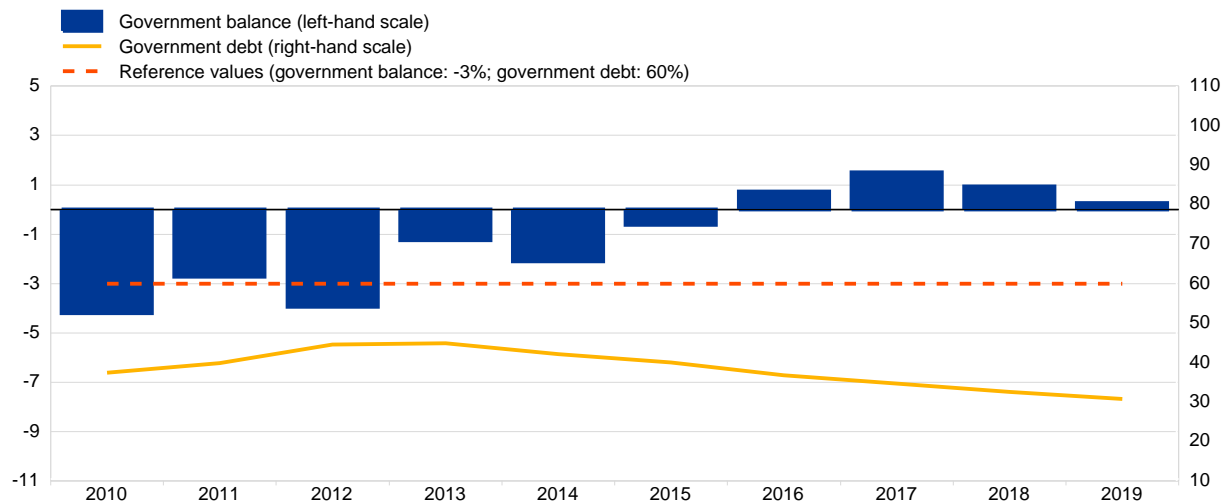
9) The series includes repurchase agreements with central counterparties.

10) 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.

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)

	2010-2019 ¹⁾	2010-2014 ¹⁾	2015-2019 ¹⁾	2015	2016	2017	2018	2019	2020 ²⁾	2021 ²⁾
Government balance	-1.1	-2.8	0.6	-0.6	0.7	1.5	0.9	0.3	-6.7	-4.0
Total revenue	40.9	40.4	41.4	41.1	40.7	41.0	42.2	42.1	41.9	41.7
Current revenue	39.8	39.2	40.4	39.1	40.1	40.3	41.3	41.3	41.0	40.8
Direct taxes	7.6	7.0	8.1	7.2	8.1	8.3	8.6	8.5	7.5	7.7
Indirect taxes	12.1	12.0	12.3	12.2	12.3	12.4	12.2	12.2	12.2	12.2
Net social contributions	14.9	14.7	15.1	14.4	14.7	15.0	15.7	15.8	16.2	16.1
Other current revenue ³⁾	5.2	5.4	4.9	5.2	4.9	4.6	4.9	4.7	5.1	4.8
Capital revenue	1.1	1.2	1.0	2.0	0.6	0.6	0.9	0.8	0.9	0.9
Total expenditure	42.0	43.2	40.9	41.7	40.0	39.5	41.2	41.9	48.5	45.7
Current expenditure	36.7	37.5	36.0	35.7	36.0	35.4	36.3	36.8	43.1	40.4
Compensation of employees	9.1	8.8	9.3	8.7	8.8	9.2	9.8	10.2	11.3	11.1
Social benefits	15.9	16.2	15.5	15.4	15.8	15.4	15.4	15.6	18.0	17.5
Interest payable	1.1	1.3	0.8	1.1	0.9	0.7	0.8	0.7	0.9	0.9
Other current expenditure ⁴⁾	10.7	11.0	10.4	10.5	10.5	10.1	10.4	10.3	12.8	10.9
Capital expenditure	5.3	5.8	4.8	6.0	4.0	4.1	4.9	5.1	5.5	5.3
of which: Investment	4.2	4.3	4.1	5.1	3.3	3.4	4.2	4.4	4.6	4.6
Cyclically adjusted balance	-1.0	-2.2	0.1	-0.7	0.7	0.8	0.1	-0.5	-4.6	-2.9
One-off and temporary measures	-0.2	-0.4	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	0.0
Structural balance ⁵⁾	-0.8	-1.7	0.1	-0.7	0.7	0.8	0.1	-0.5	-4.6	-2.9
Government debt	38.4	41.7	35.0	40.0	36.8	34.7	32.6	30.8	38.7	39.9
Average residual maturity (in years)	-	-	-	-	-	-	-	-	-	-
In foreign currencies (% of total)	17.9	21.8	14.1	16.7	15.7	14.6	12.0	11.4	-	-
of which: Euro	17.0	20.4	13.5	15.6	15.1	14.2	11.7	11.1	-	-
Domestic ownership (% of total)	64.2	69.4	59.0	63.1	55.2	54.6	60.4	61.6	-	-
Medium and long-term maturity (% of total) ⁶⁾	94.4	91.3	97.5	94.4	99.7	97.5	96.9	98.8	-	-
of which: Variable interest rate (% of total)	14.2	14.5	13.9	18.1	14.6	11.8	12.5	12.4	-	-
Deficit-debt adjustment	-0.1	-0.3	0.2	-0.2	-1.0	1.4	0.6	0.3	-	-
Net acquisitions of main financial assets	0.2	-0.1	0.5	-0.1	0.4	1.9	0.2	0.3	-	-
Currency and deposits	0.3	-0.2	0.8	0.1	0.6	2.3	0.4	0.4	-	-
Debt securities	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	-	-
Loans	0.0	0.2	-0.2	-0.1	-0.2	-0.3	-0.2	-0.1	-	-
Equity and investment fund shares or units	0.0	0.0	-0.1	-0.1	0.0	-0.1	0.0	0.0	-	-
Revaluation effects on debt	-0.1	-0.2	-0.1	-0.2	0.0	-0.2	0.1	0.0	-	-
of which: Foreign exchange holding gains/losses	0.0	0.1	-0.1	-0.1	0.0	-0.3	0.0	0.0	-	-
Other ⁷⁾	-0.2	-0.1	-0.2	0.1	-1.3	-0.2	0.3	0.0	-	-
Convergence programme: government balance	-	-	-	-	-	-	-	-	-5.1	-4.1
Convergence programme: structural balance	-	-	-	-	-	-	-	-	-	-
Convergence programme: government debt	-	-	-	-	-	-	-	-	37.0	40.0

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 2020 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.

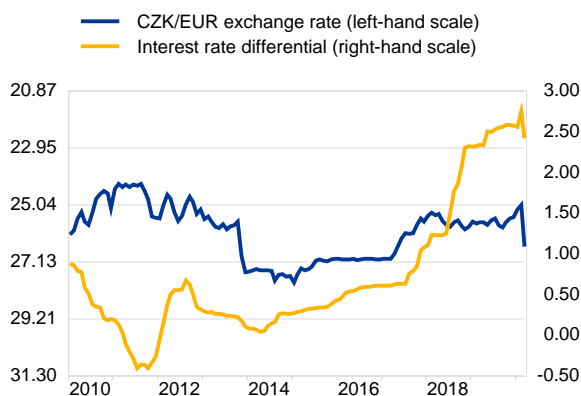
6) Original maturity of more than one year.

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

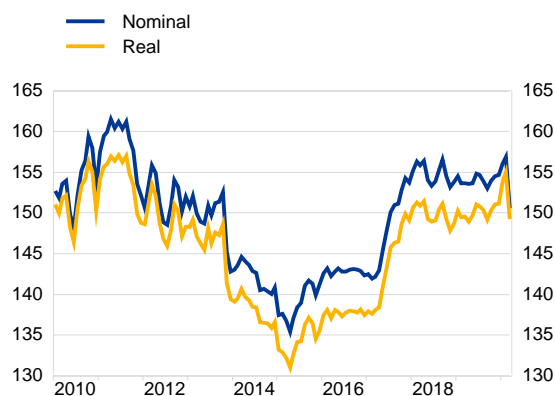
(CZK/EUR exchange rate: monthly averages; difference between three-month interbank interest rates and three-month EURIBOR: basis points, monthly values)



Sources: National data and ECB calculations.

Chart 5.2.4 Effective exchange rates ¹⁾

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



Source: ECB.

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

Table 5.2.3 External developments

(as a percentage of GDP, unless otherwise indicated)

	2010-2019 ¹⁾	2010-2014 ¹⁾	2015-2019 ¹⁾	2015	2016	2017	2018	2019	2020 ²⁾	2021 ²⁾
Balance of payments										
Current account and capital account balance ³⁾	0.6	-0.5	1.6	2.4	2.7	2.4	0.7	-0.1	-0.8	0.0
Current account balance	-0.4	-1.5	0.7	0.2	1.6	1.6	0.4	-0.4	-1.5	-1.0
Goods	3.7	3.0	4.5	4.1	5.2	5.1	3.8	4.2	.	.
Services	2.0	1.8	2.1	1.7	2.3	2.5	2.3	1.8	.	.
Primary income	-5.6	-6.0	-5.3	-5.6	-5.3	-5.1	-4.9	-5.7	.	.
Secondary income	-0.5	-0.4	-0.6	0.0	-0.6	-0.9	-0.8	-0.7	.	.
Capital account balance	1.0	1.1	0.9	2.2	1.1	0.8	0.3	0.3	.	.
Combined direct and portfolio investment balance ³⁾	-3.3	-2.7	-3.9	-2.5	-7.5	-6.0	-0.4	-3.2	.	.
Direct investment	-1.4	-1.6	-1.1	1.1	-3.9	-0.9	-1.0	-1.1	.	.
Portfolio investment	-1.9	-1.1	-2.8	-3.6	-3.6	-5.1	0.6	-2.1	.	.
Other investment balance	-1.3	0.7	-3.2	-1.3	-2.1	-15.5	0.9	1.8	.	.
Reserve assets	5.5	1.7	9.3	7.7	11.8	24.1	0.9	1.9	.	.
Exports of goods and services	76.7	74.6	78.7	80.8	79.4	79.9	78.1	75.5	.	.
Imports of goods and services	71.0	69.8	72.1	75.0	71.9	72.3	72.1	69.4	.	.
Net international investment position ⁴⁾	-34.5	-43.0	-26.1	-32.9	-26.9	-25.0	-24.8	-20.7	.	.
Gross external debt ⁴⁾	69.5	61.4	77.6	67.9	73.4	86.6	82.9	77.6	.	.
Trade with the euro area ⁵⁾										
Exports of goods and services	62.8	63.2	62.4	62.5	62.6	62.6	62.5	61.9	.	.
Imports of goods and services	52.1	51.8	52.3	52.2	53.2	52.5	52.1	51.7	.	.
Investment position with the euro area ⁵⁾										
Direct investment assets ⁴⁾	78.2	79.0	77.3	80.6	77.7	80.4	73.7	74.3	.	.
Direct investment liabilities ⁴⁾	81.0	81.1	80.9	81.6	81.0	80.8	80.5	80.4	.	.
Portfolio investment assets ⁴⁾	72.7	75.2	70.1	72.7	69.4	70.2	69.2	69.2	.	.
Portfolio investment liabilities ⁴⁾	56.9	54.0	59.9	51.9	54.0	61.3	63.8	68.4	.	.

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 2020 Economic Forecast.

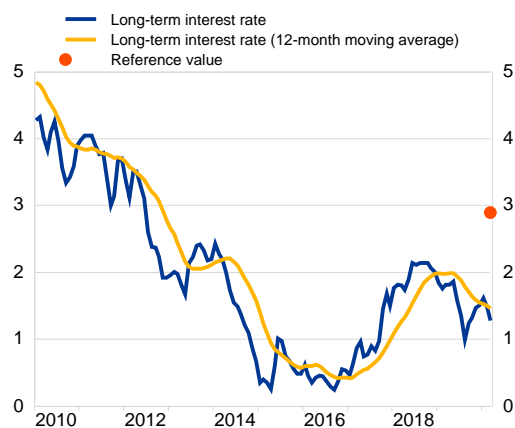
3) Differences between totals and the sum of their components are due to rounding.

4) End-of-period outstanding amounts.

5) As a percentage of the total.

Czech Republic - Long-term interest rate developments

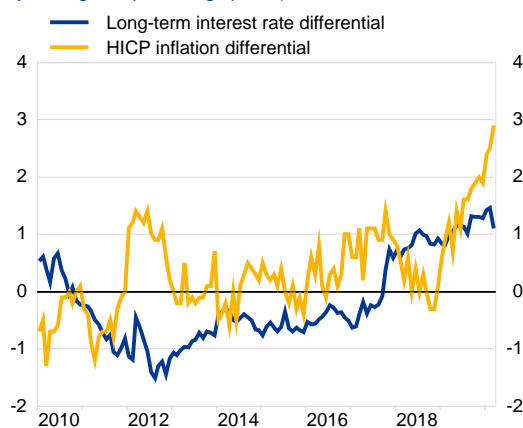
Chart 5.2.5 Long-term interest rate ¹⁾
(monthly averages in percentages)



Sources: European System of Central Banks and ECB calculations.

1) The basis of the calculation of the reference value for the period from April 2019 to March 2020 is the unweighted arithmetic average of the interest rate levels in Portugal, Cyprus and Italy plus 2 percentage points. The reference value is 2.9%.

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)

	2010-2019 ¹⁾	2010-2014 ¹⁾	2015-2019 ¹⁾	2016	2017	2018	2019	Apr. 2019 to Mar. 2020	Memo item: euro area 2019
Long-term interest rates									
Czech Republic ²⁾	2.0	2.8	1.1	0.4	1.0	2.0	1.5	1.5	-
Euro area ^{2), 3)}	2.2	3.4	0.9	0.9	1.1	1.1	0.4	0.2	-
Euro area AAA par curve, ten-year residual maturity ^{2), 3)}	1.3	2.3	0.3	0.2	0.4	0.5	-0.2	-0.3	-
Indicators of financial development and integration									
Debt securities issued by financial corporations ⁴⁾	12.0	11.9	12.2	13.1	12.5	11.5	9.5	-	66.7
Debt securities issued by non-financial corporations ⁵⁾	6.7	6.3	7.0	7.3	6.7	6.9	6.6	-	11.8
Stock market capitalisation ⁶⁾	14.8	17.3	12.4	12.6	13.6	11.4	10.5	-	67.7
MFI credit to non-government residents ⁷⁾	53.6	52.2	55.1	55.3	55.4	56.1	55.5	-	107.4
Claims of euro area MFIs on resident MFIs ⁸⁾	13.9	6.7	21.2	16.8	25.3	26.0	25.0	-	26.1

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 (excluding the national central bank) 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 market values.

7) MFI (excluding national central bank) credit to domestic non-MFI residents other than general government. Credit comprises 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 2020 the 12-month average rate of HICP inflation in Croatia was 0.9%, i.e. well below the reference value of 1.8% for the criterion on price stability (see Chart 5.3.1). In the light of the coronavirus (COVID-19) pandemic, there is a high level of uncertainty as to how this rate is going to evolve 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 4.0%, and the average for that period was subdued, standing at 1.2%. Average inflation was rising between 2010 and 2013, owing to increases in energy and food prices, 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, mainly driven by food price developments and a recovery in domestic demand (see Table 5.3.1). Headline inflation further increased in 2018 as growth in energy prices accelerated largely, while wage growth picked up against the tightening of the labour markets and public sector wage increases. Accordingly, growth in unit labour costs turned positive in 2018 after having declined for four years, although it has remained moderate. The unemployment rate, which rose sharply during the recession, has been decreasing since 2013 and has reached record lows. In 2019, inflation declined to 0.8% compared to 1.6% in 2018, owing to a significant reduction in the value added tax (VAT) rate on selected unprocessed foods and moderate energy price inflation.

In the first quarter of 2020 the average annual rate of HICP inflation stood at 1.2%. This inflation rate mainly reflected the contributions of services and food prices, including the base effect from the VAT cut in 2019, while energy and non-energy industrial goods price inflation remained low.

The national authorities have taken major fiscal and monetary policy measures to offset the economic damage wrought by the COVID-19 pandemic. The governmental measures include minimum wage payment schemes, tax rebates or deferrals, interest subsidies, and credit lines through the Croatian Bank for Reconstruction and Development (HBOR). Moreover, Hrvatska narodna banka started to purchase government securities in the secondary market for the first time.

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 the economic downturn, Hrvatska narodna banka abolished, reversed or loosened several of the administrative and prudential measures it had adopted previously in order to curb the growing financial and macroeconomic imbalances. In addition, in 2017, the Government introduced a number of growth-enhancing credit schemes. Nevertheless, domestic credit growth to the private sector recovered only

gradually and was primarily fuelled by general-purpose cash loans to households. With the aim of fostering the use of the kuna in the banking system, in 2016 Hrvatska narodna banka introduced a long-term structural repo operation allowing banks to increase lending in local currency at more favourable financing conditions. In March 2020 the first auction was held since December 2018 with a view to supporting economic growth amid increased external uncertainty and the coronavirus outbreak. With this aim in mind, Hrvatska narodna banka also provided liquidity through regular weekly operations.

Inflation is expected to remain at low levels in the coming years. However, in the current exceptional circumstances, the forecasts are subject to an unusual level of uncertainty. Over the longer term there are concerns regarding the sustainability of inflation convergence in Croatia.

According to the European Commission's Spring 2020 Economic Forecast, the average annual rate of HICP inflation will decrease to 0.4% in 2020, before picking up somewhat to 0.9% in 2021. Given the COVID-19 outbreak, considerable uncertainty surrounds the balance between downward pressures on inflation (linked to weaker demand) and upward pressures related to supply disruptions (in particular on food prices, which have a significant weight in the HICP basket). In 2020 deflationary pressures are also supported by the sharp decline in oil prices. The risks to the inflation outlook are broadly balanced. In addition to the uncertainty about the global economy and commodity prices, upside risks mainly relate to a faster than expected recovery from the economic downturn brought about by the COVID-19 pandemic, while a more protracted economic downturn constitutes a significant downside risk for the inflation outlook. 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 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 competitiveness of the economy. Priority should be given to improving the quality of the institutional and business environment, including enhancing competition in product markets. In addition, it is essential to improve the effectiveness of the public administration and the judicial system. Overall, policies should be geared to support innovation and investment in new technologies, also in view to reduce the country's high dependence on tourism. Modernising the country's infrastructure (in particular its rail network) would boost potential output and support a more efficient allocation of resources. Against this background, it will be of utmost importance to ensure an efficient 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, push up the low participation rate and align the education system with the needs of the market. 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 2020 and concluded that Croatia 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. As of end-2019, the Croatian banking sector showed a sound capital position and sufficient liquidity. Banking system profitability remained relatively high in recent years and the non-performing loan ratio, although still elevated, has been declining. The private sector debt-to-GDP ratio has been falling, but remains high. The ongoing legal actions pertaining to the loans denominated in, or linked to, Swiss francs, including those that have already matured, highlight the need for a more predictable legal system. On 27 May 2019, Croatia sent a request for establishing close cooperation between Hrvatska narodna banka and the European Central Bank. The ECB will take a decision on close cooperation based on the comprehensive assessment of five Croatian banks and the legal assessment. 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.

5.3.2 Fiscal developments

Croatia's general government budget balance complied with the Maastricht criterion in 2019, while debt was above the reference value. In the reference year 2019 the general government budget balance recorded a small surplus of 0.4% of GDP, thus comfortably meeting the 3% deficit reference value. The general government gross debt-to-GDP ratio was 73.2%, above the 60% reference value (see Table 5.3.2), but was declining in line with the debt reduction benchmark. Compared with the previous year, the government surplus increased slightly, by 0.2 percentage points of GDP, while the debt ratio decreased by 1.5 percentage points of GDP. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2019.

Croatia has been subject to the preventive arm of the Stability and Growth Pact since 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 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 the subsequent period to 2019, the deficit criterion was comfortably met and Croatia was compliant with the provisions of the preventive arm of the Stability and Growth Pact.

Both structural and cyclical factors drove the reduction of the deficit ratio in the period from 2015 to 2019. The nominal budget deficit improved markedly from an average of 6.1% of GDP in the period 2010-14 to an average of 0.6% in 2015-19. This was driven by a large structural adjustment, with the average structural deficit shrinking from 4.9% of GDP to 1.1% of GDP between these two periods. The easing of the macroeconomic conditions also contributed significantly to the improvement in the nominal budget balance.

The debt-to-GDP ratio, currently above the 60% reference value, followed a downward path from 2015 to 2019. The debt ratio increased rapidly and continuously from 48.7% of GDP in 2009 to a peak of 84.7% of GDP in 2014. From 2015 to 2019 it followed a downward path, mostly reflecting primary surpluses, as well as some favourable deficit-debt adjustments (stemming from the use of existing resources). From 2017 the favourable interest rate-growth differential also contributed to the debt ratio reduction. Regarding the other government liabilities, the stock of trade credits and advances, especially in the healthcare system, has increased.

While Croatia is protected, to some extent, from interest rate shocks, its fiscal balances would be sensitive to potential exchange rate movements. The share of government debt with a short-term maturity is low (4.6% in 2019 – see Table 5.3.2). Taking into account the fact that the medium and long-term debt is based entirely on fixed rates, fiscal balances are relatively insensitive to interest rate changes. However, a high share of public debt is denominated in foreign currency (71.6% in 2019), mainly euro (99.7% of foreign-denominated debt). Taking the ratio of government debt to GDP into account, this implies that fiscal balances are highly sensitive to exchange rate changes. However, the high sensitivity of fiscal balances to euro/kuna exchange rate changes is mitigated by the tightly managed float operated by Hrvatska narodna banka (designed to reduce exchange rate volatility against the euro). In addition, the proportion of government debt issued in kuna has increased, see Table 5.3.2.

As a consequence of the COVID-19 pandemic, the European Commission's Spring 2020 Economic Forecast foresees a notable deterioration in the budget balance and a marked increase in the debt ratio. According to the European Commission's latest forecast, the headline balance is projected to temporarily deteriorate and to reach a deficit of 7.1% of GDP in 2020. The sharp deterioration in the government balance results from the marked deterioration in economic activity and the fiscal measures implemented to mitigate the crisis. The nominal deficit is expected to return to below the 3% reference value in 2021. Over 2020-21, the structural deficit is projected to stand above the medium-term objective of 1% of GDP.¹⁶⁴ Nevertheless, in the context of the COVID-19 pandemic, the general escape clause provides that “in periods of severe economic downturn for the euro area or the Union as a whole, Member States may be allowed temporarily to depart from the adjustment path towards the medium-term budgetary objective..., provided that this does not endanger fiscal sustainability in the medium term”.¹⁶⁵ Regarding the debt ratio, the European Commission forecasts a marked increase by around 15

¹⁶⁴ In January 2020 Croatia's medium-term objective changed from a structural deficit of 1.75% of GDP to a structural deficit of 1% of GDP.

¹⁶⁵ For more details, see Box 2 in the Framework for analysis.

percentage points of GDP in 2020, followed by a notable reduction in 2021, to reach 83.4% of GDP, i.e. close to the peak value of 2014. Croatia's medium-term fiscal policy strategy, as presented in the 2020 update of the convergence programme, forecasts a path for both the nominal and the structural deficit which is very close to that contained in the European Commission's Spring 2020 Economic Forecast..

Croatia has improved its fiscal framework, but further progress remains

warranted. In December 2018 the Croatian Parliament adopted the Fiscal Responsibility Act to reinforce the Fiscal Policy Commission (in terms of its mandate and organisation) and the numerical fiscal rules. The new framework is aligned with the EU fiscal rules. However, the Commission is not yet fully functional. Short and medium-term budget planning, at central and local government level, is expected to be improved by the adoption of the new Budget Act.

The European Commission's 2019 Debt Sustainability Monitor, which was released prior to the COVID-19 pandemic, suggested that Croatia faced a low debt sustainability risk, but that the adequacy of the pension system needed to be ensured.

The 2019 Debt Sustainability Monitor foresaw low medium-term fiscal risks because of the favourable initial fiscal position.¹⁶⁶ Over the long term, Croatia also appeared to be at low risk,¹⁶⁷ mostly because of the projected decrease in age-related spending, in particular old age pension spending. Indeed, according to the 2018 Ageing Report prepared by the Ageing Working Group (AWG) of the EU's Economic Policy Committee,¹⁶⁸ Croatia was likely to experience a decline in age-related public expenditure by 3.4 percentage points of GDP by 2070 in the AWG's reference scenario, from a level of 20.7% of GDP in 2016, and by 1.8 percentage points of GDP in the AWG's risk scenario.¹⁶⁹ This was mainly due to significant savings in gross pensions, which were projected to fall from 10.6% of GDP to 6.8% in the period 2016-70, owing to a very strong decline in the benefit ratio¹⁷⁰. A recent reform of the pension system could have mitigated the drop of the benefit ratio by increasing the retirement age and penalising early retirement. Yet the key elements of this reform were repealed. Inadequacy of the pension system could trigger social payments to support the elderly population and therefore weighs on long-term fiscal sustainability.

¹⁶⁶ As explained in the Framework for analysis, the potential implications of the COVID-19 pandemic for the medium to long-term sustainability of budgetary positions beyond its impact on the latest forecasts are not covered because of the high levels of uncertainty.

¹⁶⁷ 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.

¹⁶⁸ European Commission and Economic Policy Committee, "The 2018 Ageing Report: Economic & Budgetary Projections for the 28 EU Member States (2016-2070)", *European Economy Institutional Paper*, No 079, European Commission, 2018.

¹⁶⁹ In 2019 the European Commission and the Economic Policy Committee updated the ageing costs projected for Croatia to take into account the impact of the end-2018 pension reform, which was then reversed at the end of 2019. According to this update, pension spending would have declined by 2.4 percentage points of GDP by 2070, compared with a drop of 3.8 percentage points of GDP in the 2018 Ageing Report. Considering that the key provisions of the reform have been reversed, the 2018 Ageing Report projections appear more accurate than the 2019 update. Nevertheless, because of its cut-off date (7 November 2019), the 2019 Debt Sustainability Monitor relied on the updated projections for ageing costs.

¹⁷⁰ Average pensions in relation to average wages.

Looking ahead and leaving aside the policy measures to address the COVID-19 pandemic, a prudent and credible fiscal policy as well as further structural reforms are needed for public finances to ensure a downward debt path.

A consistent and prudent fiscal policy will ensure that Croatia continues to comply with the Stability and Growth Pact and maintains buffers to alleviate adverse shocks. A fiscal policy aimed at enhancing the efficiency of public spending – especially with respect to the public administration – should also create space for more growth-supportive policies. Also, in order to ensure a downward debt path, the fiscal responsibility legislation should be enforced. Continued efforts to improve the governance framework of state-owned enterprises are warranted to further reduce the Government's contingent liabilities.

5.3.3 Exchange rate developments

In the two-year reference period from 1 April 2018 to 31 March 2020, 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 April 2018 average exchange rate against the euro of 7.4209 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 31 March 2020 the exchange rate stood at 7.6255 kuna per euro, i.e. 2.8% weaker than its average level in April 2018. Over the reference period the maximum upward deviation from this benchmark was 0.6%, while the maximum downward deviation amounted to 2.8%. Over the past ten years the exchange rate of the Croatian kuna against the euro has depreciated by 5.0%. On 4 July 2019 the Croatian authorities expressed their intention to seek inclusion of the Croatian kuna in ERM II and announced an action plan detailing the reforms the country intends to implement before participating in ERM II. On 8 July 2019 the finance ministers of the euro area countries and Denmark, the ECB, and the representative of the Governor of Denmark's Nationalbank welcomed the intention of the Croatian authorities to put in place the necessary elements for successful participation in ERM II. Croatia made a number of commitments in policy areas which are of high relevance for a smooth transition to, and participation in, ERM II. In addition to banking supervision, these commitments relate to the country's macroprudential framework, its anti-money-laundering framework, the collection, production and dissemination of statistics, public sector governance and reducing the financial and administrative burden. The ECB and the European Commission are monitoring the effective implementation of these commitments, acting within their respective areas of competence as provided for by the Treaties and secondary legislation.

The exchange rate of the Croatian kuna against the euro exhibited, on average, a very 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 six foreign exchange interventions by selling domestic currency for euro, and also intervened five times in foreign exchange markets by selling euro in support of the kuna. The purpose was to alleviate

appreciation pressures caused by favourable tourist seasons and improved macroeconomic performance and to counter heightened volatility following the intensification of the coronavirus (COVID-19) crisis. 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 combined current and capital account balance has improved over the past ten years and the country's net foreign liabilities have declined, but remain very high (see Table 5.3.3). The combined current and capital account balance has remained in surplus since 2014, reaching 3.3% of GDP in 2018 and 4.5% of GDP in 2019. These developments primarily reflected buoyant tourism receipts, which more than offset the rising goods trade deficit. Gross external debt peaked at 113.5% of GDP in 2014, but steadily declined thereafter, to 76.0% of GDP in 2019. At the same time the country's net international investment position, which had deteriorated substantially to -95.4% of GDP in 2010, improved to reach -51.0% in 2019. 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 2019 exports of goods and services to the euro area constituted 55.1% of total exports, while the corresponding figure for imports was higher, at 58.5%. In 2019 the share of the euro area in Croatia's stock of inward direct investment stood at 68.8% and its share in the country's stock of portfolio investment liabilities was 53.0%. The share of Croatia's stock of foreign portfolio investment assets invested in the euro area amounted to 42.2% in 2019.

5.3.4 Long-term interest rate developments

Over the reference period from April 2019 to March 2020, long-term interest rates in Croatia stood at 0.9% on average and thus remained well below the 2.9% reference value for the interest rate convergence criterion (see Chart 5.3.5).

Long-term interest rates in Croatia stood at 1.0% at the end of the reference period, after having declined continuously since 2010, when they averaged slightly less than 7.0%. Over the past ten years the declining trend in long-term interest rates in Croatia was interrupted by just three spells of sizeable increases. The first episode occurred in the second half of 2011 and was due to the uncertainty over the impact of both the euro area sovereign debt crisis and the expected slowdown in the global economic recovery on Croatia. At that time, credit default swap spreads on Croatian long-term debt doubled in a few months, confirming the higher risk perceived

by investors, which lasted until early 2012. The other two episodes of increasing interest rates occurred in 2013 and mid-2015. In contrast to the rise in 2011, in both episodes, domestic factors played a major role in driving up long-term interest rates. In 2013 the increase in the long-term interest rate was accompanied by the downgrading of Croatian sovereign debt to below investment grade and by rising credit default swap spreads. In 2015 the upward movements in the risk premia on Croatian long-term bond yields were driven by the slowdown in the economy and the perceived political uncertainty, as well as the expected cost increase for banks following the conversion of loans denominated in Swiss francs into euro. Since 2015 long-term interest rates in Croatia have been falling steadily, declining at a higher pace in 2019 and reaching 1.0% in March 2020, which is 40 basis points higher than in February 2020. The trend decline in long-term interest rates since the end of the last review period in May 2018 is attributable to a combination of domestic factors – such as accommodative monetary policy, lower fiscal risks and an improving economic outlook – and the downward pressures arising from global developments in interest rates. Since March 2020 Hrvatska Narodna Banka has initiated a government bond purchase programme to dampen the high volatility in the market for government securities induced by the COVID-19 pandemic-. At the start of 2020 credit default swap spreads, which are a measure of investors' perceptions of Croatian sovereign risk, declined significantly and stood at around 80 basis points in March 2020. In the first half of 2019 two of the three main international rating agencies upgraded the country's rating to investment grade for the first time in several years.

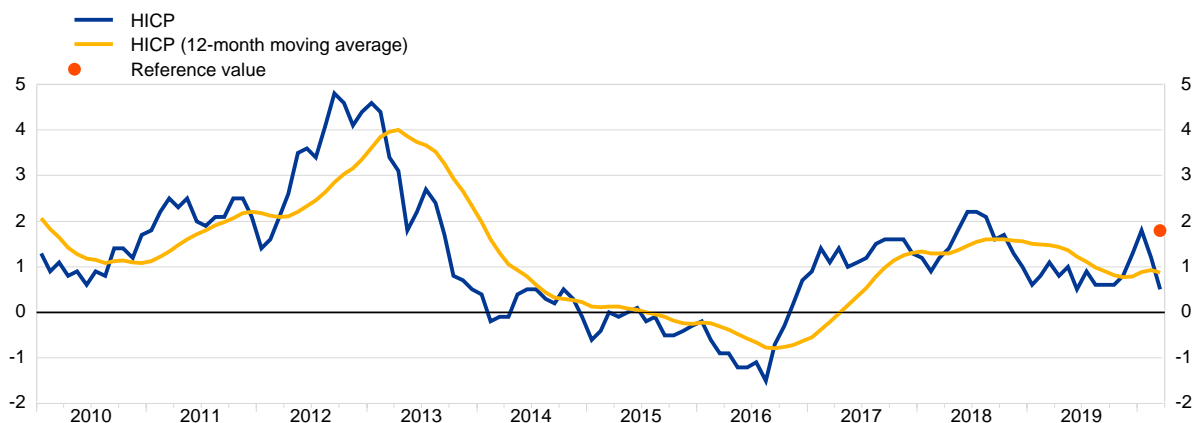
Croatia's long-term interest rate differential vis-à-vis the euro area has declined slightly since mid-2018 and stood at 0.8 percentage points in March 2020. From 2010 to mid-2016 the long-term interest rate differential fluctuated between 160 and 340 basis points, reflecting investors' perceptions of remaining vulnerabilities, despite inflation being lower than in the euro area at times. Since the summer of 2016 the economic recovery, accommodative monetary policy and significant fiscal consolidation have been reflected in the gradual but continuous convergence of Croatian long-term interest rates towards euro area levels. The differential declined from 310 basis points in July 2016 to 80 basis points in March 2020.

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 90% of the total assets of the banking sector), but non-banking institutions also play an increasingly significant role in financial intermediation. In particular, insurance corporations and, since the start of the pension system reform in 2002, pension funds together account for around 18% of total financial sector assets. Stock market capitalisation as a percentage of GDP is higher than in many peer countries in the region and stood at 37.5% in 2019. Overall, the degree of financial intermediation remains much lower than in the euro area, but is in line with that of peer countries in the region. MFI credit to private residents as a percentage of GDP has been declining since 2011, reaching 55.4% in 2019. By February 2020 loans to the domestic private sector – mainly households – stood at 51%, with a rather large but historically declining percentage of loans remaining denominated in foreign currencies. The corporate debt market remains relatively

underdeveloped. The share of debt securities issued by financial and non-financial institutions as a percentage of GDP remains very low, standing at 0.4% and 4.2% respectively at the end of 2019. Recourse by Croatia's banking sector to funding from euro area banks has fallen dramatically over the past five years. The claims of euro area MFIs on resident MFIs decreased from an annual average of 17% of GDP between 2010 and 2014 to 4.7% of GDP over the period 2015-19.

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 2019 to March 2020 is the unweighted arithmetic average of the annual percentage changes in the HICP for Portugal, Cyprus and Italy plus 1.5 percentage points. The reference value is 1.8%.

Table 5.3.1 Measures of inflation and related indicators
(annual percentage changes, unless otherwise indicated)

	2010-2019 ¹⁾	2010-2014 ¹⁾	2015-2019 ¹⁾	2015	2016	2017	2018	2019	2020 ²⁾	2021 ²⁾
Measures of inflation										
HICP	1.2	1.8	0.5	-0.3	-0.6	1.3	1.6	0.8	0.4	0.9
HICP excluding unprocessed food and energy	1.1	1.2	0.9	0.8	0.2	1.4	1.1	1.1	0.7	1.0
HICP at constant tax rates ³⁾	0.9	1.3	0.5	-0.6	-0.8	1.2	1.5	1.4	-	-
CPI	1.0	1.7	0.4	-0.5	-1.1	1.1	1.5	0.8	0.4	0.9
Private consumption deflator	1.0	1.7	0.3	-0.3	-1.1	0.9	1.4	0.8	0.4	0.9
GDP deflator	0.9	1.0	0.9	0.1	-0.1	1.2	1.8	1.5	0.7	0.9
Producer prices ⁴⁾	1.2	3.0	-0.5	-3.8	-3.9	2.1	2.4	0.8	-	-
Related indicators										
Real GDP growth	1.0	-0.9	2.9	2.4	3.5	3.1	2.7	2.9	-9.1	7.5
GDP per capita in PPS ⁵⁾ (euro area = 100)	56.5	55.5	57.7	55.9	57.1	58.3	59.5	.	-	-
Comparative price levels (euro area = 100)	66.8	68.0	65.3	64.3	64.9	65.8	66.4	.	-	-
Output gap ⁶⁾	-0.7	-2.7	1.2	-1.6	0.1	1.5	2.5	3.7	-6.1	-0.7
Unemployment rate (%) ⁷⁾	13.2	15.2	11.1	16.2	13.1	11.2	8.5	6.6	10.2	7.4
Unit labour costs, whole economy	-0.8	-1.5	-0.2	-0.5	-2.7	-0.7	1.4	1.9	4.5	-3.1
Compensation per employee, whole economy	0.6	-0.1	1.4	0.7	0.4	0.2	2.2	3.4	-1.2	1.1
Labour productivity, whole economy	1.4	1.4	1.5	1.2	3.2	0.9	0.8	1.5	-5.5	4.3
Imports of goods and services deflator	1.0	2.0	0.1	-0.9	-2.2	2.3	1.1	0.4	-0.2	1.3
Nominal effective exchange rate ⁸⁾	-0.2	-1.3	0.9	-2.1	2.6	1.6	2.5	-0.1	-	-
Money supply (M3) ⁹⁾	4.2	1.5	5.6	4.2	5.3	5.6	8.4	4.5	-	-
Lending from banks ¹⁰⁾	0.6	-2.3	2.3	-2.4	0.5	4.5	4.4	5.8	-	-
Stock prices (CROBEX) ¹¹⁾	0.7	-12.9	15.6	-3.2	18.1	-7.6	-5.1	15.4	-	-
Residential property prices	0.3	-2.7	3.3	-2.9	0.9	3.8	6.1	9.0	-	-

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 Refinitiv 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 2020 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).

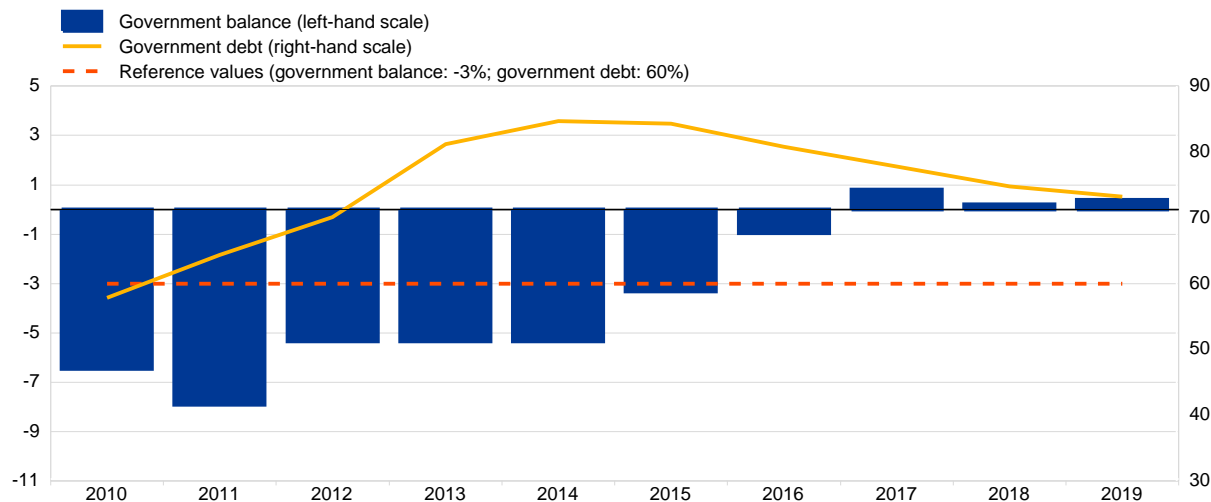
9) The series includes repurchase agreements with central counterparties.

10) 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.

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)

	2010-2019 ¹⁾	2010-2014 ¹⁾	2015-2019 ¹⁾	2015	2016	2017	2018	2019	2020 ²⁾	2021 ²⁾
Government balance	-3.3	-6.1	-0.6	-3.3	-1.0	0.8	0.2	0.4	-7.1	-2.2
Total revenue	44.4	42.5	46.4	45.3	46.5	46.1	46.5	47.5	46.3	47.4
Current revenue	43.9	42.1	45.8	44.8	45.8	45.7	46.0	46.6	45.0	46.1
Direct taxes	6.4	6.4	6.4	6.1	6.5	6.3	6.5	6.7	5.5	5.7
Indirect taxes	18.8	18.0	19.6	19.1	19.3	19.5	20.0	20.3	19.7	19.9
Net social contributions	11.7	11.6	11.9	12.0	11.9	11.9	12.0	11.8	11.0	11.8
Other current revenue ³⁾	6.9	6.1	7.8	7.6	8.1	8.0	7.5	7.8	8.7	8.6
Capital revenue	0.5	0.4	0.6	0.5	0.7	0.4	0.6	0.9	1.3	1.3
Total expenditure	47.8	48.6	47.0	48.6	47.4	45.3	46.3	47.1	53.4	49.6
Current expenditure	42.3	42.7	41.8	43.7	42.3	41.3	40.9	40.9	47.4	43.8
Compensation of employees	11.8	11.9	11.6	11.5	11.4	11.4	11.8	11.9	13.1	12.7
Social benefits	16.2	16.4	15.9	17.0	16.0	15.6	15.5	15.5	17.8	17.0
Interest payable	2.8	2.9	2.7	3.4	3.1	2.7	2.3	2.2	2.3	2.3
Other current expenditure ⁴⁾	11.5	11.5	11.5	11.8	11.8	11.6	11.3	11.2	14.2	11.8
Capital expenditure	5.5	5.8	5.2	5.0	5.1	4.0	5.4	6.3	6.0	5.7
of which: Investment	3.6	3.8	3.5	3.4	3.3	2.8	3.5	4.3	4.3	4.2
Cyclically adjusted balance	-3.0	-4.9	-1.1	-2.6	-1.0	0.1	-0.9	-1.2	-4.4	-1.9
One-off and temporary measures	0.0	0.0	0.0	0.0	0.1	-0.1	0.0	0.0	0.0	0.0
Structural balance ⁵⁾	-3.0	-4.9	-1.1	-2.6	-1.1	0.2	-0.9	-1.2	-4.4	-1.9
Government debt	74.9	71.6	78.2	84.3	80.8	77.8	74.7	73.2	88.6	83.4
Average residual maturity (in years)	5.4	5.5	5.3	5.3	5.0	5.5	5.3	5.4	.	.
In foreign currencies (% of total)	77.4	78.7	76.1	79.7	78.0	76.4	74.9	71.6	.	.
of which: Euro	73.2	73.4	72.9	75.4	73.8	72.9	71.1	71.4	.	.
Domestic ownership (% of total)	59.4	56.8	62.1	58.0	61.1	60.7	63.4	67.3	.	.
Medium and long-term maturity (% of total) ⁶⁾	93.1	91.0	95.1	94.4	95.1	95.2	95.3	95.4	.	.
of which: Variable interest rate (% of total)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	.	.
Deficit-debt adjustment	0.6	1.1	0.1	-1.6	-1.7	1.1	0.5	2.1	.	.
Net acquisitions of main financial assets	0.3	0.6	0.0	-1.3	-0.9	0.4	0.4	1.5	.	.
Currency and deposits	0.1	0.4	-0.2	-1.5	-1.4	0.2	0.1	1.7	.	.
Debt securities	0.0	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	.	.
Loans	0.3	0.2	0.3	0.3	0.6	0.2	0.5	-0.2	.	.
Equity and investment fund shares or units	0.0	0.0	-0.1	0.0	-0.1	-0.1	-0.2	-0.1	.	.
Revaluation effects on debt	0.1	0.5	-0.2	0.3	-0.6	-0.3	-0.7	0.3	.	.
of which: Foreign exchange holding gains/losses	0.2	0.5	-0.2	0.2	-0.6	-0.4	-0.6	0.3	.	.
Other ⁷⁾	0.2	0.1	0.3	-0.6	-0.2	1.0	0.9	0.3	.	.
Convergence programme: government balance	-	-	-	-	-	-	-	-	-6.8	-2.4
Convergence programme: structural balance	-	-	-	-	-	-	-	-	.	.
Convergence programme: government debt	-	-	-	-	-	-	-	-	86.7	83.2

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 2020 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.

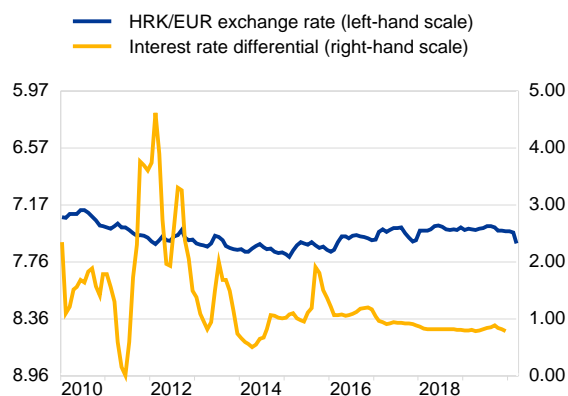
6) Original maturity of more than one year.

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)

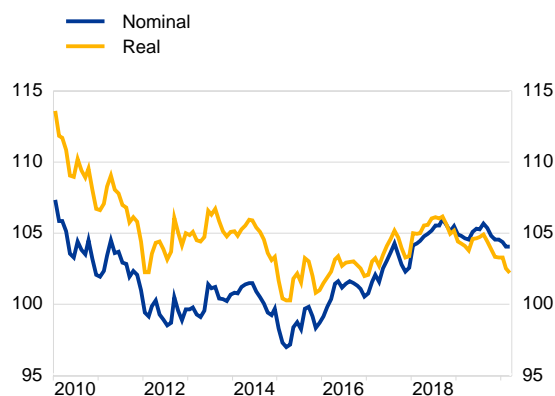


Sources: National data and ECB calculations.

1) The interest rate differential is calculated against ZIBOR. Production of ZIBOR reference rate was discontinued by the national central bank as of 1 January 2020; a comparable rate is not currently available.

Chart 5.3.4 Effective exchange rates ¹⁾

(EER-38 group of trading partners; monthly averages; 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)

	2010-2019 ¹⁾	2010-2014 ¹⁾	2015-2019 ¹⁾	2015	2016	2017	2018	2019	2020 ²⁾	2021 ²⁾
Balance of payments										
Current account and capital account balance ³⁾	1.4	-1.2	4.0	4.0	3.6	4.5	3.3	4.5	.	.
Current account balance	0.6	-1.3	2.6	3.2	2.1	3.4	1.9	2.5	.	.
Goods	-15.9	-14.4	-17.4	-16.0	-16.3	-17.2	-18.7	-19.1	.	.
Services	15.3	13.0	17.6	16.2	17.5	17.9	17.8	18.6	.	.
Primary income	-2.3	-2.9	-1.6	-0.6	-3.0	-1.5	-1.5	-1.5	.	.
Secondary income	3.5	3.0	4.1	3.6	3.9	4.2	4.2	4.5	.	.
Capital account balance	0.8	0.2	1.4	0.8	1.5	1.1	1.4	2.0	.	.
Combined direct and portfolio investment balance ³⁾	-2.3	-3.7	-0.8	-0.8	-1.3	-1.5	0.3	-0.6	.	.
Direct investment	-2.0	-1.9	-2.0	-0.5	-4.3	-2.3	-1.4	-1.6	.	.
Portfolio investment	-0.3	-1.8	1.2	-0.3	2.9	0.8	1.7	1.0	.	.
Other investment balance	2.4	2.0	2.7	3.4	5.4	1.8	0.1	2.6	.	.
Reserve assets	2.0	1.5	2.3	1.7	-0.6	5.3	3.0	1.8	.	.
Exports of goods and services	44.5	39.7	49.2	46.4	47.7	50.1	50.5	51.5	.	.
Imports of goods and services	45.1	41.1	49.1	46.2	46.5	49.4	51.4	51.9	.	.
Net international investment position ⁴⁾	-78.2	-91.3	-65.1	-78.4	-72.4	-65.6	-57.9	-51.0	.	.
Gross external debt ⁴⁾	100.9	111.2	90.6	108.4	96.2	89.6	82.7	76.0	.	.
Trade with the euro area ⁵⁾										
Exports of goods and services	57.0	56.9	57.0	59.7	58.7	55.9	55.8	55.1	.	.
Imports of goods and services	55.7	52.0	58.6	59.6	59.2	58.5	57.1	58.5	.	.
Investment position with the euro area ⁵⁾										
Direct investment assets ⁴⁾	-	45.0	-	68.2	-	-	-	-	.	.
Direct investment liabilities ⁴⁾	73.2	67.9	74.2	74.6	80.7	82.6	64.5	68.8	.	.
Portfolio investment assets ⁴⁾	52.2	63.5	50.0	55.2	56.3	47.8	48.3	42.2	.	.
Portfolio investment liabilities ⁴⁾	54.2	55.0	53.5	49.4	53.1	58.0	54.2	53.0	.	.

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 2020 Economic Forecast.

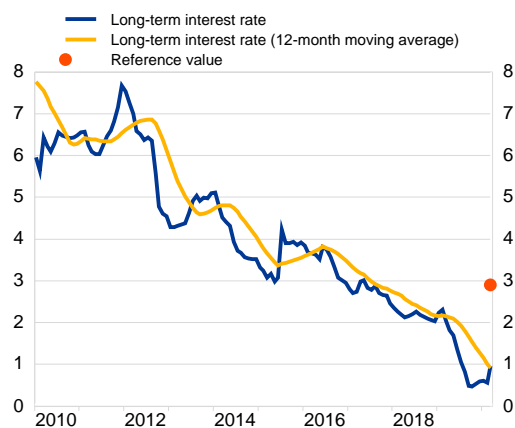
3) Differences between totals and the sum of their components are due to rounding.

4) End-of-period outstanding amounts.

5) As a percentage of the total. Figures for "Direct investment assets" between 2016 and 2019 are under investigation and thus excluded.

Croatia - Long-term interest rate developments

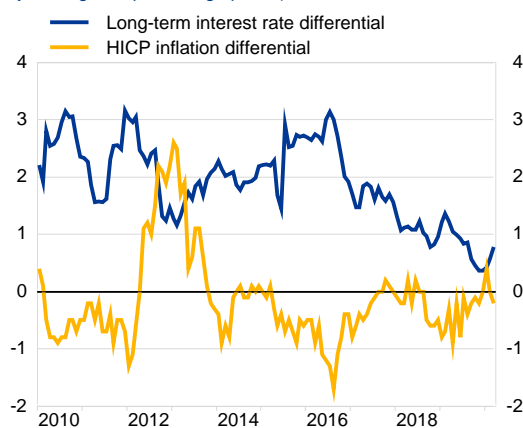
Chart 5.3.5 Long-term interest rate ¹⁾
(monthly averages in percentages)



Sources: European System of Central Banks and ECB calculations.

1) The basis of the calculation of the reference value for the period from April 2019 to March 2020 is the unweighted arithmetic average of the interest rate levels in Portugal, Cyprus and Italy plus 2 percentage points. The reference value is 2.9%.

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)

	2010-2019 ¹⁾	2010-2014 ¹⁾	2015-2019 ¹⁾	2016	2017	2018	2019	Apr. 2019 to Mar. 2020	Memo item: euro area 2019
Long-term interest rates									
Croatia ²⁾	4.1	5.5	2.7	3.5	2.8	2.2	1.3	0.9	-
Euro area ^{2), 3)}	2.2	3.4	0.9	0.9	1.1	1.1	0.4	0.2	-
Euro area AAA par curve, ten-year residual maturity ^{2), 3)}	1.3	2.3	0.3	0.2	0.4	0.5	-0.2	-0.3	-
Indicators of financial development and integration									
Debt securities issued by financial corporations ⁴⁾	0.4	-	0.3	0.4	0.2	0.3	0.4	-	66.7
Debt securities issued by non-financial corporations ⁵⁾	4.7	-	4.5	5.3	4.0	3.8	4.2	-	11.8
Stock market capitalisation ⁶⁾	38.1	-	38.4	42.3	38.9	35.1	37.5	-	67.7
MFI credit to non-government residents ⁷⁾	65.7	72.0	59.3	61.1	58.0	56.5	55.4	-	107.4
Claims of euro area MFIs on resident MFIs ⁸⁾	10.9	17.0	4.7	4.7	3.4	4.1	3.1	-	26.1

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 (excluding the national central bank) 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 market values. Data available since 2013.

7) MFI (excluding national central bank) credit to domestic non-MFI residents other than general government. Credit comprises 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 2020 the 12-month average rate of HICP inflation in Hungary was 3.7%, i.e. well above the reference value of 1.8% for the criterion on price stability (see Chart 5.4.1). In the light of the coronavirus (COVID-19) pandemic, there is a high level of uncertainty as to how this rate is going to evolve 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 5.7%, and the average for that period was elevated at 2.5%. 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 4.8% 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 of contracting bank lending to the private sector. As inflation receded, Magyar Nemzeti Bank loosened 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 HICP inflation has accelerated again, reaching 2.4% in 2017 on account of the ongoing economic recovery, and further increasing to 2.9% in 2018 and 3.4% in 2019, reflecting strong domestic demand and a tight labour market environment, changes to indirect taxes and the impact of volatile items sensitive to global commodity price movements (which were partially offset by a reduction in social security contributions).

In the first quarter of 2020 the average annual rate of HICP inflation stood at 4.4%. Buoyant domestic demand, supported by historically low unemployment and wage growth at around 9% in January and February, continued to push up HICP inflation. These domestic inflationary pressures, partially reinforced by volatile energy and food price developments, were to some extent offset by the subdued external environment.

The national authorities have taken major fiscal and monetary policy measures to offset the economic damage wrought by the COVID-19 pandemic. To ease strains in funding markets caused by the pandemic, Magyar Nemzeti Bank, in March 2020, introduced long-term collateralised lending at fixed interest rates, expanded the range of eligible collateral and suspended sanctions on reserve deficiency. Moreover, the authorities partially deferred social security and pension contributions of businesses and employees, introduced partial wage compensation by the state for employees with reduced working hours due to COVID-19 and also temporarily cut certain sectoral taxes.

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% with an ex-ante tolerance band of ± 1 percentage point that was adopted in March 2015. 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 triggered an EU-IMF financial assistance programme, which was discontinued in June 2010. In November 2011 Hungary requested precautionary financial assistance from the EU and the IMF, but the ensuing negotiations were not completed and Hungary did not further request any assistance.

Inflation is expected to gradually decline in the coming years. However, in the current exceptional circumstances, the forecasts are subject to an unusual level of uncertainty. Over the longer term, however, there remain concerns regarding the sustainability of inflation convergence in Hungary.

According to the European Commission's Spring 2020 Economic Forecast, the rate of inflation is projected to decline to 3.0% in 2020 and 2.7% in 2021. This outlook is based on the expectation that economic growth will moderate, while nevertheless remaining very robust with unemployment stabilising at historically low levels and private consumption continuing to be the main driver of growth. The risks to the inflation outlook are assessed as being broadly balanced. Upside risks mainly relate to stronger than expected wage pressures stemming from a potential further tightening of labour market conditions and a faster recovery from the economic downturn brought about by the COVID-19 pandemic, while a more protracted economic downturn constitutes a significant downside risk for the inflation outlook. Looking further ahead, unless counteracted by an appreciation of the nominal exchange rate, the catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area, since GDP per capita and price levels are still significantly lower in Hungary than in the euro area. In order to prevent the build-up of excessive price pressures and macroeconomic imbalances, the catching-up process must therefore 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 should ensure a soft landing of the economy, which is currently characterised by a very tight labour market, a positive – albeit closing – output gap and elevated house price valuations. Improving the quality of public institutions and ensuring that they are free from undue political intervention as well as implementing adequate product market policies are prerequisites for private sector-led economic growth. 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 2020.

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

sustainable economic growth. Efforts to strengthen balance sheets in recent years have borne fruit, and the banking sector overall displays sound capital positions and sufficient liquidity buffers. Profitability has improved and the ratio of non-performing loans declined further. However, there remain significant risks to long-term profitability stemming from the notoriously low cost-efficiency of the Hungarian banking sector. Credit growth to both non-financial corporations and households remains strong on the back of the booming housing market and strong household income growth, also due to accommodative monetary policy and government subsidies. At the same time there are imminent signs of overvaluation at least in some segments of the housing market, mainly in the capital city. Moreover, corporate real estate lending in foreign currency has been increasing steadily, which, going forward, may lead to significant currency mismatches and increase foreign exchange risk of credit institutions. It is therefore necessary to prevent the build-up of macro-financial 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.

5.4.2 Fiscal developments

Hungary's general government budget balance complied with the Maastricht criterion in 2019, whereas debt was above the reference value. In the reference year 2019 the general government budget balance recorded a deficit of 2.0% of GDP, i.e. below the 3% reference value. The general government gross debt-to-GDP ratio was 66.3%, i.e. above the 60% reference value (see Table 5.4.2). Compared with the previous year, the deficit ratio decreased by 0.1 percentage points of GDP while the debt ratio declined by 3.9 percentage points. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2019.

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; its excessive deficit procedure ended in June 2013. In 2017, however, a structural deterioration led to a divergence from the adjustment path towards the medium-term objective, and in 2018 a significant deviation procedure was launched with a view to its correction. In June 2019 the EU Council issued a Recommendation with a view to correcting the significant observed deviation from the adjustment path towards the medium-term budgetary objective in Hungary. In November 2019 the European Commission established that no effective action had been taken in response to the Recommendation, and in December 2019 the Council adopted a corresponding Decision and issued a new Recommendation.

Cyclical factors improved the fiscal position over the past few years, while structural fiscal policy was procyclical. Following a significant reduction of the nominal deficit after the global financial crisis, the deficit ratio reached its lowest level of 1.8% of GDP in 2016. Its subsequent significant deterioration was driven by a sizeable cut in social security contributions and a rise in public investment in 2017. As

a consequence, the structural balance deteriorated by 1.6 percentage points of GDP between 2016 and 2018. Conversely, the budget balance benefited from favourable macroeconomic conditions over that period. In 2019 restraint in current public expenditure and still strong economic growth contributed to improving the country's fiscal position.

The government debt-to-GDP ratio remained above the 60% reference value over the past decade, but followed a downward path from 2012 to 2019. The debt ratio increased rapidly in the period 2007-11, from 65.7% of GDP to 80.8%. In the subsequent period to 2019 the debt ratio followed a downward path, underpinned largely by persistent primary surpluses. From 2017 to 2019, the reduction was strongly supported by a favourable interest-growth differential. Conversely, unfavourable deficit-debt adjustments (due to the acquisition of financial assets and revaluation effects) had the opposite effect.

The level and structure of government debt indicate sensitivity to exchange rate movements and to interest rate variations. Hungary has managed to considerably reduce the proportion of foreign currency-denominated government debt (almost exclusively denominated in euro); it declined from 45.9% on average over 2010-14 to 20.5% in 2019. At the same time fiscal balances remain relatively sensitive to changes in the exchange rate vis-à-vis the euro. The introduction of a new preferential bond type targeted specifically at households (MÁP+) in July 2019 contributed to the further reduction in the share of foreign currency-denominated debt. The share of government debt with a short-term maturity is also noticeable (11.5% in 2019), which poses risks of budget balance deterioration due to changes in market interest rates.

As a consequence of the COVID-19 pandemic, the European Commission's Spring 2020 Economic Forecast foresees a notable deterioration in the budget balance and a significant increase in the debt ratio. According to the European Commission's latest forecast, the headline deficit is expected to increase to 5.2% of GDP in 2020 and improve to 4.0% of GDP in 2021, i.e. it is likely to be well above the 3% deficit reference value in 2020 and remain above it in 2021. The sharp deterioration of the government balance results from the marked worsening of the macroeconomic outlook and the fiscal measures implemented to mitigate the crisis. Over 2020-21, the structural deficit is projected to stand above the medium-term objective of 1% of GDP.¹⁷¹ Nevertheless, in the context of the COVID-19 pandemic, the Stability and Growth Pact's general escape clause provides that "in periods of severe economic downturn for the euro area or the Union as a whole, Member States may be allowed temporarily to depart from the adjustment path towards the medium-term budgetary objective..., provided that this does not endanger fiscal sustainability in the medium term".¹⁷² Regarding the debt ratio, the European Commission forecasts an increase by around 9 percentage points of GDP in 2020, followed by a slight reduction in 2021, to reach 73.5% of GDP. Hungary's medium-term fiscal policy strategy, as presented in the 2020 update of the convergence programme,

¹⁷¹ In January 2020 Hungary's medium-term objective changed from a structural deficit of 1.5% of GDP to a structural deficit of 1% of GDP.

¹⁷² For more details, see Box 2 in the Framework for analysis.

assumes a more benign path for the budget balance and public debt than those projected by the European Commission.

Despite some progress in reforming the fiscal framework, there is scope for further improvement. In December 2019 the Hungarian Parliament adopted amendments to the national fiscal rules that should increase their transparency and enhance their implementation. However, the fiscal framework should put stronger emphasis on the multi-annual dimension of the budget process. In particular, the incentives to systematically spend budget reserves before the end of the calendar year should be removed as they lower the quality of public spending. The country has made some progress at reducing the complexity of its tax system. It has focused on decreasing the high tax-to-GDP ratio and especially the labour tax burden, and has improved of the effectiveness of value added tax collection.

The European Commission's 2019 Debt Sustainability Monitor, which was released prior to the COVID-19 pandemic, suggested that Hungary was at low risk of fiscal stress over the short and medium term, but at medium risk over the long term, mostly on account of projected adverse demographic developments. The European Commission's 2019 Debt Sustainability Monitor pointed to low risk over the short and medium term but to medium risk over the long term.¹⁷³ ¹⁷⁴ This higher long-term risk was based on the notable increase in age-related budgetary costs. According to the 2018 Ageing Report prepared by the Ageing Working Group (AWG) of the EU's Economic Policy Committee,¹⁷⁵ Hungary would experience a rise in age-related expenditure of 3.0 percentage points of GDP by 2070, in the AWG's reference scenario, from a level of 19.0% of GDP in 2016. In the AWG's risk scenario, the increase was projected to be 7.6 percentage points of GDP (arising mostly from increases of, respectively, 4.1% and 1.8% of GDP in long-term care and health care), which was significantly above the EU average. All these factors suggested that reforms were needed to improve the long-term sustainability of public finances.

Looking ahead and leaving aside the policy measures to address the COVID-19 pandemic, a prudent fiscal policy is needed to safeguard the sustainability of public finances. A consistent and prudent fiscal policy will ensure that Hungary continues to comply with the Stability and Growth Pact and maintains buffers to alleviate adverse shocks. Policies aimed at simplification of the tax system, improvement of tax collection and reduction of the informal economy should be continued. Reinforcing multi-annual fiscal planning could mitigate the procyclicality of fiscal policy and increase the effectiveness of public spending. Structural reforms of the pension system, as well as the health and long-term care systems, are also necessary to address longer-term risks to fiscal sustainability. The debt management

¹⁷³ As explained in the Framework for analysis, the potential implications of the COVID-19 pandemic for the medium to long term sustainability of budgetary positions beyond its impact on the latest forecasts are not covered because of the high levels of uncertainty.

¹⁷⁴ 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.

¹⁷⁵ European Commission and Economic Policy Committee, "The 2018 Ageing Report: Economic & Budgetary Projections for the 28 EU Member States (2016-2070)", *European Economy Institutional Paper*, No 079, European Commission, 2018.

framework could be further refined by targeting a reduction of costs and risks in the medium term.

5.4.3 Exchange rate developments

Over the reference period from 1 April 2018 to 31 March 2020, 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 mostly traded significantly weaker than its April 2018 average exchange rate against the euro of 311.72 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 31 March 2020 the exchange rate stood at 360.02 forints per euro, i.e. 15.5% weaker than its average level in April 2018. Over the reference period the maximum upward deviation from this benchmark was 0.5%, while the maximum downward deviation amounted to 15.5%. Over the past ten years the exchange rate of the Hungarian forint against the euro has depreciated by 35.6%.

The exchange rate of the Hungarian forint against the euro exhibited, on average, a relatively high degree of volatility over the reference period. Between April and June 2018 the Hungarian forint depreciated relatively strongly against the euro amid low interest rate differentials and a general strengthening of major global currencies as risk appetite in foreign exchange markets decreased. Between mid-2018 and early 2019 the Hungarian forint gradually recovered while the outlook for growth in the domestic economy remained very robust. Thereafter, the currency began to weaken again despite the favourable economic outlook, largely owing to external factors related to uncertainty around the withdrawal of the United Kingdom from the European Union, global trade tensions and a weakening outlook for major trading partners. The depreciation of the Hungarian forint gained further momentum in mid-March 2020 following the outbreak of the coronavirus (COVID-19) in Europe and its impact on economic activity and on global financial market tensions. As a result, the forint reached record-low levels by the end of the two-year reference period. At the same time, the favourable financial conditions and domestic economic environment have supported demand for Hungarian debt instruments and thus depressed yields, with short-term real interest rates among the lowest in the region. Over the reference period short-term interest rate differentials against the three-month EURIBOR were overall small, although increasing, and stood at 0.6 percentage points in the three-month period ending in March 2020.

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 consistently remained in surplus and has contributed to a reduction in the country's net foreign liabilities, which remain high (see Table 5.4.3). Between 2010 and 2013,

Hungary's combined current and capital account balance increased steadily to peak at 7.2%, largely reflecting a substantial adjustment in the goods and services balance owing to robust export growth and relatively subdued domestic demand as well as an increasing capital account surplus due to larger transfers from the EU budget. Following a decline to 4.9% of GDP in 2014 on account of a lower trade surplus, the combined current and capital account surplus increased again to 6.9% of GDP in 2015. The increase reflected both a recovery of net exports and a peak in the capital account surplus of 4.6% of GDP due to transfers from the EU budget. Related to the beginning of a new EU funds cycle, this peak in the capital account surplus was followed by a sharp drop in 2016, which was only partly offset by a further expansion of net exports. Since 2017, the trade balance has started to narrow again on account of very robust domestic demand. As a result the current account balance turned negative as of 2018. As this was only partly offset by a recovery of the capital account balance, the combined current and capital account balance continued to narrow and stood at 2.3% of GDP in 2018 and 1.0% of GDP in 2019. Hungary's combined current and capital account surplus has been mirrored in sizeable net financial outflows over the past decade. Since 2010, Hungary – while having been a net recipient of foreign direct investment flows – has been a net exporter of capital in the form of portfolio investment and other investment. Against this background, gross external debt decreased from 128.4% of GDP in 2015 to 100.4% of GDP in 2018 and 88.8% of GDP in 2019. As a result, Hungary's net international investment position improved, from -66.6% of GDP in 2015 to -51.3% of GDP in 2018 and -47.2% in 2019. 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 2019 exports of goods and services to the euro area constituted 57.7% of total exports, while the corresponding figure for imports was marginally lower, at 56.8%. In 2019 the share of the euro area in Hungary's stock of inward direct investment stood at 45.6% and its share in the country's stock of portfolio investment liabilities was 36.6%. The share of Hungary's stock of foreign assets invested in the euro area amounted to 25.9% in the case of direct investment and 59.4% for portfolio investment in 2019.

5.4.4 Long-term interest rate developments

Over the reference period from April 2019 to March 2020, long-term interest rates in Hungary stood at 2.3% on average and thus remained below the 2.9% 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 2012. After a period of relative stability in 2010-11, when long-term interest rates fluctuated between 6 and 8 percentage points, domestic vulnerability as a result of high external and public debt, combined with the euro area sovereign debt crisis and heightened uncertainty regarding the ability of the country to implement sound fiscal policies, led to an abrupt increase in long-term interest rates to approximately 10% by the end of

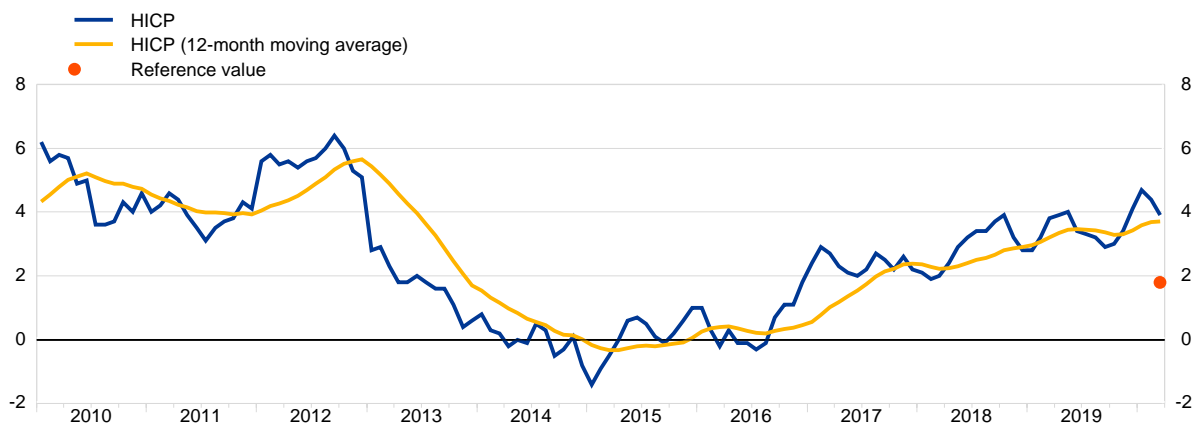
2011. Since mid-2012 improving macroeconomic conditions, lower global risk aversion and several measures adopted in the framework of an accommodative monetary policy – including the reduced availability of the central bank’s short-term deposit facilities, foreign exchange and long-term interest rate swaps, and purchases of mortgage bonds – brought down long-term interest rates to around 2% in December 2017. In 2018 strong economic activity and rising inflation, which remained within the tolerance band of the Magyar Nemzeti Bank’s target, drove long-term interest rates higher at the end of 2018, to about 100 basis points above the December 2017 level. Since then, the long-term interest rate dynamics in Hungary seem to have been driven mainly by global developments. This led to a decline for most of 2019 as a result of the deterioration in the economic outlook and higher levels of global risk aversion, leading investors to reshuffle their portfolios towards fixed income assets. Long-term interest rates stabilised by the end of 2019, when the global economic cycle improved somewhat and the factors driving risk aversion higher partially subsided, and stood at 2.4% in March 2020. Since the end of April 2020 the Magyar Nemzeti Bank has initiated a government bond purchase programme to dampen the high volatility in the market for government securities induced by the coronavirus (COVID-19) pandemic. Since 2018 credit default swap spreads for Hungarian government debt have declined somewhat and, after a further significant decline at the beginning of 2020, stood at around 80 basis points in March 2020. Hungary’s government debt is rated investment grade by all three main rating agencies.

Hungary’s long-term interest rate differential vis-à-vis the euro area has fluctuated around 200 basis points since 2015, after declining over the period 2012-14 from a level of around 500 basis points (see Chart 5.4.6). The high interest rate differential at the end of 2011 was due to the heightened perceived risk regarding the sustainability of the Hungarian debt situation. Thereafter, the Magyar Nemzeti Bank initiated a series of interest rate cuts. By reducing its base rate from 7% in December 2011 to 0.9% in May 2016, the central bank contributed to bringing down the differential. Since 2018 the differential has been continually around 200 basis points, which in 2019 seemed to almost fully account for the positive inflation differential between Hungary and the euro area.

Capital markets in Hungary are smaller and much less developed than in the euro area (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 slightly less than 21% of GDP in 2019, which is above the annual average during the period 2010-14. Outstanding debt securities issued by non-financial corporations have declined since the period 2010-14, when they averaged 2.1% of GDP annually, to stand at 1.6% in 2019. Debt securities issued by financial institutions stood at 5.8% of GDP in 2019, which is about half of the value recorded on average over the period 2010-14. Furthermore, Hungarian banks have significantly reduced their borrowing from euro area banks. Claims by euro area banks on Hungarian banks stood at 4.3% of GDP in 2019 compared with an average of 15.2% over the period 2010-14. The degree of financial intermediation is low compared with the euro area average and is among the lowest in the region. MFI credit to non-government residents in 2019 stood at 36.3% of GDP, approximately 19 percentage points below its average level in the period 2010-14.

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 2019 to March 2020 is the unweighted arithmetic average of the annual percentage changes in the HICP for Portugal, Cyprus and Italy plus 1.5 percentage points. The reference value is 1.8%.

Table 5.4.1 Measures of inflation and related indicators
(annual percentage changes, unless otherwise indicated)

	2010-2019 ¹⁾	2010-2014 ¹⁾	2015-2019 ¹⁾	2015	2016	2017	2018	2019	2020 ²⁾	2021 ²⁾
Measures of inflation										
HICP	2.5	3.2	1.8	0.1	0.4	2.4	2.9	3.4	3.0	2.7
HICP excluding unprocessed food and energy	2.7	3.2	2.2	1.3	1.4	2.1	2.3	3.7	4.0	2.8
HICP at constant tax rates ³⁾	2.1	2.2	2.0	0.0	0.6	2.9	3.4	3.2	-	-
CPI	2.5	3.2	1.8	-0.1	0.4	2.4	2.8	3.3	3.0	2.7
Private consumption deflator	2.6	3.4	1.9	-0.1	0.2	2.7	3.1	3.6	3.0	2.7
GDP deflator	3.0	2.9	3.2	2.5	1.0	3.7	4.5	4.5	4.2	3.1
Producer prices ⁴⁾	2.4	3.1	1.6	-3.1	-3.1	4.6	6.2	3.9	-	-
Related indicators										
Real GDP growth	2.7	1.4	4.1	3.8	2.2	4.3	5.1	4.9	-7.0	6.0
GDP per capita in PPS ⁵⁾ (euro area = 100)	63.3	61.9	65.0	64.9	63.6	64.5	66.8	.	-	-
Comparative price levels (euro area = 100)	59.6	59.4	59.9	58.2	59.0	61.6	61.0	.	-	-
Output gap ⁶⁾	-0.1	-2.3	2.1	0.8	0.6	1.8	3.1	4.1	-5.2	-2.1
Unemployment rate (%) ⁷⁾	7.4	10.2	4.6	6.8	5.1	4.2	3.7	3.4	7.0	6.1
Unit labour costs, whole economy	2.6	1.6	3.6	0.4	4.0	4.5	3.4	6.0	8.6	-0.4
Compensation per employee, whole economy	3.6	1.8	5.4	2.0	2.4	7.0	6.2	9.4	5.0	4.4
Labour productivity, whole economy	0.9	0.2	1.7	1.6	-1.5	2.4	2.7	3.2	-3.4	4.8
Imports of goods and services deflator	1.4	2.1	0.8	-1.0	-2.2	1.8	3.8	1.4	2.8	2.5
Nominal effective exchange rate ⁸⁾	-1.7	-2.5	-0.9	-3.6	1.2	1.6	-1.2	-2.4	-	-
Money supply (M3) ⁹⁾	5.4	2.8	8.0	6.3	6.2	8.5	10.7	8.5	-	-
Lending from banks ¹⁰⁾	-0.7	-6.3	5.2	-8.1	3.3	6.4	11.0	15.1	-	-
Stock prices (BUX) ¹¹⁾	117.1	-21.6	177.0	43.8	33.8	23.0	-0.6	17.7	-	-
Residential property prices	5.7	-1.6	13.6	13.1	13.4	8.5	14.4	14.8	-	-

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 Refinitiv 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 2020 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).

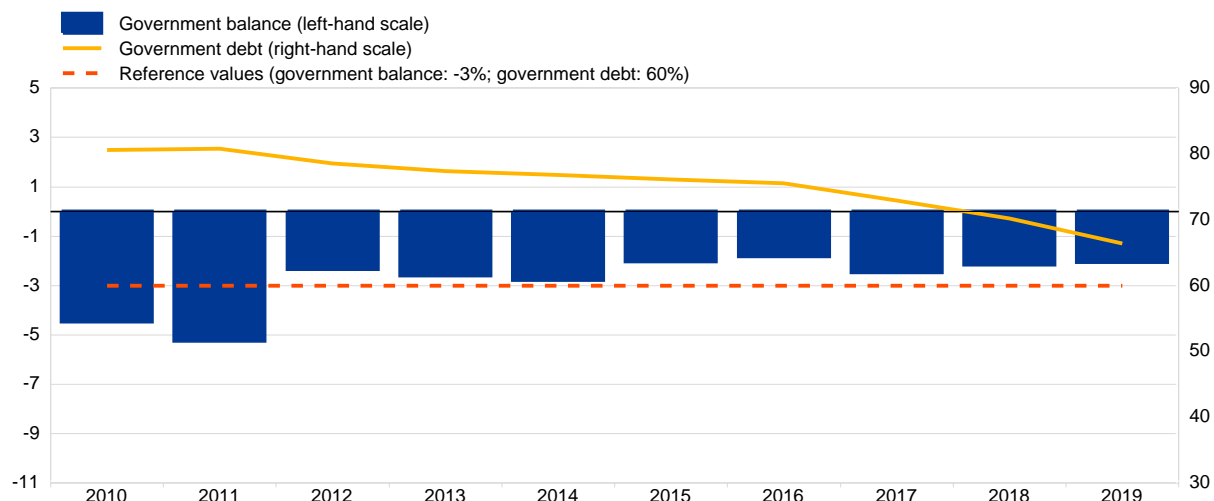
9) The series includes repurchase agreements with central counterparties.

10) 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)

	2010-2019 ¹⁾	2010-2014 ¹⁾	2015-2019 ¹⁾	2015	2016	2017	2018	2019	2020 ²⁾	2021 ²⁾
Government balance	-2.8	-3.5	-2.1	-2.0	-1.8	-2.5	-2.1	-2.0	-5.2	-4.0
Total revenue	45.8	46.2	45.4	48.6	45.4	44.5	44.5	44.0	45.1	43.6
Current revenue	43.8	43.8	43.7	44.7	44.8	43.5	43.2	42.2	43.2	41.8
Direct taxes	6.9	6.8	7.0	6.8	7.3	7.2	6.7	6.7	7.2	7.0
Indirect taxes	18.2	18.1	18.3	18.7	18.2	18.0	18.3	18.2	18.3	17.8
Net social contributions	13.0	13.1	12.9	13.3	13.9	12.9	12.3	11.9	12.0	11.5
Other current revenue ³⁾	5.7	5.9	5.6	5.9	5.5	5.3	5.8	5.4	5.8	5.6
Capital revenue	2.0	2.3	1.7	3.9	0.6	1.0	1.4	1.8	1.9	1.8
Total expenditure	48.6	49.7	47.5	50.6	47.2	47.0	46.7	46.1	50.3	47.7
Current expenditure	41.9	43.8	40.0	41.3	41.6	40.3	38.8	37.9	42.2	40.0
Compensation of employees	10.4	10.3	10.6	10.4	10.8	10.9	10.6	10.2	11.2	10.7
Social benefits	15.4	17.2	13.6	14.7	14.5	13.7	13.0	12.2	13.7	13.0
Interest payable	3.5	4.3	2.8	3.5	3.1	2.7	2.4	2.3	2.5	2.4
Other current expenditure ⁴⁾	12.5	12.1	13.0	12.7	13.2	13.0	12.8	13.2	14.7	13.9
Capital expenditure	6.7	5.8	7.5	9.4	5.6	6.7	7.9	8.1	8.1	7.6
of which: Investment	4.7	4.1	5.2	6.6	3.2	4.5	5.9	6.0	5.8	5.7
Cyclically adjusted balance	-2.7	-2.4	-3.0	-2.4	-2.1	-3.3	-3.6	-3.9	-2.8	-3.1
One-off and temporary measures	0.1	0.2	0.0	0.0	-0.1	0.4	0.0	-0.2	-0.2	0.0
Structural balance ⁵⁾	-2.9	-2.6	-3.1	-2.3	-2.0	-3.6	-3.6	-3.8	-2.6	-3.1
Government debt	75.5	78.8	72.2	76.2	75.5	72.9	70.2	66.3	75.0	73.5
Average residual maturity (in years)	4.3	4.6	4.0	4.3	4.1	3.9	3.8	3.8	.	.
In foreign currencies (% of total)	36.7	45.9	27.5	37.1	30.8	26.1	23.2	20.5	.	.
of which: Euro	36.0	44.5	27.5	37.1	30.8	26.1	23.2	20.5	.	.
Domestic ownership (% of total)	50.8	41.0	60.7	52.4	58.5	62.8	63.7	66.1	.	.
Medium and long-term maturity (% of total) ⁶⁾	85.6	87.3	83.8	85.0	81.6	81.8	82.1	88.5	.	.
of which: Variable interest rate (% of total)	9.5	5.9	13.0	12.6	11.4	13.7	14.4	13.2	.	.
Deficit-debt adjustment	0.2	-0.5	0.9	2.0	-0.1	0.7	1.7	0.3	.	.
Net acquisitions of main financial assets	0.6	0.5	0.6	0.4	2.1	-0.1	1.0	-0.1	.	.
Currency and deposits	0.0	-0.1	0.2	-0.8	2.0	-0.5	1.0	-0.6	.	.
Debt securities	0.0	0.0	0.0	0.0	-0.1	0.0	0.0	-0.1	.	.
Loans	0.1	-0.2	0.3	0.8	0.3	0.3	0.1	0.2	.	.
Equity and investment fund shares or units	0.4	0.7	0.1	0.3	-0.1	0.1	-0.1	0.4	.	.
Revaluation effects on debt	0.8	1.3	0.4	0.3	0.0	0.3	0.8	0.5	.	.
of which: Foreign exchange holding gains/losses	0.8	1.3	0.2	0.3	-0.2	-0.1	0.6	0.6	.	.
Other ⁷⁾	-1.2	-2.3	-0.1	1.3	-2.2	0.5	-0.1	-0.1	.	.
Convergence programme: government balance	-	-	-	-	-	-	-	-	-3.8	-2.7
Convergence programme: structural balance	-	-	-	-	-	-	-	-	.	.
Convergence programme: government debt	-	-	-	-	-	-	-	-	72.6	69.3

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 2020 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.

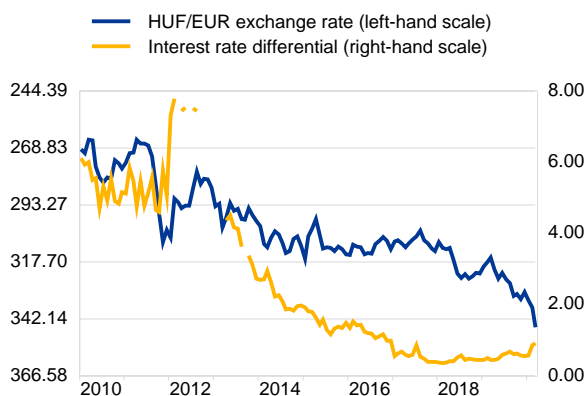
6) Original maturity of more than one year.

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

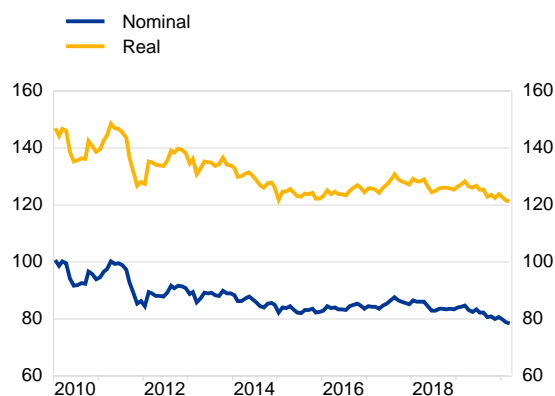
(HUF/EUR exchange rate: monthly averages; difference between three-month interbank interest rates and three-month EURIBOR: basis points, monthly values)



Sources: National data and ECB calculations.

Chart 5.4.4 Effective exchange rates ¹⁾

(EER-38 group of trading partners; monthly averages; 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)

	2010-2019 ¹⁾	2010-2014 ¹⁾	2015-2019 ¹⁾	2015	2016	2017	2018	2019	2020 ²⁾	2021 ²⁾
Balance of payments										
Current account and capital account balance ³⁾	3.9	4.3	3.6	6.9	4.5	3.2	2.3	1.0	3.3	3.4
Current account balance	1.6	1.4	1.7	2.3	4.6	2.4	0.0	-0.8	1.3	1.5
Goods	1.9	2.7	1.1	3.6	3.4	1.5	-1.3	-1.9	.	.
Services	4.5	3.6	5.4	4.4	5.3	5.8	5.8	5.6	.	.
Primary income	-3.9	-4.1	-3.7	-4.5	-2.6	-4.0	-3.8	-3.6	.	.
Secondary income	-0.9	-0.7	-1.0	-1.1	-1.5	-1.0	-0.6	-0.9	.	.
Capital account balance	2.4	2.8	1.9	4.6	0.0	0.9	2.3	1.8	.	.
Combined direct and portfolio investment balance ³⁾	-1.4	-3.4	0.7	2.7	1.9	1.4	-2.2	-0.2	.	.
Direct investment	-1.9	-1.9	-1.9	-2.3	-2.4	-1.6	-2.0	-1.3	.	.
Portfolio investment	0.6	-1.5	2.7	5.0	4.2	3.0	-0.1	1.1	.	.
Other investment balance	4.5	5.8	3.2	8.2	6.4	0.8	0.9	-0.4	.	.
Reserve assets	-0.1	1.1	-1.3	-4.3	-5.3	0.0	2.7	0.2	.	.
Exports of goods and services	85.9	85.5	86.2	88.0	87.1	87.2	85.3	83.4	.	.
Imports of goods and services	79.5	79.2	79.8	80.0	78.4	79.9	80.8	79.7	.	.
Net international investment position ⁴⁾	-74.8	-93.1	-56.4	-67.9	-59.6	-55.1	-51.6	-47.9	.	.
Gross external debt ⁴⁾	133.6	158.2	109.0	130.9	120.2	102.6	101.0	90.2	.	.
Trade with the euro area ⁵⁾										
Exports of goods and services	56.5	56.3	56.7	54.8	56.8	56.8	57.4	57.7	.	.
Imports of goods and services	56.8	55.5	58.1	57.8	59.8	58.6	57.7	56.8	.	.
Investment position with the euro area ⁵⁾										
Direct investment assets ⁴⁾	31.8	37.0	26.6	37.7	19.7	19.6	29.9	25.9	.	.
Direct investment liabilities ⁴⁾	56.4	55.2	57.5	60.4	68.2	64.6	48.8	45.6	.	.
Portfolio investment assets ⁴⁾	63.9	66.3	61.5	65.1	62.0	60.3	60.6	59.4	.	.
Portfolio investment liabilities ⁴⁾	44.0	50.0	38.1	41.2	37.6	37.9	37.0	36.6	.	.

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 2020 Economic Forecast.

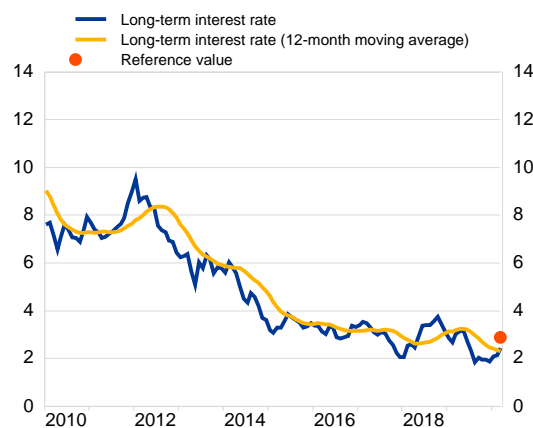
3) Differences between totals and the sum of their components are due to rounding.

4) End-of-period outstanding amounts.

5) As a percentage of the total.

Hungary - Long-term interest rate developments

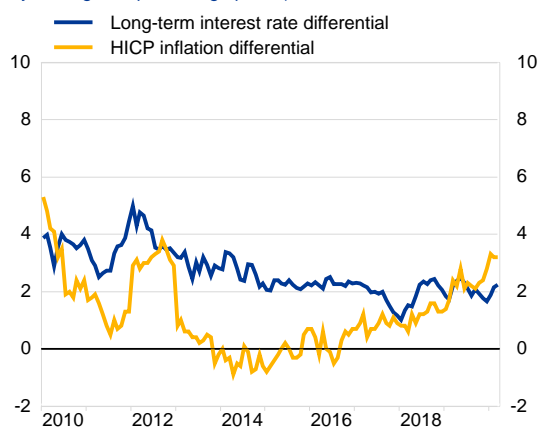
Chart 5.4.5 Long-term interest rate ¹⁾
(monthly averages in percentages)



Sources: European System of Central Banks and ECB calculations.

1) The basis of the calculation of the reference value for the period from April 2019 to March 2020 is the unweighted arithmetic average of the interest rate levels in Portugal, Cyprus and Italy plus 2 percentage points. The reference value is 2.9%.

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)

	2010-2019 ¹⁾	2010-2014 ¹⁾	2015-2019 ¹⁾	2016	2017	2018	2019	Apr. 2019 to Mar. 2020	Memo item: euro area 2019
Long-term interest rates									
Hungary ²⁾	4.9	6.7	3.0	3.1	3.0	3.1	2.5	2.3	-
Euro area ^{2), 3)}	2.2	3.4	0.9	0.9	1.1	1.1	0.4	0.2	-
Euro area AAA par curve, ten-year residual maturity ^{2), 3)}	1.3	2.3	0.3	0.2	0.4	0.5	-0.2	-0.3	-
Indicators of financial development and integration									
Debt securities issued by financial corporations ⁴⁾	9.0	11.3	6.6	6.7	5.8	5.6	5.8	-	66.7
Debt securities issued by non-financial corporations ⁵⁾	1.8	2.1	1.5	1.9	1.4	1.4	1.6	-	11.8
Stock market capitalisation ⁶⁾	17.2	15.7	18.7	18.4	21.0	19.0	20.7	-	67.7
MFI credit to non-government residents ⁷⁾	45.6	55.2	36.1	36.6	34.7	35.0	36.3	-	107.4
Claims of euro area MFIs on resident MFIs ⁸⁾	9.7	15.2	4.2	3.7	3.4	3.7	4.3	-	26.1

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 (excluding the national central bank) 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 market values.

7) MFI (excluding national central bank) credit to domestic non-MFI residents other than general government. Credit comprises 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 2020 the 12-month average rate of HICP inflation in Poland was 2.8%, i.e. well above the reference value of 1.8% for the criterion on price stability (see Chart 5.5.1). In the light of the coronavirus (COVID-19) pandemic, there is a high level of uncertainty as to how this rate is going to evolve 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 4.1%, while the average for that period was moderate, standing at 1.5%. After declining in summer 2010 to slightly below 2.0%, 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 from early 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 in 2013 and the significant fall in global commodity prices from 2012 to 2015 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. HICP inflation has risen gradually since mid-2016 on the back of relatively strong economic activity and rising food and energy prices. In particular, although moderating somewhat since mid-2018, real GDP has been rising since the beginning of 2017 at annual average rate slightly above 4.5%. Since the beginning of 2019, HICP inflation has increased more markedly, rising to 3% at the end of the year, largely driven by increases in food and services prices. On average, HICP inflation stood at 2.1% in 2019 (see Table 5.5.1).

In the first quarter of 2020 the average annual rate of HICP inflation stood at 3.9%. In line with the marked upward pattern already seen at the end of 2019, HICP inflation has further increased at the beginning of 2020, pushed upwards by some temporary factors such as food and energy price increases, in the context of a protracted period of past buoyant domestic economic activity and robust wage growth as unemployment rates are falling to historically low levels.

The national authorities have taken major fiscal, macroprudential and monetary policy measures to offset the economic damage wrought by the COVID-19 pandemic. Poland provided a substantial economic support package consisting of five pillars: protection of jobs, healthcare funding, financial system stability, support for businesses and public investment. Similarly, Narodowy Bank Polski cut its policy rate in mid-March and early April 2020 by 50 basis points on each occasion. Furthermore, Narodowy Bank Polski introduced repo transactions to provide liquidity to the Polish banking sector, offered bill discount credit and also entered into purchases of government securities and government guaranteed debt securities on the secondary market as part of the structural operations.

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 stay close to 2.5% over the coming years. However, in the current exceptional circumstances, the forecasts are subject to an unusual level of uncertainty. Over the longer term there are concerns about the sustainability of inflation convergence in Poland. According to the European Commission's Spring 2020 Economic Forecast, average annual HICP inflation is projected to increase from 2.5% in 2020 to 2.8% in 2021. Given the COVID-19 outbreak, considerable uncertainty surrounds the balance between downward pressures on inflation (linked to weaker demand) and upward pressures related to supply disruptions (in particular on food prices, which have a significant weight in the HICP basket). In 2020 deflationary pressures are also supported by the sharp decline in oil prices. The risks to the inflation outlook are tilted to the downside as the economic downturn wrought by the COVID-19 outbreak could be more protracted than expected. 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 in 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. Keeping foreign workers on a more permanent basis would also help to reduce labour supply constraints. 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 2020.

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 lowered profitability of financial institutions, the increasing role

of the state in the domestic financial system and the ongoing uncertainty regarding the conversion of foreign exchange-denominated mortgage loans according to national court rulings, 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. In order to further bolster confidence in the financial system, the national competent 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 general government budget balance and debt complied with the Maastricht criteria in 2019. In the reference year 2019 the general government budget balance recorded a deficit of 0.7% of GDP, i.e. well below the 3% reference value. The general government gross debt-to-GDP ratio was 46.0%, i.e. below the 60% reference value (see Table 5.5.2). Compared with the previous year, the deficit increased by 0.5 percentage points of GDP, reversing its long-term declining trend, and the debt ratio fell by 2.8 percentage points. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2019.

Poland has been subject to the preventive arm of the Stability and Growth Pact since 2015. The ECOFIN Council abrogated the excessive deficit procedure for Poland in June 2015, one year earlier than the extended deadline, on account of a systemic pension reform. In the subsequent period to 2019, some deviations from the requirements of the preventive arm of the Stability and Growth Pact were observed, in particular vis-à-vis the recommended adjustment path towards the country's medium-term objective.

The increase in the deficit in 2019 was attributable to the expansionary measures implemented in that year. Following a significant reduction of the nominal deficit after the global financial crisis, the deficit ratio reached its lowest level of 0.2% of GDP in 2018. The deterioration to 0.7% of GDP in 2019 was a consequence of expansionary fiscal measures implemented in Poland. In particular, measures to cushion the rise in electricity prices contributed to an increase in subsidies, while social expenditure rose owing to higher transfers to pensioners and households with children. As a consequence, the structural balance deteriorated by 0.8 percentage points of GDP.

The debt-to-GDP ratio followed a declining path from 2017 to 2019, remaining below the 60% reference value. The debt ratio decreased by 8.3 percentage points between 2016 and 2019, from a peak of 54.3% of GDP to 46.0%, mainly driven by primary surpluses and favourable interest-growth differentials.

The structure of government debt exposes Poland to interest rate and exchange rate risks. While the share of short-term debt in total government debt is negligible (1.1% in 2019 – see Table 5.5.2), a significant proportion of medium and

long-term debt (around 23.9% in 2019) 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 (28.4% in 2019), with around 83.8% 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.

As a consequence of the COVID-19 pandemic, the European Commission's Spring 2020 Economic Forecast foresees a marked deterioration in the budget balance and a marked increase in the debt ratio.

According to the European Commission's latest forecast, the headline balance is projected to temporarily deteriorate, reaching a deficit of 9.5% of GDP in 2020 and 3.8% of GDP in 2021. The sharp deterioration in the government balance results from the marked deterioration in economic activity and the fiscal measures implemented to mitigate the crisis. Over 2020-21, the structural deficit is projected to stand above the medium-term objective of 1% of GDP. Nevertheless, in the context of the COVID-19 pandemic, the Stability and Growth Pact's general escape clause provides that "in periods of severe economic downturn for the euro area or the Union as a whole, Member States may be allowed temporarily to depart from the adjustment path towards the medium-term budgetary objective..., provided that this does not endanger fiscal sustainability in the medium term".¹⁷⁶ Regarding the debt ratio, the European Commission forecasts a marked increase by around 12.5 percentage points of GDP in 2020, and a stabilisation in 2021 at 58.3% of GDP. The government's plans presented in the 2020 update of the convergence programme assume more benign projections for 2020 than those of the European Commission.

The Polish fiscal framework is robust, but its effectiveness should be improved.

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 expenditure rule was circumvented in 2019: extraordinary lump sum pension benefits were rerouted to extra-budgetary funds. 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. Poland is the only EU country without an independent fiscal council. Regarding tax compliance, tax collection has benefited from the recent implementation of a broad range of measures, in particular the compulsory split payment mechanism.¹⁷⁷ Policies aimed at improving tax collection should be continued. Lastly, in spite of efforts to reduce labour taxation, the tax system remains complex and should be streamlined.

¹⁷⁶ For more details, see Box 2 in the Framework for analysis.

¹⁷⁷ In this system invoices paid to a supplier are divided into two parts: (i) the net price of the commodity, paid directly into the supplier's business bank account; and (ii) the VAT amount paid directly into the supplier's dedicated VAT account.

The European Commission's 2019 Debt Sustainability Monitor, which was released prior to the COVID-19 pandemic, suggested that over the medium and long term Poland faced low risks to fiscal sustainability, but the adequacy of the pension system needed to be ensured.

The analysis laid out in the European Commission's 2019 Debt Sustainability Monitor pointed to low risk over the medium and long term.^{178 179} This stemmed largely from a favourable initial fiscal position, especially a relatively low government debt-to-GDP ratio. Over the long term, this low sustainability risk also reflected a relatively low increase in age-related costs. Indeed, the 2018 Ageing Report prepared by the Ageing Working Group (AWG) of the EU's Economic Policy Committee¹⁸⁰ showed a moderate rise (1.0 percentage point) in age-related expenditure by 2070, as projected in the AWG's reference scenario, from a level of 20.4% of GDP in 2016. In the AWG's risk scenario, ageing costs increased notably over the period (by 2.7 percentage points of GDP), albeit by much less than the EU average. The expected increase was entirely driven by healthcare and long-term care spending. Conversely, pension spending acted as a mitigating factor, as it declined in the period to 2070. This was mostly driven by a substantial drop in the benefit ratio¹⁸¹. Inadequacy of the pension system could trigger social payments to support the elderly population and might therefore weigh in the long-term on fiscal sustainability. Moreover, the AWG's risk scenario signalled the need for further reforms in healthcare and long-term care systems.

Looking ahead and leaving aside the policy measures to address the COVID-19 pandemic, a prudent fiscal policy as well as further structural reforms are needed to safeguard the sustainability of public finances.

A consistent and prudent fiscal policy will ensure that Poland continues to comply with the Stability and Growth Pact and maintains buffers to alleviate adverse shocks. Moreover, the role and independence of the national institutions that monitor compliance with the EU fiscal rules should be improved. The extensive use of reduced rates of value added tax should be limited and labour taxation simplified. 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 and long-term care spending while ensuring the adequacy of the pension system.

5.5.3 Exchange rate developments

In the two-year reference period from 1 April 2018 to 31 March 2020, the Polish zloty did not participate in ERM II, but traded under a flexible exchange rate regime. Over the reference period the Polish zloty mostly traded significantly weaker

¹⁷⁸ As explained in the Framework for analysis, the potential implications of the COVID-19 pandemic for the medium to long-term sustainability of budgetary positions beyond its impact on the latest forecasts are not covered because of the high levels of uncertainty.

¹⁷⁹ 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.

¹⁸⁰ European Commission and Economic Policy Committee, "The 2018 Ageing Report: Economic & Budgetary Projections for the 28 EU Member States (2016-2070)", *European Economy Institutional Paper*, No 079, European Commission, 2018.

¹⁸¹ Average pensions in relation to average wages.

than its April 2018 average exchange rate against the euro of 4.1937 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 31 March 2020 the exchange rate stood at 4.5506 zlotys per euro, i.e. 8.5% weaker than its average level in April 2018, following a more pronounced depreciation in the wake of the economic impact of the coronavirus (COVID-19). Over the reference period the maximum upward deviation from this benchmark was 0.8%, while the maximum downward deviation amounted to 10.0%. Over the past ten years the exchange rate of the Polish zloty against the euro has depreciated by 17.3%.

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 until February 2020, reflecting a stable main policy rate, improved domestic conditions and no major disturbances in global financial markets. From mid-2018 to February 2020, the exchange rate of the Polish zloty mostly fluctuated in a rather narrow range of between 4.25 and 4.35 zlotys per euro, in a context of broadly stable short-term interest rate differentials vis-à-vis euro area assets and of US official interest rates increasing during 2018 and declining from mid-2019. In mid-March 2020 following the outbreak of the coronavirus (COVID-19) in Europe and its impact on economic activity, global financial market tensions increased substantially and the Polish zloty rapidly depreciated against the euro. From mid-2018 to February 2020, short-term interest rate differentials against the three-month EURIBOR remained largely stable, although relatively wide at around 2.0 percentage points, on account of monetary policy rates being higher in Poland than in the euro area. However, following the cut of the reference interest rate by 50 basis points in mid-March 2020, short-term interest rate differentials against the three-month EURIBOR narrowed slightly. Outside the reference period, on 8 April 2020 there was another 50-basis-point cut of the reference interest rate, to 0.5%.

The real effective exchange rate of the Polish zloty has depreciated somewhat over the past ten years (see Chart 5.5.4). The real effective exchange rate weakened until 2016, when it began to appreciate; this continued until 2018, after which it remained broadly stable. 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 combined current and capital account balance has improved over the past ten years, while the country's net foreign liabilities remain very high, although in decline since 2017 and consisting mostly of net direct investment liabilities (see Table 5.5.3). Following relatively large deficits in the period 2010-12, 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 2010 to 2018; in 2019 direct and portfolio investment flows were virtually balanced. Gross external debt increased up to 2016 and declined in 2017-19, reaching 58.4% of GDP. Over this period Poland's net international investment position deteriorated up to 2017, but improved somewhat in 2018-19,

reaching -49.8% of GDP. However, the country's net foreign liabilities remain very high. Fiscal and structural policies therefore continue to be important for supporting external sustainability and maintaining Poland's attractiveness as a target for foreign direct investment, to enhance the competitiveness of the economy.

The Polish economy is well integrated with the euro area through trade and investment linkages. In 2019 exports of goods and services to the euro area constituted 56.4% of total exports, while the corresponding figure for imports was slightly higher at 56.7%. In 2019 the share of the euro area in Poland's stock of inward direct investment stood at 78.7%, and its share in the country's stock of portfolio investment liabilities was 44.9%. The share of Poland's stock of foreign assets invested in the euro area amounted to 57.8% in the case of direct investment and 34.2% for portfolio investment in 2019.

5.5.4 Long-term interest rate developments

Over the reference period from April 2019 to March 2020, long-term interest rates in Poland stood at 2.2% on average and were thus below the reference value for the interest rate convergence criterion (see Chart 5.5.5).

Long-term interest rates in Poland started to decline in 2011 after remaining stable in 2010 at around 6% (see Chart 5.5.5). In 2011 inflation and real GDP growth both accelerated, leading Narodowy Bank Polski to respond with a series of rate hikes. Over the following three years Poland's fiscal stance improved gradually, notwithstanding the impact of the global and euro area crises pushing up risk premia incorporated in the long-term interest rates on sovereign bonds (as measured by credit default swap spreads). In 2014 declining inflation and the loose monetary policy stances in the euro area and other major jurisdictions led to a continuous decline in Polish long-term interest rates to slightly above 2% at the beginning of 2015. Long-term interest rates in Poland then increased for two years as a result of strong economic activity and gradually increasing price dynamics, although inflation remained negative until the end of 2016. After peaking at the start of 2017 at levels slightly below 4%, the long-term interest rate remained stable in 2018 at around 3%, as the upward pressure exerted by buoyant economic activity was offset by the dampening effect of lower inflation. Since the end of 2018 long-term interest rates have followed global trends in a context of continued robust domestic growth, rising inflation and a relatively low supply of government bonds in the primary market, gradually declining to reach 1.8% at the end of the review period. In mid-March 2020 Narodowy Bank Polski announced a government bond purchase programme to dampen the high volatility in the market for government securities induced by the coronavirus (COVID-19) pandemic. Credit default swap spreads are low by historical standards and one of the lowest among the group of peer countries in the region. Currently, Poland's government debt is rated high quality investment grade by all three main rating agencies.

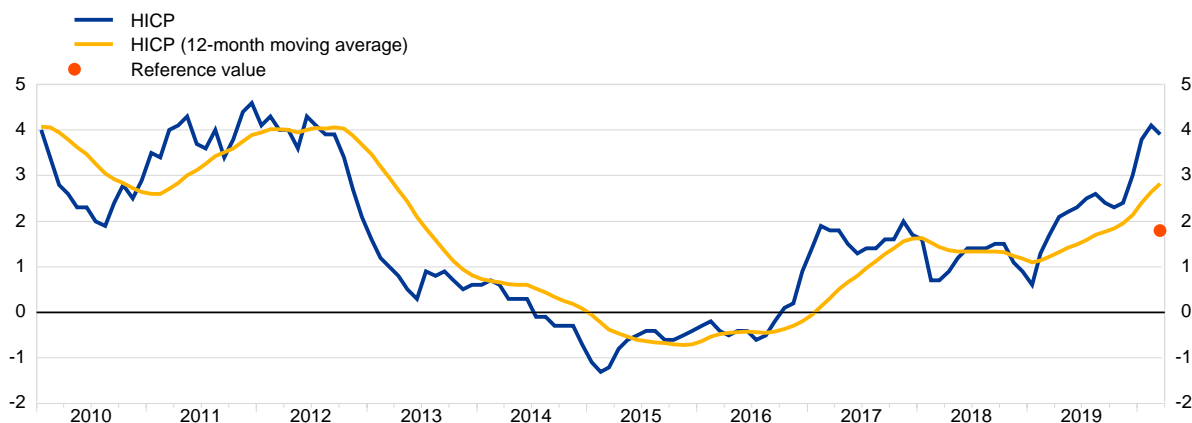
Poland's long-term interest rate differential vis-à-vis the euro area has fluctuated over time within a relatively small range until stabilising in 2018 at

around 200 basis points (see Chart 5.5.6). Since 2010 the interest rate differential has almost always moved within a band of between approximately 1 and 2 percentage points. Between 2011 and 2013 the faster decline in Poland's long-term interest rates compared with the euro area took the differential vis-à-vis the euro area to its lowest level, at 70 basis points, in spring 2013. Since then, the differential has increased again, because annual GDP growth in Poland has been consistently higher than that of the euro area. At the end of the reference period the interest rate differential had declined to 160 basis points (230) basis 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 respective markets in the euro area at the end of 2019. In 2019 stock market capitalisation was slightly below 25% of GDP, which was lower than the annual average over the period 2010-19, but still one of the highest levels among peer countries. Euro area banks' provision of funds to the Polish banking system is quite limited. The claims of euro area MFIs on Polish banks accounted for 3.6% of Polish banks' liabilities at the end of 2019. The degree of financial intermediation in Poland is in line with that of peer countries in the region and, as measured by the credit extended by MFIs to the private sector, amounted to slightly less than 55% of GDP in 2019 (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. At the end of 2019 the share of foreign banks in total Polish banking sector assets stood at around 45%.

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 2019 to March 2020 is the unweighted arithmetic average of the annual percentage changes in the HICP for Portugal, Cyprus and Italy plus 1.5 percentage points. The reference value is 1.8%.

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

	2010-2019 ¹⁾	2010-2014 ¹⁾	2015-2019 ¹⁾	2015	2016	2017	2018	2019	2020 ²⁾	2021 ²⁾
Measures of inflation										
HICP	1.5	2.2	0.8	-0.7	-0.2	1.6	1.2	2.1	2.5	2.8
HICP excluding unprocessed food and energy	1.4	1.9	0.9	0.3	0.3	1.2	0.6	2.3	2.4	2.7
HICP at constant tax rates ³⁾	1.3	1.8	0.8	-0.7	-0.2	1.6	1.2	2.1	-	-
CPI	1.6	2.3	0.9	-1.0	-0.6	2.0	1.7	2.3	-	-
Private consumption deflator	1.5	2.2	0.8	-1.1	-0.4	2.0	1.6	1.9	2.4	2.6
GDP deflator	1.5	1.6	1.4	0.8	0.3	1.9	1.2	2.9	2.4	2.5
Producer prices ⁴⁾	1.9	2.5	1.3	-2.3	0.0	4.8	2.8	1.6	-	-
Related indicators										
Real GDP growth	3.6	3.0	4.3	3.8	3.1	4.9	5.3	4.1	-4.3	4.1
GDP per capita in PPS ⁵⁾ (euro area = 100)	63.0	61.3	65.1	64.5	64.2	65.1	66.6	.	-	-
Comparative price levels (euro area = 100)	55.3	55.7	54.9	54.6	53.0	55.7	56.2	.	-	-
Output gap ⁶⁾	0.5	-0.3	1.4	-1.0	-0.6	1.3	3.4	4.0	-2.5	-1.8
Unemployment rate (%) ⁷⁾	7.5	9.8	5.2	7.5	6.2	4.9	3.9	3.3	7.5	5.3
Unit labour costs, whole economy	1.6	1.2	2.0	-0.6	2.5	2.2	3.0	2.8	3.5	0.7
Compensation per employee, whole economy	4.9	4.3	5.5	1.7	4.8	5.8	8.2	7.2	3.8	2.6
Labour productivity, whole economy	3.3	3.1	3.4	2.3	2.2	3.6	5.0	4.2	0.3	1.8
Imports of goods and services deflator	1.6	2.4	0.8	-1.3	-0.3	1.4	2.7	1.4	0.0	0.1
Nominal effective exchange rate ⁸⁾	0.0	0.2	-0.2	-2.8	-2.4	3.4	2.2	-1.1	-	-
Money supply (M3) ⁹⁾	8.1	7.9	8.2	8.9	9.1	5.9	8.7	8.7	-	-
Lending from banks ¹⁰⁾	5.9	5.8	6.0	6.2	4.0	7.4	6.3	5.8	-	-
Stock prices (Warsaw General Index) ¹¹⁾	44.6	28.6	12.5	-9.6	11.4	23.2	-9.5	0.2	-	-
Residential property prices ¹²⁾	1.7	-1.7	4.5	1.5	1.9	3.9	6.6	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 Refinitiv 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 2020 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.

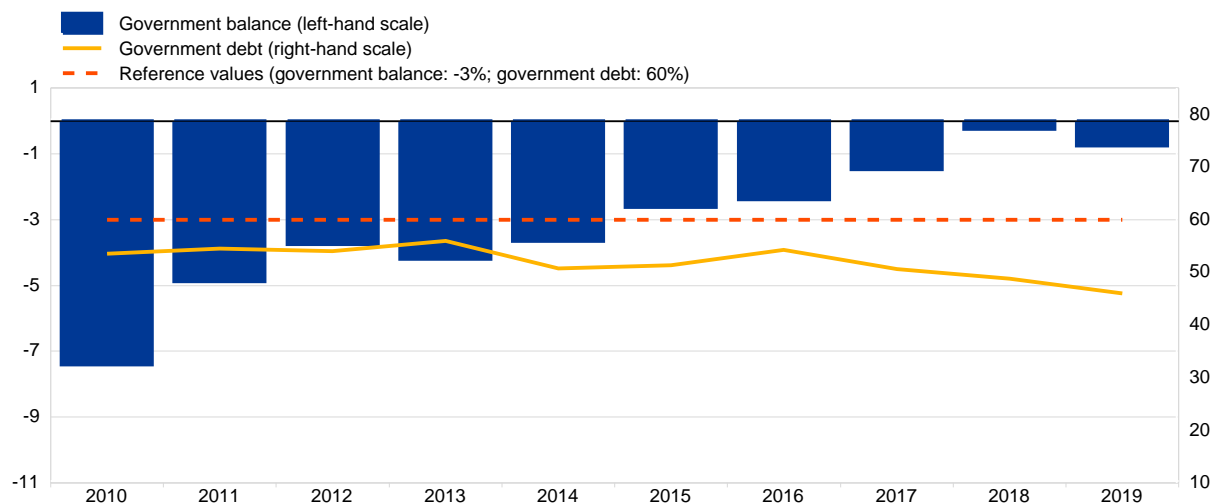
10) Adjusted for the derecognition of loans from the MFI statistical balance sheet due to their sale or securitisation.

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)

	2010-2019 ¹⁾	2010-2014 ¹⁾	2015-2019 ¹⁾	2015	2016	2017	2018	2019	2020 ²⁾	2021 ²⁾
Government balance	-3.1	-4.8	-1.5	-2.6	-2.4	-1.5	-0.2	-0.7	-9.5	-3.8
Total revenue	39.4	38.7	40.0	39.1	38.7	39.8	41.3	41.3	40.8	40.3
Current revenue	38.3	37.4	39.1	37.9	38.2	39.0	40.1	40.2	39.5	39.2
Direct taxes	7.1	6.8	7.4	6.9	7.1	7.3	7.8	8.0	7.3	7.5
Indirect taxes	13.4	13.2	13.6	12.9	13.4	13.8	14.1	13.9	13.8	13.6
Net social contributions	13.3	12.7	13.9	13.5	13.8	13.9	14.1	14.3	14.2	14.1
Other current revenue ³⁾	4.4	4.7	4.1	4.6	3.9	4.0	4.1	4.0	4.1	3.9
Capital revenue	1.1	1.3	0.9	1.1	0.6	0.8	1.2	1.1	1.3	1.2
Total expenditure	42.5	43.5	41.5	41.7	41.1	41.2	41.5	42.0	50.3	44.1
Current expenditure	37.5	38.0	36.9	36.7	37.4	36.6	36.4	37.3	42.1	39.1
Compensation of employees	10.4	10.5	10.3	10.4	10.4	10.2	10.1	10.2	11.1	10.8
Social benefits	16.5	16.2	16.9	16.2	17.2	17.0	16.7	17.5	19.0	18.3
Interest payable	2.0	2.4	1.6	1.8	1.7	1.6	1.4	1.4	1.4	1.4
Other current expenditure ⁴⁾	8.5	8.9	8.2	8.4	8.1	7.9	8.2	8.3	10.5	8.6
Capital expenditure	5.0	5.5	4.6	4.9	3.8	4.6	5.1	4.7	8.3	5.0
of which: Investment	4.6	5.0	4.1	4.5	3.3	3.8	4.7	4.3	4.3	4.2
Cyclically adjusted balance	-3.4	-4.6	-2.2	-2.1	-2.1	-2.1	-1.9	-2.7	-8.3	-2.9
One-off and temporary measures	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.3	0.2
Structural balance ⁵⁾	-3.4	-4.6	-2.2	-2.1	-2.1	-2.1	-1.9	-2.7	-8.5	-3.1
Government debt	52.0	53.8	50.2	51.3	54.3	50.6	48.8	46.0	58.5	58.3
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)	31.7	31.3	32.1	34.8	34.9	31.7	30.9	28.4	.	.
of which: Euro	23.8	22.1	25.6	26.3	27.1	25.6	25.1	23.8	.	.
Domestic ownership (% of total)	48.6	48.9	48.2	42.2	45.6	47.6	49.9	55.9	.	.
Medium and long-term maturity (% of total) ⁶⁾	98.9	98.8	99.0	98.9	99.2	99.2	99.0	98.9	.	.
of which: Variable interest rate (% of total)	18.4	14.9	21.8	20.9	21.0	21.3	21.8	23.9	.	.
Deficit-debt adjustment	-1.0	-2.2	0.3	0.1	2.3	-1.6	1.1	-0.3	.	.
Net acquisitions of main financial assets	-0.3	-0.9	0.3	-1.0	1.0	-0.1	0.9	0.6	.	.
Currency and deposits	0.1	-0.1	0.2	-1.0	1.0	-0.1	0.8	0.4	.	.
Debt securities	0.1	0.0	0.1	0.0	0.1	0.2	0.0	0.4	.	.
Loans	0.1	0.1	0.0	0.0	0.1	0.0	0.1	-0.1	.	.
Equity and investment fund shares or units	-0.5	-0.9	-0.1	-0.1	-0.2	-0.2	0.0	0.0	.	.
Revaluation effects on debt	0.3	0.4	0.2	0.5	1.0	-1.2	0.6	-0.1	.	.
of which: Foreign exchange holding gains/losses	0.2	0.3	0.1	0.5	0.8	-1.4	0.6	-0.1	.	.
Other ⁷⁾	-0.9	-1.7	-0.1	0.7	0.3	-0.3	-0.4	-0.8	.	.
Convergence programme: government balance	-	-	-	-	-	-	-	-	-8.4	.
Convergence programme: structural balance	-	-	-	-	-	-	-	-	.	.
Convergence programme: government debt	-	-	-	-	-	-	-	-	55.2	.

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 2020 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.

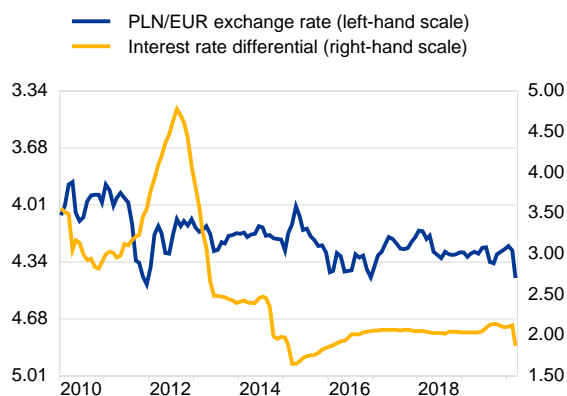
6) Original maturity of more than one year.

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

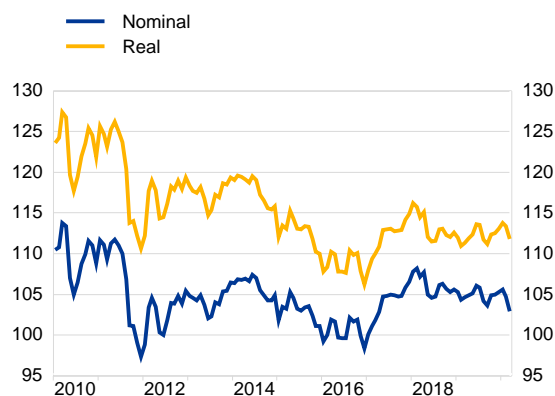
(PLN/EUR exchange rate: monthly averages; difference between three-month interbank interest rates and three-month EURIBOR: basis points, monthly values)



Sources: National data and ECB calculations.

Chart 5.5.4 Effective exchange rates ¹⁾

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



Source: ECB.

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

Table 5.5.3 External developments

(as a percentage of GDP, unless otherwise indicated)

	2010-2019 ¹⁾	2010-2014 ¹⁾	2015-2019 ¹⁾	2015	2016	2017	2018	2019	2020 ²⁾	2021 ²⁾
Balance of payments										
Current account and capital account balance ³⁾	0.0	-1.4	1.4	1.8	0.5	1.3	1.1	2.5	1.3	1.7
Current account balance	-1.9	-3.5	-0.3	-0.6	-0.5	0.1	-1.0	0.5	0.6	0.9
Goods	-0.8	-1.9	0.2	0.5	0.7	0.3	-1.0	0.5	.	.
Services	2.7	1.6	3.8	2.5	3.3	3.8	4.4	4.8	.	.
Primary income	-3.6	-3.2	-4.0	-3.4	-4.2	-4.1	-4.1	-4.4	.	.
Secondary income	-0.1	0.0	-0.2	-0.2	-0.3	0.0	-0.3	-0.3	.	.
Capital account balance	1.9	2.1	1.8	2.4	1.0	1.3	2.1	2.0	.	.
Combined direct and portfolio investment balance ³⁾	-2.9	-4.3	-1.4	-1.5	-1.7	-2.3	-1.8	0.2	.	.
Direct investment	-1.8	-1.8	-1.8	-2.1	-0.9	-1.4	-2.5	-1.9	.	.
Portfolio investment	-1.1	-2.6	0.4	0.7	-0.8	-0.9	0.7	2.1	.	.
Other investment balance	0.2	-0.2	0.7	1.6	-2.8	3.6	1.1	-0.1	.	.
Reserve assets	1.3	1.4	1.3	0.2	4.8	-1.5	1.3	1.7	.	.
Exports of goods and services	48.8	44.2	53.4	49.5	52.1	54.3	55.4	55.7	.	.
Imports of goods and services	47.0	44.5	49.5	46.4	48.2	50.1	52.0	50.5	.	.
Net international investment position ⁴⁾	-62.1	-66.2	-58.1	-62.1	-61.6	-61.2	-55.6	-49.8	.	.
Gross external debt ⁴⁾	68.6	69.8	67.5	71.8	76.4	67.0	63.8	58.4	.	.
Trade with the euro area ⁵⁾										
Exports of goods and services	55.9	55.4	56.4	56.4	56.2	56.2	56.8	56.4	.	.
Imports of goods and services	57.8	57.4	58.2	58.5	59.4	58.7	57.7	56.7	.	.
Investment position with the euro area ⁵⁾										
Direct investment assets ⁴⁾	61.0	62.0	60.1	66.2	60.6	55.6	60.1	57.8	.	.
Direct investment liabilities ⁴⁾	77.3	76.1	78.4	77.6	78.6	78.4	78.9	78.7	.	.
Portfolio investment assets ⁴⁾	49.5	56.2	42.8	58.6	44.3	42.8	34.2	34.2	.	.
Portfolio investment liabilities ⁴⁾	45.4	48.0	42.8	42.2	44.0	41.4	41.8	44.9	.	.

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 2020 Economic Forecast.

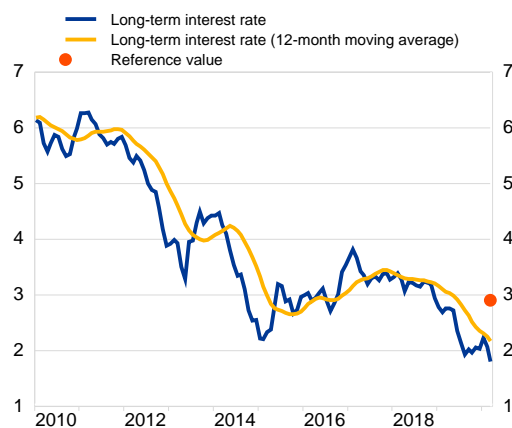
3) Differences between totals and the sum of their components are due to rounding.

4) End-of-period outstanding amounts.

5) As a percentage of the total.

Poland - Long-term interest rate developments

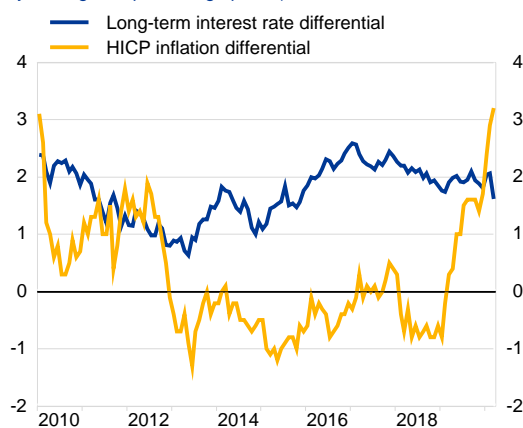
Chart 5.5.5 Long-term interest rate ¹⁾
(monthly averages in percentages)



Sources: European System of Central Banks and ECB calculations.

1) The basis of the calculation of the reference value for the period from April 2019 to March 2020 is the unweighted arithmetic average of the interest rate levels in Portugal, Cyprus and Italy plus 2 percentage points. The reference value is 2.9%.

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)

	2010-2019 ¹⁾	2010-2014 ¹⁾	2015-2019 ¹⁾	2016	2017	2018	2019	Apr. 2019 to Mar. 2020	Memo item: euro area 2019
Long-term interest rates									
Poland ²⁾	3.9	4.9	2.9	3.0	3.4	3.2	2.3	2.2	-
Euro area ^{2), 3)}	2.2	3.4	0.9	0.9	1.1	1.1	0.4	0.2	-
Euro area AAA par curve, ten-year residual maturity ^{2), 3)}	1.3	2.3	0.3	0.2	0.4	0.5	-0.2	-0.3	-
Indicators of financial development and integration									
Debt securities issued by financial corporations ⁴⁾	3.9	3.2	4.6	4.2	5.2	5.1	5.0	-	66.7
Debt securities issued by non-financial corporations ⁵⁾	4.4	4.1	4.8	5.6	5.3	4.9	3.3	-	11.8
Stock market capitalisation ⁶⁾	30.4	32.7	28.2	28.6	32.0	27.5	24.6	-	67.7
MFI credit to non-government residents ⁷⁾	54.6	52.9	56.3	57.7	55.8	56.1	54.8	-	107.4
Claims of euro area MFIs on resident MFIs ⁸⁾	6.9	9.4	4.4	4.8	4.3	4.1	3.6	-	26.1

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 (excluding the national central bank) 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 market values.

7) MFI (excluding national central bank) credit to domestic non-MFI residents other than general government. Credit comprises 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 2020 the 12-month average rate of HICP inflation in Romania was 3.7%, i.e. well above the reference value of 1.8% for the criterion on price stability (see Chart 5.6.1). In the light of the coronavirus (COVID-19) pandemic, there is a high level of uncertainty as to how this rate is going to evolve 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 7.8%, and the average for that period was elevated, standing at 2.7%. After moderating in the first half of 2010 along with a sharp contraction in economic activity in Romania, HICP inflation increased temporarily, peaking in 2011 at the high level of 8.5%, driven by the value added tax (VAT) rate hike, from 19% to 24% in July 2010, and rises in energy and food prices (see Table 5.6.1). Following three years of wage cuts, mainly in the public sector, compensation per employee rose again as of 2012, albeit at a somewhat lower rate than before 2009. In 2015, inflation declined to historically low levels, owing to successive cuts in indirect taxes. In particular, on the back of a reduction in the 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 as of the fourth quarter of 2017. After averaging at 4.1% in 2018, HICP inflation slightly tempered to 3.9% in 2019, while remaining held up by developments in volatile food prices, tobacco and fuel prices, as well as by a new tax imposed on the telecom sector, overlapping with inflationary pressures stemming from the positive output gap and strong wage growth on the back of expansionary fiscal and income policies. In view of these developments and of the inflation outlook, Banca Națională a României narrowed the interest rate corridor on standing facilities around the policy rate by ± 0.25 percentage points in October and November 2017 to the standard width of ± 1 percentage point. It also raised the key policy rate in three steps of 25 basis points from the historically low levels of May 2015, from 1.75% to 2.5% in May 2018. On 20 March 2020, in response to the COVID-19 crisis, among other measures Banca Națională a României cut the key policy rate by 50 basis points to 2%, and again narrowed the interest rate corridor to a width of ± 0.5 percentage points.

In the first quarter of 2020 the average annual rate of HICP inflation stood at 3.1%. The significant decline in the rate of inflation reflects, to a large extent, the decline in the dynamics of fuel prices and volatile food prices, mainly attributable to base effects and the influence from removing the special excise duty on motor fuels and from the fall in oil price. Core inflation also made a minor contribution, while continuing to indicate significant underlying inflationary pressures, as fiscal stimuli and

income policies aiming to boost household consumption resulted in two-digit increases in compensation per employee and the persistence of a positive output gap.

The national authorities have taken major fiscal, macroprudential and monetary policy measures to offset the economic damage wrought by the COVID-19 pandemic. The governmental measures include a €810 million fiscal package to buy medical equipment and protective equipment, paid leave for parents with children under 12 years who cannot work remotely and loan payment deferral for affected debtors. In addition, on 20 March 2020, Banca Națională a României decided to carry out repurchase transactions of government securities and purchases of leu-denominated government securities on the secondary market, in order to ensure a smooth functioning of the markets.

Policy choices have played an important role in shaping inflation dynamics in Romania over the past decade, most notably the orientation of monetary policy towards price stability. In 2005 Banca Națională a României shifted to an inflation-targeting framework combined with a managed floating exchange rate regime. The annual CPI inflation target was initially set at 7.5% and was reduced gradually to stand at 2.5% starting in 2013, with a 1 percentage point variation band around the central target.

Inflation is expected to decrease in the coming years. However, in the current exceptional circumstances, the forecasts are subject to an unusual level of uncertainty. Over the longer term there are concerns about the sustainability of inflation convergence in Romania. According to the European Commission's Spring 2020 Economic Forecast, average annual HICP inflation is expected to decrease to 2.5% in 2020 and 3.1% in 2021. Given the COVID-19 outbreak, considerable uncertainty surrounds the balance between downward pressures on inflation (linked to weaker demand) and upward pressures related to supply disruptions (in particular on food prices, which have a significant weight in the HICP basket). In 2020 deflationary pressures are also supported by the sharp decline in oil prices. The risks surrounding the forecast are assessed as being broadly balanced. Upside risks are associated with a faster than expected recovery from the economic downturn brought about by the COVID-19 pandemic, while a more protracted economic downturn constitutes a significant downside risk for the inflation outlook. Looking further ahead, there are serious concerns regarding the sustainability of inflation convergence in Romania over the longer term, also taking into account the marked increase in unit labour costs. The catching-up process is also 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. In particular, wage growth needs to be consistent with productivity growth, among other things, in order to safeguard price competitiveness and the attractiveness of Romania to foreign investors.

Achieving an environment that is conducive to sustainable convergence in Romania requires stability-oriented economic policies and wide-ranging structural reforms. In this respect it is noteworthy, that the European Commission

highlighted backtracking on previous progress made on judicial reforms, judicial independence and the fight against corruption in the framework of the Cooperation and Verification Mechanism in 2018 and 2019. Yet, 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 absorption of EU funds continues to warrant further 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 as well as at increasing the activity rate of the labour force need to be stepped up to reduce labour market tensions. With regard to macroeconomic imbalances, the European Commission selected Romania for an in-depth review in its Alert Mechanism Report 2020 – to be conducted in early 2020 – and highlighted issues related to its external position and the risks to financial stability.

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. After several profitable years, performance of the banking sector is strong, with banks showing solid capital and liquidity positions, and non-performing loans having come closer to EU levels. A continued deterioration of the external position and the rising fiscal deficit prompted the re-emergence 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 general government budget deficit breached the 3% reference value in 2019, while its debt complied with the Maastricht criterion. In 2019 the general government budget balance recorded a deficit of 4.3% of GDP, thus well above the 3% reference value. The general government debt ratio was 35.2%, well below the 60% reference value (see Table 5.6.2). Compared with the previous year, the deficit ratio continued to deteriorate, while the debt ratio increased slightly, by 0.5 percentage points of GDP. With regard to other fiscal factors, the deficit ratio exceeded the ratio of public investment to GDP in 2019.

Romania did not comply with the deficit criterion in 2019; an excessive deficit procedure was launched in April 2020, under which the country was required to rectify its excessive deficit by 2022 at the latest. The ECOFIN Council abrogated the previous excessive deficit procedure in June 2013, and Romania achieved its medium-term objective of a structural deficit of 1% of GDP over the period 2014-15. The structural deterioration in 2016, however, led to a divergence from the medium-term objective. A significant deviation procedure under the preventive arm of

the Stability and Growth Pact was thus launched in June 2017 with a view to correcting the significant observed deviation from the adjustment path towards the medium-term budgetary objective. However, between 2017 and 2019 Romania repeatedly failed to take effective action in response to the Council recommendations, prompting the European Commission to propose, and the Council to endorse, revised recommendations with a view to correcting Romania's significant observed deviation from the adjustment path toward the medium-term budgetary objective. In December 2019 the new Romanian Government adopted and sent to Parliament its Fiscal-Budgetary Strategy for 2020-22 with an accrual deficit target of 3.8% of GDP in 2019, which provided prima facie evidence of the existence of an excessive deficit. This was later confirmed by the deficit data notified to Eurostat and published at end-April 2020, which showed a deficit of 4.3 % of GDP. In February 2020, the Commission prepared a report in accordance with Article 126(3) of the Treaty on the Functioning of the European Union in order to comprehensively assess the departure from the deficit reference value. After taking into account the economic background and all other relevant factors, it concluded that the deficit criterion was not complied with and that an excessive deficit procedure was warranted. Following this, the EU Council decided on 3 April 2020 that an excessive deficit existed in Romania and recommended that the country take the necessary measures in order to bring the deficit below the reference value by 2022 at the latest.¹⁸²

Sizeable procyclical expansionary measures from 2015 to 2019 led to a sharp increase in the deficit ratio. Following a significant reduction of the nominal deficit after the global financial crisis, the deficit ratio reached its lowest level of 0.6% of GDP in 2015, partly as a result of the EU/IMF precautionary programme that was in place from October 2013 until September 2015. The notable deterioration in the deficit ratio that subsequently took place was driven mostly by expansionary measures adopted by the Government. In particular, sizeable reductions in the standard value added tax rate took place in 2016 and 2017. On the expenditure side, public wages increased considerably, which, however, was partly offset by a cut in government investment expenditure. The significant increases in old age pensions that were legislated in the summer of 2019 and took partial effect as of September 2019 also affected the 2019 outcome. Overall, the structural balance deteriorated by 3.9 percentage points between 2015 and 2019, while the change in cyclical conditions improved the budgetary position overall over the period.

The debt-to-GDP ratio, well below the 60% reference value, declined from its 2014 peak but increased in 2019. The debt ratio increased notably in the period 2009-14, from 21.8% of GDP to 39.2%, on the back of primary deficits as well as unfavourable deficit-debt adjustments. From then and until 2018, the debt ratio followed a downward path owing to a favourable interest-growth differential and, to a lesser extent, some favourable deficit-debt adjustments (stemming from the use of existing resources). In 2019, by contrast, the debt ratio increased slightly for the first

¹⁸² Following the activation of the Stability and Growth Pact's general escape clause (see Box 2 in the Framework for analysis for more details) in the context of the COVID-19 pandemic, the European Commission signalled in a letter to the Romanian Minister of Public Finance in April 2020 that it would take into account the economic and fiscal impact of the COVID-19 outbreak as well as the implications of the general escape clause in its assessment in the autumn and that it would then stand ready to revise the Recommendation accordingly.

time since 2014 as the favourable interest-growth differential was insufficient to offset the primary deficit and the unfavourable deficit-debt adjustments (see Table 5.6.2).

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 (3.1% of overall debt in 2019 – 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 (48.7% in 2019), 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 (83.0% of foreign-denominated debt in 2019). After decreasing during the global financial crisis, the share of debt with a medium and long-term maturity reached a peak of 96.9% in 2019.

As a consequence of the COVID-19 pandemic and the legislated pension increases, the European Commission's Spring 2020 Economic Forecast foresees a notable deterioration in the budget balance and a marked increase in the debt ratio, with significant consolidation required for Romania to return to its medium-term budgetary objective and to correct its excessive deficit situation. According to the European Commission's Spring 2020 Economic Forecast, the deficit is projected to deteriorate markedly to 9.2% of GDP in 2020 and 11.4% of GDP in 2021, which thus points to a widening margin vis-à-vis the 3% of GDP reference value. The sharp deterioration in the budget and structural balances is mostly driven by the marked deterioration in economic activity and the fiscal measures implemented to mitigate the COVID-19 crisis, as well as the significant increase in old age pensions resulting from the new pension law passed in the summer of 2019. Nevertheless, in the context of the COVID-19 pandemic, the Stability and Growth Pact's general escape clause provides that "in the case of a severe economic downturn in the euro area or in the Union as a whole, the Council may also decide, on a recommendation from the Commission, to adopt a revised recommendation under Article 126(9) TFEU, on condition that this does not endanger fiscal sustainability in the medium term".¹⁸³ Regarding the debt ratio, the European Commission forecasts a marked increase by 10.9 percentage points of GDP in 2020, followed by a significant increase of 8.5 percentage points in 2021, with the debt ratio projected to reach 54.7% of GDP, the highest level since 1995. Romania's April 2020 convergence programme update, which includes projections for 2020 alone, forecasts a deficit of 6.7% of GDP and a debt ratio of 40.9% of GDP for 2020 both of which are significantly lower than the European Commission forecast. On the basis of the European Commission's Spring 2020 Economic Forecast, significant further consolidation will be required to correct the excessive deficit situation.

Romania has strengthened its national fiscal governance framework significantly, but the framework has not been respected or applied effectively, particularly in the context of policy decisions taken from 2015 onwards.

¹⁸³ For more details, see Box 2 in the Framework for analysis.

Romania's fiscal governance framework was 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 a reform of the tax collection agency. However, the authorities continue to depart from the rules contained in the national fiscal framework, thereby rendering them largely ineffective. In particular, the Romanian authorities should fully support the Fiscal Council by submitting the budget on a timely basis and by increasing the transparency of the macroeconomic and fiscal forecasts and the budget documentation. The Government should also increase efforts to improve its public finance management, reform the public administration and make tax policy and administration more efficient. Limited progress has been made on public investment project preparation and prioritisation. Moreover, the corporate governance of state-owned enterprises has been weakened.

The European Commission's 2019 Debt Sustainability Monitor, which was released prior to the COVID-19 pandemic, suggested that Romania faced high sustainability risks in the medium and long term and needed to address the challenges of its ageing population. The European Commission's 2019 Debt Sustainability Monitor pointed to low risks over the short term, but high risks over the medium and long term.¹⁸⁴ ¹⁸⁵ Both the medium and long-term risk classifications worsened from medium to high compared with the European Commission's 2018 Fiscal Sustainability Report, largely driven by the deterioration in the forecast structural primary balance. For the long-term category, higher risks also stemmed from higher age-related public spending. Indeed, the European Commission and the Ageing Working Group (AWG) of the EU's Economic Policy Committee updated the 2018 Ageing Report¹⁸⁶ calculations of Romania's ageing costs to take into account the impact of the pension increases decided in the summer of 2019. Romania was expected in the AWG's updated reference scenario to experience an increase of 6.0 percentage points of GDP in age-related public expenditure, from a level of 15.1% of GDP in 2016, compared with an expected increase of 2.2 percentage points in the 2018 Ageing Report. In the AWG's updated risk scenario, the increase in the cost of ageing amounted to almost 13 percentage points of GDP. All these developments suggested that further reforms were needed to improve the long-term sustainability of public finances.

Looking ahead and leaving aside the policy measures to address the COVID-19 pandemic, 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 2020 and beyond. Significant consolidation is required to correct the excessive deficit and return

¹⁸⁴ As explained in the Framework for analysis, the potential implications of the COVID-19 pandemic for the medium to long-term sustainability of budgetary positions beyond its impact on the latest forecasts are not covered because of the high levels of uncertainty.

¹⁸⁵ However, this assessment does not necessarily reflect the uncertainty surrounding the long-term assumptions.

¹⁸⁶ European Commission and Economic Policy Committee, "The 2018 Ageing Report: Economic & Budgetary Projections for the 28 EU Member States (2016-2070)", *European Economy Institutional Paper*, No 079, European Commission, 2018.

to the medium-term objective. Additional government investment should be financed by a 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 age-related costs.

5.6.3 Exchange rate developments

Over the reference period from 1 April 2018 to 31 March 2020, 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 mostly traded close to its April 2018 average exchange rate against the euro of 4.6578 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 31 March 2020 the exchange rate stood at 4.8283 lei per euro, i.e. 3.7% weaker than its average level in April 2018. Over the reference period the maximum upward deviation from this benchmark was 0.8%, while the maximum downward deviation amounted to 4.1%. Over the past ten years, the exchange rate of the Romanian leu against the euro has depreciated by 16.9%.

The exchange rate of the Romanian leu against the euro exhibited, on average, a low 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 the re-emergence of internal and external balances owing to an expansionary fiscal policy stance. This depreciation gained momentum in mid-March 2020 following the outbreak of the coronavirus (COVID-19) in Europe and its impact on economic activity and global financial markets. Over the reference period short-term interest rate differentials against the three-month EURIBOR remained relatively wide on account of monetary policy rates in Romania being higher than in the euro area. Reflecting the widening of the inflation differential vis-à-vis the euro area, the spreads increased amid interest rate increases by Banca Națională a României between January 2018 and May 2018. Following the cut of the policy rate by 50 basis points on 20 March 2020 to mitigate the impact of the coronavirus (COVID-19), short-term interest rate differentials against the three-month EURIBOR declined by around 70 basis points.

The real effective exchange rate of the Romanian leu has depreciated slightly 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 over the past ten years. As a result, the country's net foreign liabilities have declined gradually, while remaining high (see Table 5.6.3). Following three consecutive EU and IMF financial assistance programmes between 2009 and 2015, the combined current and capital

account balance turned into surplus in 2013. From 2017 the combined 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, on the back of fiscal easing. Net inflows in direct and portfolio investment were more than offset by net outflows of other investment from 2012 to 2015, and external debt declined at the same time. Portfolio inflows in the form of debt securities subsequently gained in importance. Together with other debt-creating inflows, this led to an increase in external debt in nominal euro terms from 2015 onwards. Yet, as a result of nominal GDP growth, the gross external debt ratio decreased from 59.1% in 2015 to 47.4% in 2019, and the country's net international investment position improved from -53.7% of GDP in 2015 to -42.8% of GDP in 2019. 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 2019 exports of goods and services to the euro area constituted 57.2% of total exports, while the corresponding figure for imports amounted to 52.8%. In 2019 the share of the euro area in Romania's stock of inward direct investment stood at 80.8% and its share in the country's stock of portfolio investment liabilities was 61.2%. The share of Romania's stock of foreign assets invested in the euro area amounted to 68.1% in the case of direct investment and 64.6% for portfolio investment in 2019.

5.6.4 Long-term interest rate developments

Over the reference period from April 2019 to March 2020, long-term interest rates in Romania stood at 4.4% on average and were thus above the 2.9% reference value for the interest rate convergence criterion (see Chart 5.6.5).

Long-term interest rates in Romania stood at 4.6% in March 2020, increasing by 60 basis points compared with February 2020, which was the lowest level since autumn 2017. Long-term interest rates in Romania reached double digit levels during the financial crisis and stood at more than 9% in January 2010. Between then and early 2015 long-term interest rates in Romania declined steadily and closely followed global developments, particularly in the euro area, before reaching a historical low of 2.8% in February 2015 in a context of negative inflation. Since then the long-term interest rate in Romania has fluctuated at between 3% and 4% until the beginning of 2017. Thereafter it started to increase gradually and, although it remained within a higher range of 4-5%, it stood at 4.6% in March 2020. This was possibly owing to the sustained inflation dynamics, sizeable current account deficit and persistent uncertainty regarding the sustainability of the government's fiscal policy. Since April 2020 Banca Națională a României has initiated government bond purchases to dampen the high volatility in the market for government securities induced by the coronavirus (COVID-19) pandemic. These factors are also behind the persistently high credit default swap spreads for Romanian government bonds that stood at more than 120 basis points in March 2020, one of the highest among the group of peer

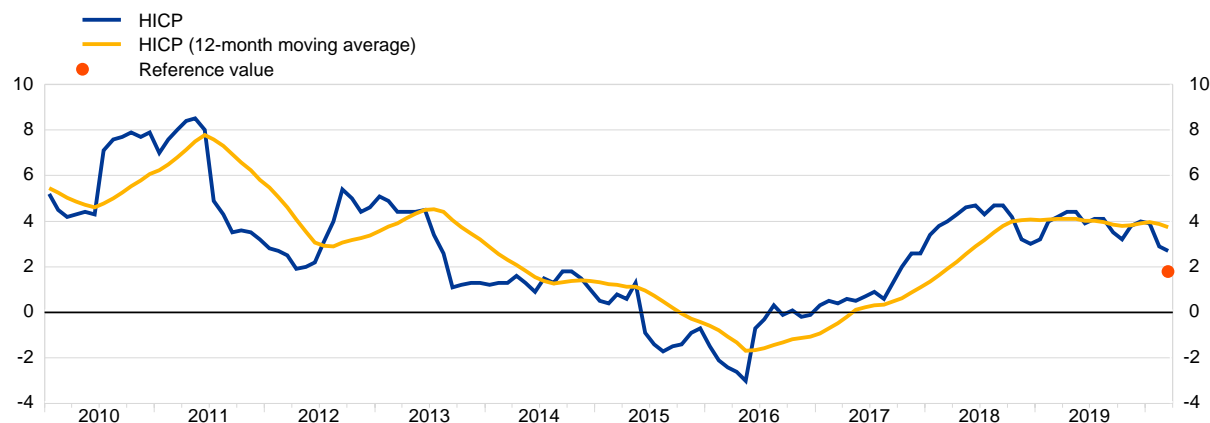
countries in the region. Romania's government debt is rated at the lowest investment-grade notch by all three main rating agencies.

The long-term interest rate differential of Romanian bonds vis-à-vis the euro area has gradually increased since the end of 2016. After a period of relatively high volatility from 2010 to 2012, the long-term interest rate differential of Romanian sovereign bonds vis-à-vis the euro area average stabilised between the end of 2014 and the end of 2016. Since then the interest rate differential increased steadily to reach levels of around 400 basis points in early 2019 and then stabilised.

Capital markets in Romania are much smaller than in the euro area and are still underdeveloped (see Table 5.6.4). At the end of 2019 the corporate debt market barely existed, as the outstanding amount of debt securities issued by financial corporations amounted to 0.4% of GDP, while the outstanding amount of debt securities issued by non-financial corporations was virtually non-existent. Romania's equity market is also still quite small, as its stock market capitalisation, at 9.5% of GDP in 2019, ranks among the lowest in the region. In Romania, foreign-owned banks play a major role and account for around 74% of total banking assets in 2019. The degree of financial intermediation is quite small and is the lowest in the region, as measured by the credit extended by MFIs to the private sector, which stood at 25.3% of GDP in 2019. Over the past decade Romanian banks have gradually relied less and less on euro area banks for their funding needs. The claims of euro area banks on Romanian banks have declined from an annual average of more than 23% of total liabilities of domestic MFIs over the period 2010-14 to 4% in 2019. Since 2010 the share of MFI loans denominated in domestic currency in total loans extended to the private sector has increased consistently, from about 37% at the end of 2010 to 67% in February 2020.

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 2019 to March 2020 is the unweighted arithmetic average of the annual percentage changes in the HICP for Portugal, Cyprus and Italy plus 1.5 percentage points. The reference value is 1.8%.

Table 5.6.1 Measures of inflation and related indicators
(annual percentage changes, unless otherwise indicated)

	2010-2019 ¹⁾	2010-2014 ¹⁾	2015-2019 ¹⁾	2015	2016	2017	2018	2019	2020 ²⁾	2021 ²⁾
Measures of inflation										
HICP	2.7	4.0	1.5	-0.4	-1.1	1.1	4.1	3.9	2.5	3.1
HICP excluding unprocessed food and energy	2.6	3.7	1.5	0.7	-0.2	0.9	2.7	3.8	3.5	3.1
HICP at constant tax rates ³⁾	2.6	2.6	2.5	1.2	2.1	2.0	3.8	3.7	-	-
CPI	2.8	4.0	1.5	-0.6	-1.6	1.3	4.6	3.8	2.5	3.1
Private consumption deflator	3.2	3.6	2.8	1.0	0.7	2.7	4.2	5.2	2.0	2.0
GDP deflator	3.9	3.3	4.6	2.6	2.5	4.7	6.3	6.9	2.3	2.5
Producer prices ⁴⁾	2.8	3.8	1.8	-1.8	-2.6	3.1	5.2	5.1	-	-
Related indicators										
Real GDP growth	3.1	1.4	4.9	3.9	4.8	7.1	4.4	4.1	-6.0	4.2
GDP per capita in PPS ⁵⁾ (euro area = 100)	53.1	49.5	57.5	52.6	55.8	59.6	62.0	.	-	-
Comparative price levels (euro area = 100)	51.6	51.9	51.3	52.2	50.9	51.0	51.1	.	-	-
Output gap ⁶⁾	-1.4	-2.8	0.0	-1.5	-1.1	1.3	1.0	0.5	-8.0	-6.6
Unemployment rate (%) ⁷⁾	6.1	7.0	5.1	6.8	5.9	4.9	4.2	3.9	6.5	5.4
Unit labour costs, whole economy	3.8	2.1	5.6	-3.1	8.5	9.8	8.8	4.5	6.4	1.3
Compensation per employee, whole economy	7.5	4.4	10.7	1.9	15.0	14.8	13.4	8.9	2.6	4.8
Labour productivity, whole economy	3.5	2.3	4.8	5.2	6.0	4.6	4.2	4.1	-3.6	3.5
Imports of goods and services deflator	1.4	2.3	0.5	-1.2	-6.8	4.8	4.1	2.1	-1.2	1.0
Nominal effective exchange rate ⁸⁾	-0.9	-1.1	-0.7	-2.4	0.8	-0.6	0.6	-1.9	-	-
Money supply (M3) ⁹⁾	8.2	6.6	9.9	8.4	9.5	11.1	10.6	9.9	-	-
Lending from banks ¹⁰⁾	5.0	3.1	7.0	3.8	6.4	7.9	10.2	6.7	-	-
Stock prices (BET) ¹¹⁾	112.7	51.0	40.9	-1.1	1.2	9.4	-4.8	35.1	-	-
Residential property prices	-0.5	-5.5	4.8	2.9	6.0	6.1	5.6	3.4	-	-

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 Refinitiv 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 2020 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).

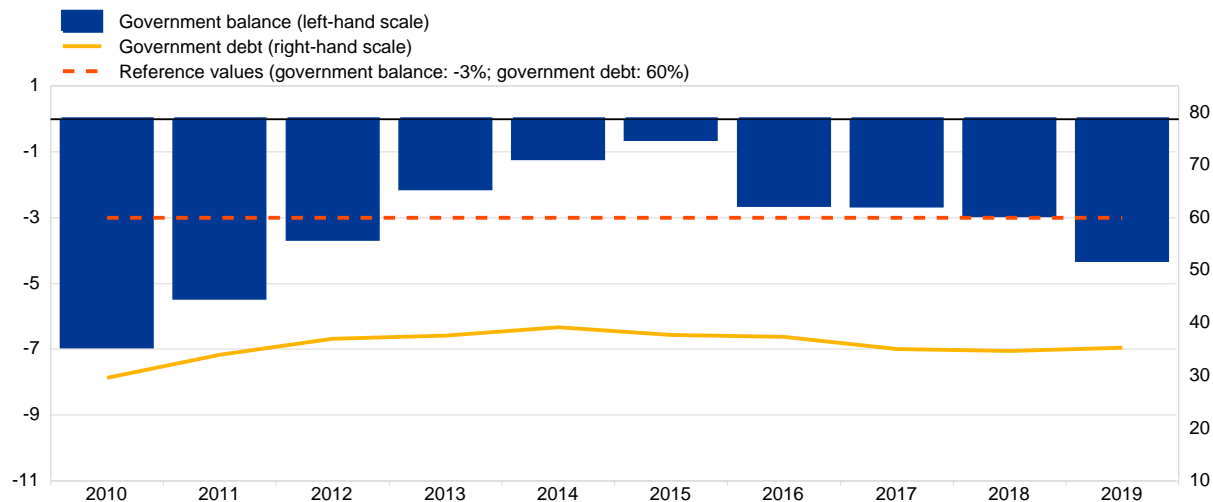
9) The series includes repurchase agreements with central counterparties.

10) 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.

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)

	2010-2019 ¹⁾	2010-2014 ¹⁾	2015-2019 ¹⁾	2015	2016	2017	2018	2019	2020 ²⁾	2021 ²⁾
Government balance	-3.2	-3.9	-2.6	-0.6	-2.6	-2.6	-2.9	-4.3	-9.2	-11.4
Total revenue	33.0	33.7	32.4	35.5	31.9	30.8	31.9	31.7	32.3	32.2
Current revenue	31.4	32.0	30.8	32.7	30.6	29.4	30.9	30.6	30.9	30.7
Direct taxes	5.9	6.0	5.8	6.6	6.4	6.1	4.9	4.8	4.6	4.7
Indirect taxes	11.9	12.7	11.2	13.3	11.3	10.3	10.4	10.6	10.2	10.3
Net social contributions	9.3	8.9	9.8	8.1	8.8	9.4	11.4	11.3	11.7	11.6
Other current revenue ³⁾	4.3	4.5	4.1	4.7	4.0	3.7	4.2	3.9	4.5	4.1
Capital revenue	1.6	1.6	1.5	2.8	1.3	1.4	1.0	1.1	1.3	1.5
Total expenditure	36.2	37.5	35.0	36.1	34.5	33.5	34.8	36.0	41.5	43.5
Current expenditure	30.7	31.1	30.3	29.7	29.4	30.0	30.9	31.5	37.2	38.5
Compensation of employees	9.0	8.3	9.8	7.8	9.0	9.8	10.9	11.2	12.5	12.2
Social benefits	12.1	12.5	11.6	11.5	11.5	11.6	11.6	11.8	14.4	16.8
Interest payable	1.5	1.7	1.4	1.6	1.5	1.3	1.1	1.2	1.5	1.7
Other current expenditure ⁴⁾	8.1	8.7	7.6	8.8	7.4	7.3	7.3	7.2	8.9	7.7
Capital expenditure	5.6	6.4	4.7	6.3	5.2	3.5	3.9	4.5	4.3	5.0
of which: Investment	4.2	4.9	3.5	5.2	3.6	2.6	2.7	3.4	3.3	4.0
Cyclically adjusted balance	-2.8	-3.0	-2.6	-0.1	-2.3	-3.0	-3.3	-4.4	-6.7	-9.2
One-off and temporary measures	-0.1	-0.1	-0.1	0.3	-0.4	0.0	-0.3	-0.1	0.0	0.0
Structural balance ⁵⁾	-2.7	-2.8	-2.5	-0.4	-1.9	-3.0	-2.9	-4.3	-6.7	-9.2
Government debt	35.8	35.5	36.0	37.8	37.3	35.1	34.7	35.2	46.2	54.7
Average residual maturity (in years)	5.5	4.9	6.2	5.4	5.7	6.2	6.6	6.9	.	.
In foreign currencies (% of total)	54.6	57.9	51.3	53.8	52.0	51.7	50.3	48.7	.	.
of which: Euro	44.7	47.2	42.1	43.6	41.9	43.2	41.2	40.4	.	.
Domestic ownership (% of total)	50.7	49.1	52.3	50.6	52.0	51.5	52.2	55.1	.	.
Medium and long-term maturity (% of total) ⁶⁾	89.9	84.7	95.1	93.6	93.1	95.0	96.7	96.9	.	.
of which: Variable interest rate (% of total)	12.9	16.8	9.0	11.7	10.1	11.3	6.3	5.5	.	.
Deficit-debt adjustment	0.5	1.2	-0.2	0.4	-0.5	-0.8	0.1	-0.2	.	.
Net acquisitions of main financial assets	0.3	0.9	-0.4	-0.6	1.9	-0.9	-0.5	-1.7	.	.
Currency and deposits	0.4	1.0	-0.2	-0.5	2.0	-0.5	-0.3	-1.4	.	.
Debt securities	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.0	.	.
Loans	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	.	.
Equity and investment fund shares or units	-0.2	-0.1	-0.2	-0.1	-0.1	-0.6	-0.3	-0.3	.	.
Revaluation effects on debt	0.0	0.0	0.1	-0.2	-0.2	0.3	0.1	0.3	.	.
of which: Foreign exchange holding gains/losses	0.2	0.3	0.2	0.2	0.1	0.5	0.0	0.5	.	.
Other ⁷⁾	0.2	0.3	0.1	1.2	-2.3	-0.1	0.6	1.2	.	.
Convergence programme: government balance	-	-	-	-	-	-	-	-	-6.7	.
Convergence programme: structural balance	-	-	-	-	-	-	-	-	.	.
Convergence programme: government debt	-	-	-	-	-	-	-	-	40.9	.

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 2020 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.

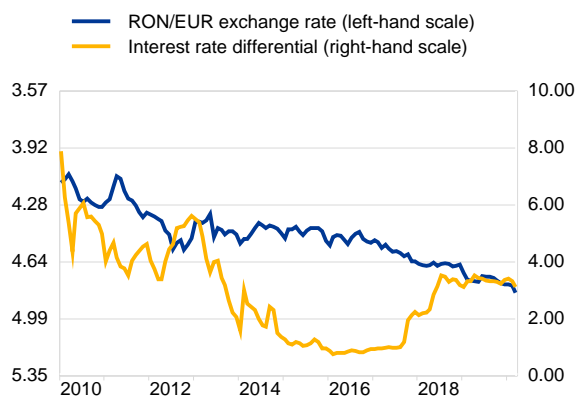
6) Original maturity of more than one year.

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

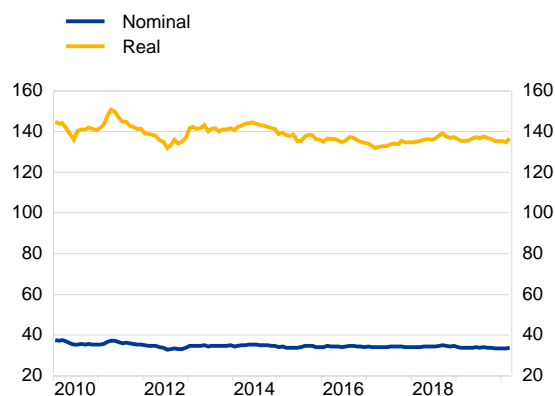
(RON/EUR exchange rate: monthly averages; difference between three-month interbank interest rates and three-month EURIBOR: basis points, monthly values)



Sources: National data and ECB calculations.

Chart 5.6.4 Effective exchange rates ¹⁾

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



Source: ECB.

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

Table 5.6.3 External developments

(as a percentage of GDP, unless otherwise indicated)

	2010-2019 ¹⁾	2010-2014 ¹⁾	2015-2019 ¹⁾	2015	2016	2017	2018	2019	2020 ²⁾	2021 ²⁾
Balance of payments										
Current account and capital account balance ³⁾	-1.4	-1.8	-1.0	1.8	1.1	-1.6	-3.2	-3.3	-1.7	-1.7
Current account balance	-3.0	-3.2	-2.7	-0.6	-1.4	-2.8	-4.4	-4.6	-3.3	-3.4
Goods	-6.2	-6.0	-6.4	-4.9	-5.5	-6.5	-7.2	-7.8	.	.
Services	3.3	2.3	4.2	4.3	4.6	4.4	4.1	3.9	.	.
Primary income	-1.3	-1.2	-1.4	-1.1	-1.3	-1.4	-1.8	-1.4	.	.
Secondary income	1.3	1.8	0.8	1.1	0.8	0.8	0.6	0.7	.	.
Capital account balance	1.5	1.4	1.7	2.4	2.5	1.2	1.2	1.3	.	.
Combined direct and portfolio investment balance ³⁾	-3.6	-3.8	-3.3	-1.9	-3.2	-4.2	-3.8	-3.5	.	.
Direct investment	-2.1	-1.8	-2.4	-1.9	-2.6	-2.6	-2.4	-2.4	.	.
Portfolio investment	-1.5	-2.1	-0.9	0.0	-0.6	-1.6	-1.4	-1.1	.	.
Other investment balance	2.1	1.7	2.4	3.6	3.4	2.3	1.6	1.2	.	.
Reserve assets	0.3	0.6	0.1	-0.4	1.3	0.2	-0.4	-0.1	.	.
Exports of goods and services	39.6	37.7	41.5	41.3	41.7	42.1	41.8	40.4	.	.
Imports of goods and services	42.5	41.4	43.6	42.0	42.5	44.2	45.0	44.2	.	.
Net international investment position ⁴⁾	-55.6	-63.6	-47.6	-54.7	-49.1	-47.4	-43.7	-43.1	.	.
Gross external debt ⁴⁾	63.0	72.9	53.1	60.1	56.0	52.9	48.9	47.7	.	.
Trade with the euro area ⁵⁾										
Exports of goods and services	55.0	52.4	56.5	54.9	55.8	57.0	57.6	57.2	.	.
Imports of goods and services	53.4	53.0	54.1	54.6	55.0	54.3	54.0	52.8	.	.
Investment position with the euro area ⁵⁾										
Direct investment assets ⁴⁾	57.4	32.5	67.3	50.3	73.6	72.7	72.0	68.1	.	.
Direct investment liabilities ⁴⁾	80.3	78.4	81.1	80.0	81.1	81.7	81.9	80.8	.	.
Portfolio investment assets ⁴⁾	61.3	55.5	63.6	64.0	63.9	65.1	60.4	64.6	.	.
Portfolio investment liabilities ⁴⁾	58.5	61.1	55.8	48.4	54.7	58.3	56.1	61.2	.	.

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. Owing to the unavailability of data, the multi-annual averages for the "trade with the euro area" series are calculated for the period starting in 2013.

2) Data from the European Commission's Spring 2020 Economic Forecast.

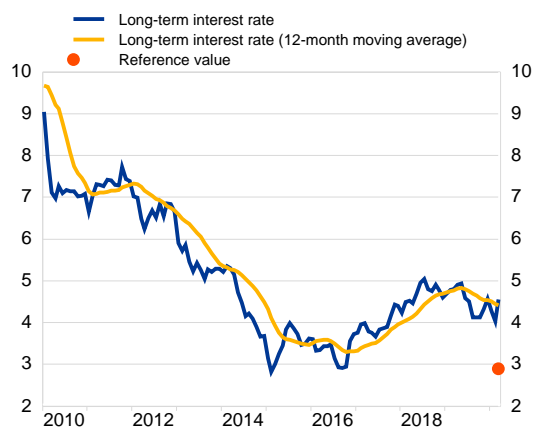
3) Differences between totals and the sum of their components are due to rounding.

4) End-of-period outstanding amounts.

5) As a percentage of the total.

Romania - Long-term interest rate developments

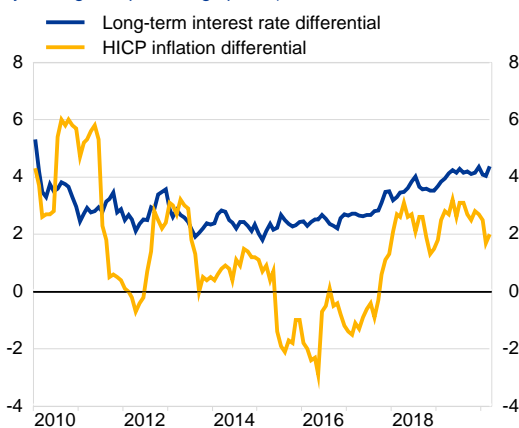
Chart 5.6.5 Long-term interest rate ¹⁾
(monthly averages in percentages)



Sources: European System of Central Banks and ECB calculations.

1) The basis of the calculation of the reference value for the period from April 2019 to March 2020 is the unweighted arithmetic average of the interest rate levels in Portugal, Cyprus and Italy plus 2 percentage points. The reference value is 2.9%.

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)

	2010-2019 ¹⁾	2010-2014 ¹⁾	2015-2019 ¹⁾	2016	2017	2018	2019	Apr. 2019 to Mar. 2020	Memo item: euro area 2019
Long-term interest rates									
Romania ²⁾	5.1	6.2	4.0	3.3	4.0	4.7	4.5	4.4	-
Euro area ^{2), 3)}	2.2	3.4	0.9	0.9	1.1	1.1	0.4	0.2	-
Euro area AAA par curve, ten-year residual maturity ^{2), 3)}	1.3	2.3	0.3	0.2	0.4	0.5	-0.2	-0.3	-
Indicators of financial development and integration									
Debt securities issued by financial corporations ⁴⁾	0.3	0.2	0.3	0.2	0.3	0.2	0.4	-	66.7
Debt securities issued by non-financial corporations ⁵⁾	0.0	0.0	0.0	0.1	0.0	0.0	0.0	-	11.8
Stock market capitalisation ⁶⁾	9.6	10.2	9.1	8.9	9.3	8.0	9.5	-	67.7
MFI credit to non-government residents ⁷⁾	32.2	36.7	27.6	28.8	27.1	26.4	25.3	-	107.4
Claims of euro area MFIs on resident MFIs ⁸⁾	15.5	23.2	7.9	9.5	7.3	5.8	4.0	-	26.1

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 (excluding the national central bank) 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 market values.

7) MFI (excluding national central bank) credit to domestic non-MFI residents other than general government. Credit comprises 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 2020 the 12-month average rate of HICP inflation in Sweden was 1.6%, i.e. below the reference value of 1.8% for the criterion on price stability (see Chart 5.7.1). In the light of the coronavirus (COVID-19) pandemic, there is a high level of uncertainty as to how this rate is going to evolve over the coming months.

Over the past ten years the 12-month average rate of HICP inflation has fluctuated within a relatively narrow range from 0.2% to 2.1%, and the average for that period was subdued, standing at 1.2%. From 2010 to 2013, the steady appreciation of the krona in nominal effective terms, along with low external price pressures, kept a lid on consumer price inflation. 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. Between early 2017 and early 2019, HICP inflation hovered between 1.4% and 2.5%, as volatile energy prices contributed to fitful inflation growth. Amid historically low interest rates and supply-side frictions in the housing market, house prices have increased substantially in recent years, together with household indebtedness. Despite a downward correction at the end of 2017, house prices have remained elevated. In December 2018, Sveriges Riksbank increased its repo rate from -0.50% to -0.25%, in the light of robust economic growth and accelerating core inflation. Despite a marked slowdown in economic activity and a weakening in inflation below the 2% target, owing to lower energy prices, the central bank further lifted its policy rate at the end of December 2019 from -0.25% to 0%. At the same time, core inflation has continued accelerating and stood at 1.8% in the fourth quarter of 2019.

In the first quarter of 2020 the average annual rate of HICP inflation declined and stood at 1.2%. The unusually mild winter and lower oil prices have contributed to falling energy prices, keeping inflation down.

The national authorities have taken major fiscal, macroprudential and monetary policy measures to offset the economic damage wrought by the COVID-19 pandemic. The governmental measures include subsidies for shorter working hours, tax rebates, loan guarantees and easier rules for claiming benefits. Similarly, the Riksbank stands ready in particular to provide liquidity support to the financial sector as well as directly to private companies and to continue purchases of government and mortgage bonds.

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 drop back well below 2% over the next couple of years. However, in the current exceptional circumstances, the forecasts are subject to an unusual level of uncertainty. According to the European

Commission's Spring 2020 Economic Forecast, average annual HICP inflation is set to decline to 0.4% in 2020 before rebounding to 1.1% in 2021. Given the COVID-19 outbreak, the balance between downward pressures on inflation linked to weaker demand and upward pressures related to supply disruptions, is surrounded by considerable uncertainty. However, inflation is expected to decline in 2020 mainly on oil prices. The risks to the inflation outlook are broadly balanced. Upside risks mainly relate to a faster recovery from the economic downturn brought about by the COVID-19 pandemic, while a more protracted economic downturn constitutes a significant downside risk for the inflation outlook. Looking further ahead, monetary policy and the stability-oriented institutional framework should continue to support the achievement of price stability in Sweden.

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 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 2020 that, although some progress had been made in implementing measures to address the issues of the housing market, 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. In the short term, the priority for the national authorities is to

safeguard financial stability in view of the COVID-19 outbreak. However, over the long-term, it remains important to tackle the imbalances related to the housing market. Indeed, macro-financial risks have been high these last years, stemming primarily from high housing prices, high household indebtedness and the large exposure of the banking sector to the housing market. Although the resilience of the banking sector has improved in recent years, as banks have built up liquidity buffers and increased their capital ratios, the Swedish authorities need to tackle the structural factors behind the house price dynamics to further ease macro-financial risks. 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 2019. In 2019 the general government sector recorded a surplus of 0.5% of GDP, thus comfortably meeting the 3% deficit reference value. The general government debt ratio was 35.1% of GDP, i.e. well below the 60% reference value (see Table 5.7.2). Compared with the previous year, the surplus decreased by 0.3 percentage points of GDP and the debt ratio declined by 3.7 percentage points.

Sweden is 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. The European Commission's Spring 2020 Economic Forecast assessed that the structural balance remained within the medium-term objective in 2019.

The reduction in the government surplus over 2018-19 was driven mostly by structural factors. Since having peaked at a surplus of 1.4% of GDP in 2017, the budget balance deteriorated by 0.9 percentage points over 2018-19. The European Commission's estimates (see Table 5.7.2) indicate that the structural balance deteriorated by 0.8 percentage points between 2017 and 2019, while cyclical factors contributed slightly (0.2 percentage points) to the deterioration in the budget balance; no substantial temporary or one-off measures occurred in that period.

The debt ratio declined steadily from its peak in 2014 to 2019, staying at levels well below the 60% reference value. The debt ratio decreased steadily from its peak of 45.1% of GDP in 2014 (see Table 5.7.2). Between 2014 and 2019 it fell by 10.0 percentage points to 35.1%, on account of favourable interest-growth differentials and sizeable primary surpluses, which more than offset positive deficit-debt adjustments.¹⁸⁷

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 (20.7% in 2019 – 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. Moreover, the proportion of government debt denominated in foreign currency is relatively high (21.1% in 2019). 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.

¹⁸⁷ In 2019 the large negative deficit-debt adjustments were driven by Sveriges Riksbank's decision to decrease its holdings of foreign-exchange reserve assets and not to roll over currency loans granted by the Government.

The European Commission's Spring 2020 Economic Forecast indicates a notable deterioration in the budgetary outlook on account of the COVID-19 pandemic. According to the Commission's latest forecast, the budget balance is projected to temporarily deteriorate to a deficit of 5.6% of GDP in 2020 on account of the macroeconomic effects of the COVID-19 pandemic and related fiscal policy measures. The budget balance is projected to return to below the 3% reference value in 2021, reaching a deficit of 2.2% of GDP. The structural surplus of 0.1% of GDP in 2019 is projected to become a deficit of 2.1% of GDP in 2020, improving to a deficit of 0.2% in 2021. Nevertheless, in the context of the COVID-19 pandemic, the Stability and Growth Pact's general escape clause provides that "in periods of severe economic downturn for the euro area or the Union as a whole, Member States may be allowed temporarily to depart from the adjustment path towards the medium-term budgetary objective..., provided that this does not endanger fiscal sustainability in the medium term".¹⁸⁸ The government debt ratio is projected to increase in 2020, by 7.5 percentage points to 42.6% of GDP, and stabilise at about the same level in 2021, thus remaining below the 60% reference value. Sweden's medium-term fiscal policy strategy, as presented in the 2020 convergence programme update, projects a smaller deterioration in the budget balance to a deficit of 3.8% of GDP in 2020, which is then projected to improve to a deficit of 1.4% of GDP in 2021. The projection of the structural balance is also more favourable than the Commission's forecast, at a deficit of 0.9% of GDP in 2020 and a surplus of 0.6% of GDP in 2021.

Sweden has a strong fiscal governance framework. Following the last revision of the fiscal framework, which entered into force in 2019, the general government surplus target is now 1/3% of GDP over the business cycle. This target is much more ambitious than the structural balance targets of the EU fiscal framework. In addition, a debt anchor was introduced into the fiscal framework in 2019, targeting a debt ratio of 35% (Maastricht definition). 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. The debt level of 35% 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 is strong, and compliance with the revised surplus target would support the medium-term sustainability of public finances in line with the requirements of the Stability and Growth Pact.

The European Commission's 2019 Debt Sustainability Monitor, which was released prior to the COVID-19 pandemic, suggested that Sweden faced low risks to the medium-term and long-term sustainability of public finances. The European Commission's 2019 Debt Sustainability Monitor pointed to low risk over the medium and long term.¹⁸⁹ This stemmed largely from a favourable initial fiscal position, especially the low government debt. Over the long term, it also resulted from a relatively low increase in age-related costs. Indeed, the 2018 Ageing Report

¹⁸⁸ For more details, see Box 2 in the Framework for analysis.

¹⁸⁹ However, this assessment does not necessarily reflect the uncertainty surrounding the long-term assumptions.

prepared by the Ageing Working Group (AWG) of the EU's Economic Policy Committee¹⁹⁰ showed a moderate rise (1.6 percentage points) in age-related expenditure by 2070, as projected in the AWG's reference scenario, from a level of 24.4% of GDP in 2016, mainly driven by long-term care costs. In the AWG's risk scenario, the increase in the cost of ageing amounted to 3.1 percentage points of GDP, which was below the EU average.

Looking ahead and leaving aside the policy measures to address the COVID-19 pandemic, Sweden should build on its strong track record and comply with its national surplus target and the requirements 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 target of a budget surplus on average over the business cycle, 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.

5.7.3 Exchange rate developments

In the two-year reference period from 1 April 2018 to 31 March 2020, 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 weaker than its April 2018 average exchange rate against the euro of 10.3717 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 31 March 2020 the exchange rate stood at 11.0613 kronor per euro, i.e. 6.6% weaker than its average level in April 2018. Over the reference period the maximum upward deviation from this benchmark was 2.3%, while the maximum downward deviation amounted to 7.5%. During the past ten years the exchange rate of the Swedish krona against the euro has depreciated by 14.5%. In January 2019 Sveriges Riksbank announced that it would withdraw its decision of 4 January 2016 which enabled it to intervene quickly in the foreign exchange market when necessary to ensure that developments in the krona exchange rate did 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. Overall, the exchange rate followed a depreciating trend, despite the monetary policy rate hikes in December 2018 and December 2019 and the withdrawal of the decision which

¹⁹⁰ European Commission and Economic Policy Committee, "The 2018 Ageing Report: Economic & Budgetary Projections for the 28 EU Member States (2016-2070)", *European Economy Institutional Paper*, No 079, European Commission, 2018.

allowed Sveriges Riksbank to intervene quickly in foreign exchange markets if deemed necessary. From early November 2019 to mid-December 2019 the krona appreciated as markets anticipated the interest rate hike from -0.25% to 0.00% on 19 December 2019. Thereafter the exchange rate depreciated again, reflecting the expected marked slowdown in economic activity as well as heightened global uncertainties to which small open economies react particularly strongly. This depreciation gained further momentum in mid-March 2020 following the outbreak of the coronavirus (COVID-19) in Europe and its impact on economic activity and global financial markets. Over the reference period short-term interest rate differentials against the three-month EURIBOR were overall small and stood at 0.4 percentage points in the three-month period ending in April 2020.

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 since 2015 its net international investment position has been positive (see Table 5.7.3). In 2019 the surplus in the combined current and capital account of the balance of payments stood at 3.9% 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 164.2% of GDP in 2019. Over the past ten years Sweden recorded on average a negative net international investment position. Since 2015, however, its net international investment position has been positive, reaching 20.9% of GDP in 2019.

The Swedish economy is well integrated with the euro area through trade and investment linkages. In 2019 exports of goods and services to the euro area constituted 38.9% of total exports, while the corresponding figure for imports was higher, at 49.3%. In 2019 the share of the euro area in Sweden's stock of inward direct investment stood at 56.1%, and its share in the country's stock of portfolio investment liabilities was 43.2%. The share of Sweden's stock of foreign assets invested in the euro area amounted to 45.7% in the case of direct investment and to 34.7% for portfolio investment in 2019.

5.7.4 Long-term interest rate developments

Over the reference period from April 2019 to March 2020, long-term interest rates in Sweden stood at a slightly negative level of -0.1% on average and thus remained well below the 2.9% 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 2010, falling from above 3% to - 0.2% at the end of the reference period. Sweden entered the global financial crisis with sound public finances that helped isolate the country from the tensions that characterised the euro area over the period 2010-12. The long-term interest rate on Swedish sovereign bonds declined steadily from 2010 to 2015, with the exception of a short break in the second half of 2010, when Sveriges

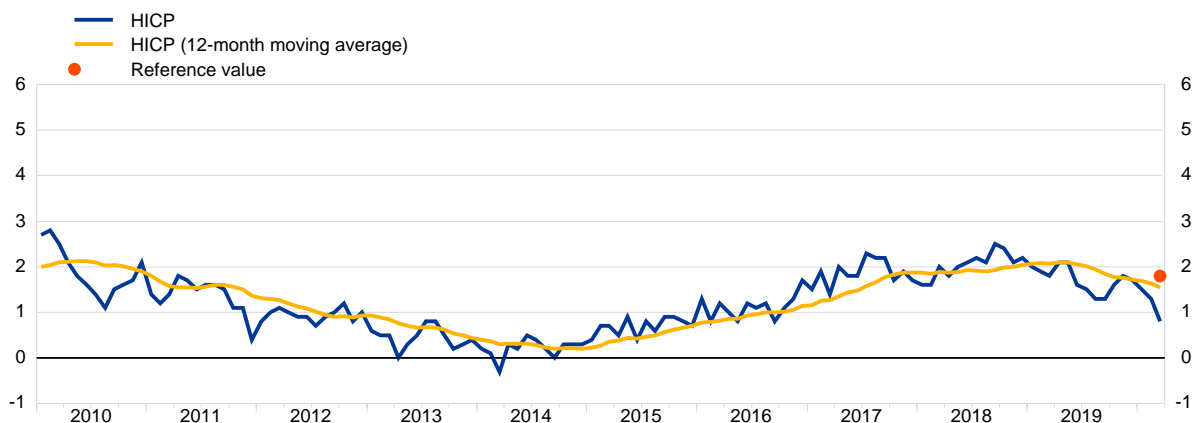
Riksbank raised interest rates. Subsequently, in 2011 long-term interest rates declined again on the back of bond investors rebalancing their portfolios by reducing their holdings of euro area debt. After a period of gradual increase, owing to high levels of risk appetite and a gradual shift from safe to risky assets, long-term interest rates declined by almost 200 basis points in 2014. Sveriges Riksbank responded to subdued domestic inflation developments and cut interest rates by 100 basis points in one year, bringing its repo rate to stand at 0% in December 2014. In 2015 long-term interest rates increased only marginally, as the effects of strong GDP growth were partly offset by persistently low inflation and further monetary policy accommodation placing the repo rate in negative territory. In the first half of 2016 long-term interest rates declined again as economic activity weakened, while inflation remained muted until reaching an historical low in the summer. Over the following two years long-term interest rates increased gradually, as inflation recovered and the economy continued to grow, albeit at a moderate pace. After stabilising in 2018 at levels below 1%, long-term interest rates in Sweden followed the global downward trend in 2019. After hitting negative values in the course of the year, they have stabilised since October 2019 owing to expectations of a gradual normalisation of monetary policy and settled at -0.2% in March 2020. Since mid-March 2020, owing to the coronavirus (COVID-19) pandemic, Sveriges Riksbank has announced an increase in the envelope of its quantitative easing programme until the end of 2020. The programme includes government bond purchases and is aimed at dampening the high volatility in financial markets and ensuring loose financing conditions. Sweden's government debt is rated at the top investment-grade notch by all three main rating agencies.

Sweden's long-term interest rate differential vis-à-vis the highest-rated euro area countries is very small. As a result of its sound fiscal policy and its balanced and healthy economy, Sweden enjoys the same credibility as the highest rated euro area countries. Over time marginal fluctuations related to the differences in the respective business cycles have resulted in a marginally positive interest rate differential vis-à-vis AAA-rated euro area government bonds. However, the interest rate differential vis-à-vis the euro area average has remained negative since 2010 and declined significantly during the euro area debt crisis from 2010 to 2012, when Sweden benefitted from safe heaven inflows of sovereign bonds. At the end of the reference period, lower rates in Sweden led the interest rate differential vis-à-vis the euro area to stand at -40 basis points, while the differential vis-à-vis the best-rated euro area government bonds was positive and stood at 30 basis points.

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 over twice those in the euro area. The size of the Swedish stock market, as a percentage of GDP, is more than twice that of the euro area. Sweden's banks tend to fund their activities by borrowing from euro area banks only to a limited extent. Claims of euro area MFIs accounted for 9.1% of Swedish banks' total liabilities in 2019. The degree of financial intermediation in Sweden is high. At the end of 2019 bank credit to the private sector amounted to 136.2% of GDP, much higher than the corresponding figure in the euro area of 107.4%.

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 2019 to March 2020 is the unweighted arithmetic average of the annual percentage changes in the HICP for Portugal, Cyprus and Italy plus 1.5 percentage points. The reference value is 1.8%.

Table 5.7.1 Measures of inflation and related indicators
(annual percentage changes, unless otherwise indicated)

	2010-2019 ¹⁾	2010-2014 ¹⁾	2015-2019 ¹⁾	2015	2016	2017	2018	2019	2020 ²⁾	2021 ²⁾
Measures of inflation										
HICP	1.2	1.0	1.5	0.7	1.1	1.9	2.0	1.7	0.4	1.1
HICP excluding unprocessed food and energy	1.1	0.9	1.3	1.1	1.1	1.5	1.2	1.6	1.1	0.9
HICP at constant tax rates ³⁾	1.2	1.0	1.3	0.5	1.0	1.7	1.8	1.6	-	-
CPI	1.1	1.0	1.3	0.0	1.0	1.8	2.0	1.8	-	-
Private consumption deflator	1.2	0.9	1.6	1.1	0.9	1.8	2.2	1.9	0.3	1.0
GDP deflator	1.7	1.1	2.2	2.2	1.5	2.2	2.3	2.7	1.0	1.3
Producer prices ⁴⁾	1.4	0.6	2.2	-1.0	0.0	4.1	5.5	2.7	-	-
Related indicators										
Real GDP growth	2.5	2.5	2.5	4.4	2.4	2.4	2.2	1.2	-6.1	4.3
GDP per capita in PPS ⁵⁾ (euro area = 100)	117.4	118.5	116.0	119.2	115.8	115.1	113.8	.	-	-
Comparative price levels (euro area = 100)	121.4	121.8	120.9	121.1	123.7	122.1	116.8	.	-	-
Output gap ⁶⁾	-0.3	-1.4	0.9	0.6	0.9	1.1	1.4	0.8	-6.3	-3.7
Unemployment rate (%) ⁷⁾	7.5	8.1	6.9	7.4	7.0	6.7	6.4	6.8	9.7	9.3
Unit labour costs, whole economy	1.6	1.4	1.9	-0.3	2.0	2.1	3.3	2.4	2.4	2.3
Compensation per employee, whole economy	2.7	2.6	2.9	2.6	2.6	2.1	4.0	3.0	-1.3	5.6
Labour productivity, whole economy	1.1	1.2	0.9	2.9	0.5	0.0	0.7	0.6	-3.6	3.2
Imports of goods and services deflator	1.0	-0.5	2.5	1.4	-1.6	4.0	6.0	2.9	-1.0	0.3
Nominal effective exchange rate ⁸⁾	-0.1	2.6	-2.7	-6.2	0.8	-0.8	-3.9	-3.6	-	-
Money supply (M3) ⁹⁾	5.8	4.9	6.7	6.1	8.5	8.5	3.0	7.5	-	-
Lending from banks ¹⁰⁾	5.4	4.9	5.8	4.9	7.4	6.9	4.7	5.2	-	-
Stock prices (OMXS30) ¹¹⁾	86.2	53.9	21.0	-1.2	4.9	3.9	-10.7	25.8	-	-
Residential property prices	5.5	5.2	5.8	13.1	8.2	6.6	-0.9	2.5	-	-

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 Refinitiv 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 2020 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).

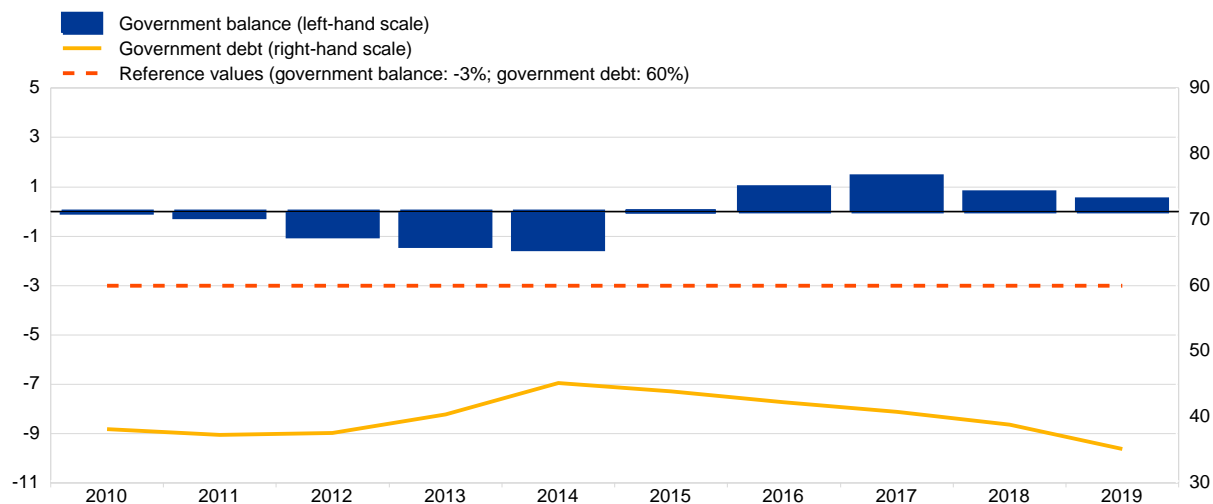
9) The series includes repurchase agreements with central counterparties.

10) 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)

	2010-2019 ¹⁾	2010-2014 ¹⁾	2015-2019 ¹⁾	2015	2016	2017	2018	2019	2020 ²⁾	2021 ²⁾
Government balance	-0.1	-0.8	0.7	0.0	1.0	1.4	0.8	0.5	-5.6	-2.2
Total revenue	50.1	49.9	50.3	49.5	50.7	50.7	50.6	49.8	49.5	49.8
Current revenue	49.9	49.7	50.0	49.2	50.5	50.5	50.4	49.6	49.3	49.6
Direct taxes	18.1	17.7	18.6	18.3	18.9	19.0	18.6	18.1	17.8	17.7
Indirect taxes	22.0	21.8	22.1	21.5	22.4	22.3	22.3	22.0	22.2	21.9
Net social contributions	3.3	3.3	3.3	3.3	3.3	3.3	3.4	3.4	2.8	3.5
Other current revenue ³⁾	6.4	6.9	6.0	6.0	6.0	5.9	6.1	6.1	6.5	6.4
Capital revenue	0.2	0.2	0.2	0.3	0.2	0.2	0.2	0.2	0.2	0.2
Total expenditure	50.1	50.8	49.5	49.5	49.7	49.3	49.8	49.3	55.1	52.0
Current expenditure	45.4	46.1	44.7	45.0	45.1	44.6	44.7	44.1	49.6	46.7
Compensation of employees	12.5	12.5	12.6	12.4	12.6	12.6	12.7	12.6	13.7	13.2
Social benefits	16.8	17.1	16.5	16.8	17.0	16.5	16.2	15.9	17.4	16.7
Interest payable	0.7	0.9	0.5	0.6	0.5	0.5	0.5	0.4	0.3	0.3
Other current expenditure ⁴⁾	15.4	15.7	15.2	15.2	15.0	14.9	15.3	15.3	18.2	16.4
Capital expenditure	4.7	4.6	4.8	4.5	4.6	4.7	5.1	5.2	5.5	5.4
of which: Investment	4.5	4.4	4.6	4.2	4.4	4.6	4.9	4.9	5.2	5.1
Cyclically adjusted balance	0.1	0.0	0.2	-0.3	0.5	0.8	0.0	0.1	-2.1	-0.2
One-off and temporary measures	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Structural balance ⁵⁾	0.1	0.0	0.2	-0.3	0.5	0.8	0.0	0.1	-2.1	-0.2
Government debt	39.9	39.7	40.2	43.9	42.2	40.8	38.8	35.1	42.6	42.5
Average residual maturity (in years)	-	-	-	-	-	-	-	-	-	-
In foreign currencies (% of total)	23.2	22.4	24.0	24.8	25.9	23.4	24.6	21.1	.	.
of which: Euro	9.2	9.2	9.1	8.4	9.0	8.8	9.7	9.7	.	.
Domestic ownership (% of total)	69.5	65.3	73.7	63.3	70.9	76.8	76.9	80.3	.	.
Medium and long-term maturity (% of total) ⁶⁾	74.8	73.2	76.5	72.4	77.0	74.7	79.3	79.3	.	.
of which: Variable interest rate (% of total)	12.2	13.8	10.7	9.8	10.7	10.6	11.3	10.9	.	.
Deficit-debt adjustment	1.0	1.4	0.7	1.6	1.0	1.8	0.6	-1.7	.	.
Net acquisitions of main financial assets	0.9	1.9	-0.1	-0.6	0.5	2.9	-1.3	-1.9	.	.
Currency and deposits	0.2	0.4	0.0	-0.4	0.2	0.5	-0.2	-0.3	.	.
Debt securities	0.4	0.5	0.3	0.2	0.6	2.7	-1.1	-0.6	.	.
Loans	0.7	1.2	0.3	0.8	0.4	0.3	0.6	-0.9	.	.
Equity and investment fund shares or units	-0.4	-0.2	-0.6	-1.2	-0.7	-0.5	-0.6	-0.2	.	.
Revaluation effects on debt	0.3	0.3	0.4	0.5	0.4	-0.2	0.8	0.4	.	.
of which: Foreign exchange holding gains/losses	0.2	0.0	0.3	0.6	0.5	-0.4	0.6	0.2	.	.
Other ⁷⁾	-0.2	-0.8	0.4	1.7	0.1	-0.9	1.2	-0.2	.	.
Convergence programme: government balance	-	-	-	-	-	-	-	-	-3.8	-1.4
Convergence programme: structural balance	-	-	-	-	-	-	-	-	-0.9	0.6
Convergence programme: government debt	-	-	-	-	-	-	-	-	39.9	38.3

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 2020 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.

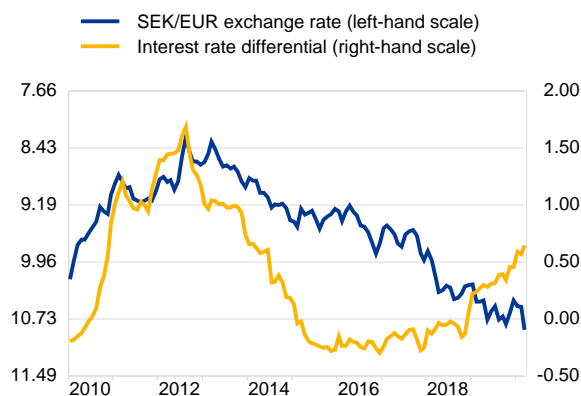
6) Original maturity of more than one year.

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

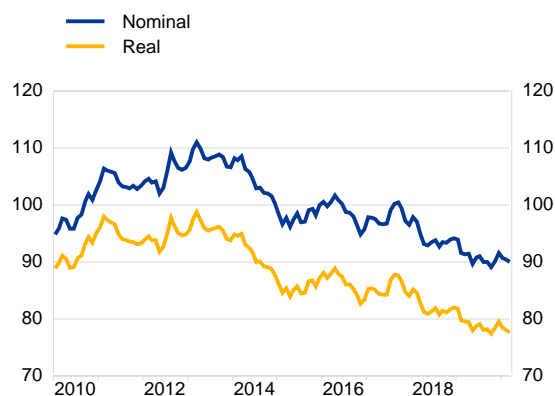
(SEK/EUR exchange rate: monthly averages; difference between three-month interbank interest rates and three-month EURIBOR: basis points, monthly values)



Sources: National data and ECB calculations.

Chart 5.7.4 Effective exchange rates ¹⁾

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



Source: ECB.

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

Table 5.7.3 External developments

(as a percentage of GDP, unless otherwise indicated)

	2010-2019 ¹⁾	2010-2014 ¹⁾	2015-2019 ¹⁾	2015	2016	2017	2018	2019	2020 ²⁾	2021 ²⁾
Balance of payments										
Current account and capital account balance ³⁾	4.2	5.1	3.2	3.9	3.4	3.0	1.7	3.9	3.7	4.0
Current account balance	4.3	5.3	3.3	4.1	3.5	3.1	1.7	3.9	3.7	4.0
Goods	3.0	3.6	2.3	2.8	2.1	2.1	1.5	3.0	.	.
Services	1.2	1.2	1.1	2.2	2.1	0.8	0.1	0.3	.	.
Primary income	1.8	2.2	1.4	0.7	0.6	1.7	1.7	2.5	.	.
Secondary income	-1.7	-1.7	-1.6	-1.6	-1.3	-1.5	-1.7	-1.9	.	.
Capital account balance	-0.1	-0.2	-0.1	-0.2	-0.1	-0.1	0.0	0.0	.	.
Combined direct and portfolio investment balance ³⁾	0.1	-0.3	0.5	-1.7	-1.6	2.6	0.6	2.5	.	.
Direct investment	1.8	3.0	0.6	0.9	-2.8	2.1	2.4	0.4	.	.
Portfolio investment	-1.7	-3.3	-0.1	-2.6	1.2	0.5	-1.8	2.1	.	.
Other investment balance	2.9	5.1	0.6	3.0	-3.6	2.7	-0.2	1.4	.	.
Reserve assets	0.3	0.5	0.0	0.3	0.8	0.1	-0.1	-1.2	.	.
Exports of goods and services	44.8	44.5	45.0	44.8	43.6	44.3	45.4	47.0	.	.
Imports of goods and services	40.6	39.7	41.6	39.8	39.3	41.4	43.7	43.7	.	.
Net international investment position ⁴⁾	-2.4	-9.5	4.6	-5.2	-1.9	1.4	8.0	20.9	.	.
Gross external debt ⁴⁾	180.1	186.6	173.6	176.6	176.6	179.7	170.6	164.2	.	.
Trade with the euro area ⁵⁾										
Exports of goods and services	39.4	39.2	39.6	39.0	39.7	39.9	40.4	38.9	.	.
Imports of goods and services	48.9	48.9	49.0	47.9	49.3	49.5	48.7	49.3	.	.
Investment position with the euro area ⁵⁾										
Direct investment assets ⁴⁾	48.8	50.8	46.9	48.0	45.9	47.9	46.8	45.7	.	.
Direct investment liabilities ⁴⁾	57.8	59.0	56.5	56.6	56.0	57.4	56.6	56.1	.	.
Portfolio investment assets ⁴⁾	37.9	39.6	36.2	36.9	36.9	36.4	36.1	34.7	.	.
Portfolio investment liabilities ⁴⁾	39.8	38.7	40.8	37.8	39.0	40.7	43.3	43.2	.	.

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 2020 Economic Forecast.

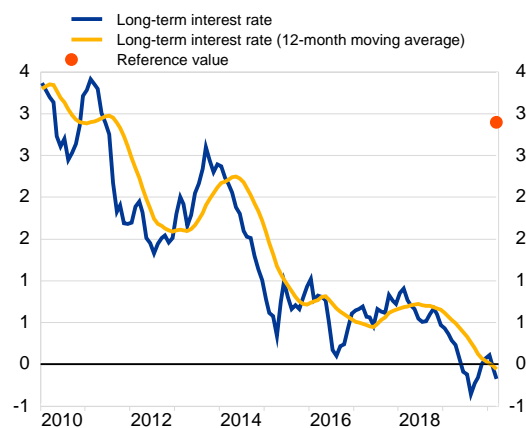
3) Differences between totals and the sum of their components are due to rounding.

4) End-of-period outstanding amounts.

5) As a percentage of the total.

Sweden - Long-term interest rate developments

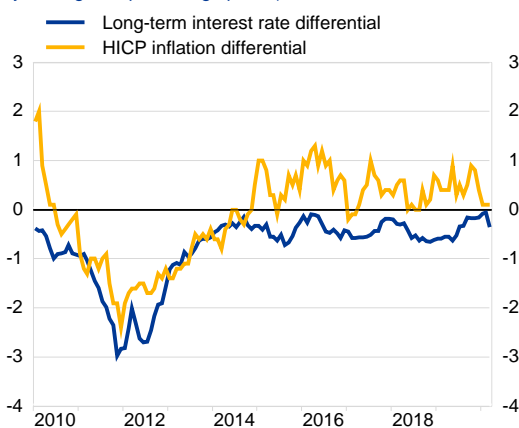
Chart 5.7.5 Long-term interest rate ¹⁾
(monthly averages in percentages)



Sources: European System of Central Banks and ECB calculations.

1) The basis of the calculation of the reference value for the period from April 2019 to March 2020 is the unweighted arithmetic average of the interest rate levels in Portugal, Cyprus and Italy plus 2 percentage points. The reference value is 2.9%.

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)

	2010-2019 ¹⁾	2010-2014 ¹⁾	2015-2019 ¹⁾	2016	2017	2018	2019	Apr. 2019 to Mar. 2020	Memo item: euro area 2019
Long-term interest rates									
Sweden ²⁾	1.4	2.2	0.5	0.5	0.7	0.7	0.0	-0.1	-
Euro area ^{2), 3)}	2.2	3.4	0.9	0.9	1.1	1.1	0.4	0.2	-
Euro area AAA par curve, ten-year residual maturity ^{2), 3)}	1.3	2.3	0.3	0.2	0.4	0.5	-0.2	-0.3	-
Indicators of financial development and integration									
Debt securities issued by financial corporations ⁴⁾	104.7	107.6	101.8	107.7	104.5	92.7	95.3	-	66.7
Debt securities issued by non-financial corporations ⁵⁾	20.6	17.8	23.3	20.9	23.6	24.9	27.4	-	11.8
Stock market capitalisation ⁶⁾	120.9	109.2	132.6	134.9	138.2	115.4	144.5	-	67.7
MFI credit to non-government residents ⁷⁾	130.4	127.8	133.1	131.9	135.0	134.8	136.2	-	107.4
Claims of euro area MFIs on resident MFIs ⁸⁾	8.8	8.9	8.8	9.1	8.1	9.5	9.1	-	26.1

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 (excluding the national central bank) 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 market values.

7) MFI (excluding national central bank) credit to domestic non-MFI residents other than general government. Credit comprises 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 high 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 on European statistics¹⁹¹ and the European Statistics Code of Practice¹⁹². 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.

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

¹⁹¹ 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, 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), as amended by Regulation (EU) 2015/759 of the European Parliament and of the Council of 29 April 2015 (OJ L 123, 19.5.2015, p.90).

¹⁹² 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 Committee in September 2011 and November 2017.

in 2005. In the specific context of the EU fiscal surveillance system and of the excessive deficit procedure (EDP), Council Regulation (EU) No 679/2010¹⁹³ granted Eurostat new competences for the regular monitoring and verification of 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 requires the compilation of high-quality statistical information, which needs to be produced under robust quality management.¹⁹⁴ 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 the NSIs and Eurostat coordinate all activities involved in the development, production and dissemination of European statistics (produced in accordance with the Regulation on European statistics¹⁹⁵) at the level of their national statistical systems and the ESS respectively.

In 2015 the Regulation on European statistics was amended¹⁹⁶ 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.

The independence of other statistical authorities responsible for the compilation of European statistics (e.g. ministries of finance) also needs to be assured. Other statistical authorities' responsibility for the publication of statistics 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

¹⁹³ 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).

¹⁹⁴ 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.

¹⁹⁵ 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 set out in Article 2(1) of the Regulation. Given that some European statistics may be compiled by NCBs in their capacity as members of the ESCB, the NSIs and the NCBs also cooperate closely under national arrangements with a view to ensuring the necessary cooperation between the ESS and the ESCB and guaranteeing the production of complete and coherent European statistics.

¹⁹⁶ 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).

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.

In their letter on ERM II participation dated 4 July 2019, the Croatian authorities commit to improving the collection, production and dissemination of statistics, by strengthening the institutional and methodological capacities in relation to the quality of national accounts and GFS/EDP reporting. This includes specific deliverables, such as the adoption of a new Official Statistics Act to strengthen the professional independence of the Head of the NSI and free access to all administrative data sources, a new Memorandum of Understanding (signed in February 2020) between the compilers of statistics and data providers (the NSI, Ministry of Finance and NCB) to improve procedures and the timeliness of data exchange, and the adoption of a revision policy for national accounts statistics.

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	Under 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 inflation¹		
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. A follow-up report showing the issues addressed by Bulgaria was published in 2018. There were no apparent instances of non-compliance with the HICP methodology.	Eurostat made a compliance monitoring visit in 2019 and published a report in January 2020 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 2010-19.	Revenue, expenditure, deficit and debt data are provided for the period 2010-19.
Outstanding statistical issues	No major outstanding statistical issues identified. Eurostat made an EDP visit in 2018 and published the final findings on its website.	No major outstanding statistical issues identified. Eurostat made an EDP visit in 2019 and published the final findings on its website.
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) See [Eurostat's website](#) for the full reports on the findings and recommendations of the HICP compliance monitoring visits for each country.

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 Act CLV of 2016 on Official Statistics, statistics are compiled following the principles of 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 inflation¹		
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 in line with requirements.	Eurostat made a compliance monitoring visit in 2019 and published a report in March 2020 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. A follow-up report published in 2018 showed good progress regarding the compliance monitoring report's recommendations for further improvements to the Croatian HICP.	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 2010-19.	Revenue, expenditure, deficit and debt data are provided for the period 2010-19.
Outstanding statistical issues	No major outstanding statistical issues identified. Eurostat made an EDP visit in 2019 and will publish the final findings on its website.	No major outstanding statistical issues identified. Eurostat made an EDP visit in 2019 and published the final findings on its website.
Institution responsible for the compilation of statistics	The NSI compiles the non-financial accounts of government; the NCB compiles government debt and the financial accounts of government.	The NSI compiles the non-financial accounts of government; the NCB compiles government debt and the financial accounts of government.

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 Public 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.	Under 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.	Under 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 inflation¹		
Compliance with legal minimum standards	Eurostat made a compliance monitoring visit in 2015 and published a report in 2016 confirming that the methods used for producing the HICP are of a good standard and in line with legal requirements.	Eurostat made a compliance monitoring visit in 2018 and published a report in February 2020 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	In the 2016 report, Eurostat made further recommendations for increasing the accuracy and reliability of the Polish HICP. A follow-up report issued in 2018 showed that most recommendations had been implemented or were in the process of being implemented.	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 2010-19.	Revenue, expenditure, deficit and debt data are provided for the period 2010-19.
Outstanding statistical issues	No major outstanding statistical issues identified. Eurostat made an EDP visit in 2020 and will publish the final findings on its website.	No major outstanding statistical issues identified. Eurostat made an EDP visit in 2018 and published the final findings on its website.
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 (six years; three-year reappointment possible only once).
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 stems from 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 inflation¹	
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 2010-19.
Outstanding statistical issues	There is a public unit currently classified as an MFI, which may be subject to a reclassification into the government sector. Eurostat made an EDP visit in 2019 and will publish the final findings on its website.
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.¹⁹⁷ The HICP

¹⁹⁷ See Eurostat's website for details on the HICP [legislative framework](#). Eurostat has also published [recommendations and a methodological manual](#).

covering the euro area as a whole has been the main measure of price developments for the monetary policy of the ECB since January 1999.

The coronavirus (COVID-19) outbreak and related government measures, such as restrictions on the movement of people and the closure of outlets, have posed significant challenges for the data collection for the HICP. In particular, as of April 2020 a significant number of prices and sub-indices have needed to be imputed.¹⁹⁸ The March-2020 HICP data were therefore chosen as the reference period end point for this report.

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. The framework regulation introduced to establish HICPs, Council Regulation (EC) No 2494/95¹⁹⁹, was adopted in October 1995, and was subsequently replaced by a new Regulation, (EU) 2016/792²⁰⁰, which 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 are 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.

¹⁹⁸ In some Member States a limited amount of imputation related to the COVID-19 crisis was required in March 2020. This has not had a significant impact on the data out-turns.

¹⁹⁹ Council Regulation (EC) No 2494/95 of 23 October 1995 concerning harmonized indices of consumer prices (OJ L 257, 27.10.1995, p. 1).

²⁰⁰ 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).

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 concepts as defined in the ESA 2010²⁰¹ and Commission Regulation (EU) No 220/2014²⁰². 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 swaps²⁰³, as well as trade credits²⁰⁴ 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.

Government deficit and debt ratios are expressed as a percentage of GDP at current market prices.

6.3.1 Data source

The NCBs provide the ECB with detailed GFS data under the ECB’s GFS Guideline²⁰⁵. 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

²⁰¹ 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, 26.06.2013, p. 1).

²⁰² 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, 8.3.2014, p. 101).

²⁰³ 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.

²⁰⁴ 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.

²⁰⁵ Guideline ECB/2018/13 of 24 April 2018 amending Guideline ECB/2013/23 on government finance statistics (OJ L 153, 15.6.2018, p. 161).

government debt with breakdowns by instrument, by initial and residual maturity and by holder.

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 national 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, a public unit is currently classified as part of the financial sector and is on the ECB's list of MFIs but may be reclassified into the government sector subject to the outcome of methodological discussion at European level.

In October 2019 Eurostat withdrew 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, since these foundations, including their subsidiaries, were reclassified into the general government sector.

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 exchange rate mechanism 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.²⁰⁶ 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.

²⁰⁶ Since 1 July 2016 the reference rates have been published at around 16:00 CET (for details see "[ECB introduces changes to euro foreign exchange reference rates](#)", *press release*, ECB, 7 December 2015).

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 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;²⁰⁷ and ii) statistics on financial and non-financial integration with the euro area.²⁰⁸

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 excluding the national central bank and non-monetary financial corporations) and non-financial corporations are reported by the respective NCBs in accordance with the methodology set out in Guideline ECB/2014/43²⁰⁹. 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 1071/2013²¹⁰. Historical data are compiled by the relevant NCBs, where appropriate. For the indicators mentioned in this paragraph, 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) and with compilation guidance provided by the ECB and Eurostat.²¹¹ 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.²¹²

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

²⁰⁷ Debt securities issued by resident corporations, stock market capitalisation, MFI credit to non-government residents and claims of euro area MFIs on resident MFIs.

²⁰⁸ External trade and investment position with the euro area.

²⁰⁹ 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).

²¹⁰ 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) (ECB/2013/33) (OJ L 297, 7.11.2013, p. 1).

²¹¹ For further details, see "[European Union Balance of Payments and International Investment Position statistical sources and methods \("B.o.p. and i.i.p. book"\)](#)", ECB, Frankfurt am Main, 2016.

²¹² The [economic forecasts](#) made by the Directorate-General for Economic and Financial Affairs (DG ECFIN) on behalf of the European Commission.

a harmonised basis under the EU Regulation on European business statistics²¹³. 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. Croatia is working during 2020 on improving its employment statistics²¹⁴ under both the “domestic” and “national” national accounts concepts; it is expected that the figures on unit labour costs will subsequently reflect these changes. 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.

²¹³ Regulation (EU) No 2019/2152 of the European Parliament and of the Council of 27 November 2019 on European business statistics (OJ L 327, 17.12.2019, p. 1).

²¹⁴ See [Croatia's response to the Eurostat/OECD 2018 questionnaire on the methodology underlying labour input data in national accounts](#), March 2018.

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).²¹⁵

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,²¹⁶
- the Law on Българска народна банка (Bulgarian National Bank) (hereinafter the “Law on BNB”).²¹⁷

The Law on counter-corruption and unlawfully acquired assets forfeiture (hereinafter the “Law on counter-corruption”)²¹⁸ applies to public office holders.

There have been multiple changes in relation to the points identified in the ECB’s Convergence Report of May 2018, also addressing some of the recommendations made in previous convergence reports.

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.

²¹⁵ According to Section 2.2.2.1 of this Convergence Report.

²¹⁶ Constitution of the Republic of Bulgaria, Darjaven vestnik issue 56, 13.7.1991.

²¹⁷ Law on Българска народна банка (Bulgarian National Bank), Darjaven vestnik issue 46, 10.6.1997.

²¹⁸ Darjaven vestnik issue 7, 19.01.2018.

Institutional independence

Article 44 of the Law on BNB prohibits European Union institutions, bodies, offices or agencies, the Council of Ministers or the governments of other EU Member States, as well as any other bodies and institutions from giving instructions to Българска народна банка (Bulgarian National Bank), the Governor or the members of the Governing Council. This provision has been amended and is now in line with Article 130 of the Treaty and Article 7 of the Statute.²¹⁹

Personal independence

Article 14(1) of the Law on BNB lists the grounds on which members of the Governing Council may be relieved from office; it provides that the National Assembly or Bulgaria's President may relieve a member of the Governing Council, including the Governor, from office if they no longer fulfil the conditions required for the performance of their duties or if they have been found guilty of serious misconduct. Article 14(3) of the Law on BNB provides that the decision to relieve the Governor of the Bulgarian National Bank from office may be referred to the Court of Justice of the European Union on the grounds of infringement of the Treaties on European Union or of a rule of law relating to their application. Article 14 of the Law on BNB therefore now fully complies with Article 14.2 of the Statute.²²⁰

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 relieving the Governor, Deputy Governors and the other members of the Governing Council of Българска народна банка (Bulgarian National Bank) from office. Thus, the Law on counter-corruption specifies a ground for relieving from office 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.²²¹

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

²¹⁹ See paragraph 3.2 of Opinion CON/2018/53.

²²⁰ See paragraph 3.1 of Opinion CON/2018/53.

²²¹ See also Opinion CON/2009/13.

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 relieved from office under conditions other than those mentioned in Article 14.2 of the Statute, even if they have not yet taken up their duties.

7.1.3 Confidentiality

Article 4(2) of the Law on BNB provides that Българска народна банка (Bulgarian National Bank) may not disclose or transmit to other persons any information it obtained that constitutes a banking, professional, commercial or other legally protected secret for the banks and the other participants in monetary and credit transactions, except in two cases: (i) exchange of information within the framework of the close cooperation established with the ECB under Article 7 of Council Regulation (EU) No 1024/2013;²²² and (ii) exchange of information with the Single Resolution Board in accordance with Regulation (EU) No 806/2014.²²³ Article 23(2) of the Law on BNB provides that the employees of Българска народна банка (Bulgarian National Bank) shall observe secrecy requirements concerning negotiations, deals contracted, the amount of assets on customers' deposits and their transactions, and information received by the Bank, as well as any circumstances concerning the activities of the Bank and its customers, which constitute business, banking, professional, commercial or other legally protected secrets, even after termination of their employment contract. 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 extend credit or guarantees in any form whatsoever to, or purchase debt instruments directly from, the Council of Ministers, municipalities, other government or municipal institutions, organisations or undertakings in the public sector, European Union institutions, bodies, offices or agencies, the central government, regional, local or other public authorities, other bodies governed by public law or public sector entities of EU Member States. Article 45(3) of the Law on BNB provides that Българска народна банка (Bulgarian National Bank) may not purchase in the primary and/or secondary markets debt instruments issued by the

²²² Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (OJ L 287, 29.10.2013, p. 63).

²²³ Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010 (OJ L 225, 30.7.2014, p. 1).

Bulgarian government or municipalities, or by Bulgarian government or municipal institutions, organisations or 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, Article 45(3) of the Law on BNB should be amended and references to “primary” and “secondary” markets should be deleted.²²⁴

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 in Article 45(2) of the Law on BNB addressed to publicly owned and municipal credit institutions is brought into line with the scope of the exemption under Article 123(2) of the Treaty. That article of the Treaty provides that the prohibition of monetary financing under Article 123(1) of the Treaty does not apply to publicly owned credit institutions which, in the context of the supply of reserves by central banks, must be given the same treatment by national central banks as private credit institutions.²²⁵

Pursuant to the Law on credit institutions, Българска народна банка (Bulgarian National Bank) operates a central credit register (Article 56) and a bank account register (Article 56a). 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 prohibition of monetary financing, the Law on credit institutions would benefit from a limitation of the liability of Българска народна банка (Bulgarian National Bank) in relation to the operation of the two registers.²²⁶

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.

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

²²⁴ See paragraph 3.3 of Opinion CON/2018/53.

²²⁵ See paragraph 3.3 of Opinion CON/2018/53.

²²⁶ 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.

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.

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.

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.

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.

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.

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 and the Law on counter-corruption 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,²²⁷

²²⁷ Constitutional Law No 1/1993 Coll.

- the Law on Česká národní banka (hereinafter the “Law on CNB”).²²⁸

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.²²⁹ 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 May 2018, 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 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.

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.

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.

²²⁸ Law No 6/1993 Coll.

²²⁹ In respect of Laws No. 135/2014 and 375/2015, see Opinion CON/2015/22.

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.

Česká národní banka is assigned certain tasks relating to preparedness for crisis situations and to their resolution. Pursuant to Article 13 of Law No 240/2000 Coll. on the management of crisis situations, and to Article 23 of Law No 241/2000 Coll. on economic measures for crisis situations (hereinafter together referred to as the "Laws on management of crisis situations and on economic measures for crisis situations"), Česká národní banka is obliged, among other things, to discuss with the government proposals for crisis measures which affect Česká národní banka, to adopt a crisis plan and to establish and operate a crisis headquarters. For compatibility with the principle of central bank independence, those provisions of Law No 240/2000 Coll. and Law No 241/2000 Coll. should be amended to make it clear that they are without prejudice to the independent exercise by Česká národní banka of its ESCB-related tasks.

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.²³⁰

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.

As outlined in Section 7.2.2, Česká národní banka has been assigned certain tasks relating to national preparedness for crisis situations and to their resolution under the Laws on management of crisis situations and on economic measures for crisis situations. No provision is made for the costs incurred by Česká národní banka in

²³⁰ See paragraphs 3.1.2 and 3.1.3 of Opinion CON/2015/22.

carrying out such tasks to be met by the State. If they were to go beyond the internal contingency planning tasks of a central bank and to the extent that such tasks would be performed on behalf of, and in the exclusive interest of, the government, they would be government tasks, rather than central banking tasks. Therefore, in such a case, a mechanism for the reimbursement of Česká národní banka for any costs incurred in the performance of those tasks would need to be introduced in order to comply with the monetary financing prohibition.

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.

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.

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.

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.

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.

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.

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.

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 2533/98,²³¹ 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.

7.2.5 Conclusions

The Law on CNB, the Law on competences and the Laws on management of crisis situations and on economic measures for crisis situations 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.

²³¹ 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).

7.3 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,²³²
- the Law on Hrvatska narodna banka (hereinafter the “Law on HNB”).²³³

There were no changes prior to 24 March 2020 in relation to the points identified in the ECB’s Convergence Report of May 2018,²³⁴ 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.

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. 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 Statute²³⁵.

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.

²³² Constitution of the Republic of Croatia, OG 5/2014. - Decision of the Constitutional Court No SuP-O-2014 of 14 January 2014.

²³³ 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.

²³⁴ In Opinion CON/2020/8 on Hrvatska narodna banka, the ECB considered certain legislative proposals that related to points identified in the ECB’s Convergence Report of May 2018, and that were adopted on 7 April 2020. As stated in Section 2.2.1 of this Convergence Report, the compatibility of national legislation is considered in the light of legislation enacted before 24 March 2020, and therefore progress on those points will be assessed in the next ECB Convergence Report.

²³⁵ 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.

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,²³⁶
- Law CXXXIX of 2013 on the Magyar Nemzeti Bank (hereinafter the "Law on the MNB").²³⁷

There have been no major changes in relation to the points identified in the ECB's Convergence Report of May 2018, and those comments are therefore repeated in this year's assessment. Although the Law on the MNB has been amended several times since that Convergence Report, no additional points are necessary 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 2008²³⁸ need to be adapted as set out below.

²³⁶ Magyarország Alaptörvénye, Magyar Közlöny 2013/163. (X.3.).

²³⁷ 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.

²³⁸ Law XXVII of 2008 on the oath of certain public officials.

Institutional independence

The Law on the MNB has been amended several times in the past two years, but without any significant change to the institutional framework regarding the Magyar Nemzeti Bank.²³⁹ 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.²⁴⁰ Further recent amendments concerned the allocation of new tasks to the Magyar Nemzeti Bank, such as: resolution tasks²⁴¹; supervisory tasks involving the verification of compliance with the new legal measures applicable to consumer loan contracts²⁴²; mediation of complaints and the initiation of legal proceedings in the public interest.²⁴³ 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.

Personal independence

The ECB's Convergence Reports of 2010, 2012, 2014, 2016 and 2018 noted that Law XXVII of 2008 specifies the wording of the oath that the members of the Monetary 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.²⁴⁴ 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,

²³⁹ Amendments to the Law on the MNB were introduced by Law CXXXVI of 2018, Law CXXII of 2018, Law XXXIV of 2019, Law CXVIII of 2019, Law CXII of 2019, Law CXXVII of 2019 and Law LXVII of 2019.

²⁴⁰ See Articles 176 to 183 of the Law on the MNB as well as Opinions CON/2013/56 and CON/2013/71.

²⁴¹ Law XXXVII of 2014.

²⁴² Law XL of 2014.

²⁴³ Law XL of 2014 and Law LXXXV of 2015.

²⁴⁴ 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!"

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.²⁴⁵

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 entities²⁴⁶ 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 MNB²⁴⁷; (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, 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 MNB²⁴⁸, 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

²⁴⁵ 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.

²⁴⁶ These entities are voluntary mutual insurance funds, private pension funds, cooperative credit institutions and insurance associations.

²⁴⁷ 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.

²⁴⁸ 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.

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.²⁴⁹ 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 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 the members of the Monetary Council may not be dismissed for reasons other than those laid down in Article 14.2 of the Statute.²⁵⁰

Financial independence

Article 183 of the Law on the MNB, read in conjunction with Article 176, 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

²⁴⁹ Introduced to Article 156(7) of the Law CXXXIX of 2013 by Article 174 of Law LXXXV of 2015.

²⁵⁰ See paragraphs 2.3 to 2.5 of Opinion CON/2014/8.

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, 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 new tasks should be supplemented by provisions regarding the necessary resources to carry them out.²⁵¹

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

²⁵¹ 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). In addition, the Magyar Nemzeti Bank implements the following Regulations: Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation, and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012 (OJ L 347, 28.12.2017, p. 35); Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC (OJ L 168, 30.6.2017, p. 12); and Regulation (EU) 2019/1156 of the European Parliament and of the Council of 20 June 2019 on facilitating cross-border distribution of collective investment undertakings and amending Regulations (EU) No 345/2013, (EU) No 346/2013 and (EU) No 1286/2014 (OJ L 188, 12.7.2019, p. 55). The Magyar Nemzeti Bank also acts in compliance with Regulation (EU) 2017/1131 of the European Parliament and of the Council of 14 June 2017 on money market funds (OJ L 169, 30.6.2017, p. 8) and with Regulation (EU) 2017/1991 of the European Parliament and of the Council of 25 October 2017 amending Regulation (EU) No. 345/2013 on European venture capital funds and Regulation (EU) No. 346/2013 on European social entrepreneurship funds (OJ L 293, 10.11.2017, p. 1).

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,²⁵² 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 procedure (including pending administrative legal procedures)²⁵³. 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.

²⁵² See, for example, paragraph 9.3 of Opinion CON/2011/104.

²⁵³ See paragraph 3.7 of Opinion CON/2008/83.

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 2018 Annual Report²⁵⁴ addressed other monetary financing concerns in relation to the activities and operations of the Magyar Nemzeti Bank. In particular, the ECB had previously 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 needed to be corrected. The MNB in 2017 took corrective actions and no longer owns or controls MARK Zrt. Following the completion of the necessary corrective actions by the Magyar Nemzeti Bank, the case was closed in 2019.²⁵⁵

7.4.4 Single spelling of the euro

In several Hungarian legal acts²⁵⁶ 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.²⁵⁷

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.

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

²⁵⁴ Published on the ECB's website.

²⁵⁵ See Section 9.3 of the 2018 Annual Report.

²⁵⁶ For example, the Laws on the 2015 general budget in Hungary.

²⁵⁷ Opinion CON/2006/55.

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.

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.

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 on the MNB 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.

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 2000,²⁵⁸ in conjunction with Government Decree 221/2000 (XII.19),²⁵⁹ 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.

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.

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.

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

²⁵⁸ A számvitelről szóló törvény, Magyar Közlöny 2000/95. (IX. 21.).

²⁵⁹ A Magyar Nemzeti Bank éves beszámoló készítési és könyvvezetési kötelezettségének sajátosságairól szóló kormányrendelet, Magyar Közlöny 2000/125. (XII.19.).

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 7.4.2, 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.²⁶⁰

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,²⁶¹
- the Law on Narodowy Bank Polski (hereinafter the “Law on NBP”),²⁶²
- the Law on the Bank Guarantee Fund, deposit guarantee system and compulsory restructuring,²⁶³
- the Law on banking (hereinafter the “Law on banking”),²⁶⁴
- the Law on settlement finality in the payment and settlement systems and on the supervision of such systems.²⁶⁵

²⁶⁰ See paragraph 3.7 of Opinion CON/2008/83.

²⁶¹ Konstytucja Rzeczypospolitej Polskiej of 2 April 1997, Dziennik Ustaw of 1997, No 78, item 483, with further amendments.

²⁶² Ustawa o Narodowym Banku Polskim of 29 August 1997. Consolidated version published in Dziennik Ustaw of 2019, item 1810.

²⁶³ Ustawa o Bankowym Funduszu Gwarancyjnym, systemie gwarantowania depozytów oraz przymusowej restrukturyzacji of 10 June 2016. Consolidated version published in Dziennik Ustaw of 2019, item 795, with further amendments.

²⁶⁴ Ustawa Prawo bankowe of 29 August 1997. Consolidated version published in Dziennik Ustaw of 2019, item 2357.

²⁶⁵ 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 2019, item 212, with further amendments.

No major new legislation has been enacted in relation to the points identified in the ECB's Convergence Report of May 2018, and those comments are therefore largely repeated in this year's assessment.

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 Tribunal²⁶⁶ need to be adapted in the respects set out below.

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. Even though the Polish Constitutional Court has confirmed²⁶⁷ that while the Polish Constitution does not expressly lay down the principle of Narodowy Bank Polski's independence, such principle can be implicitly derived from the Constitution's provisions relating to Narodowy Bank Polski. Legal certainty would nevertheless be increased by making explicit provision for this principle in the Polish Constitution on the occasion of a future amendment.

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,²⁶⁸ should comply with the prohibition on giving instructions to an

²⁶⁶ Ustawa o Trybunale Stanu of 26 March 1982; consolidated version published in Dziennik Ustaw of 2019, item 2122.

²⁶⁷ Judgment of 16 July 2009 of the Polish Constitutional Court. Kp 4/08.

²⁶⁸ For the activities of the NCB's independent external auditors see, as an example, Article 27.1 of the Statute.

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 price stability.²⁶⁹ Article 203(1) of the Constitution needs to be adapted to comply with Article 130 of the Treaty and Article 7 of the Statute.

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,²⁷⁰
- been prohibited by the State Tribunal from occupying executive positions or holding posts of particular responsibility in state bodies.²⁷¹

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.²⁷²

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,

²⁶⁹ See paragraph 3.6 of Opinion CON/2011/9.

²⁷⁰ 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).

²⁷¹ 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).

²⁷² 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.

- a conviction for a criminal offence under a final court sentence,
- submission of an untruthful lustration declaration, and this has been confirmed by a final court judgment,²⁷³
- 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 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.

Financial independence

In March 2019 the Law amending the Law on prohibitions regarding conducting of business activities by public officials and the Law on NBP²⁷⁴ entered into force. According to Article 66(3) of the amended Law on NBP, the upper salary limit (salary cap) for all employees (excluding members of the Management Board of Narodowy Bank Polski) is set at 60% of the salary of the President of Narodowy Bank Polski (the salary of the President is determined on the basis of other provisions which have not been amended). However, amendments included in any legislative proposal that lead to reductions in remuneration are not compatible with the principle of financial independence if the ability of the relevant national central bank to employ and retain staff to perform independently the tasks conferred on it by the Treaty and the Statute is affected. Any adopted legislative solution should provide for a cooperation mechanism with Narodowy Bank Polski, to ascertain if it considers that an exception to a cap on remuneration is required. Such an exception should be decided upon in close and effective cooperation with Narodowy Bank Polski, taking due account of its views, to

²⁷³ 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).

²⁷⁴ Ustawa z dnia 22 lutego 2019 r. o zmianie ustawy o ograniczeniu prowadzenia działalności gospodarczej przez osoby pełniące funkcje publiczne oraz ustawy o Narodowym Banku Polskim, Dz. U. 2019 item 371.

ensure its ongoing ability to independently carry out its tasks.²⁷⁵ As such close and effective cooperation with Narodowy Bank Polski is not provided for in the present legal framework regarding the salary cap, the legislation does not satisfy the requirements of Article 130 of the Treaty and Article 7 of the Statute.

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”.²⁷⁶ 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.²⁷⁷

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 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.²⁷⁸ 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.²⁷⁹ 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.²⁸⁰ Safeguards currently contained in such rules aiming at ensuring timely repayment of the credit do

²⁷⁵ See paragraph 2.2.3 of Opinion CON/2019/3.

²⁷⁶ Article 23(7)(3) of the Law on NBP.

²⁷⁷ See Opinion CON/2008/53.

²⁷⁸ 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).

²⁷⁹ Article 142(1) and (2) of the Law on banking.

²⁸⁰ Article 42(7) of the Law on NBP.

not fully exclude an interpretation that would allow an extension of refinancing credit to a bank undergoing rehabilitation proceedings which then becomes insolvent.²⁸¹ 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.²⁸² 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 Council Regulation (EC) No 3603/93, is directly applicable, so in general, it is unnecessary to transpose it into national legislation.

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.

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.

²⁸¹ 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).

²⁸² See Opinion CON/2013/5.

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.

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.

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.

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.

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.²⁸³

²⁸³ For a detailed review of necessary adaptations of the Constitution, the Law on NBP and other laws, see Opinion CON/2011/9.

7.6 Romania

7.6.1 Compatibility of national legislation

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

- Law No 312/2004 on the Statute of Banca Națională a României (hereinafter the “Law on BNR”).²⁸⁴

There have been no changes in relation to the points identified in the ECB’s Convergence Report of May 2018 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 Națională a României’s independence, the Law on BNR and other legislation needs to be adapted in the respects set out below.

Institutional independence

Article 3(1) of the Law on BNR provides that, when carrying out their tasks, Banca Națională 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 Națională a României’s decision-making bodies in situations where this may have an impact on Banca Națională a 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.

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 Națională 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

²⁸⁴ Published in Monitorul Oficial al României, Part One, No 582, 30.6.2004.

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 Națională 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,²⁸⁵ and Law 176/2010 on the integrity in the exercise of public functions and dignities,²⁸⁶ define the conflicts of interest and incompatibilities applicable to the Governor and the other members of the Board of Banca Națională 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 incompatibility²⁸⁷ do not constitute new grounds for dismissal of the Governor or other members of the Board of Banca Națională 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.

Financial independence

Article 43 of the Law on BNR provides that each month, Banca Națională 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-year credit, which in turn may undermine the financial independence of Banca Națională 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 Națională 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

²⁸⁵ Published in Monitorul Oficial al României, Part One, No 279, 21.4.2003.

²⁸⁶ Published in Monitorul Oficial al României, Part One, No 621, 2.9.2010.

²⁸⁷ According to the relevant provisions of Article 99 of Law 161/2003, if a member of the Board of Banca Națională a României or an employee occupying a leading position with Banca Națională 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.

not undermine the ability of Banca Națională 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,²⁸⁸ the Court of Auditors is empowered to control the establishment, management and use of the public sector's financial resources, including Banca Națională a României's financial resources, and to audit management of the funds of Banca Națională 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 Națională 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 Națională 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 Națională a României.²⁸⁹

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 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.

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 Națională 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 Națională 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.

²⁸⁸ Published in Monitorul Oficial al României, Part One, No 238, 3.4.2014.

²⁸⁹ For the activities of the NCB's independent external auditors see, for example, Article 27.1 of the Statute.

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 Națională a României in the same way as any other credit institution eligible under Banca Națională 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 Națională 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 Națională 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 Națională 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 Națională 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 Națională 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 Națională a României's legal integration into the Eurosystem, the Law on BNR needs to be adapted in the respects set out below.

Economic policy objectives

Article 2(3) of the Law on BNR provides that, without prejudice to the primary objective of price stability, Banca Națională 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.

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 Națională 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 Națională 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 Națională 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 Națională 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 Națională a României's role in issuing banknotes and coins, do not recognise the Council's and the ECB's powers in this field.

Financial provisions

Appointment of independent auditors

Article 36(1) of the Law on BNR, which provides that the annual financial statements of Banca Națională 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 Națională 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 Națională 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 Națională 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 Națională 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 Națională a României's obligation to comply with the Eurosystem's regime for financial reporting of NCB operations, pursuant to Article 26 of the Statute.

Exchange rate policy

Article 2(2)(a) and (d), Article 9 and Article 33(1)(a) of the Law on BNR, which empower Banca Națională 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 Națională 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.

Miscellaneous

With regard to Article 3(2) of the Law on BNR, which entitles Banca Națională a României to be consulted on draft national legislation, consulting Banca Națională 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 Națională 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.

7.6.6 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,²⁹⁰ which forms part of the Swedish Constitution,
- the Law on Sveriges Riksbank,²⁹¹
- the Law on exchange rate policy.²⁹²

The ECB notes that a proposal for a new Law on Sveriges Riksbank, together with proposed amendments to the Instrument of Government and the Law on exchange rate policy have been included in the Swedish Government's Official Report published on 29 November 2019.²⁹³ However, as no major changes have yet been made in relation to the points identified in the ECB's Convergence Report of May 2018, and as the proposed new Law on Sveriges Riksbank and the proposed amendments to the Instrument of Government and the Law on exchange rate policy are only intended to enter into force between 2021-2028, the comments made in the ECB's Convergence Report of May 2018 are largely repeated in this year's assessment.

²⁹⁰ SFS 1974:152.

²⁹¹ SFS 1988:1385.

²⁹² SFS 1998:1404.

²⁹³ SOU 2019:46 – En ny riksbankslag (A new Law on Sveriges Riksbank).

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.

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, which has investigated how the Swedish Government may continue to be kept informed of monetary policy decisions of major importance without restricting the independence of Sveriges Riksbank. The conclusions of that investigation, including the relevant proposals, were presented in the Swedish Government's Official Report referred to in Section 7.7.1.

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 have been reviewed. The Swedish Government submitted a draft legislative proposal to strengthen the Sveriges Riksbank's financial independence and balance sheet, which the ECB has reviewed and commented on.²⁹⁴ After receiving extensive comments on the proposal from a number of consultation bodies, the Swedish Government appointed the Parliamentary Committee on Sveriges Riksbank to further investigate 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 conclusions of that investigation, including the relevant proposals, were presented in the Swedish Government's Official Report referred to in Section 7.7.1. 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 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

²⁹⁴ See Opinion CON/2017/17.

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.

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.

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 11²⁹⁵ 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.

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.

²⁹⁵ 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).

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.

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.

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.

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 Act²⁹⁶ 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

²⁹⁶ SFS 2009:400.

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. At present it is not clear to what extent the Swedish Government's Official Report referred to in Section 7.7.1 may result in such legislative action. Although the legislative proposals contained in that Official Report should aim to achieve the required legal convergence, they would not do so as they stand.²⁹⁷

²⁹⁷ Opinion CON/2020/13.

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For terminology and abbreviations, please refer to the [ECB glossary](#).

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Conventions used in the tables

“..” data do not exist/data are not applicable

“.” data are not yet available