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CONVERGENCE REPORT
MAY 2012

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In 2012 all ECB publications feature a motif taken from the €50 banknote.

CONVERGENCE REPORT
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ABBREVIATIONS

COUNTRIES

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

OTHERS

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

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

I INTRODUCTION

Since the introduction of the euro in 11 EU Member States on 1 January 1999, six other countries have adopted the single currency, the most recent being Estonia on 1 January 2011. This means that ten EU Member States do not yet participate fully in EMU, i.e. they have not yet adopted the euro. Two of these, Denmark and the United Kingdom, gave notification that they would not participate in Stage Three of EMU. As a consequence, convergence reports for these two countries only have to be provided if they so request. Given the absence of such a request from either country, this report examines eight countries: Bulgaria, the Czech Republic, Latvia, Lithuania, Hungary, Poland, Romania and Sweden. All eight countries are committed under the Treaty on the Functioning of the European Union (Treaty) 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 to report to the Council of the European Union (EU Council) at least once every two years or at the request of an EU Member State with a derogation "on the progress made by the Member States with a derogation in fulfilling their obligations regarding the achievement of economic and monetary union". The eight countries under review in this report have therefore been examined as part of this regular two-year cycle. The same mandate has been given to the European Commission, which 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 eight countries concerned, whether a high degree of sustainable economic convergence has been achieved, whether the national legislation is compatible with the Treaty and whether the statutory requirements are fulfilled for NCBs to become an integral part of the Eurosystem.

The examination of the economic convergence process is highly dependent on the quality and integrity of the underlying statistics. The compilation and reporting of statistics, particularly government finance statistics, must not be subject to political considerations 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 compiling these statistics, 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 national statistical institutes and in helping to support confidence in the quality of government finance statistics (see Section 9 of Chapter 5).

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 eight EU Member States under review and provides an overview of the convergence indicators and the statistical methodology used to compile them. Finally, Chapter 6 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 and with the Statute of the European System of Central Banks and of the European Central Bank (Statute).

2 FRAMEWORK FOR ANALYSIS

2.1 ECONOMIC CONVERGENCE

To examine the state of economic convergence in the eight EU Member States under review, the ECB makes use of a common framework for analysis which is applied to each country in turn. The common framework is based, first, on the Treaty provisions and their application by the ECB with regard to developments in prices, fiscal balances and debt ratios, exchange rates and long-term interest rates, together with other factors relevant to economic integration and convergence. Second, it is based on a range of additional backward and forward-looking economic indicators which are considered to be useful for examining the sustainability of convergence in greater detail. The examination of the Member States concerned based on all these factors is important in ensuring that their integration into the euro area will proceed without major difficulties. Boxes 1 to 5 below briefly recall 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 this 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 having economic conditions that are conducive to the maintenance of price stability and the coherence of the euro area can participate in it. Second, the convergence criteria constitute a coherent and integrated package, and they must all be satisfied; the Treaty lists the criteria on an equal footing and does not suggest a hierarchy. Third, the convergence criteria have to be met on the basis of actual data. Fourth, the application of the convergence criteria should be consistent, transparent and simple. Moreover, it is emphasised that convergence must be achieved on a lasting basis and not just at a given point in time. For this reason, the country examinations elaborate on the sustainability of convergence.

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

In addition, and to the extent appropriate, a forward-looking perspective is adopted. In this context, particular attention is drawn to the fact that the sustainability of favourable economic developments hinges critically on appropriate and lasting policy responses to existing and future challenges. Strong governance and sound institutions are also essential in 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, on the existence of sound institutions, and on the pursuit of appropriate policies after the adoption of the euro.

The common framework is applied individually to the eight EU Member States under review. These country 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 30 April 2012. The statistical data used in the application of the convergence criteria have been provided by the European Commission (see Section 9 of Chapter 5 as well as the tables and charts), in cooperation with the ECB in the case of exchange rates and long-term interest rates. Convergence data on price and long-term interest rate developments are presented up to March 2012, the latest month for which data

on HICPs were available. For monthly data on exchange rates, the period considered in this report ends in April 2012. Historical data for fiscal positions cover the period up to 2011. Account is also taken of forecasts from various sources, together with the most recent convergence programmes of the Member States concerned and other information considered to be relevant to a forward-looking examination of the sustainability of convergence. The European Commission's spring 2012 forecast and the Alert Mechanism Report[1], which are taken into account in this report, were released on 11 May 2012 and 14 February 2012 respectively. This report was adopted by the General Council of the ECB on 25 May 2012.

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

1 The first step of the new surveillance procedure for the prevention and correction of macroeconomic imbalances (see Glossary for more details).

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 referred to in Article 140 of the Treaty 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 latest available

12-month average of the HICP over the previous 12-month average. Hence, with regard to the rate of inflation, the reference period considered in this report is April 2011 to March 2012.

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 three lowest inflation rates registered by EU Member States: those of Sweden (1.3%), Ireland (1.4%) and Slovenia (2.1%), with no "outlier" identified this time.[1] As a result, the average rate is 1.6% and, adding 1½ percentage points, the reference value is 3.1%.

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 9 of Chapter 5). For information, the average euro area inflation rate is shown in the statistical part of this report.

1 The concept of "outlier" has been referred to in previous Convergence Reports of the ECB (see, for example, the 2010 report), as well as in Convergence Reports of the EMI. In line with those reports, a Member State is considered to be an outlier if two conditions are fulfilled: first, its 12-month average inflation rate is significantly below the comparable rates in other Member States and, second, its price developments have been strongly affected by exceptional factors. Including a country that has been an "outlier" among the three best performers in terms of price stability would have led to a distortion in the reference value. The identification of outliers does not follow any mechanical approach. The approach used was introduced to deal appropriately with potential significant distortions in individual countries' inflation developments. For example, in the 2010 Convergence Reports of the ECB and the European Commission, Ireland was regarded as an "outlier" as, at that time, its inflation rate was 1.5 percentage points below the second lowest inflation rate in the EU, reflecting an exceptionally strong downturn in economic activity and the associated significant decline in wages in Ireland. At the current juncture, however, Ireland's real output growth and inflation rate do not differ significantly from those in other Member States.

To allow a more detailed examination of the sustainability of price developments in the eight countries under review, the average rate of HICP inflation over the 12-month reference period from April 2011 to March 2012 is reviewed in the light of the economic performance of those Member States over the last ten years in terms of price stability. In this connection, attention is drawn to the orientation of monetary policy, in particular to whether the focus of the monetary authorities has been primarily on achieving and maintaining price stability, as well as to the contribution of other areas of economic policy to this objective. Moreover, the implications of the macroeconomic environment for the achievement of price stability are taken into account. Price developments are examined in the light of demand and supply conditions, focusing on, inter alia, factors influencing unit labour costs and import prices. Finally, trends in other relevant price indices (such as the HICP excluding unprocessed food and energy, the HICP at constant tax rates, the national CPI, the private consumption deflator, the GDP deflator and producer prices) are considered. From a forward-looking perspective, a view is provided of prospective inflationary developments in the coming years, including forecasts by major international organisations and market participants. Moreover, institutional and structural aspects which are relevant for maintaining an environment conducive to price stability after adoption of the euro are discussed.

With regard to fiscal developments, the 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 referred to in Article 140 of the Treaty 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 EDP. According to 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:

(a) 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:

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

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

(b) the ratio of government debt to GDP exceeds a reference value (defined in the Protocol on the 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 Council Regulation (EC) No 1467/97 as last amended by Council Regulation (EU) No 1177/2011[1], 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. 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 on its pace of the economic cycle 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 TSCG, which builds on the provisions of the enhanced Stability and Growth Pact, was signed on 2 March 2012 by 25 EU Member States (all EU Member States except the United Kingdom and the Czech Republic) and will enter into force after twelve euro area Member States have ratified it[2] Title III (Fiscal Compact) provides, inter alia, 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 reach a structural deficit of at most 1% of GDP. The TSCG also includes the debt reduction benchmark rule referred to in Council Regulation (EU) No 1177/2011, which has amended Council Regulation (EC) 1467/97[3], thus lifting this rule to the level of primary law for the signatory EU Member States. 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.

1 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), as last amended by Council Regulation (EU) No 1177/2011 of 8 November 2011 (OJ L 306, 23.11.2011, p.33). A consolidated version has been published: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1997R1467:20111213:EN:PDF

2 Once the TSCG is in force, it will apply also 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.

3 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 EDP (OJ L 306, 23.11.2011, p.33).

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 2002 to 2011, the outlook and the challenges for general government finances, and focuses on the links between deficit and debt developments. New ECB analysis is provided with respect to the effectiveness of national budgetary frameworks, as referred to in Article 2(3)(b) of Council Regulation (EC) No 1467/97 as last amended by Council Regulation (EU) No 1177/2011 and in Council Directive 2011/85/EU[4]. Moreover, this report provides a tentative assessment of the expenditure benchmark rule application, as set out in Article 9(1) of Council Regulation (EC) No 1466/97 as last amended by Regulation (EU) No 1175/2011 of the European Parliament and of the Council[5]. This rule aims to ensure a proper financing of expenditure increases. Under the rule, inter alia, EU Member States that have not yet reached their medium-term budgetary objective should ensure that the annual growth of relevant primary expenditure does not exceed a rate below a reference medium-term rate of potential GDP growth, unless the excess is matched by discretionary revenue measures.

With regard to Article 126, the ECB, in contrast to the Commission, has no formal role in the EDP. The ECB report only recounts 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 EU Member States in which the debt ratio exceeds the reference value, for illustrative purposes the ECB provides a debt sustainability analysis, including with reference to the aforementioned debt reduction benchmark laid down in Article 2(1a) of Council Regulation (EC) No. 1467/97 as last amended by Council Regulation (EU) No 1177/2011.

The examination of fiscal developments is based on data compiled on a national accounts basis, in compliance with the ESA 95 (see Section 9 of Chapter 5). Most of the figures presented in this report were provided by the Commission in April 2012 and include government financial positions from 2002 to 2011 as well as Commission forecasts for 2012.

4 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).

5 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), as last amended by Regulation (EU) No 1175/2011 of the European Parliament and of the Council of 16 November 2011 (OJ L 306, 23.11.2011, p. 12). A consolidated version has been published: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1997R1466:20111213:EN:PDF

With regard to the sustainability of public finances in the countries under review, the outcome in the reference year, 2011, is reviewed in the light of the performance of the individual Member States over the past ten years. As a starting point, the development of the deficit ratio is investigated. In this context, it is considered useful to bear in mind that the change in a country's annual deficit ratio is typically influenced by a variety of underlying forces. These influences are often divided into "cyclical effects" on the one hand, which reflect the reaction of deficits to changes in the economic cycle, and "non-cyclical effects" on the other, which are often taken to reflect structural or permanent adjustments to fiscal policies. However, such non-cyclical effects, as quantified in this report, cannot necessarily be seen as entirely reflecting a structural change to fiscal positions, because they include temporary effects on the budgetary balance stemming from the impact of

both policy measures and special factors. Indeed, assessing how structural budgetary positions have changed during the crisis is particularly difficult in view of uncertainty over the level and growth rate of potential output. As regards other fiscal indicators, past government expenditure and revenue trends are also considered in more detail.

As a further step, the development of the government debt ratio in this period is considered, as well as the factors underlying it, namely the difference between nominal GDP growth and interest rates, the primary balance, and the deficit-debt adjustment. Such a perspective can offer further information on the extent to which the macroeconomic environment, in particular the combination of growth and interest rates, has affected the dynamics of debt. It can also provide more information on the contribution of fiscal consolidation efforts, as reflected in the primary balance, and on the role played by special factors, as included in the deficit-debt adjustment. In addition, the structure of government debt is considered, 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 is highlighted.

Turning to a forward-looking perspective, national budget plans and recent forecasts by the European Commission for 2012 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 a Member State'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. Finally, 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, especially during the financial and economic crisis.

In line with past practices, the analysis described above also covers most of the relevant factors identified in Article 2(3) of Council Regulation (EC) No 1467/97 as last amended by Council Regulation (EU) No 1177/2011, 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 referred to in Article 140(1) of the Treaty stipulates that:

"The criterion on participation in the Exchange Rate mechanism of the European Monetary System referred to in the third indent of Article 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 as in previous reports.

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

Moreover, the issue of the absence of "severe tensions" is generally addressed by: i) examining the degree of deviation of exchange rates from the ERM II central rates against the euro; ii) using indicators such as exchange rate volatility vis-à-vis the euro and its trend, as well as short-term interest rate differentials vis-à-vis the euro area and their development; 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 May 2010 to 30 April 2012. All bilateral exchange rates are official ECB reference rates (see Section 9 of Chapter 5).

Two of the Member States examined in this report currently participate in ERM II. Lithuania has participated in ERM II with effect from 28 June 2004. Latvia entered the mechanism on 2 May 2005. For these countries currency movements vis-à-vis the euro in the reference period are analysed as deviations from the corresponding ERM II central parity. For the other six Member States covered in this report, in the absence of ERM II central rates, the average exchange rates vis-à-vis the euro in April 2010 are used as benchmarks for illustrative purposes. This follows a convention adopted in earlier reports and does not reflect any judgement regarding the appropriate level of the exchange rate.

In addition to the performance of the nominal exchange rate against the euro, evidence relevant to the sustainability of the current exchange rate is briefly reviewed. This is derived from the development of the real bilateral and effective exchange rates, export market shares and the current, capital and financial accounts of the b.o.p. The evolution of gross external debt and the net international investment position over longer periods are also examined. The sections on exchange rate developments also consider 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 sections on exchange rate developments report whether the countries examined have benefited from central bank liquidity assistance or b.o.p. 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 referred to in Article 140 of the Treaty 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 2011 to March 2012.

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

entering the calculation of the reference value for the criterion on price stability (see Box 1). However, one of the best performing countries in terms of price stability is Ireland, a country that had very limited access to financial markets during the reference period. The long-term interest rate of Ireland was 9.1% over the reference period. This is far above the euro area average of 4.4% during the same period. In view of the high country-specific risk premia currently prevailing in markets (driven by factors other than inflation), the Irish long-term interest rate is currently not an appropriate benchmark for assessing progress towards economic convergence in EU Member States with a derogation. During the reference period, the Irish sovereign bond market suffered significant tensions, with a strong outflow of international investments. Reflecting this, the long-term interest rate of Ireland is not only significantly higher than the euro area average, but it also substantially exceeds the long-term interest rates of the other two best performing Member States in terms of price stability. Therefore, Ireland has been excluded from the calculation of the reference value. Over the reference period considered in this report, the long-term interest rates of the two other best performing countries in terms of price stability were 2.2% (Sweden) and 5.4% (Slovenia); as a result, the average rate is 3.8% and, adding 2 percentage points, the reference value is 5.8%.

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 Section 9 of Chapter 5).

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 2011 to March 2012 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 partly reflected the high country-specific risk premia of several euro area countries. Therefore, the euro area AAA long-term 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. The comparison between the average euro area long-term interest rate and the euro area AAA long-term yield is presented in Chart 1. As background to this analysis, this report also provides information about the size and development of the financial market. This is based on three indicators (the outstanding amount of debt securities issued by corporations, stock market capitalisation and domestic bank credit to the private sector), which, together, measure the size of capital markets in each country.

Chart 1 Long-term interest rates

(January 2006 to March 2012; percentages)

Source: ECB.
Notes: "Euro area" denotes the GDP-weighted average long-term interest rate of euro area countries. "Euro area (AAA)" denotes the long-term par yield of the euro area AAA curve, which includes the euro area countries with AAA rating.

Finally, Article 140(1) of the Treaty requires this report to take account of several other relevant factors (see Box 5). In this respect, since the publication of the previous report in 2010, an enhanced economic governance framework in accordance with Article 121(6) of the Treaty has entered into force 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 recalls 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)), following 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".[1] The new legislative package includes an enhanced surveillance framework (the MIP) aimed at preventing excessive macroeconomic imbalances and 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 undergoing a 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, inter alia, nominal and real convergence inside and outside the euro area.[2] 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 EMU.[3]

2 Application of Treaty provisions

In line with past practices, the additional factors referred to in Article 140(1) of the Treaty are reviewed for each country in Chapter 5, under the headings of the individual criteria described

1 See 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, recital 2.
2 See Regulation (EU) No 1176/2011, Article 4(4).
3 See Regulation (EU) No 1176/2011, recital 17.

in Boxes 1 to 4. Regarding the elements of the MIP, most of the macroeconomic indicators have been referred to in this report in the past (some with different statistical definitions), as part of the wide range of additional backward and forward-looking economic indicators that are considered to be useful for examining the sustainability of convergence in greater detail, as required by Article 140 of the Treaty. For completeness, in Chapter 3 the scoreboard indicators (including in relation to the alert thresholds) are presented for all countries covered in this report, thereby ensuring the provision of all available information relevant to the detection of macroeconomic imbalances that may be hampering the achievement of a high degree of sustainable convergence as stipulated by 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 by 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 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 bodies becomes vacant.[2] 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, Latvia, Lithuania, 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.[3] As far as the other Member States are concerned, Articles 4[4] and 5[5] of the Acts concerning the conditions of accession provide that:

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

3 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.

4 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).

5 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).

'Each of the new Member States shall participate in Economic and Monetary Union from the date of accession as a Member State with a derogation within the meaning of Article 139 of the Treaty'.

The ECB has examined the level of legal convergence in Bulgaria, the Czech Republic, Latvia, Lithuania, Hungary, Poland, Romania and Sweden, as well as the legislative measures that have been taken or need to be taken by them to achieve this goal. This report does not cover Denmark or the United Kingdom, which are Member States with a special status and which have 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, Danmarks 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, Danmarks Nationalbank does not need to be legally integrated into the Eurosystem and no Danish legislation needs to be adapted.

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.[6]

The compatibility of national legislation is considered in the light of legislation enacted before 12 March 2012.

6 In particular the ECB's Convergence Reports of May 2010 (on Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovakia 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, Slovenia, Slovakia and Sweden), May 2002 (on Sweden) and April 2000 (on Greece and Sweden), and the EMI's Convergence Report of March 1998.

2.2.2 SCOPE OF ADAPTATION

2.2.2.1 AREAS OF ADAPTATION

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

– compatibility with provisions on the independence of NCBs in the Treaty (Article 130) and the Statute (Articles 7 and 14.2) and 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) and 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).

2.2.2.2 '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 EU's exclusive competence in monetary matters. Indeed, Article 14.4 of the Statute permits NCBs to perform functions other than those specified in the Statute, to the extent that they do not interfere with the ESCB's objectives and tasks. 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 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.[7]

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

7 See, amongst others, Case 167/73 *Commission of the European Communities v French Republic* [1974] ECR 359 ('Code du Travail Maritime').

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 provisions[8] 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 and confidentiality are concerned, national legislation in the Member States that joined the EU in 2004 or 2007 had to be adapted to comply with the relevant provisions of the Treaty and the Statute, and be in force on 1 May 2004 and 1 January 2007 respectively. 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 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. In the case of Sweden it is not clear whether this obligation should run from the date the ESCB was established or from the date of adoption of the euro. For those Member States that joined the EU on 1 May 2004 or 1 January 2007, it is not clear whether it should run from the date of accession or from the date of 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

8 OJ L 189, 3.7.1998, p. 42.

their primary objective runs from 1 June 1998 in the case of Sweden, and from 1 May 2004 and 1 January 2007 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. [9]

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. Such influence, whether exercised through shareholders' rights or otherwise, may affect an NCB's independence and should therefore be limited by law.

Prohibition on giving instructions

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

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. [10] 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.[11] 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.[12]

9 Opinion CON/2011/104. ECB opinions are available on the ECB's website at www.ecb.europa.eu.
10 Opinion CON/2010/31.
11 Opinion CON/2009/93.
12 Opinion CON/2010/94.

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.

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.

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.

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

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

However, dialogue between 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 General Council is fully respected; and

– confidentiality requirements resulting from the Statute are observed.

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

Statutory provisions regarding the discharge provided by third parties (e.g. governments) regarding the duties of members of the NCB's decision-making bodies (e.g. in relation to accounts) should contain adequate safeguards, so that such a power does not impinge on the capacity of the individual NCB member independently to adopt decisions in respect of ESCB-related tasks (or implement decisions adopted at ESCB level). 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. Article 14.2 of the Statute provides that NCB statutes must, in particular, provide for a minimum term of office of five years for Governors. It also protects against the arbitrary dismissal of Governors by providing that Governors may only be relieved from office if they no longer fulfil the conditions required for the performance of their duties or if they have been guilty of serious

misconduct, with the possibility of recourse to the Court of Justice of the European Union. 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.[13]

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 dismissal of a Governor are in line with those of Article 14.2 of the Statute. 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 may have to deputise for the Governor.

Grounds for dismissal of Governors

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

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

Personal independence would be jeopardised if the same rules for the security of tenure and grounds for dismissal of Governors were not also to apply to other members of the decision-making bodies of NCBs involved in the performance of ESCB-related tasks.[14] Various Treaty and Statute provisions require comparable security of tenure. Article 14.2 of the Statute does not restrict the security of tenure of office to Governors, while 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 may have to deputise for the Governor.

Right of judicial review

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

Article 14.2 of the Statute stipulates that NCB Governors who have been dismissed from office may refer such a decision to the Court of Justice of the European Union. National legislation should

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

14 See paragraph 8 of Opinion CON/2004/35; paragraph 8 of Opinion CON/2005/26; paragraph 3.3 of Opinion CON/2006/44; paragraph 2.6 of Opinion CON/2006/32; and paragraphs 2.3 and 2.4 of Opinion CON/2007/6.

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.

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. As a matter of principle, membership of a decision-making body involved in the performance of ESCB-related tasks is incompatible with the exercise of other functions that might create a conflict of interest. In particular, members of such decision-making bodies may not hold an office or have an interest that may influence their activities, whether through office in the executive or legislative branches of the state or in regional or local administrations, or through involvement in a business organisation. Particular care should be taken to prevent potential conflicts of interest on the part of non-executive members of decision-making bodies.

FINANCIAL INDEPENDENCE

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

Member States may not put their NCBs in a position where they have insufficient financial resources to carry out their ESCB or Eurosystem-related tasks, as applicable. It should be noted that Articles 28.1 and 30.4 of the Statute provide for the possibility of the ECB making further calls on the NCBs to contribute to the ECB's capital and to make further transfers of foreign reserves.[15] Moreover, Article 33.2 of the Statute provides[16] 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. financing its administration and own operations).

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 statutory capital or is even negative, including where losses beyond the level of capital and the reserves are carried over. Any such

15 Article 30.4 of the Statute only applies within the Eurosystem.
16 Article 33.2 of the Statute only applies within the Eurosystem.

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.[17] It enables the Governing Council of the ECB to decide on an actual increase at some point in time in the future to sustain the adequacy of the capital base to support the operations of the ECB[18]; 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, and some of them have only been refined recently.[19] 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.

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.

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, should be without prejudice to the activities of the NCB's independent external auditors[20] 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.[21] The state audit should be done on a non-political, independent and purely professional basis.

17 OJ L 115, 16.5.2000, p. 1.
18 Decision ECB/2010/26 of 13 December 2010 on the increase of the ECB's capital (OJ L 11, 15.1.2011, p. 53).
19 The main formative ECB opinions in this area are: 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.
20 For the activities of the independent external auditors of the NCBs see Article 27.1 of the Statute.
21 Opinions CON/2011/9 and CON/2011/53.

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.

Profits may be distributed to the State budget only after any accumulated losses from previous years have been covered[22] 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 admissible.[23] Similarly, a tax on an NCB's unrealised capital gains would also impair the principle of financial independence.[24]

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 cooperation with the NCB, which is best placed to assess its required level of reserve capital.[25] 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 Eurosystem to fulfil its tasks.[26]

Financial liability for supervisory authorities

Some Member States place their financial supervisory authorities within their NCB. This poses no problems if such authorities are subject to the NCB's independent decision-making. However, if the law provides for separate decision-making by such supervisory authorities, it is important to ensure that decisions adopted by them do not endanger the finances of the NCB as a whole. In 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. 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.[27] 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, taking due account of its views, to ensure the ongoing ability of the NCB to independently carry out its tasks.[28] Autonomy in staff matters extends to issues relating to staff pensions.

22 Opinion CON/2009/85.
23 Opinion CON/2009/26.
24 Opinion CON/2009/63 and Opinion CON/2009/59.
25 Opinion CON/2009/83 and Opinion CON/2009/53.
26 Opinion CON/2009/26.
27 Opinion CON/2008/9 and Opinion CON/2008/10.
28 The main Opinions are CON/2010/42, CON/2010/51, CON/2010/56, CON/2010/69, CON/2010/80, CON/2011/104, CON/2011/106 and CON/2012/6.

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 under Article 37 of the Statute may give rise to similar provisions in NCBs' statutes or in the Member States' legislation. The primacy of EU 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 access of a state audit office or similar body to an NCB's information and documents must be limited and must be without prejudice to the ESCB's confidentiality regime to which the members of NCBs' decision-making bodies and staff are subject. 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 or 2007 had to be adapted to comply with the relevant provisions of the Treaty and the Statute and be in force on 1 May 2004 and 1 January 2007 respectively. Sweden had to bring the necessary adaptations into force by 1 January 1995.

2.2.5.1 PROHIBITION ON MONETARY FINANCING

The monetary financing prohibition is laid down in Article 123(1) of the Treaty, which prohibits overdraft facilities or any other type of credit facility with the ECB or the NCBs of Member States in favour of 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; and the purchase directly from these public sector entities by the ECB or NCBs of debt instruments. The Treaty contains one exemption from the prohibition; it does not apply to publicly-owned credit institutions which, in the context of the supply of reserves by central banks, must be given the same treatment as private credit institutions (Article 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 establishing the European Community[29], which makes it clear that the prohibition includes any financing of the public sector's obligations vis-à-vis third parties.

The monetary financing prohibition is of essential importance to 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.

29 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 on the Functioning of the European Union.

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.[30]

NATIONAL LEGISLATION TRANSPOSING THE MONETARY FINANCING PROHIBITION

In general, it is unnecessary to transpose Article 123 of the Treaty, supplemented by Regulation (EC) No 3603/93, into national legislation as they are both directly applicable. If, however, national legislative provisions mirror these directly applicable EU provisions, 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, as provided for in Regulation (EC) No 3603/93) or to third countries is incompatible with the monetary financing prohibition.

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

National legislation may not require an NCB to finance either the performance of functions by other public sector bodies or the public sector's obligations vis-à-vis third parties. For example, national laws authorising or requiring an NCB to finance judicial or quasi-judicial bodies that are independent of the NCB and operate as an extension of the state are incompatible with the monetary financing prohibition. Moreover, in line with the prohibition on monetary financing, an NCB may not finance any resolution fund.[31] However, the provision of resources by an NCB to a supervisory authority does not give rise to monetary financing concerns insofar as the NCB will be financing the performance of a legitimate financial supervisory task under national law as part of its mandate, or as long as the NCB can contribute to and have influence on the decision-making of the supervisory authorities.[32] 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. [33]

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 insulating the NCB from financial obligations resulting from the prior activities of such a body, would be incompatible with the monetary financing prohibition.

FINANCIAL SUPPORT FOR CREDIT AND/OR FINANCIAL INSTITUTIONS

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

30 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. Other formative ECB opinions in this area are: CON/2008/46; CON/2008/80; CON/2009/59 and CON/2010/4.
31 Opinion CON/2011/103.
32 Opinion CON/2010/4.
33 Opinions CON/2011/91 and CON/2011/99.

support of insolvent credit and/or other financial institutions, would be incompatible with the monetary financing prohibition. To this end, inserting references to Article 123 of the Treaty should be considered.

FINANCIAL SUPPORT FOR DEPOSIT INSURANCE AND INVESTOR COMPENSATION SCHEMES

The Deposit Guarantee Schemes Directive[34] and the Investor Compensation Schemes Directive[35] provide that the costs of financing deposit guarantee schemes and investor compensation schemes must be borne, respectively, by credit institutions and investment firms themselves. National legislation which provides for the financing by an NCB of a national deposit insurance scheme for credit institutions or a national investor compensation scheme for investment firms would be compatible with the monetary financing prohibition only if it were short term, addressed urgent situations, systemic stability aspects were at stake, and decisions were at the NCB's discretion. To this end, inserting references to Article 123 of the Treaty should be considered. When exercising its discretion to grant a loan, the NCB must ensure that it is not de facto taking over a State task.[36] In particular, central bank support for deposit guarantee schemes should not amount to a systematic pre-funding operation.[37]

FISCAL AGENCY FUNCTION

Article 21.2 of the Statute establishes that the 'ECB and the national central banks may act as fiscal agents' for 'Union institutions, bodies, offices or agencies, central governments, regional local or other public authorities, other bodies governed by public law, or public undertakings of Member States.' The purpose of Article 21.2 of the Statute is, following transfer of the monetary policy competence to the Eurosystem, to enable NCBs to continue to provide the fiscal agent service traditionally provided by central banks to governments and other public entities without automatically breaching the monetary financing prohibition. Regulation (EC) No 3603/93 establishes a number of explicit and narrowly drafted exemptions from the monetary financing prohibition relating to the fiscal agency function, as follows (i) intra-day credits to the public sector are permitted provided that they remain limited to the day and that no extension is possible;[38] (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;[39] 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.[40]

National legislation on the fiscal agency function should be compatible with EU law in general, and with the monetary financing prohibition in particular. Taking into account the express recognition in Article 21.2 of the Statute of the provision of fiscal agency services as a legitimate function traditionally performed by NCBs, the provision by central banks of fiscal agency services complies with the prohibition on monetary financing, provided that such services remain within the field of the fiscal agency function and do not constitute central bank financing of public sector obligations

34 Recital 23 of Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes (OJ L 135, 31.5.1994, p. 5).
35 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).
36 Opinion CON/2011/83.
37 Opinion CON/2011/84.
38 See Article 4 of Regulation (EC) No 3603/93.
39 See Article 5 of Regulation (EC) No 3603/93.
40 See Article 6 of Regulation (EC) No 3603/93.

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.[41] National legislation that enables an NCB to hold government deposits and to service government accounts does not raise concerns about compliance with the monetary financing prohibition as long as such provisions do not enable the extension of credit, including overnight overdrafts. However, there would be a concern about compliance with the monetary financing prohibition if, for example, national legislation were to enable the remuneration of deposits or current account balances above, rather than at or below, market rates. Remuneration that is above market rates constitutes a de facto credit, contrary to the objective of the prohibition on monetary financing, and might therefore undermine the prohibition's objectives. It is essential for any remuneration of an account to reflect market parameters and it is particularly important to correlate the remuneration rate of the deposits with their maturity.[42] 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.[43]

2.2.5.2 PROHIBITION ON PRIVILEGED ACCESS

As public authorities, NCBs may not take measures granting privileged access by the public sector to financial institutions if such measures are not based on prudential considerations. Furthermore, the rules on the mobilisation or pledging of debt instruments enacted by the NCBs must not be used as a means of circumventing the prohibition on privileged access.[44] Member States' legislation in this area may not establish such privileged access.

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

2.2.6 SINGLE SPELLING OF THE EURO

Article 3(4) of the Treaty on European Union lays down that the 'Union shall establish an economic and monetary union whose currency is the euro'. In the texts of the Treaties in all the authentic languages written using the Roman alphabet, the euro is consistently identified in the nominative singular case as 'euro'. In the Greek alphabet text, the euro is spelled 'ευρώ' and in the Cyrillic alphabet text the euro is spelled 'евро'.[45] Consistent with this, Council Regulation (EC) No 974/98 of 3 May 1998 on the introduction of the euro[46] 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.

41 Opinions CON/2009/23, CON/2009/67 and CON/2012/9.
42 See, among others, Opinions CON/2010/54 and CON/2010/55.
43 Opinion CON/2012/9.
44 See Article 3(2) of and recital 10 of Council Regulation (EC) No 3604/93 of 13 December 1993 specifying definitions for the application of the prohibition on privileged access referred to in Article 104a [now Article 124] of the Treaty (OJ L 332, 31.12.1993, p. 4).
45 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'.
46 OJ L 139, 11.5.1998, p. 1.

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

2.2.7 LEGAL INTEGRATION OF NCBs INTO THE EUROSYSTEM

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

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

2.2.7.1 ECONOMIC POLICY OBJECTIVES

The full integration of an NCB into the Eurosystem requires its statutory objectives to be compatible with the ESCB's objectives, as laid down in Article 2 of the Statute. Among other things, this means that statutory objectives with a 'national flavour' – for example, where statutory provisions refer to an obligation to conduct monetary policy within the framework of the general economic policy of the Member State concerned – need to be adapted. Furthermore, an NCB's secondary objectives must be consistent and not interfere with its obligation to support the general economic policies in the EU with a view to contributing to the achievement of the objectives of the EU as laid down in Article 3 of the Treaty on European Union, which is itself an objective expressed to be without prejudice to maintaining price stability.[47]

2.2.7.2 TASKS

The tasks of an NCB of a Member State whose currency is the euro are predominantly determined by the Treaty and the Statute, given that NCB's status as an integral part of the Eurosystem. In order to comply with Article 131 of the Treaty, provisions on tasks in an NCB's statutes therefore need to be compared with the relevant provisions of the Treaty and the Statute, and any incompatibility must be removed.[48] 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.

47 Opinions CON/2010/30 and CON/2010/48.
48 See, in particular, Articles 127 and 128 of the Treaty and Articles 3 to 6 and 16 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.[49] 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.

In the context of recent 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.[50]

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.[51]

National legislative provisions assigning the exclusive right to issue banknotes to the NCB must recognise that, once the euro is adopted, the ECB's Governing Council has the exclusive right to authorise the issue of euro banknotes, pursuant to Article 128(1) of the Treaty and Article 16 of the Statute, while the right to issue euro banknotes belongs to the ECB and the NCBs. National legislative provisions enabling the government to influence issues such as the denominations, production, volume or withdrawal of euro banknotes must also either be repealed or recognition must be given to the ECB's powers with regard to euro banknotes, as set out in the provisions of the Treaty and the Statute. Irrespective of the division of responsibilities in relation to coins between governments and NCBs, the relevant provisions must recognise the ECB's power to approve the volume of issue of euro coins once the euro is adopted. A Member State may not consider currency in circulation as its NCB's debt to the government of that Member State, as this would defeat the concept of a single currency and be incompatible with the requirements of Eurosystem legal integration.[52]

With regard to foreign reserve management,[53] any Member State that has adopted the euro and which does not transfer its official foreign reserves[54] 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.

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.[55]

49 First indent of Article 127(2) of the Treaty.
50 Opinions CON/2009/99 and CON/2011/79.
51 Opinion CON/2010/8.
52 Opinion CON/2008/34.
53 Third indent of Article 127(2) of the Treaty.
54 With the exception of foreign-exchange working balances, which Member State governments may retain pursuant to Article 127(3) of the Treaty.
55 Opinion CON/2009/63.

2.2.7.3 FINANCIAL PROVISIONS

The financial provisions in the Statute comprise rules on financial accounts,[56] auditing,[57] capital subscription,[58] the transfer of foreign reserve assets[59] and the allocation of monetary income.[60] NCBs must be able to comply with their obligations under these provisions and therefore any incompatible national provisions must be repealed.

2.2.7.4 EXCHANGE RATE POLICY

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

2.2.7.5 INTERNATIONAL COOPERATION

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

2.2.7.6 MISCELLANEOUS

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

56 Article 26 of the Statute.
57 Article 27 of the Statute.
58 Article 28 of the Statute.
59 Article 30 of the Statute.
60 Article 32 of the Statute.

3 THE STATE OF ECONOMIC CONVERGENCE

Since the most recent Convergence Report in May 2010, economic activity has recovered in 2011, on average, in all countries under review.[1] In some cases, this recovery has taken place following severe adjustment processes. With the exception of Sweden, Poland and, to a lesser extent, the Czech Republic, output levels in 2011 remained below pre-crisis levels. In the second half of 2011, macroeconomic and financial conditions deteriorated, as adverse spillovers from the euro area via trade and financial channels exacerbated the effects of certain imbalances and other weaknesses in the domestic economies. In most countries, such weaknesses point to the need for further fiscal consolidation and structural reforms that support an environment conducive to sustainable output and employment growth over the medium term. Intensifying strains and higher volatility in financial markets generally translated into falling stock prices, as well as higher credit default swaps and interest rate spreads, showing that the euro area sovereign debt crisis has been affecting, to different extents, the countries under review. Financial market pressures have been particularly severe in economies with significant vulnerabilities, such as high public debt and/or deficit ratios, high private sector and external debt, currency or maturity mismatches in the national balance sheet, labour market rigidities, poor-quality outstanding bank loans and weak institutions.

Regarding the price stability criterion, three countries examined in this report, namely Bulgaria, the Czech Republic and Sweden, have 12-month average inflation rates below – in the case of Sweden, well below – the reference value. In the other five countries, inflation is well above the reference value, despite a relatively weak economic environment in most countries.

In the majority of countries, with the notable exception of Hungary, the underlying fiscal situation improved compared with 2010, mainly reflecting structural fiscal consolidation, along with some positive cyclical developments (according to the European Commission's data). However, with the exception of Sweden, all Member States under review are, at the time of this report, subject to an EU Council decision on the existence of an excessive deficit. Government debt-to-GDP ratios increased in 2011 in all Member States under review, with the exception of Bulgaria, Latvia, Hungary and Sweden. However, in Hungary there was no increase because of a one-off effect related to the transfer of assets from the mandatory private pension scheme to the state pillar. Apart from Hungary, all countries under review have a general government debt-to-GDP ratio below the 60% reference value. While debt ratios increased in 2011 to levels close to 56% of GDP in Poland, they were above 40% of GDP in Latvia and the Czech Republic. This ratio remained below 40% in Lithuania, Romania and Sweden and below 20% in Bulgaria.

Concerning the exchange rate criterion, the currencies of two of the countries examined in this report are participating in ERM II, namely the Latvian lats and the Lithuanian litas. None of the other countries under review has joined ERM II since the previous convergence assessment in 2010. Over the reference period, financial market conditions in Latvia and Lithuania were overall stabilising. At the same time, the exchange rates of currencies not participating in ERM II exhibited relatively wide fluctuations, except for Bulgaria, whose currency operates under a currency board vis-à-vis the euro.

With regard to the convergence of long-term interest rates, six of the eight countries under review in this report, namely Bulgaria, the Czech Republic, Latvia, Lithuania, Poland and Sweden, are at or below – in the case of the Czech Republic and Sweden, well below – the 5.8% reference value for the interest rate convergence criterion. In 2010 only two out of the nine countries considered in that report recorded interest rates below the reference value.

1 Of the nine countries examined in the 2010 Convergence Report, Estonia has, in the meantime, adopted the euro. This change in the composition of the group of countries under review is important and has to be taken into account when comparing the findings of the two reports.

When considering compliance with the convergence criteria, sustainability is an essential factor as convergence must be lasting and not short-lived. The first decade of EMU has shown the risks that weak fundamentals, an excessively loose macroeconomic stance at country level and overly optimistic expectations about the convergence in real incomes pose not only for the countries concerned but also for the smooth functioning of the euro area as a whole. Large and persistent macroeconomic imbalances, for example, in the form of sustained losses in competitiveness or the build-up of indebtedness and housing market bubbles, accumulated over the past decade in many EU Member States, including euro area countries, and are one of the main reasons for the current economic and financial crisis.

Overall, the need for improved economic governance in the EU has been recognised. In particular, a new legislative package entered into force on 13 December 2011, providing a significant reinforcement of surveillance of fiscal policies as well as a new surveillance procedure for the prevention and correction of macroeconomic imbalances.

Lasting policy adjustments are required in many of the countries on account of a combination of the following factors, which are relevant to economic integration and convergence:

i) High public or private indebtedness, particularly in connection with a relatively high level of external debt, makes economies vulnerable to contagion from stress in financial markets. Such indebtedness may also hinder sustainable output growth because of its potentially negative impact on bank funding or financial inflows, as well as due to the necessary deleveraging.

ii) Containing wage growth and fostering productivity remain necessary for supporting competitiveness in many countries.

iii) In order to support higher, balanced and sustainable growth, many countries need to tackle skill mismatches and encourage labour market participation, with a focus on high value-added goods and services in the tradable sector. This would help to dampen existing labour shortages and support a stronger growth contribution from the export sector in the years ahead.

iv) In most countries, improvements in the business environment and measures to strengthen governance as well as to enhance the quality of institutions are required to support higher sustainable output growth and to make the economy more resilient to country-specific shocks.

v) Regarding the financial sector, it is essential to monitor as closely as possible the banking sector, and notably the risks relating to its exposure to other countries and relatively high foreign currency lending. It is also necessary to develop funding markets in local currency, especially at longer maturities.

vi) The further convergence of income levels in most Member States covered in this report is likely to exert additional upward pressure on prices or nominal exchange rates (or both). Hence, a proven ability to achieve and maintain price stability on a lasting basis under conditions of stable exchange rates vis-à-vis the euro remains crucial for the assessment of sustainable economic convergence.

vii) Sustainable policy adjustments are needed to avoid any new build-up of macroeconomic imbalances. This risk exists, in particular, if income convergence is accompanied by renewed strong credit growth and asset price increases, fuelled, for example, by low or negative real interest rates.

viii) The projected demographic changes, which are expected to be rapid and substantial in nature, need to be addressed, e.g. through responsible and forward-looking fiscal policies.

THE PRICE STABILITY CRITERION

Over the 12-month reference period from April 2011 to March 2012, the reference value for the price stability criterion was 3.1%. It was calculated by adding 1.5 percentage points to the unweighted arithmetic average of the rate of HICP inflation over the 12 months in Sweden (1.3%), Ireland (1.4%) and Slovenia (2.1%). Focusing on the performance of individual Member States over the reference period, three of the eight countries (i.e. Bulgaria, the Czech Republic and Sweden) had average HICP inflation rates below – in the case of Sweden, well below – the reference value. HICP inflation was well above the reference value in the remaining countries, with the largest deviation being observed in Romania (see Table 1).

Table 1 Overview table of economic indicators of convergence

		Price stability	Government budgetary position			Exchange rate		Long-term interest rate
		HICP inflation[1]	Country in excessive deficit[2,3]	General government surplus (+)/ deficit (-)[4]	General government gross debt[4]	Currency participating in ERM II[3]	Exchange rate vis-à-vis euro[5]	Long-term interest rate[6]
Bulgaria	2010	3.0	No	-3.1	16.3	No	0.0	6.0
	2011	3.4	Yes	-2.1	16.3	No	0.0	5.4
	2012	2.7[1]	Yes[3]	-1.9	17.6	No[3]	0.0[3]	5.3[6]
Czech Republic	2010	1.2	Yes	-4.8	38.1	No	4.4	3.9
	2011	2.1	Yes	-3.1	41.2	No	2.7	3.7
	2012	2.7[1]	Yes[3]	-2.9	43.9	No[3]	-1.8[3]	3.5[6]
Latvia	2010	-1.2	Yes	-8.2	44.7	Yes	-0.4	10.3
	2011	4.2	Yes	-3.5	42.6	Yes	0.3	5.9
	2012	4.1[1]	Yes[3]	-2.1	43.5	Yes[3]	1.1[3]	5.8[6]
Lithuania	2010	1.2	Yes	-7.2	38.0	Yes	0.0	5.6
	2011	4.1	Yes	-5.5	38.5	Yes	0.0	5.2
	2012	4.2[1]	Yes[3]	-3.2	40.4	Yes[3]	0.0[3]	5.2[6]
Hungary	2010	4.7	Yes	-4.2	81.4	No	1.7	7.3
	2011	3.9	Yes	4.3	80.6	No	-1.4	7.6
	2012	4.3[1]	Yes[3]	-2.5	78.5	No[3]	-6.1[3]	8.0[6]
Poland	2010	2.7	Yes	-7.8	54.8	No	7.7	5.8
	2011	3.9	Yes	-5.1	56.3	No	-3.2	6.0
	2012	4.0[1]	Yes[3]	-3.0	55.0	No[3]	-2.4[3]	5.8[6]
Romania	2010	6.1	Yes	-6.8	30.5	No	0.7	7.3
	2011	5.8	Yes	-5.2	33.3	No	-0.6	7.3
	2012	4.6[1]	Yes[3]	-2.8	34.6	No[3]	-2.8[3]	7.3[6]
Sweden	2010	1.9	No	0.3	39.4	No	10.2	2.9
	2011	1.4	No	0.3	38.4	No	5.3	2.6
	2012	1.3[1]	No[3]	-0.3	35.6	No[3]	1.9[3]	2.2[6]
Reference value[7]		3.1%		-3.0%	60.0%			5.8%

Sources: European Commission (Eurostat) and ECB.
1) Average annual percentage change. Data for 2012 refer to the period April 2011-March 2012.
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 2012 refers to the period until the cut-off date for statistics (30 April 2012).
4) As a percentage of GDP. Data for 2012 are taken from the European Commission spring 2012 forecasts.
5) Average annual percentage change. Data for 2012 are calculated as a percentage change of the average over the period 1 January 2012-30 April 2012 compared with the average of 2011. A positive (negative) number denotes an appreciation (depreciation) vis-à-vis the euro.
6) Average annual interest rate. Data for 2012 refer to the period April 2011-March 2012.
7) The reference value refers to the period April 2011-March 2012 for HICP inflation and for long-term interest rates, and to the year 2011 for general government balance and general government debt.

Inflation over the past ten years in most of the central and eastern European countries has been volatile, declining from relatively high levels in 2001-02 to more moderate levels in 2003. Thereafter, inflation started to increase in most of the countries under review. In the second half of the decade, inflation accelerated in several countries, reaching double-digit levels in some cases. Annual average rates peaked in 2008, before declining substantially in 2009 as a result of the negative global commodity price shock and the significant downturn in economic activity in most countries. In 2010, inflation increased in most countries in spite of the continued weak domestic demand and the still large spare capacity. Reflecting a mixture of domestic and external factors, inflation increased further in 2011 in most of the countries under review.

Although this general pattern applied to most countries over the last decade, the cross-country variation in annual HICP inflation rates remained significant. Specifically, inflation has been very volatile in Latvia and, to a lesser extent, in Bulgaria and Lithuania. In these countries, overheating domestic economic conditions fuelled inflation to double-digit levels up to 2008, and then declined significantly until 2010. In Romania, inflation rates remained stubbornly high until 2011, despite a marked downward trend until 2007, reflecting mostly a series of supply-side shocks as well as exchange rate developments. In the Czech Republic, Hungary, Poland and Sweden inflation developments have been less volatile than in the other countries under review, with annual inflation averaging 5.1% in Hungary, 2.7% in Poland, 2.1% in the Czech Republic and 1.8% in Sweden in the past ten years.

Inflation developments have reflected the overall macroeconomic conditions prevailing in the countries under review. A period of robust economic growth until 2008, which led to a build-up of significant macroeconomic imbalances in some countries, came to a halt with the outbreak of the global financial and economic crisis. An abrupt economic slowdown supported the correction, to different degrees, of some of those imbalances in the countries affected. Also in the relatively sounder economies, macroeconomic conditions weakened abruptly, particularly in late 2008 and early 2009. More recently, growth in economic activity has resumed, although the levels of activity remain below pre-crisis levels in most countries under review. Although the contribution of domestic demand to economic growth has been increasing in most countries, relatively weak labour market conditions and fiscal consolidation needs still constrain the recovery. In several countries, inflation rates have also been affected in recent years by certain measures taken in the context of fiscal consolidation, such as indirect taxes, administered prices and excise duties. At the same time, among the most important external drivers of inflation, changes in energy and food prices have added to the volatility of inflation developments, particularly in central and eastern Europe. This reflects the relatively high sensitivity of these economies to changes in commodity prices. Exchange rate developments in the inflation-targeting countries, as well as monetary policy conditions in exchange rate-targeting countries, have also contributed to the volatility of inflation in most countries under review.

Forecasts by major international institutions indicate that annual average inflation is likely to remain broadly stable or decline in 2012 and 2013 in most countries under review. The main exception is Hungary, where inflation is expected to increase in 2012, reflecting a number of temporary cost shocks, tax changes and the lagged effect of a weaker exchange rate. The fragility of the international environment, coupled with the still subdued outlook for domestic demand and some capacity slack, is likely to help contain inflationary pressures in most countries. However, inflation developments are subject to both upside and downside risks. On the one hand, changes in global commodity prices (particularly energy) pose an upside risk to inflation. Further increases in indirect taxes and administered prices, stemming from the need for fiscal consolidation,

may add to inflationary pressures in the years to come. Moreover, developments in the labour market, especially in countries with relatively high structural unemployment and where bottlenecks in the faster-growing sectors have started to emerge, constitute an additional upside risk to inflation. On the other hand, a stronger than expected weakening in economic activity, reflecting, inter alia, negative trade channel and confidence effects, financial sector spillover effects and/or potential deleveraging in the private sector, would help to dampen inflationary pressures. In the central and eastern European countries under review, the ongoing catching-up process may in the longer run lead to renewed upward pressures on prices and/or the nominal exchange rate, although the exact size of this effect is difficult to assess. The risk of renewed inflationary pressures will be particularly high if the next upswing is again accompanied by further strong credit growth and asset price increases fuelled by low real interest rates.

An environment conducive to sustainable price stability in the countries covered in this report requires the pursuit of a stability-oriented monetary policy. Creating, maintaining or strengthening an environment supportive of price stability will, in addition, crucially depend on further fiscal policy efforts, particularly the implementation of credible consolidation paths. Wage increases should not exceed labour productivity growth and should take into account labour market conditions and developments in competing countries. In addition, continued efforts to reform product and labour markets are needed in order to further improve flexibility 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 also essential. As regards financial stability, regulatory, supervisory and macro-prudential policies should aim to avoid risks to financial stability, for example, by preventing episodes of excessive credit growth and the accumulation of financial vulnerabilities. Given the potential risks to financial stability associated with high shares of foreign currency-denominated loans in total loans, particularly in some of the countries under review, the European Systemic Risk Board's recommendations on lending in foreign currencies released in 2011 need to be adequately taken into account. Close cooperation between supervisors across EU countries is important to ensure the effective implementation of the measures. In ERM II countries, given the limited room for manoeuvre for monetary policy under the current unilateral tight exchange rate pegs, it is imperative that other policy areas support the capacity of the economy to cope with country-specific shocks and to avoid the re-emergence of macroeconomic imbalances.

THE GOVERNMENT BUDGETARY POSITION CRITERION

With the exception of Sweden, all Member States under review are, at the time of this report, subject to an EU Council decision on the existence of an excessive deficit. The deadlines for correcting the excessive deficit situation were set as follows: 2011 for Hungary and Bulgaria, 2012 for Latvia, Lithuania, Poland and Romania, and 2013 for the Czech Republic. All countries, with the exception of Sweden, Bulgaria and, temporarily, Hungary, posted a fiscal deficit-to-GDP ratio above the 3% reference value in 2011, albeit declining compared with the previous year. Sweden recorded a surplus (0.3% of GDP) in 2011, while Bulgaria posted a deficit ratio below the reference value (2.1%). Hungary, on the other hand, recorded a surplus (4.3% of GDP) on account of one-off and temporary revenue measures amounting to about 10% of GDP, which were primarily related to the transfer of assets from private pension schemes to the state pillar. Overall, in the majority of countries, with the notable exception of Hungary, the underlying fiscal situation improved in 2011 compared with 2010, mainly reflecting structural fiscal consolidation along with some positive cyclical developments (according to the European Commission's data). While Hungary formally respected the 3% of GDP reference value in 2011, this was achieved through one-off measures and not based on a structural and sustainable correction. In January 2012 the EU Council adopted a decision establishing that Hungary had not taken effective action in response to the Council

recommendation of 7 July 2009. As a consequence, on 13 March 2012 the Council adopted a decision to suspend part of the 2013 EU Cohesion Fund commitments for Hungary, as well as a fifth revised recommendation asking the Hungarian authorities to put an end to the excessive deficit by 2012. In this regard, it was recommended that Hungary take the necessary measures, including additional fiscal consolidation, to comply with the targets set in its 2011 convergence programme update. Latvia and Romania, still under EU-IMF financial assistance programmes in 2011, continued the strict fiscal consolidation. Bulgaria and Lithuania continued their prudent fiscal policies based on expenditure restraint, supported – particularly in the latter country – by positive cyclical developments. The Czech Republic and Poland, where automatic stabilisers were allowed to operate at the beginning of the global financial and economic crisis, also turned to fiscal consolidation. In the Czech Republic, the fiscal restraint which started in 2010 continued in 2011, mostly through broad-based expenditure cuts. Poland's consolidation in 2011 relative to the previous year – in which the fiscal position had continued to deteriorate – was largely revenue-based and partly temporary. In Sweden, the fiscal surplus remained unchanged in 2011, since a structural loosening, as estimated by the European Commission, was compensated for by positive cyclical factors on the back of continued strong growth.

For 2012, the European Commission forecasts the deficit-to-GDP ratio to remain above the 3% reference value only in Lithuania (at 3.2%). Poland is projected to post a deficit ratio at the reference value, while all the other countries are projected to stay below.

Government debt-to-GDP ratios increased in 2011 in all Member States under review, with the exception of Bulgaria – where it remained at the same level as in 2010 – Latvia, Sweden and Hungary, which recorded a decline in debt. The ratio declined in Hungary because of a one-off effect related to the transfer of assets from private pension schemes to the state scheme. The increase in the debt ratio in the four countries concerned, though more contained compared with the previous year, reflected still large fiscal deficits, while the deficit-debt adjustment and the growth-interest rate differential had generally a decreasing impact on the debt ratio. Only Hungary had a debt-to-GDP ratio above the 60% of GDP reference value in 2011. The debt ratios remained below 40% of GDP in Bulgaria, Lithuania, Romania and Sweden.

Between 2002 and 2011, government debt-to-GDP ratios increased substantially in Latvia (29.0 percentage points) and Hungary (24.7), followed by Lithuania (16.3), the Czech Republic and Poland (each 14.1) and Romania (8.4). By contrast, in Bulgaria and Sweden the 2011 debt ratio stood clearly below that of 2002. For 2012, the European Commission projects a rise in the debt ratio in all Member States examined in this report, with the exception of Hungary, Poland and Sweden. The European Commission's projections also indicate that debt-to-GDP ratios will remain below the 60% reference value in 2012 in all countries except Hungary.

Looking ahead, it is absolutely essential for the countries examined to achieve and maintain sound and sustainable fiscal positions. Countries that are subject to an EU Council decision on the existence of an excessive deficit must comply with their excessive deficit procedure commitments in a credible and timely manner in order to bring their budget deficits below the reference value in accordance with the agreed deadline. Further consolidation is also required in those other countries that have yet to attain their medium-term budgetary objectives. In this respect, particular attention should be paid to limiting expenditure growth to a rate below the medium-term potential growth rate, consistent with the expenditure benchmark rule of the revised Stability and Growth Pact. Moreover, beyond the legislated transition period, countries whose debt-to-GDP ratio would exceed the reference value should ensure that the ratio is declining sufficiently according to the provisions

of the enhanced Pact. Further consolidation would also make it possible to deal with the budgetary challenges related to the ageing of the population. Strong fiscal frameworks should support fiscal consolidation and limit slippages in public expenditure, while helping to prevent a re-emergence of macroeconomic imbalances. Overall, such strategies should be embedded in comprehensive structural reforms to increase potential growth.

THE EXCHANGE RATE CRITERION

Among the countries examined in this report, Latvia and Lithuania are currently participating in ERM II. The currencies of both Member States had been in ERM II for more than two years prior to the convergence examination, as laid down in Article 140 of the Treaty. The agreements on participation in ERM II were based on a number of policy commitments by the respective authorities, relating, inter alia, to pursuing sound fiscal policies, promoting wage moderation, containing credit growth and implementing further structural reforms. In both cases, there were unilateral commitments on the part of the countries concerned regarding the maintenance of narrower fluctuation bands. These commitments impose no additional obligations on the ECB. In particular, it was accepted that Lithuania could join ERM II with its existing currency board arrangement in place. The Latvian authorities also declared, unilaterally, that they would maintain the exchange rate of the lats at its central rate against the euro with a fluctuation band of ±1%. The currencies of the other six countries remained outside the exchange rate mechanism during this period.

Within ERM II, neither of the central rates of the currencies examined in this report were devalued in the reference period from 1 May 2010 to 30 April 2012. The Lithuanian litas traded continuously at its central rate. The exchange rate volatility of the Latvian lats vis-à-vis the euro within the ±1% unilaterally set fluctuation band stood at very low levels in 2010 and thereafter increased slightly, although it remained at relatively low levels, also for the rest of the period under review. Market conditions in Latvia and Lithuania, which reflected changes in global risk aversion amid tensions in some euro area sovereign debt markets, were overall stabilising throughout the period as confidence increased, credit ratings improved and money market spreads narrowed. In the case of Latvia, the international financial assistance programme, led by the EU and the IMF, ended on 19 January 2012 and the country is now under post-programme surveillance. Regarding the reference period, Latvia received disbursements from the programme only in 2010. As the assistance programme helped to reduce financial vulnerabilities, it might also have contributed to reducing exchange rate pressures. Towards the end of 2011, financial market conditions temporarily deteriorated somewhat on account of the uncertainties related to some segments of international financial markets as well as the failure of two domestic banks in Latvia and Lithuania, before improving again in early 2012.

The Bulgarian currency did not participate in ERM II but was pegged to the euro within the framework of a currency board agreement. The other currencies remaining outside ERM II were subject to relatively wide fluctuations during the reference period which were partly driven by changes in global risk aversion amid tensions in some euro area sovereign debt markets. Between mid-2010 and early 2011, these currencies appreciated gradually against the euro on account of improving sentiment in global financial markets, robust growth momentum and rather large positive interest rate differentials vis-à-vis euro area assets. Compared with their average levels in May 2010 the appreciation was strongest in the case of the currencies of Sweden and the Czech Republic, mainly reflecting the economic rebound of these economies following the global financial and economic crisis of 2008-09. Against the background of renewed tensions in some euro area sovereign debt markets and a sharp increase in global risk aversion, but also on account of a deteriorating economic outlook of the countries under review, all currencies of inflation-targeting countries, with the

exception of the Swedish krona, weakened significantly against the euro in the second half of 2011, before recovering some of their losses in early 2012. After a depreciation of the Polish zloty during the second half of 2011, Narodowy Bank Polski occasionally intervened in the foreign exchange market between September and December 2011. Already in early 2011 the IMF had prolonged and extended Poland's precautionary Flexible Credit Line arrangement. As this arrangement helped to reduce risks related to financial vulnerabilities, it might also have contributed to reducing the risk of exchange rate pressures. It is noted that Poland has not drawn on the Flexible Credit Line since its establishment. Over the reference period, the Romanian leu mostly traded significantly below its May 2010 average exchange rate. At the beginning of 2011, the two-year international financial assistance package agreed for Romania in early 2009 was replaced by a precautionary international financial assistance package. Over the reference period the Hungarian forint overall depreciated to levels substantially below its May 2010 average, reflecting the downgrade of its sovereign credit rating, triggered by government policies that have eroded foreign investor confidence and concerns about fiscal sustainability. In Hungary, an international financial assistance arrangement – designed to restore market confidence and shore up the economy, while redressing fiscal imbalances – was in place between November 2008 and late 2010. As the international financial assistance programmes for Hungary and Romania helped to reduce financial vulnerabilities, they might also have contributed to reducing exchange rate pressures. The interruption of negotiations between the Hungarian authorities and the EU and the IMF, following the request by the former for renewed financial assistance in late 2011, was a factor that contributed to the depreciation of the forint at that time. The drawn-out follow-up talks and uncertainties regarding the possibility and eventual form of the financial package are likely to have added to the forint's volatility since then.

THE LONG-TERM INTEREST RATE CRITERION

The general reassessment of risks, mainly related to the euro area sovereign debt crisis and country-specific factors, has generally influenced long-term bond market developments.

During the period under review, long-term interest rate spreads vis-à-vis the euro area average tightened in most of the countries under review, partly reflecting a rise in credit risk premia in several euro area countries which raised the euro area average. Financial markets repeatedly differentiated between countries by assessing their external and internal vulnerabilities, including the developments in budgetary performance and the prospects for sustainable convergence.

Over the 12-month reference period from April 2011 to March 2012, the reference value for long-term interest rates was 5.8%. This value was calculated by adding 2 percentage points to the unweighted arithmetic average of the long-term interest rates of two of the three best performing Member States in terms of price stability, namely Sweden (2.2%) and Slovenia (5.4%). Ireland had very limited access to financial markets during the reference period and the country's long-term interest rate was substantially influenced by risk premia. The average value of Ireland's long-term interest rate stood at 9.1%, considerably above the average of the long-term interest rates of the other two best-performing countries in terms of price stability and well above both the euro area average and the average of all Member States. Therefore, Ireland has been excluded from the calculation of the reference value for the long-term interest rate criterion. During the reference period, the euro area average long-term interest rate and the long-term AAA yield, which are included for illustrative purposes only, stood respectively at 4.4% and 2.9%.

Over the reference period, six of the Member States examined (Bulgaria, the Czech Republic, Latvia, Lithuania, Poland and Sweden) had average long-term interest rates at or below – in the case of the Czech Republic and Sweden, well below – the 5.8% reference value for the interest rate

convergence criterion (see Table 1). In Romania and Hungary, long-term interest rates significantly exceeded the reference value during the reference period. In Romania, long-term interest rates were affected by unfavourable economic developments, while Hungary was also affected by investors' perceptions of government policies. On average during the reference period, long-term interest rates stood at 7.3% in Romania and 8.0% in Hungary. Interest rate differentials vis-à-vis the euro area average stood at around 2.8 percentage points on average for Romania (4.4 percentage points with respect to the euro area long-term AAA yield). In Hungary, interest rate differentials vis-à-vis the euro area average stood at 3.6 percentage points (5.2 percentage points with respect to the euro area long-term AAA yield).

OTHER RELEVANT FACTORS

Article 140 of the Treaty requires the examination of other factors relevant to economic integration and convergence. These additional factors include the integration of markets, the situation and development of the balance of payments and the development of unit labour costs and other price indices. Moreover, in order to ensure closer coordination of economic policies and sustained convergence of the economic performances of the EU Member States (Article 121 (3)), a new surveillance procedure for the prevention and correction of macroeconomic imbalances has entered into force.[2] The first step in this procedure is an Alert Mechanism Report prepared by the European Commission for the early detection and monitoring of possible macroeconomic imbalances. This is followed by an in depth-review which the Commission undertakes for each Member State that it considers may be affected by, or may be at risk of being affected by, imbalances. The first Alert Mechanism Report was published by the Commission on 14 February 2012 and included a qualitative economic and financial assessment based, among other things, on an indicative and transparent scoreboard with a set of indicators, the values of which were compared with their indicative thresholds as provided for in the aforementioned Regulation (see Table 2).[3]

Examining these additional factors is important, as they provide relevant information to assess whether the integration of a Member State into the euro area is likely to be sustainable over time.

The unwinding of the macroeconomic imbalances accumulated in most countries under review in the pre-crisis years has proceeded at different speeds. Three of the countries examined in this report, namely Bulgaria, Hungary and Sweden, have been identified in the Alert Mechanism Report for an in-depth review. The outcome of this review, which may include recommendations by the European Commission for the implementation of preventive measures or corrective measures, or the formal ending of the procedure without any recommendations for any of these three countries, is scheduled to be published by the Commission on 30 May 2012.[4] The final outcome of the 2012 Macroeconomic Imbalance Procedure, aiming to prevent and correct excessive imbalances within the EU, will be determined by a Council decision expected in June 2012. Another country, Romania, is currently under a precautionary EU-IMF programme and was therefore not examined in the Alert Mechanism Report. Latvia, which completed an international financial assistance programme led by the EU and the IMF in January 2012, was subject to the Alert Mechanism Report but, together with the Czech Republic, Lithuania and Poland, was not recommended for an in-depth review.

2 EU Regulation No 1176/2011 of 16 November 2011.

3 The scoreboard published in the above-mentioned Alert Mechanism Report provided figures for the year 2010 (with a cut-off date of 30 January 2012). By contrast, Table 2 provides a scoreboard for the period 2009-11, as available at the cut-off date of this report, i.e. 30 April 2012.

4 The outcome of this review was not available at the time this report was concluded.

Table 2 Scoreboard for the surveillance of macroeconomic imbalances

		External imbalances/competitiveness indicators					Internal imbalances				
		Current account balance[1]	Net international investment position[2]	Real effective exchange rate, HICP-deflated[3]	Export market shares[4]	Nominal unit labour cost[5]	House prices, consumption-deflated[6]	Private sector credit flow[2]	Private sector debt[2]	General government debt[2]	Unemployment rate[7]
Bulgaria	2009	-19.1	-101.8	18.6	18.3	38.5	-	19.0	175	15	6.4
	2010	-11.0	-94.7	10.4	15.8	33.9	-11.1	-0.2	169	16	7.6
	2011	-3.0	-85.3	2.8	18.2	20.3	-	-	-	16	9.4
Czech Republic	2009	-2.9	-46.2	13.6	10.1	8.7	-4.6	0.7	76	34	5.5
	2010	-2.8	-48.5	12.7	10.2	5.1	-3.4	1.7	77	38	6.1
	2011	-3.0	-49.7	-0.1	9.3	1.8	-	-	-	41	6.9
Latvia	2009	-9.0	-82.7	23.7	31.8	42.0	-42.4	-6.1	147	37	10.2
	2010	-0.5	-80.2	8.5	14.0	0.4	-3.9	-8.8	141	45	14.4
	2011	3.5	-72.5	-0.6	24.7	-15.1	-	-	-	43	17.1
Lithuania	2009	-7.6	-58.6	16.9	22.7	16.0	-33.5	-11.5	88	29	8.0
	2010	-2.3	-55.9	9.1	13.9	0.8	-8.7	-5.3	81	38	12.5
	2011	1.5	-52.2	3.5	26.4	-9.0	-	-	-	39	15.6
Hungary	2009	-4.9	-117.9	7.8	6.6	14.1	-	5.2	170	80	8.4
	2010	-2.1	-112.7	-0.5	1.4	3.9	-6.7	-18.7	155	81	9.7
	2011	0.8	-105.2	-3.7	-0.2	3.9	-	-	-	81	10.7
Poland	2009	-5.5	-58.8	-4.0	27.9	12.8	-4.7	3.9	72	51	8.3
	2010	-5.0	-64.0	-0.5	20.1	12.4	-6.1	3.8	74	55	8.3
	2011	-4.3	-63.5	-10.9	12.8	5.4	-	-	-	56	9.2
Romania	2009	-9.7	-62.2	-4.8	32.7	45.9	-	7.9	123	24	6.4
	2010	-6.7	-63.8	-10.4	21.3	36.6	-12.1	1.7	78	31	6.6
	2011	-4.3	-61.6	-2.8	24.0	13.0	-	-	-	33	7.2
Sweden	2009	8.4	-11.4	-8.4	-14.8	12.1	-0.1	4.8	248	43	6.9
	2010	7.6	-8.5	-2.5	-11.3	5.6	6.3	2.5	235	39	7.6
	2011	7.0	-6.8	4.3	-10.8	1.5	-	6.3	233	38	8.1
Threshold		-4.0/+6.0%	-35.0%	±11.0%	-6.0%	+12.0%	+6.0%	+15.0%	+160%	+60%	+10.0%

Sources: European Commission (Eurostat, DG ECFIN) and ECB.
1) As a percentage of GDP, three-year average.
2) As a percentage of GDP.
3) Index: 1999=100. Three-year percentage change relative to 35 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.

A simple, purely mechanical reading of external imbalances and competitiveness indicators in the Alert Mechanism Report shows that current account imbalances have adjusted sharply in recent years, particularly in Bulgaria, Latvia and Lithuania. The scoreboard indicator on the current account balance (three-year average of current account balances as a percentage of GDP) still shows deficits exceeding the indicative threshold of 4% of GDP in 2011 in Poland and Romania. Sweden has recorded persistently large current account surpluses, above the 6% of GDP indicative threshold, in the past few years.

The net international investment position as a share of GDP has stayed at high negative levels, above the indicative threshold of -35% of GDP in all countries under review, with the exception of Sweden. Those negative levels exceeded -80% of GDP in Bulgaria and Hungary in 2011. They reflect persistent current account deficits, high levels of foreign direct investment in the economy as well as more volatile other investment (in particular in the form of loans and deposits) which accumulated mainly before the global financial and economic crisis.

In terms of price competitiveness, the global crisis halted a general trend of declining competitiveness in several countries under review. On the basis of the scoreboard definition, between 2008 and 2011, real effective exchange rates depreciated in Hungary, Poland and Romania as well as – to a lesser extent – in the Czech Republic and Latvia. In the case of Poland, the observed depreciation was close to the indicative threshold of 11%. In contrast, Bulgaria, Lithuania and Sweden recorded a real effective exchange rate appreciation. Furthermore, the cumulative three-year growth rate in unit labour costs, which in the pre-crisis years stood at very high levels in all countries under review except in the Czech Republic, remained in 2011 above the indicative threshold of 12% in Bulgaria and Romania. In Latvia, however, unit labour costs have declined substantially in recent years. Notwithstanding the losses in price competitiveness in some countries, in 2011 export market shares increased (in value terms, over the five previous years) in all countries under review, except in Hungary and Sweden, where they declined – in the case of Sweden by 10.8% (i.e. by more than the 6% indicative threshold). Higher export market shares in the central and eastern European countries are likely to reflect the catching-up process, which is becoming visible in quality improvements in goods and services, as well as increased integration with foreign markets.

Turning to the indicators of possible internal imbalances, a relatively long period of credit expansion prior to the global financial and economic crisis has left economic agents with large levels of accumulated debt. High indebtedness, particularly in the private sector, constitutes a key vulnerability facing most of the countries under review. The level of private sector debt in 2010 stood above the indicative threshold of 160% of GDP in Bulgaria (where much of it represents inter-company loans) and in Sweden. Public debt-to-GDP ratios have also increased strongly in several countries under review, although from relatively low levels, in the aftermath of the global financial and economic crisis. High indebtedness, particularly in connection with a relatively high level of external debt, makes economies vulnerable to contagion from stress in financial markets. Through its potentially negative impact on bank funding or financial inflows, as well as due to the necessary deleveraging, high indebtedness may also hinder sustainable output growth. Furthermore, the prevalence of foreign currency loans in several countries under review represents a macroeconomic and financial risk, as it exposes unhedged borrowers also to exchange rate risk. Risks stemming from foreign currency mismatches are large in Hungary, Poland and Romania, notably exposing households and, in Hungary, also local governments. In Bulgaria, Latvia and Lithuania, where foreign currency lending is even more widespread as a share of banks' total loan portfolio, this lending is largely denominated in euro and the central banks in these countries are strongly committed to a tight currency peg vis-à-vis the euro (Latvia) or euro-based currency boards (Bulgaria and Lithuania).

Developments in the housing market need to be carefully monitored in Sweden, where real housing prices rose rapidly in 2010, at 6.3% year-on-year, which was slightly above the indicative threshold of 6%. In the remaining countries under review, house prices have declined – sometimes substantially – in recent years. In most countries, households and banks remain vulnerable to further adjustments/declines in house prices, particularly to the extent that banks have shown forbearance in dealing with loans that may no longer be performing.

In the labour market, the adjustment process has been translated into a relatively high level of unemployment, which in 2011 stood above the indicative threshold of 10% (three-year average) in Latvia (17.1%), Lithuania (15.6%) and Hungary (10.7%). Increases in unemployment in recent years have occurred despite significant labour outflows in some countries, especially in Latvia and Lithuania, and have been accompanied by a worsening of skill and/or geographical mismatches and adverse demographic trends.

The preliminary indications based on a mechanical reading of the scoreboard should not be interpreted as conclusive evidence of the existence of imbalances. For example, a mechanical reading of the

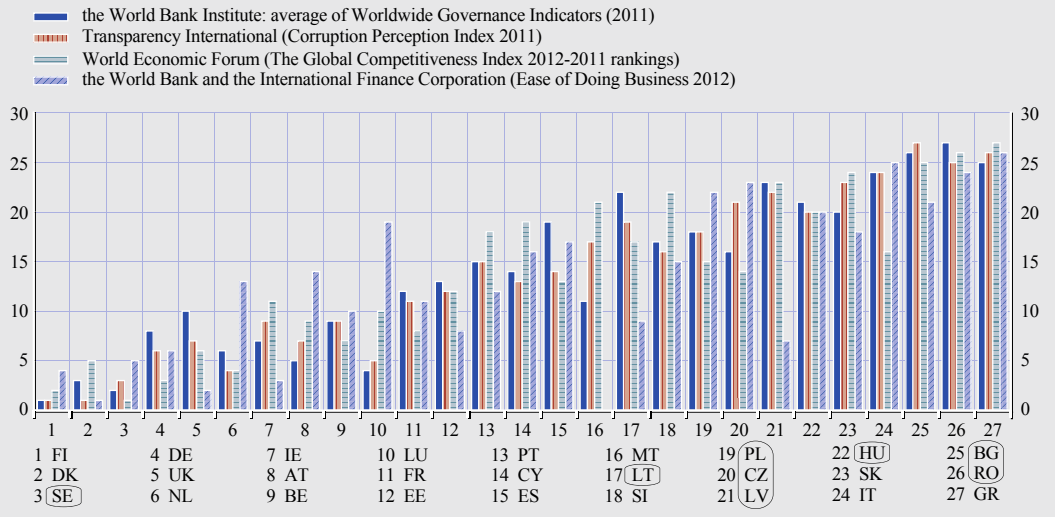
scoreboard could mask the existence of imbalances and vulnerabilities in the more recent period, as three- or five-year averages are strongly influenced by the sharp post-crisis adjustment, which might not be sustainable in the future. Not least for this reason, additional factors have already been taken into account in the Alert Mechanism Report, such as the evolution of indicators over time, the most recent developments and outlook, catching-up effects, and an additional set of indicators that the EU Council and the European Parliament stressed as being of particular relevance. In the subsequent in-depth reviews, a detailed analysis of country-specific circumstances has to be made together with an examination of an even broader range of variables, analytical tools and qualitative information.

The strength of the institutional environment, including in the area of statistics, is another important, complementary variable to be examined as an additional factor relevant to the sustainability of economic integration and convergence. In certain central and eastern European countries under review, removing the existing rigidities and impediments to the efficient use and allocation of production factors would help to enhance those countries' economic potential. They reflect weaknesses in the business environment, the relatively low quality of institutions, weak governance and corruption. By hampering potential output growth, the institutional environment may also undermine a country's debt-servicing ability and make economic adjustments more difficult. Indeed, in the economic literature some studies have shown that the quality of governance had a positive effect on economic resilience in the 2008-09 recession.[5] It has also been found that governance indicators are an important explanatory variable for regional growth differences across the EU.[6]

Chart 2 below shows the current ranking of the 27 Member States of the EU, as reported by various international organisations in the following reports: the Worldwide Governance Indicators

5 Giannone et al. (2011) – "Market Freedom and the Global Recession", *IMF Economic Review* 59, 111-135.
6 Arbia et al. (2010), "Institutions and geography: Empirical test of spatial growth models for European regions", *Economic Modelling* 27, 12-21.

Chart 2 Country rank in the EU



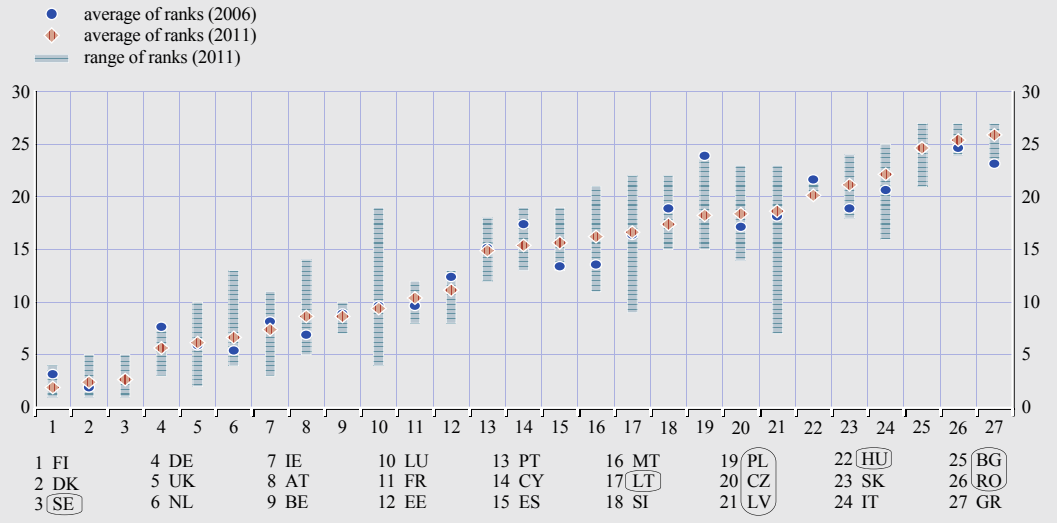
Sources: The World Bank Institute (Worldwide Governance Indicators 2011), World Economic Forum (The Global Competitiveness Index 2012-2011 rankings), Transparency International (Corruption Perception Index 2011) and the World Bank and the International Finance Corporation (Ease of Doing Business 2012).
Notes: In the Ease of Doing Business report, Malta is not covered. Countries are ranked from one (best performer in the EU) to 27 (worst performer in the EU) and ordered according to their average position in the rankings.

(World Bank Institute), the Global Competitiveness Index (World Economic Forum), the Corruption Perception Index (Transparency International) and the Ease of Doing Business Report (International Finance Corporation and World Bank). These indicators provide mostly qualitative information and, in some cases, they reflect perceptions rather than observed facts. Nevertheless, taken as a whole, they summarise a broad set of highly relevant information on the quality of the institutional environment. For completeness, the average of those ranks in 2011 and five years earlier, based on ECB calculations, is also reported in Chart 3.

It can be seen that, with the notable exception of Sweden, which ranks third among Member States, in all the countries under review − despite significant differences between them − the quality of institutions and governance is reported as being relatively weak, on average, compared with most euro area countries. After Sweden, among the countries under review, Lithuania occupies the highest average position, 17th, among EU countries in 2011. Bulgaria and Romania, respectively in 25th and 26th position, are almost at the bottom of the ranking. Furthermore, with the main exception of Poland, which moved up from 25th in 2006 to 19th in 2011, no overall institutional improvements have been made, at least in relative terms (i.e. in comparison with developments in other Member States) over the last five years (see Chart 3).

The overall picture is broadly confirmed when looking in more detail at specific institutional indicators (see chart below). Although countries are ranked differently depending on the source used to measure the quality of the business and institutional environment, there is, without doubt, still significant room for improvement in this field in most countries under review. The business environment is regarded as particularly positive in Latvia and Lithuania, which in 2011 were ranked seventh and ninth, respectively, among EU countries in the Ease of Doing Business Report (International Finance Corporation and World Bank). Yet, the relatively weak overall performance

Chart 3 Range of ranks in EU countries



Sources: The World Bank Institute (Worldwide Governance Indicators 2011, 2006), World Economic Forum (The Global Competitiveness Index 2012-2011 and 2007-2006 rankings), Transparency International (Corruption Perception Index 2011, 2006) and the World Bank and the International Finance Corporation (Ease of Doing Business 2012, 2007).
Notes: In the Ease of Doing Business report, Malta is not covered. "Early period" in the case of Luxembourg refers to the 2008 report and in the case of Cyprus to the 2009 report. Countries are ranked from one (best performer in the EU) to 27 (worst performer in the EU) and ordered according to their average position in the 2011 rankings.

in terms of governance in these two countries, which are respectively in 23rd and 22nd position in the Worldwide Governance Indicators (World Bank Institute), suggests that a stronger institutional environment is desirable.

Improving the local institutions, governance and business environment, along with further progress with the privatisation of state-owned enterprises and reinforced efforts to enhance the absorption of EU funds, would help to speed up productivity growth, inter alia, by increasing competition in key regulated sectors (e.g. energy, transport), diminishing barriers to entry and encouraging much-needed private investments.

Finally, institutional features relating to the quality of the statistics are also essential to support a smooth convergence process. This applies, inter alia, to the specification of the legal independence of the national statistical authority, its administrative supervision and budget autonomy, its legal mandate for data collection and its legal provisions governing statistical confidentiality, which are described in more detail in Section 9 of Chapter 5.

4 COUNTRY SUMMARIES

4.1 BULGARIA

Over the reference period from April 2011 to March 2012, the 12-month average rate of HICP inflation in Bulgaria was 2.7%, i.e. below the reference value of 3.1% for the criterion on price stability.

Looking back over a longer period, consumer price inflation in Bulgaria has been volatile, ranging between 2.3% and 12.0% on an annual basis over the past ten years. After a decline in 2003, inflation rose significantly to 12.0% in 2008, before falling again to 2.5% in 2009. Inflation fluctuations reflected adjustments in administered prices and excise duties, developments in commodity prices and other supply shocks, as well as the impact of domestic demand. Inflation increased gradually to 3.0% in 2010 and to 3.4% in 2011, largely reflecting higher commodity prices and increases in excise duties on tobacco. Inflation developments over the past ten years should be viewed against the background of the robust economic expansion until 2008, which was followed by a sharp GDP contraction in 2009 and a gradual recovery thereafter. Until 2008 large capital inflows into Bulgaria contributed to a boom in domestic demand, and in particular in investment, which led to an overheating economy. Subsequently, an adjustment was triggered by the global crisis in 2008 and was supported by a contraction in imports and a deceleration in capital inflows. Growth in compensation per employee decelerated from 16.3% in 2008, albeit remaining at 11.2% in 2010, despite a public wage freeze in that year, and stood at 7.3% in 2011, reflecting the impact of labour market composition effects, among other factors. Looking at recent developments, the annual HICP inflation rate broadly followed a downward path after peaking at 4.6% in March 2011 to stand at 1.7% in March 2012. The decline in inflation was supported by lower food and energy prices, while it also reflected the base effect from increases in excise duties on tobacco at the beginning of 2010.

The latest available forecasts from major international institutions project inflation to increase in 2012-13, and range between 2.1% and 3.1% in 2012 and between 2.3% and 3.3% in 2013. Higher than expected increases in commodity prices are the main upside risk to the inflation outlook, although the possible impact of recent wage growth on inflation should also be closely monitored. On the other hand, the weaker external environment and more difficult external funding conditions, along with private sector balance sheet adjustments, pose a source of downside risk in the near and medium term. Looking further ahead, maintaining low inflation rates at all times in Bulgaria may be challenging in the medium term, given monetary policy's limited room for manoeuvre under the existing currency board. The catching-up process is likely to have a bearing on inflation over the medium term, given that GDP per capita and price levels are still significantly lower in Bulgaria than in the euro area. However, it is difficult to assess the exact size of the inflation effect resulting from this catching-up process. Once the economic recovery gains momentum, with a fixed exchange rate regime, the underlying trend of real exchange rate appreciation is likely to manifest itself in terms of higher inflation. Given the currency board arrangement and the limitations of alternative counter-cyclical policy instruments, it might prove difficult to prevent macroeconomic imbalances, including high rates of inflation, from building up again.

To sum up, although the 12-month average rate of HICP inflation in Bulgaria is currently below the reference value, there are concerns regarding the sustainability of inflation convergence.

Bulgaria is at present subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2011 the general government budget balance showed a deficit of 2.1% of GDP, i.e. below the 3% reference value. The general government gross debt-to-GDP ratio was 16.3%, i.e. well below the 60% reference value. In 2012 the deficit ratio is forecast by the European

Commission to decline to 1.9% and the government debt ratio is projected to increase to 17.6%. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2011. Bulgaria must ensure that it maintains the budget deficit below the 3% reference value in a sustainable manner, in line with the EDP requirements.

In the two-year reference period, the Bulgarian lev did not participate in ERM II, but was fixed to the euro within the framework of a currency board arrangement adopted in July 1997. The Bulgarian currency did not exhibit any deviation from the rate of 1.95583 levs per euro. Short-term interest rate differentials against the three-month EURIBOR gradually declined from the high level of 3.5 percentage points in the three-month period ending in June 2010, but remained at sizeable levels throughout the reference period, standing at 2.1 percentage points in the three-month period ending in March 2012. In a longer-term context, in March 2012 both the Bulgarian lev's real effective exchange rate and its real bilateral exchange rate against the euro stood above the corresponding ten-year historical averages. Bulgaria's deficit in the combined current and capital account of the balance of payments widened progressively from 2.4% of GDP in 2002 to very high levels in excess of 20% of GDP in 2007 and 2008. After a strong fall in domestic demand, which led to lower imports, the deficit decreased substantially and the combined current and capital account reached balance in 2010 and registered a surplus in 2011. This shift in the current account balance reflected primarily a substantial reduction in the goods deficit on account of the export-led recovery and subdued domestic demand following the sharp contraction of activity, as well as a decrease in the income deficit. Bulgaria's net international investment position deteriorated sharply, from -25.3% of GDP in 2002 to -101.8% in 2009, but improved thereafter to -94.7% in 2010 and -85.3% in 2011. The fact that the country's net foreign liabilities, which mostly stem from large foreign direct investment, are still very high points to the importance of fiscal and structural policies supporting external sustainability.

Long-term interest rates were on average 5.3% over the reference period from April 2011 to March 2012 and were thus below the 5.8% reference value for the long-term interest rate convergence criterion. Long-term interest rates in Bulgaria have been on a downward trend in recent years, edging down to a low of 5.1% at the end of the reference period. Nonetheless, long-term interest rates are still somewhat above pre-crisis levels. Their differential with bond yields in the euro area narrowed significantly throughout this period, as the euro area average long-term interest rate increased at the same time. The differential with the euro area average was only 1.0 percentage point (and 2.5 percentage points with respect to the AAA euro area yield) at the end of the reference period.

Achieving an environment conducive to sustainable convergence in Bulgaria requires, among other things, the conduct of economic policies geared towards ensuring overall macroeconomic stability, including sustainable price stability. Given the limited room for manoeuvre for monetary policy under the currency board arrangement, it is imperative that other policy areas provide the economy with the wherewithal to cope with country-specific shocks and to avoid the reoccurrence of macroeconomic imbalances. Among other things, the Bulgarian authorities should persist with fiscal consolidation based on cuts in public expenditure and reforms of tax administration. In addition, Bulgaria needs to deal with a wider range of economic policy challenges that are described in more detail in Chapter 5.

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

Over the reference period from April 2011 to March 2012, the Czech Republic recorded a 12-month average rate of HICP inflation of 2.7%, i.e. below the reference value of 3.1% for the criterion on price stability.

Looking back over a longer period, annual consumer price inflation in the Czech Republic followed a broad downward trend until 2003, after which it fluctuated mostly in a range between 1.6% and 3% until the end of 2007, when it started to rise again. After peaking in 2008, inflation decreased markedly in 2009 and rose gradually from then onwards to stand at 2.1% in 2011.

Inflation developments should be viewed against the background of the cyclical phases the economy went through during the past decade. After an extended period of robust real GDP growth, the economy started to slow markedly in 2008 and slid into recession in 2009 in the wake of the global financial and economic crisis. Since then, the economy has been on a rather subdued, mainly export-driven recovery path. Over most of the last decade, growth in compensation per employee remained above labour productivity growth. Growth in unit labour costs decelerated notably during the period 2002-05, before picking up over the subsequent three years, owing to a tightening labour market. However, in the wake of the global crisis, growth in unit labour costs slowed down in 2009 and turned negative in 2010, particularly on the back of rising unemployment. The fall in import prices throughout most of the period under review was largely a by-product of the appreciation of the effective exchange rate. Looking at recent developments, after hovering around 2% for most of 2011, inflation started to accelerate in the last quarter of 2011 and stood at 4.2% in March 2012, driven mainly by food, fuel and energy prices as well as relatively significant increases in administered prices. The main factor behind the increase in food and administered prices has been the VAT rate hike, which came into effect in January 2012. A temporarily weaker nominal effective exchange rate also contributed to the recent increase in inflation, while feeble domestic demand counteracted this effect. At the same time, the rather gradual improvements in labour market conditions were reflected in a relatively moderate growth in compensation per employee and labour cost increases at low, although increasing, rates.

The latest available forecasts from major international institutions project inflation to decline from its current high levels in 2012-13, and range between 3.1% and 3.5% in 2012 and between 1.9% and 2.2% in 2013. Upside risks to inflation forecasts are associated with larger than expected hikes in commodity prices, in particular global oil and food prices. By contrast, lower than expected increases in administered prices owing to the development of world prices of natural gas and a further weakening of domestic demand constitute a source of downside risk. Looking further ahead, the catching-up process may still have a bearing on inflation and/or on the nominal exchange rate over the coming years, given that GDP per capita and price levels are still lower in the Czech Republic than in the euro area. However, it is difficult to assess the exact size of the effect resulting from this catching-up process.

The Czech Republic is, at present, subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2011 the general government budget balance showed a deficit of 3.1% of GDP, i.e. above the 3% reference value. The general government gross debt-to-GDP ratio was 41.2%, i.e. below the 60% reference value. In 2012 the deficit ratio is forecast by the European Commission to decline to 2.9% and the government debt ratio is projected to increase to 43.9%.

With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2011. The Czech Republic must ensure a sustainable reduction in the budget deficit to below the 3% reference value in 2013 and beyond, in line with the EDP commitments.

In the two-year reference period, the Czech koruna did not participate in ERM II, but traded under a flexible exchange rate regime. The koruna appreciated gradually in 2010 and stabilised over the course of 2011, before depreciating somewhat towards the end of the year. The exchange rate of the Czech koruna against the euro mostly showed a relatively high degree of volatility, while short-term interest rate differentials against the three-month EURIBOR were small in 2010 and turned negative in the second half of 2011, and stood at 0.2 percentage point in the three-month period ending in March 2012. In a longer-term context, in March 2012 both the Czech koruna's real effective exchange rate and its real bilateral exchange rate against the euro stood moderately above the corresponding ten-year historical averages. The Czech Republic recorded mostly large deficits in the combined current and capital account of its balance of payments between 2002 and 2007, before adjusting in 2008 and 2009 on account of a strong fall in domestic demand, which led to lower imports. Following the economic recovery, the deficit in the combined capital and current account balance increased to 3.0% of GDP in 2010 and 2.5% in 2011, on account of a decrease in the surplus on trade in goods and rising income payments on foreign liabilities. The country's net international investment position deteriorated substantially from -15.5% of GDP in 2002 to -48.5% in 2010 and -49.7% in 2011.

Long-term interest rates were 3.5% on average in the reference period from April 2011 to March 2012 and were thus well below the 5.8% reference value for the interest rate convergence criterion. Long-term interest rates in the Czech Republic have been on a moderate, if uneven, decline in recent years, since peaking at 5.5% in June 2009, with bond yields exhibiting some of the volatile behaviour also observed for other countries in the context of the sovereign debt crisis in the euro area. Long-term interest rates also stood at 3.5% at the end of the reference period. The progressive downward trend in long-term interest rates in the Czech Republic in recent years and the increase in euro area long-term interest rates over the same period meant that the long-term interest rate differential narrowed at first and ultimately turned negative, with Czech interest rates 0.5 percentage point lower than those of the euro area average (and 1.0 percentage point higher with respect to the AAA euro area yield) at the end of the reference period.

Achieving an environment conducive to sustainable convergence in the Czech Republic requires, among other things, maintaining a price stability-oriented monetary policy, improving the domestic fiscal framework and following a comprehensive and credible fiscal consolidation path. The latter requires implementing further measures on top of what has already been approved in the 2012 budget and continuing a prudent expenditure policy in the medium term. In addition, the Czech Republic needs to deal with a wider range of economic policy challenges, which are described in more detail in Chapter 5.

Czech law does not comply with all the requirements for central bank independence, confidentiality, 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 LATVIA

Over the reference period from April 2011 to March 2012, the 12-month average rate of HICP inflation in Latvia was 4.1%, i.e. well above the reference value of 3.1% for the criterion on price stability.

Looking back over a longer period, consumer price inflation in Latvia has been very volatile, ranging between annual averages of -1.2% and 15.3% in the past ten years. Inflation gradually picked up from generally low levels during the first half of the past decade and fluctuated between 6% and 7% for a few years, before accelerating further in 2007 and 2008. Particularly during the boom years in the second half of the decade, the Latvian economy exhibited growing signs of serious overheating and rising macroeconomic imbalances. As these macroeconomic developments proved unsustainable, the Latvian economy experienced a deep crisis beginning in 2008. After peaking at an annual average rate of 15.3% in 2008, HICP inflation fell sharply. Consumer prices and unit labour costs declined for a while, which helped the country to regain competitiveness. This adjustment came to an end in the course of 2010. Looking at recent developments, the annual rate of HICP inflation moderated to 3.2% in March 2012, following a pick-up in the first half of 2011 owing to increases in global food and energy prices and higher indirect taxes. Inflation pressures moderated again in the second half of 2011 as global commodity prices stabilised and demand-side pressures remained muted.

The latest available forecasts from major international institutions project inflation to decline in 2012-13, and range between 2.5% and 2.6% in 2012 and between 2.1% and 2.5% in 2013. Upside risks to inflation exist and stem in particular from higher commodity prices and stronger increases in wage costs, while, at the same time, lower than expected economic growth represents a downside risk. Looking further ahead, maintaining low inflation rates at all times in Latvia will be challenging in the medium term, given monetary policy's limited room for manoeuvre under the fixed exchange rate regime. The catching-up process is likely to have a bearing on inflation over the medium term, given that the GDP per capita level is still significantly lower in Latvia than in the euro area and that the price level is still approximately 30% lower than in the euro area. However, it is difficult to assess the exact size of the inflation effect resulting from this catching-up process. Once credit growth resumes, with a fixed exchange rate regime, the underlying trend of real exchange rate appreciation is likely to manifest itself in terms of higher inflation.

Latvia is at present subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2011 the general government budget balance showed a deficit of 3.5% of GDP, i.e. above the 3% reference value. The general government gross debt-to-GDP ratio was 42.6%, i.e. below the 60% reference value. In 2012 the deficit ratio is forecast by the European Commission to decline to 2.1% and the government debt ratio is projected to increase to 43.5%. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2011. Latvia must ensure a sustainable reduction in the budget deficit to below the 3% reference value in 2012 and beyond, in line with the EDP requirements, and fully implement the reform previously agreed in the context of the EU-IMF financial assistance programme.

The Latvian lats has been participating in ERM II since 2 May 2005. Over the last two years the lats has remained close to its central rate. While the maximum upward deviation of the exchange rate from the ERM II central rate amounted to 0.9% over the reference period, the maximum downward deviation was 1.0%. Between late 2008 and January 2012 an international financial assistance arrangement of €7.5 billion, led by the EU and the IMF, was in place and might also

have contributed to reducing exchange rate pressures. Regarding the period under review, Latvia received disbursements in 2010 but did not draw on the remaining resources of €3.0 billion in 2011. The exchange rate volatility of the Latvian lats vis-à-vis the euro, as measured by annualised standard deviations of daily percentage changes, stood at very low levels in 2010 and thereafter increased slightly, although it remained at relatively low levels for the rest of the reference period. Short-term interest rate differentials against the three-month EURIBOR declined from relatively high levels during the second half of 2010. After temporarily moving into negative territory in mid-2011, the short-term interest rate differential stood at low levels of 0.4 percentage point in the three-month period ending in March 2012. In a longer-term context, in March 2012 both the Latvian lats' real effective exchange rate and its real bilateral exchange rate against the euro stood above the corresponding ten-year historical averages. Latvia was characterised by substantially widening deficits in the combined current and capital account of its balance of payments, which tripled from a high level of 6.5% of GDP in 2002 to very large deficits in excess of 20% of GDP in 2006 and 2007. After a strong fall in domestic demand, which led to lower imports, as well as gains in competitiveness and a strong recovery of exports, the deficit decreased substantially and the combined current and capital account registered a very large surplus of 11.1% of GDP in 2009. This drastic shift reflected a substantial decrease of the goods deficit and, to a lesser extent, increases of the surpluses in services and transfers, as well as a temporary improvement in the income balance. However this surplus narrowed subsequently to 4.9% in 2010 and 0.9% in 2011, reflecting the rebound of domestic demand, particularly investment, with strong growth in imports outpacing growth in exports. At the same time the country's net international investment position deteriorated substantially, from -41.3% of GDP in 2002 to -82.7% in 2009, but stabilised at -80.2% in 2010 and declined thereafter to -72.5% in 2011. The fact that the country's net foreign liabilities are still very high points to the importance of fiscal and structural policies supporting external sustainability.

Long-term interest rates were 5.8% on average over the reference period from April 2011 to March 2012 and were thus at the 5.8% reference value for the interest rate convergence criterion. During the first part of the reference period, long-term interest rates declined, and the improving market situation was also reflected in Latvia's regained access to long-term domestic and international markets. Towards the end of 2011 some temporary increases in long-term interest rates were observed, mainly related to developments in the domestic banking system as well as tensions in international markets. Long-term interest rates stood at 5.2% at the end of the reference period, 1.1 percentage points higher than those of the euro area average (and 2.6 percentage points with respect to the euro area AAA yield).

Achieving an environment conducive to sustainable convergence in Latvia requires the conduct of economic policies geared towards ensuring overall macroeconomic stability, including sustainable price stability. Given the limited room for manoeuvre for monetary policy under the current exchange rate peg, it is imperative that other policy areas provide the economy with the wherewithal to cope with country-specific shocks and to avoid the reoccurrence of macroeconomic imbalances. In particular, it is crucial for Latvia to further strengthen its fiscal position, which will support the credibility of the exchange rate peg. This requires, among other things, implementing the measures proposed in the 2012 budget and continuing a prudent expenditure policy in the medium term. In addition, Latvia needs to deal with a wider range of economic policy challenges that are described in more detail in Chapter 5.

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

4.4 LITHUANIA

Over the reference period from April 2011 to March 2012, the 12-month average rate of HICP inflation in Lithuania was 4.2%, i.e. well above the reference value of 3.1% for the criterion on price stability.

Looking back over a longer period, inflation in Lithuania has been volatile, ranging between annual averages of -1.1% and 11.1% during the past ten years. Inflation started to pick up towards the middle of the decade after having been negative in 2003. During the following years, HICP inflation increased progressively to peak at 11.1% in 2008, before falling back sharply. The upward trend in inflation during most of the decade was, initially, mainly owing to higher indirect taxes, the fading impact on import prices of the earlier appreciation of the litas, and higher commodity prices. The further acceleration in inflation in the second half of the decade was the result of a combination of factors, including higher energy and food prices, as well as an increasingly tight labour market and very strong demand growth, reflecting an overheating economy and rising macroeconomic imbalances. As these macroeconomic developments proved unsustainable, the Lithuanian economy experienced a severe contraction in 2009 before recovering again during the following years. Looking at recent developments, the annual rate of HICP inflation eased gradually in the second half of 2011 and stood at 3.7% in March 2012, after reaching a peak of 5.0% in May 2011 as a result of increases in global food and energy prices. Whereas the earlier impact of food prices on inflation is gradually moderating, increases in administered energy prices have had an upward impact on inflation as higher energy prices are gradually passed on to households.

The latest available forecasts from major international institutions project inflation to decline in 2012-13, and range between 2.7% and 3.1% in 2012 and between 2.5% and 2.9% in 2013. Risks to inflation are tilted to the upside and relate mainly to higher than expected increases in global commodity prices, as well as to stronger increases in wages, particularly if labour productivity growth turns out weaker than currently expected, putting upward pressure on unit labour costs. Looking further ahead, maintaining low inflation rates at all times in Lithuania may be challenging in the medium term, given monetary policy's limited room for manoeuvre under the existing currency board. The catching-up process is likely to have a bearing on inflation over the coming years, given that GDP per capita and price levels are still lower in Lithuania than in the euro area. However, it is difficult to assess the exact size of the inflation effect resulting from this catching-up process. Once credit growth resumes, with a fixed exchange rate regime, the underlying trend of real exchange rate appreciation is likely to manifest itself in terms of higher inflation.

Lithuania is at present subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2011 the general government budget balance showed a deficit of 5.5% of GDP, i.e. well above the 3% reference value. The general government debt-to-GDP ratio was 38.5%, i.e. well below the 60% reference value. In 2012 the deficit ratio is forecast by the European Commission to decline to 3.2%, while the government debt ratio is projected to increase to 40.4%. With regard to other fiscal factors, the deficit ratio exceeded the ratio of public investment to GDP in 2011. Lithuania must bring its budget deficit below the 3% reference value by 2012, in line with the EDP commitments, and maintain sound fiscal policies thereafter.

The Lithuanian litas has been participating in ERM II since 28 June 2004. In the two-year reference period, the litas was stable at its central rate of 3.45280 litas per euro. Short-term

interest rate differentials against the three-month EURIBOR gradually decreased on account of an improving outlook for Lithuania's economy, which was also reflected in upgrades of Lithuania's sovereign credit rating by rating agencies, from a modest level of 0.9 percentage point in the three-month period ending in June 2010, to very low levels throughout 2011, standing at 0.4 percentage point in the three-month period ending in March 2012. In a longer-term context, in March 2012 both the Lithuanian litas' real effective exchange rate and its real bilateral exchange rate against the euro stood somewhat above, although close to, the corresponding ten-year historical averages. The deficit in the combined current and capital account of the balance of payments widened progressively from 4.7% of GDP in 2002 to the very high levels in excess of 10% of GDP in 2007 and 2008. After a strong fall in domestic demand, which led to lower imports, the deficit decreased substantially and the combined current and capital account registered a large surplus of 7.8% of GDP in 2009, which narrowed subsequently to 4.2% in 2010 and 0.9% in 2011. This sudden adjustment was driven predominantly by a sharp reduction in the goods deficit, an improvement in the income balance, which temporarily registered a small surplus, as well as an increase in the services surplus; the subsequent narrowing of the combined current and capital account over the past two years reflected the recovery of domestic demand. The country's net international investment position deteriorated from -32.6% of GDP in 2002 to -58.6% in 2009, but gradually improved thereafter to -55.9% of GDP in 2010 and -52.2% in 2011.

Long-term interest rates were 5.2% on average over the reference period from April 2011 to March 2012 and were thus below the 5.8% reference value for the interest rate convergence criterion. The international financial crisis had a significant adverse effect on the Lithuanian capital markets, and the long-term interest rates increased considerably to a plateau of 14.5% during 2009 with no secondary trading taking place. During 2010 and 2011 limited trading and primary issuance restarted and long-term interest rates fell to around 5% amid more stable economic developments, standing at 5.3% at the end of the reference period. From 2010 onwards the interest rate differential with the euro area average narrowed down to 1.2 percentage points (and 2.8 percentage points with respect to the AAA euro area yield) at the end of the reference period.

Achieving an environment conducive to sustainable convergence in Lithuania requires the conduct of economic policies geared towards ensuring overall macroeconomic stability, including sustainable price stability. Given the limited room for manoeuvre for monetary policy under the currency board arrangement, it is imperative that other policy areas provide the economy with the wherewithal to cope with country-specific shocks and to avoid the reoccurrence of macroeconomic imbalances. In particular, it is crucial for Lithuania to continue the implementation of its comprehensive expenditure-based consolidation strategy, which will also support the credibility of the exchange rate peg. In addition, Lithuania needs to deal with a wider range of economic policy challenges that are described in more detail in Chapter 5.

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

4.5 HUNGARY

Over the reference period from April 2011 to March 2012, the 12-month average rate of HICP inflation in Hungary was 4.3%, i.e. well above the reference value of 3.1% for the criterion on price stability.

Looking back over a longer period, during the last ten years, annual consumer price inflation in Hungary fluctuated between 3.5% and 7.9%. Frequent changes in indirect tax rates and administered prices played a major role in explaining the volatile long-term pattern of inflation during this period. Unit labour cost growth was very substantial at the beginning of the 2000s, driven by strong growth in employee compensation, and decreased only slowly during the early stages of the slowdown in the course of Hungary's fiscal adjustment. Labour market adjustment accelerated in subsequent years, leading to a strong moderation in overall unit labour cost growth. However, the growth of compensation per employee again outpaced productivity growth in 2011, leading to a rise in unit labour cost growth. Looking at recent developments, inflation pressures emerged in 2011 in spite of still very weak domestic demand conditions. These pressures reflected mainly the impact of commodity prices and the depreciation of the exchange rate in the second half of 2011, along with the full-year inflationary impact of the special taxes in various sectors (e.g. the energy sector, retail chains and the telecommunications sector) introduced in 2010, as well as indirect tax hikes in early 2012.

The latest available forecasts from major international institutions project inflation to accelerate in 2012 to between 4.9% and 5.5%, before subsiding in 2013 to between 2.9% and 3.9%. Regarding risks to the inflation outlook, on the upside, commodity prices may rise more strongly than expected and the recent price shocks may have an impact on inflation expectations. On the downside, domestic demand may pick up at a slower pace than expected (e.g. in the case of a faster than expected deleveraging process in the banking sector). Looking further ahead, the catching-up process is likely to have a bearing on inflation and/or on the nominal exchange rate over the coming years, given that GDP per capita and price levels are still lower in Hungary than in the euro area. However, it is difficult to quantify the impact on inflation of this catching-up process.

Hungary is, at present, subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2011 the general government budget balance showed a temporary surplus of 4.3% of GDP. The general government gross debt-to-GDP ratio was 80.6%, i.e. well above the 60% reference value. However, the improvement in the fiscal position was due to one-off and temporary revenue measures (of about 10% of GDP), primarily related to the transfer of pension assets from private pension schemes to the state pillar, and was therefore not based on a structural and sustainable correction. As a consequence, on 13 March 2012, the EU Council adopted a decision to suspend part of the 2013 EU cohesion fund commitments for Hungary and a fifth revised recommendation asking the Hungarian authorities to put an end to the excessive deficit by 2012. In this regard, Hungary was recommended to take the necessary measures, including additional fiscal consolidation, to meet its deficit target of 2.5% of GDP in 2012 and to ensure that the deficit in 2013 remains well below 3% of GDP, even after the phasing-out of one-off measures. In 2012 the budget deficit is forecast by the European Commission to meet the target of 2.5% and the government debt ratio is projected to decrease to 78.5%. With regard to other fiscal factors, the deficit ratio is not expected to exceed the ratio of public investment to GDP in 2012. Hungary must bring its budget deficit below the 3% reference value in a sustainable manner, in line with the renewed EDP requirements, and ensure that the debt ratio is put on a clear downward path.

In the two-year reference period, the Hungarian forint did not participate in ERM II. The forint appreciated gradually between mid-2010 and July 2011, then weakened substantially up until the end of 2011, before recovering some of its losses against the euro. The EU-IMF international financial assistance arrangement, which was in place between November 2008 and late 2010, might also have contributed to reducing exchange rate pressures. On the other hand, the interruption of negotiations between the Hungarian authorities and the EU and the IMF on a possible new financial package in late 2011 was a factor that contributed to the depreciation of the forint in late 2011, with the fact that the follow-up talks have dragged on possibly having added to the forint's volatility since then.

The forint's exchange rate against the euro showed a high degree of volatility over the period under review, with short-term interest rate differentials against the three-month EURIBOR remaining at high levels. In a longer-term context, in March 2012 both the Hungarian forint's real effective exchange rate and its real bilateral exchange rate against the euro stood close to the corresponding ten-year historical averages. Hungary's current and capital account has adjusted sharply in recent years. After reporting a large average deficit of 7.1% of GDP between 2002 and 2008, the combined current and capital account of the balance of payments reversed to register a surplus of 1.0% in 2009 and widened gradually thereafter to 3.6% in 2011, mainly on account of robust export growth and the sustained weakness in domestic demand. The country's net international investment position deteriorated sharply, from -65.2% of GDP in 2002 to -117.9% in 2009, but improved thereafter to -112.7% in 2010 and -105.2% in 2011. The fact that the country's net foreign liabilities are still very high points to the importance of fiscal and structural policies supporting external sustainability.

Long-term interest rates were 8.0% on average over the reference period from April 2011 to March 2012 and were thus well above the 5.8% reference value for the interest rate convergence criterion. Throughout the reference period, concerns about the country's fiscal situation and government policies that had eroded foreign investor confidence were reflected in rating downgrades, declining investor demand for Hungarian sovereign bonds, a weakening currency and steadily increasing long-term interest rates. At the end of 2011 Hungary requested further possible EU-IMF financial assistance. At the end of 2011 and at the beginning of 2012, long-term interest rates increased substantially. They declined afterwards and stood at 8.7% at the end of the reference period, with the interest rate differential to the euro area average standing at 4.7 percentage points (and 6.2 percentage points with respect to the AAA euro area yield).

Achieving an environment conducive to sustainable convergence in Hungary requires, among other things, a stability-oriented monetary policy including a stable institutional environment that maintains market confidence in the full independence of the central bank. Moreover, while structural fiscal consolidation is envisaged for the medium term, following two years of loosening the fiscal stance, further measures need to be identified upfront, in particular from 2013, in addition to the full implementation of the structural reforms passed in 2011. Moreover, Hungary needs to deal with a wider range of economic policy challenges that are described in more detail in Chapter 5.

Hungarian law does not comply with all the requirements for central bank independence, 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.

4.6 POLAND

Over the reference period from April 2011 to March 2012, the 12-month average rate of HICP inflation in Poland was 4.0%, i.e. well above the reference value of 3.1% for the criterion on price stability.

Looking back over a longer period, annual consumer price inflation in Poland has fluctuated within a range of 0.7% and 4.2% over the past ten years, reflecting mainly the impact of external price shocks and exchange rate fluctuations. More specifically, annual HICP inflation followed a sharp downward trend from double-digit rates at the beginning of 2000 to low rates in 2003. In 2004 there was a temporary rise in inflation, reflecting increases in administered prices and indirect taxes, as well as higher food prices stemming from Poland's accession to the EU. Following a period of low inflation in 2005 and 2006, price pressures picked up again at the end of 2006. Inflation increased to levels of above 4.0% in 2008 and remained elevated in 2009, before declining gradually in 2010. In 2011 the surge in global commodity prices, the depreciation of the nominal exchange rate and a VAT increase amid robust domestic demand contributed to a renewed rise in inflation. Inflation developments over the past ten years should be viewed against the background of rather sustained economic growth. Macroeconomic developments up to mid-2008 were characterised by a sustained upswing in economic activity, which was only partly interrupted in the first half of 2005. Capacity pressures became apparent in 2007-08, in the form of noticeable rises in unit labour cost growth, increasing current account deficits and a historically low unemployment rate. Capacity pressures were suddenly reduced with the onset of the global economic and financial crisis. A relatively short-lived economic slowdown and lower global commodity prices resulted in the temporary decline in annual HICP inflation to levels below 2% in the summer of 2010. Looking at recent developments, annual HICP inflation remained at an elevated level close to 4% throughout most of 2011. This trend continued at the beginning of 2012, with annual HICP inflation standing at 3.9% in March 2012.

The latest available forecasts from major international institutions project inflation to decline in 2012-13, and range between 2.5% and 3.8% in 2012 and between 2.5% and 2.9% in 2013. Risks to the inflation outlook are balanced. Upside risks relate mainly to higher than expected commodity prices, whereas downside risks are associated mostly with weaker than expected economic activity. Looking further ahead, the catching-up process is likely to have a bearing on inflation and/or on the nominal exchange rate over the coming years, given that GDP per capita and price levels are still lower in Poland than in the euro area. However, it is difficult to assess the exact size of the effect resulting from this catching-up process.

Poland is, at present, subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2011 the general government budget balance showed a deficit of 5.1% of GDP, i.e. well above the 3% reference value. The general government gross debt-to-GDP ratio was 56.3%, i.e. below the 60% reference value. In 2012 the deficit ratio is forecast by the European Commission to decline to 3.0% and the government debt ratio is projected to decrease to 55.0%. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2011. Poland must ensure a sustainable reduction in the budget deficit and correct the excessive deficit by 2012, in line with the EDP requirements.

In the two-year reference period, the Polish zloty did not participate in ERM II, but traded under a flexible exchange rate regime. In the second half of 2010 the zloty appreciated modestly

and remained broadly stable in the first half of 2011. As the Polish currency depreciated in the second half of 2011, Narodowy Bank Polski occasionally intervened in the foreign exchange market between September and December 2011. Thereafter, the Polish currency recovered some of its losses against the euro. A Flexible Credit Line arrangement with the IMF, introduced in March 2009 for countries with pre-specified qualification criteria and in place during the reference period, might also have contributed to reducing the risk of exchange rate pressures. It is noted that Poland has not drawn on the Flexible Credit Line since its establishment. The exchange rate of the Polish zloty against the euro has shown a high degree of volatility, while short-term interest rate differentials against the three-month EURIBOR have remained at relatively wide levels over the last two years as a result of relatively high monetary policy rates in Poland. In a longer-term context, in March 2012 both the Polish zloty's real effective exchange rate and its real bilateral exchange rate against the euro stood close to the corresponding ten-year historical averages. Poland reported a relatively large average deficit of 3.3% of GDP in the combined current and capital account of its balance of payments between 2002 and 2008. Following a strong depreciation of the zloty and a decline in domestic demand, the combined current and capital account deficit adjusted markedly in 2009 to 2.2% of GDP and stood at 2.8% of GDP in 2010 and 2.1% in 2011. This mainly reflected a renewed increase in the goods deficit on account of strengthening domestic demand. The country's net international investment position deteriorated substantially from -34.9% of GDP in 2002 to -64.0% in 2010 and -63.5% in 2011.

Long-term interest rates were 5.8% on average over the reference period from April 2011 to March 2012 and were thus at the reference value of 5.8% for the interest rate convergence criterion. During the financial crisis, long-term interest rates in Poland were, overall, relatively volatile, stabilising in the second half of 2009 and early 2010. Increasing international investor demand for Polish sovereign bonds fostered the decline of long-term interest rates in 2010. At the end of 2010 and the beginning of 2011, long-term interest rates increased somewhat, reflecting broader financial market tensions. Since the middle of 2011, long-term interest rates have followed a downward trend, notwithstanding some temporary increases in the second half of 2011. At the end of the reference period, the long-term interest rate for Poland stood at 5.4%, which was 1.3 percentage points higher than the euro area average (and 2.8 percentage points with respect to the euro area AAA yield).

Achieving an environment conducive to sustainable convergence in Poland requires, among other things, maintaining a price stability-oriented monetary policy in the medium term. Although the Polish economy managed to weather the global crisis relatively well, a number of fiscal and structural issues remain to be resolved. Specifically, on the fiscal front, a shift from the more revenue-based and temporary fiscal consolidation undertaken so far to a more comprehensive expenditure-based approach is needed to reduce the large structural deficit and to contain the rise in the debt ratio in a sustainable manner. In addition, Poland needs to deal with a wider range of economic policy challenges that are described in more detail in Chapter 5.

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.

4.7 ROMANIA

Over the reference period from April 2011 to March 2012, the 12-month average rate of HICP inflation in Romania was 4.6%, i.e. well above the reference value of 3.1% for the criterion on price stability.

Looking back over a longer period, annual consumer price inflation in Romania decreased from very high levels in the early 2000s until 2007, when the downward trend was reversed. In 2009 inflation fell again and broadly stabilised thereafter at around 6%. Besides unit labour costs, several supply-side shocks, adjustments in administered prices and excise duties as well as exchange rate developments played a major role in driving inflation. Inflation dynamics over the past ten years should be viewed against a background of overheating in the economy between 2004 and 2008, followed by a sharp contraction in economic activity in 2009 and 2010 and a moderate recovery in 2011. Between 2004 and 2008 wage growth significantly outpaced productivity growth, which in turn drove unit labour cost growth to very high levels. Thereafter, however, wage growth moderated, supported by a cut in public wages in 2010. At the same time, unit labour cost growth slowed down from 22.9% in 2008 to 1.7% in 2011. Looking at recent developments, HICP inflation broadly followed a downward path from its peak of 8.5% in May 2011 to 2.5% in March 2012. The marked decline reflected the fading-out of the impact of the 5 percentage point VAT increase in July 2010, as well as easing pressures from energy and food prices owing to global prices, a very good harvest and the disinflation pressures exerted by the negative output gap.

The latest available forecasts from major international institutions project inflation to increase in 2012-13 from historically low levels, and range between 2.9% and 3.1% in 2012 and between 3.1% and 3.7% in 2013. However, there are upside risks to this outlook, relating mainly to the dynamics of commodity and administered prices, the latter in the more medium term. Furthermore, risks stem from possible fiscal slippages in the context of the elections planned for autumn 2012. An increase in the cost of external funding, following a further escalation of the financial crisis, may also add to inflationary pressures. On the downside, a weaker external environment and greater difficulty obtaining external funding, together with private sector balance sheet adjustments, pose the main risks. Looking further ahead, the catching-up process is likely to have a bearing on inflation and/or on the nominal exchange rate over the coming years, given that GDP per capita and price levels are still significantly lower in Romania than in the euro area. However, it is difficult to assess the exact magnitude of the effect resulting from this catching-up process.

Romania is, at present, subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2011 the general government budget balance showed a deficit of 5.2% of GDP, i.e. well above the 3% reference value The general government gross debt-to-GDP ratio was 33.3%, i.e. well below the 60% reference value. In 2012 the deficit ratio is forecast by the European Commission to decline to 2.8% and the government debt ratio is projected to increase to 34.6%. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2011. Romania must ensure a sustainable reduction in the budget deficit to below the 3% reference value in 2012 and beyond, in line with the EDP requirements, and fulfil the commitments agreed upon in the context of the EU-IMF financial assistance programme.

Over the two-year reference period, the Romanian leu did not participate in ERM II, but traded under a flexible exchange rate regime. The leu was broadly stable in the course of 2010, then appreciated modestly in the first half of 2011, and has since then gradually depreciated against the euro. The two-year international financial assistance package, agreed for Romania in March 2009 and its replacement with a precautionary financial assistance programme in March 2011, also led by the EU and the IMF, might also have contributed to reducing exchange rate pressures. Over the reference period, the exchange rate of the Romanian leu against the euro showed a relatively high degree of volatility – although on average substantially lower compared with other inflation-targeting countries of the region – while short-term interest rate differentials against the three-month EURIBOR have remained, on average, at a high level over the last two years. In a longer-term context, in March 2012 both the Romanian leu's real effective exchange rate and its real bilateral exchange rate against the euro stood close to the corresponding ten-year historical averages, while Romania's current and capital account has adjusted substantially in recent years. After reporting a progressive increase in the external deficit between 2002 and 2007, the combined current and capital account deficit declined to -3.6% of GDP in 2009 and stood at -4.2% in 2010 and -4.1% in 2011. This shift in the current and capital account balance primarily reflected the sharp decline in the goods deficit, mainly driven by strong export performance and moderate domestic demand. The country's net international investment position deteriorated substantially from -21.2% of GDP in 2002 to -63.8 in 2010 and -61.6% in 2011.

Long-term interest rates were 7.3% on average over the reference period from April 2011 to March 2012 and were thus well above the 5.8% reference value for the interest rate convergence criterion. In recent years, long-term interest rates in Romania have tended to fluctuate around 7% within a margin of ±0.5 percentage point, with stubborn inflation dynamics preventing a sustained downward trend in nominal interest rates. More recently, inflation has been sharply reduced, allowing the central bank to ease policy rates more rapidly than before. This has contributed to the slight narrowing of the long-term interest rate differential between Romania and the euro area average. At the end of the reference period, the long-term interest rate stood at 6.5%, 2.4 percentage points above the euro area average (and 4.0 percentage points with respect to the AAA euro area yield).

Achieving an environment conducive to sustainable convergence in Romania requires, among other things, a stability-oriented monetary policy and the strict implementation of fiscal consolidation plans. In addition, Romania needs to deal with a wider range of economic policy challenges that are described in more detail in Chapter 5.

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.

4.8 SWEDEN

Over the reference period from April 2011 to March 2012, the 12-month average rate of HICP inflation in Sweden was 1.3%, i.e. well below the reference value of 3.1% for the criterion on price stability.

Looking back over a longer period, inflation developments in Sweden have generally been moderate, with the rate of inflation averaging 1.8% over the past ten years, reflecting the credibility of monetary policy underpinned by moderate wage formation and the country's advanced economy status. On average in 2011, annual inflation stood at 1.4%. Annual HICP inflation has occasionally deviated from 2.0%, mirroring developments in global commodity and foreign exchange markets, and wage growth out of line with productivity developments. Nevertheless, the periods when inflation has deviated from 2.0% have been sporadic, with large discrepancies rare. Looking at recent developments, the annual rate of HICP inflation continued to moderate in the course of 2011. Inflation reached a trough of 0.4% in December 2011 before increasing at the beginning of 2012 to stand at 1.1% in March 2012. Although fuel prices had an upward impact on inflation at the beginning of 2012, inflation remained firmly on a downward path. The reaction of inflation to the strong increases in economic activity was moderate, owing to a gradual appreciation of the krona and the lagged impact of past decreases in unit labour costs.

The latest available forecasts from major international institutions project inflation to increase in 2012-13, and range between 1.1% and 2.5% in 2012 and between 1.4% and 2.0% in 2013. Upside risks to inflation relate to a stronger than expected rebound in domestic demand, while a possible further appreciation of the krona constitutes a source of downside risk. Moreover, a potential correction of house prices could dampen domestic demand and HICP inflation. The fact that the price level in Sweden is still relatively high compared with the euro area average suggests that further trade integration and increased competition may have a downward effect on prices.

Sweden is not subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2011 the general government budget balance showed a surplus of 0.3% of GDP, i.e. it comfortably met the 3% deficit reference value. The general government debt-to-GDP ratio was 38.4% of GDP, i.e. well below the 60% reference value. In 2012 the budget balance is forecast by the European Commission to turn to a deficit of 0.3% of GDP and the government debt ratio is projected to decline to 35.6%. Sweden should continue to anchor its budgetary consolidation strategy in the years to come in its rules-based fiscal framework, which has so far been beneficial to fiscal performance.

In the two-year reference period, the Swedish krona did not participate in ERM II, but traded under a flexible exchange rate regime. The krona appreciated strongly against the euro until March 2011, then weakened somewhat and, from the end of 2011, started to strengthen again. The exchange rate of the Swedish krona against the euro has, on average, recorded a high degree of volatility over the reference period, while short-term interest rate differentials against the three-month EURIBOR increased gradually from -0.1 percentage point in the three-month period ending in June 2010 to 1.4 percentage points in the three-month period ending in March 2012. In a longer-term context,

in March 2012 both the Swedish krona's real effective exchange rate and its real bilateral exchange rate against the euro stood close to the corresponding ten-year historical averages. Since 2002 Sweden has maintained large surpluses – of around 7% of GDP, on average – in the combined current and capital account of its balance of payments. The country's net international investment position improved gradually from -22.1% of GDP in 2002 to -8.5% in 2010 and -6.8% in 2011.

Long-term interest rates were 2.2% on average over the reference period from April 2011 to March 2012 and were thus well below the 5.8% reference value for the interest rate convergence criterion. Long-term interest rates reached a historically low level in the period under consideration and stood at 2.0% at the end of the reference period. The differential between the Swedish long-term interest rate and the euro area average long-term interest rate had already turned negative in 2005, reflecting a fall in the inflation rate. From mid-2005 to 2007, the yield differential vis-à-vis the euro area average remained slightly negative. More recently, from 2008 onwards the interest rate differential with the euro area average widened and stood at -2.1 percentage points (and -0.6 percentage point with respect to the AAA euro area yield) at the end of the reference period, partly reflecting the high perceived creditworthiness of the Swedish government and strong demand for Swedish krona assets.

Maintaining an environment conducive to sustainable convergence in Sweden requires, among other things, the continuation of a price stability-oriented monetary policy and sound fiscal policies over the medium term. In addition, Sweden needs to deal with a wider range of economic policy challenges, which are described in more detail in Chapter 5.

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. Furthermore, the ECB notes that, 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

5.1 BULGARIA

5.1.1 PRICE DEVELOPMENTS

Over the reference period from April 2011 to March 2012, the 12-month average rate of HICP inflation in Bulgaria was 2.7%, i.e. below the reference value of 3.1% for the criterion on price stability (see Table 1). On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to remain broadly stable in the coming months.

Looking back over a longer period, consumer price inflation in Bulgaria has been volatile, ranging between 2.3% and 12.0% on an annual basis over the past ten years (see Chart 1). In 2003 inflation declined to 2.3%, before rising significantly. This increase in inflation reflected adjustments in administered prices, the harmonisation of excise duties with EU levels, a series of supply-side shocks (such as the hikes in global energy and food prices) and increasing demand pressures. After peaking at 12.0% in 2008, inflation declined sharply to 2.5% in 2009, reflecting lower commodity prices and the contraction of economic activity. Inflation increased gradually to 3.0% in 2010 and to 3.4% in 2011, reflecting largely higher commodity prices and increases in excise duties on tobacco.

Economic and monetary policy choices have played an important role in shaping inflation developments over the past decade. The process of disinflation up to 2003 was related to a number of important policy choices, most notably the orientation of monetary policy towards the achievement of price stability, which is the primary objective of monetary policy as enshrined in the central bank law. In 1997 Bulgaria adopted a currency board arrangement. The lev was fixed first to the Deutsche Mark and in 1999 to the euro. The process of disinflation up to 2003 was also supported by the implementation of a number of reforms designed to enhance product and labour market competition. However, during the period 2004-08 monetary policy conditions in Bulgaria under the currency board arrangement became too expansionary for a catching-up economy with a significantly higher growth potential than the euro area, faced with overheating pressures. Despite a relatively sound fiscal policy record, the country's overall policy stance proved to be unable to fully contain demand pressures and control price stability. The ensuing macroeconomic developments ended with a period of externally induced economic adjustment, which began in 2009. Comprehensive consolidation measures introduced in that year helped to put the fiscal deficit that had just emerged on a declining path, thanks largely to a broad-based restraint in expenditure.

Inflation developments over the past ten years should be viewed against the background of the robust economic expansion until 2008, which was followed by a sharp GDP contraction in 2009 and a gradual recovery thereafter (see Table 2). Until 2008 large capital inflows into Bulgaria contributed to a boom in domestic demand, and in particular in investment, which led to an overheating economy. Subsequently, the necessary correction was supported by a contraction of imports and a deceleration of capital inflows in the aftermath of the global financial and economic crisis. The deterioration in economic activity and reductions in public sector employment brought about a significant increase in the unemployment rate, from 5.6% in 2008 to 10.2% in 2010. At the same time, growth in compensation per employee decelerated from very high levels, but remained at 11.2% in 2010 despite a public wage freeze. In 2011 unemployment increased further, despite a gradual recovery in output growth, while wage growth decelerated to 7.3%, thereby bringing unit labour cost growth down to 1.1%. These developments reflect, inter alia, the impact of labour market composition effects following a disproportional reduction in employment of young and low-skilled labour, as well as possible labour market imperfections. Furthermore, uncertainties regarding the quality of private sector wage data

remain high, particularly given the significance of the informal economy. After having recorded very strong increases for several years during the economic boom, house prices declined by a cumulative 38% from their peak in 2008 until 2011. Overall, import prices were rather volatile during the period under review, reflecting mainly developments in oil and food prices, particularly in view of their large share in the Bulgarian HICP basket. The impact of the effective exchange rate on import prices remained relatively small. The general pattern of inflation developments has also been reflected in other relevant indices, such as the HICP excluding unprocessed food and energy.

Looking at recent developments, the annual HICP inflation rate broadly followed a downward path after peaking at 4.6% in March 2011, standing at 1.7% in March 2012 (see Table 3a). The decline in inflation was supported by lower food and energy prices, while it also reflected the base effect from increases in excise duties on tobacco at the beginning of 2010. In an environment of limited domestic demand pressures, the HICP excluding unprocessed food and energy also decelerated. Finally, the share of administered prices (including energy prices) in Bulgaria's HICP basket currently amounts to 16%, and their contribution to headline inflation turned positive at the beginning of 2012. The current inflation picture needs to be viewed against the background of an economic environment that is still weak. Real GDP increased by 0.3% in the fourth quarter of 2011, resulting in an average growth rate of 1.7% for the year as a whole.

The latest available forecasts from major international institutions project inflation to increase in 2012-13, and range between 2.1% and 3.1% in 2012 and between 2.3% and 3.3% in 2013 (see Table 3b). Inflationary pressures in Bulgaria are likely to be dampened by weak domestic demand, high unemployment and a fragile international environment. Higher than expected increases in commodity prices are the main upside risk to the inflation outlook, although the possible impact of recent wage growth on inflation should also be closely monitored. On the other hand, the weaker external environment and more difficult external funding conditions, along with private sector balance sheet adjustments, pose a downside risk in the near and medium term.

Looking further ahead, maintaining low inflation rates at all times in Bulgaria may be challenging in the medium term, given monetary policy's limited room for manoeuvre under the existing currency board. The catching-up process is likely to have a bearing on inflation over the medium term, given that GDP per capita and price levels are still significantly lower in Bulgaria than in the euro area (see Table 2). However, it is difficult to assess the exact size of the inflation effect resulting from this catching-up process. Once the economic recovery gains momentum, with a fixed exchange rate regime, the underlying trend of real exchange rate appreciation is likely to manifest itself in terms of higher inflation. In the context of the process of economic convergence, the recurrence of significant demand pressures cannot be completely ruled out, although the ongoing deleveraging process reduces this risk for the near future. Given the currency board arrangement and the limited impact of alternative counter-cyclical policy instruments, it might prove difficult to prevent macroeconomic imbalances, including high rates of inflation, from building up again.

To sum up, although the 12-month average rate of HICP inflation in Bulgaria is currently below the reference value, there are concerns regarding the sustainability of inflation convergence.

Achieving an environment conducive to sustainable convergence in Bulgaria requires the conduct of economic policies geared towards ensuring overall macroeconomic stability, including sustainable price stability. Given monetary policy's limited room for manoeuvre under the currency board arrangement, it is imperative that other policy areas provide the economy with the wherewithal to cope with country-specific shocks and to avoid the reoccurrence of macroeconomic imbalances.

Among other things, the Bulgarian authorities should persist with fiscal consolidation based on cuts in public expenditure and reforms of tax administration. Moreover, containing public sector wage growth is important for supporting sustainable developments in private sector wage growth. Regarding structural reforms, further improvements in the business and institutional environment are crucial to attract foreign direct investment flows and to raise the growth potential of the Bulgarian economy. Furthermore, additional targeted measures to increase human capital and enhance the flexibility of the labour market are required. In the current context of high unemployment, these measures are especially important in order to address a rise in structural unemployment or a decline in the participation rate. In particular, it will be necessary to eliminate sectoral, skill and educational mismatches in the labour market and improve the employability of young and low-skilled workers. Ensuring sufficient flexibility of nominal and real wages is necessary to ensure that the competitiveness of the economy is maintained over the medium term, particularly given Bulgaria's fixed exchange rate regime. Wage increases should reflect labour productivity growth, labour market conditions and developments in competitor countries. In order to sustain further economic expansion, it will also be essential to strengthen national policies aimed at enhancing competition in product markets and to proceed with the liberalisation of regulated sectors, as well as with the improvement of the country's underdeveloped transport infrastructure. It is also crucial to improve the absorption capacity of EU funds. Moreover, tax efficiency should be increased, including by continuing the fight against tax evasion. In addition, the quality of statistics should be enhanced, in particular wage statistics. Financial sector policies should be geared towards preventing boom-bust cycles in future credit developments. Given the potential risks to financial stability associated with the high share of foreign currency-denominated loans in Bulgaria, the European Systemic Risk Board's recommendations on lending in foreign currencies, released in 2011, need to be adequately taken into account. Close cooperation with supervisors across EU countries is important to ensure the effective implementation of such measures. All of these measures will help to achieve an environment conducive to sustainable price stability and promote competitiveness and employment growth.

5.1.2 FISCAL DEVELOPMENTS

Bulgaria is, at present, subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2011 the general government budget balance showed a deficit of 2.1% of GDP, i.e. below the 3% reference value. The general government gross debt-to-GDP ratio was 16.3%, i.e. well below the 60% reference value (see Table 4). Compared with the previous year, the budget balance ratio improved by one percentage point, while the public debt ratio remained unchanged. In 2012 the deficit ratio is forecast by the European Commission to decline to 1.9% and the government debt ratio is projected to increase to 17.6%. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2011 and is not expected to exceed it in 2012 either.

Looking at developments in Bulgaria's budgetary position over the period from 2002 to 2011, the budget was in deficit in 2002 and 2003, and, after a marked improvement in 2004, recorded surpluses until 2008, before registering a deficit of 4.3% of GDP in 2009. As the deficit-to-GDP ratio rose above the 3% of GDP reference value in 2009, the ECOFIN Council decided on 13 July 2010 that an excessive deficit situation existed in Bulgaria and set the deadline for correcting it at 2011. As shown in greater detail in Chart 2b, European Commission estimates indicate that, overall, cyclical factors had a limited positive impact on the budget balance before 2009. In 2009, when the financial and economic crisis strongly affected the state of public finances, and in 2010, cyclical factors had a negative, albeit declining, impact on the budget balance. Non-cyclical factors had a volatile impact on the budget balance between 2002 and 2008, before contributing to its strong

deterioration in 2009. This was mainly due to a rise in expenditure, including increases in pension benefits and other current transfers payable. In the second half of 2009 the government implemented comprehensive consolidation measures which contained the deterioration in the budget balance in that year and helped to reduce the budget deficit in 2010 and 2011. These measures were aimed at cutting current expenditure in particular and at raising tax revenue collection by improving compliance with VAT and corporate income tax rules to counteract the fall in tax revenue. Over the period under consideration, available evidence suggests that temporary and one-off factors made a sizeable contribution to the deterioration of the budget balance in 2007 (related to a debt settlement with Iraq). Accounting for this impact, the underlying changes in the budget deficit over 2003-11 seem to reflect a structural improvement in Bulgaria's fiscal position until 2007, a deterioration in 2008 and 2009, and an improvement thereafter.

Turning to developments in general government gross debt, between 2002 and 2011 the debt-to-GDP ratio declined cumulatively by 36.1 percentage points, decreasing steadily until 2008, before gradually increasing slightly thereafter. As shown in greater detail in Chart 3b, primary surpluses and the positive growth/interest rate differential contributed favourably to this development until 2008. Moreover, noticeable debt-reducing deficit-debt adjustments in the first half of the decade reflected, inter alia, the effects of debt restructuring, debt buyback and prepayment. From 2009 onwards, on the back of deteriorating macroeconomic and financial conditions, primary deficits contributed to an increase in debt, while deficit-debt adjustments limited the rise in the debt ratio as the government reduced the size of its financial assets.

As regards Bulgaria's general government debt structure, the share of government debt with a short-term maturity increased from 0.7% in 2002 to 2.8% in 2011 but remained low during the entire period (see Table 6). Taking into account the level of the debt ratio, fiscal balances are relatively insensitive to changes in interest rates. At 74.6% in 2011, the proportion of government debt denominated in foreign currency is high, although it has fallen considerably over the past decade. Given the overall debt level, with 55% of government debt denominated in euro, fiscal balances are relatively insensitive to changes in exchange rates other than the EUR/BGN exchange rate, which is fixed under the currency board. With reference to the most recent developments, the impact of the global financial and economic crisis on Bulgaria's debt structure was limited. At the same time, the Bulgarian government has not incurred contingent liabilities resulting from government interventions to support financial institutions and financial markets during the crisis (see Section 5.9).

Moving on to examine trends in other fiscal indicators, Chart 4 and Table 5 show that the general government total expenditure-to-GDP ratio declined from 39.6% in 2002 to 35.2% in 2011. After peaking at 40.7% of GDP in 2009 on account of, inter alia, sizeable increases in nominal pensions and other current transfers payable, as well as, to a lesser extent, compensation of employees in the government sector, the expenditure ratio declined markedly thereafter, mainly as a result of declines in other current expenditure and capital expenditure as well as, to a lesser extent, lower compensation of employees. Total government revenue as a share of GDP decreased substantially over the period, from 38.4% of GDP in 2002 to 33.1% of GDP in 2011. After peaking at 40.9% of GDP in 2007 on the back of rapid economic growth, the total revenue-to-GDP ratio started to decline across most revenue items in 2009 following the impact of the financial and economic crisis.

Looking ahead, Bulgaria's medium-term fiscal policy strategy as presented in the 2012-15 convergence programme update indicates the commitment to reduce the budget deficit to 1.6% of GDP in 2012 and, gradually, further to achieve a balanced budget in 2015. According to the 2012 budget, the deficit on a cash basis is planned to be reduced in 2012 to 1.35% of GDP. The projected

fiscal consolidation for 2012 is based on continued expenditure restraint, in particular a freeze of wage and pension indexation as well as savings associated with improved revenue collection. According to the 2012-15 convergence programme update and taking into account the revised medium-term fiscal plans included in the 2012 budget, the structural deficit over the programme period is planned to meet the medium-term objective of 0.5% of GDP (specified in line with the Stability and Growth Pact) in 2014. Moreover, based on information submitted in the 2012 convergence programme update, primary expenditure excluding EU fund transfers (relevant expenditure), as a share of GDP, is projected to decline by 2.1 percentage points between 2012 and 2015. The annual growth rate of relevant expenditure is projected to be below the growth rate of potential GDP over the period 2012-14 and to turn above it in 2015. According to the European Commission's projections, the structural deficit will remain above the medium-term objective by 2013.

In this respect, on 2 March 2012 Bulgaria signed the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, committing, inter alia, to apply (and include in its national legislation) the fiscal rules specified under Title III, "Fiscal Compact", as referred to in Box 2 of Chapter 2.

As regards fiscal governance, Bulgaria has implemented several reforms in recent years, including the Financial Stability Pact aimed at introducing a framework of principles and rules to ensure fiscal discipline. Looking ahead, more efforts are needed to further strengthen the binding character and the contents of the medium-term budgetary framework (in particular by restraining expenditures in upturns) and to improve the budget process and the quality of the reporting and control systems. The potential reclassification of some public companies needs to be further scrutinised, as it may incur upside risks to government debt (see Section 5.9). Full compliance with the provisions for an enhanced national governance framework under Council Directive 2011/85/EU and with the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, as referred to in Box 2 of Chapter 2, should be ensured.

Turning to factors with an impact on Bulgaria's public finances over the long term, a steep ageing of the population is expected, as highlighted in Table 8. According to the 2012 projections by the European Commission and the EU's Economic Policy Committee, starting from a level of 18.2% of GDP in 2010, Bulgaria is likely to experience a notable increase in strictly age-related public expenditure amounting to 2.8 percentage points of GDP in the years to 2060.[1]

Turning to fiscal challenges, Bulgaria must ensure that it maintains the budget deficit below the 3% reference value in a sustainable manner, in line with the EDP requirements, through continued fiscal consolidation based on cuts in public expenditure and reforms of tax administration. Bulgaria's fiscal policy strategy should be supported by the rigorous implementation of its revised fiscal framework. At the same time, every effort should be made to fully comply with the obligations under the enhanced Stability and Growth Pact, and to effectively implement the provisions of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union.

5.1.3 EXCHANGE RATE DEVELOPMENTS

In the two-year reference period from 1 May 2010 to 30 April 2012, the Bulgarian lev did not participate in ERM II, but was fixed to the euro at 1.95583 levs per euro within the framework of a currency board arrangement (see Table 9a). This arrangement, which was adopted in July 1997

1 European Commission and Economic Policy Committee, "The 2012 Ageing Report: Economic and budgetary projections for the EU-27 Member States (2010-2060)".

to address the financial crisis and hyperinflationary pressures, was initially based 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 (see Chart 5 and Table 9a). As implied by the currency board regime, Българска народна банка (Bulgarian National Bank) continued to exchange on demand domestic currency against the anchor currency and vice versa at the fixed rate. Overall, its purchases and sales of foreign currency during the two-year reference period resulted in a net sale.

Short-term interest rate differentials against the three-month EURIBOR gradually declined from the high level of 3.5 percentage points in the three-month period ending in June 2010 on account of improving confidence, as also reflected in upgrades to Bulgaria's sovereign outlook and declining credit default swap premia. Short-term interest rate spreads still remained at sizeable levels throughout the reference period, standing at 2.1 percentage points in the three-month period ending in March 2012 (see Table 9b).

In a longer-term context, in March 2012 both the Bulgarian lev's real effective exchange rate and its real bilateral exchange rate against the euro stood above the corresponding ten-year historical averages (see Table 10). However, these measures should be interpreted with caution, as in this period Bulgaria was subject to a process of economic convergence, which complicates any historical assessment of real exchange rate developments.

As regards other external developments, the deficit in the combined current and capital account of the balance of payments widened progressively from 2.4% of GDP in 2002 to very high levels in excess of 20% of GDP in 2007 and 2008 (see Table 11). After a strong fall in domestic demand, which led to lower imports, and a strong export performance, the deficit decreased substantially and the combined current and capital account reached balance in 2010 and registered a surplus in 2011. This shift in the current account balance reflected primarily a substantial reduction in the goods deficit on account of the export-led recovery and subdued domestic demand following the sharp contraction of activity, as well as a decrease in the income deficit. The narrowing of the combined current and capital account deficit over the past few years has been associated with a slowdown of capital inflows. Foreign direct investment inflows decreased in 2010 and stabilised in 2011, while Bulgaria continued to record outflows of portfolio and other investment. Against this background, gross external debt increased substantially, from 63.5% of GDP in 2002 to 108.3% in 2009, but subsequently declined to 102.8% in 2010 and 92.0% in 2011. At the same time Bulgaria's net international investment position deteriorated sharply, from -25.3% of GDP in 2002 to 101.8% in 2009, but thereafter improved to -94.7% in 2010 and -85.3% in 2011. The country's net foreign liabilities, mostly stemming from large foreign direct investment, are still very high. Fiscal and structural policies therefore continue to be important for supporting external sustainability and the competitiveness of the economy. Bulgaria is a small open economy; the ratio of foreign trade in goods and services to GDP increased from 50.2% in 2002 to 66.6% in 2011 for exports and from 58.3% in 2010 to 65.8% in 2011 for imports. Over the same period, Bulgaria's share in world exports increased from 0.10% to 0.16%.

Concerning measures of economic integration with the euro area, in 2011 exports of goods to the euro area constituted 45.6% of total goods exports, whereas the corresponding figure for imports amounted to 42.8%. The share of euro area countries in Bulgaria's stock of inward direct investment stood at 70.9% in 2011 and in its stock of portfolio investment liabilities at 99.3% in 2010. The share of Bulgaria's stock of assets invested in the euro area amounted to 38.5% in the case of direct investment in 2011 and 50.6% for portfolio investment in 2010 (see Table 12).

5.1.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from April 2011 to March 2012, long-term interest rates in Bulgaria were 5.3% on average and thus below the 5.8% reference value for the interest rate convergence criterion (see Table 13).

Long-term interest rates followed a declining trend from January 2003 until the end of 2005 (see Chart 6a).[2] Against the backdrop of robust economic growth, this period saw a number of upgrades to Bulgaria's sovereign credit rating, which reached investment grade status according to two of the three major rating agencies. Long-term interest rates subsequently embarked on an upward trend in 2006 and 2007 in an environment of accumulating domestic and external imbalances. Long-term interest rates appeared to stabilise within a range of ±0.2 percentage point around 5% for most of 2008, in spite of inflation continuing to accelerate to almost 15% in the first half of that year. However, towards the latter part of 2008 the deterioration in both global and domestic economic conditions began to have an impact on long-term rates, which started to escalate sharply once again, reaching 7.8% in December 2008. During this period, two of the three major credit rating agencies downgraded Bulgaria's sovereign credit rating, but the investment grade rating was maintained. Long-term interest rates only started to decline in a sustained manner in August 2009. By that time, the process of correcting the significant imbalances accumulated in the run-up to the crisis was under way, with inflation progressively slowing down to near zero levels in October 2009. Since then, long-term interest rates in Bulgaria have followed a gradual but consistent downward path, edging down to 5.1% at the end of the reference period. In mid-2011 one of the three major rating agencies increased the country's classification to one level above investment grade.

The differential between long-term interest rates in Bulgaria and the euro area average followed a downward path between 2003 and 2005, largely on account of the reduction in Bulgaria's long-term interest rates during this period. By the end of 2005, this differential had almost been reduced to zero. In 2006 and 2007 the differential between long-term interest rates in Bulgaria and the euro area average appeared to stabilise at a low level, averaging around 0.3 percentage point for the period as a whole (see Chart 6b). The spread increased marginally in 2008, but towards the latter part of the year the long-term interest differential vis-à-vis the euro area average increased sharply − reflecting global financial market tensions and concerns about persisting economic imbalances in Bulgaria − and reached 4.1 percentage points in December 2008. The long-term interest rate differential with the euro area average remained in a range of 3.1 to 4.0 percentage points for most of 2009. Since that time, the slow but steady reduction in Bulgarian long-term interest rates, coupled with an increase in euro area average rates, has progressively brought down the differential to just 1.0 percentage point (and 2.5 percentage points with respect to the AAA euro area yield) at the end of the reference period.

As regards financial integration and development, Bulgarian capital markets are smaller and much less developed than those in the euro area (see Table 14). Stock market capitalisation has progressively declined in recent years from a peak of 48.2% of GDP in 2007 to just 16.5% at the end of 2011. Outstanding debt securities issued by corporations (a measure of market-based indebtedness) amounted to only 2.2% of GDP in 2011. Bulgaria's financial sector is heavily bank-based, with credit to non-government residents increasing very rapidly between 2003 and 2009 and amounting to 71.5% of GDP in 2011. Foreign-owned banks, primarily from the euro area, dominate the system and the majority of loans are denominated in foreign currency, in this case the currency board reserve currency. The international claims of euro area banks in Bulgaria, defined as the share in total liabilities of loans from euro area banks to banks in the country, amounted to 11.7% in 2011.

2 Data are available on the reference long-term interest rate for Bulgaria from 2003 onwards.

LIST OF TABLES AND CHARTS

BULGARIA

1 PRICE DEVELOPMENTS

Table 1 HICP inflation

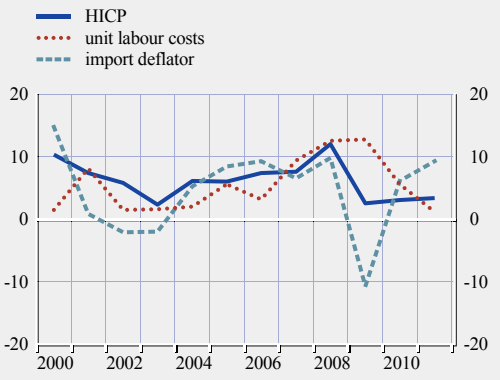
(annual percentage changes)

	2011	2012			Apr. 2011
	Dec.	Jan.	Feb.	Mar.	to Mar. 2012
HICP inflation	2.0	1.9	2.0	1.7	2.7
Reference value[1]					*3.1*
Euro area[2]	*2.7*	*2.7*	*2.7*	*2.7*	*2.8*

Source: European Commission (Eurostat).
1) The basis of the calculation for the period April 2011-March 2012 is the unweighted arithmetic average of the annual percentage changes in the HICP for Sweden, Ireland and Slovenia plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(average annual percentage changes)



Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Measures of inflation										
HICP	5.8	2.3	6.1	6.0	7.4	7.6	12.0	2.5	3.0	3.4
HICP excluding unprocessed food and energy	5.8	1.8	5.9	3.6	8.1	8.2	12.0	4.1	2.5	2.6
HICP at constant tax rates[1]	-	-	4.9	6.0	5.4	7.2	11.3	1.9	2.1	3.2
CPI	5.8	2.3	6.2	5.0	7.2	8.4	12.4	2.8	2.5	4.2
Private consumption deflator	4.5	0.7	3.4	6.8	2.2	9.0	7.2	1.5	2.4	3.8
GDP deflator	4.7	2.3	4.2	7.4	6.9	9.2	8.4	4.3	2.8	5.0
Producer prices[2]	2.2	2.8	5.4	7.3	8.7	8.0	13.3	-4.3	7.1	8.6
Related indicators										
Real GDP growth	4.7	5.5	6.7	6.4	6.5	6.4	6.2	-5.5	0.4	1.7
GDP per capita in PPS[3] (euro area = 100)	28.5	30.5	31.7	33.6	35.0	36.8	40.0	40.5	40.6	-
Comparative price levels (euro area = 100)	40.7	39.6	40.7	42.4	44.1	45.0	47.9	48.6	48.8	-
Output gap[4]	2.0	2.0	2.8	2.7	3.1	4.0	5.1	-3.4	-4.1	-3.1
Unemployment rate (%)[5]	18.1	13.7	12.1	10.1	9.0	6.9	5.6	6.8	10.2	11.2
Unit labour costs, whole economy	15	1.6	2.0	5.6	3.1	9.3	12.5	12.7	5.6	1.1
Compensation per employee, whole economy	6.0	4.2	6.2	9.3	6.3	12.7	16.3	9.4	11.2	7.3
Labour productivity, whole economy	4.4	2.5	4.1	3.6	3.1	3.2	3.5	-2.9	5.3	6.1
Imports of goods and services deflator	-2.1	-2.0	5.2	8.4	9.2	6.5	9.8	-10.7	6.1	9.2
Nominal effective exchange rate[6]	0.8	3.5	0.8	-1.0	-0.2	0.7	0.7	1.6	-2.0	-0.1
Money supply (M3)	11.7	19.6	23.1	23.8	28.5	32.9	8.3	4.7	5.5	12.3
Lending from banks	42.9	48.8	48.7	31.8	24.8	64.5	32.4	4.1	1.6	3.8
Stock prices (Bulgarian Stock Exchange SOFIX Index)	54.3	148.2	37.6	32.0	48.3	44.4	-79.7	19.1	-15.2	-11.1
Residential property prices	1.8	12.2	47.5	36.6	14.7	28.9	24.9	-21.4	-10.1	-6.1

Sources: European Commission (Eurostat), national data (CPI, money supply, lending from banks and residential property prices) and European Commission (output gap).
1) 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 on the price paid by the consumer.
2) Total industry excluding construction and domestic sales.
3) PPS stands for purchasing power standards.
4) Percentage difference of potential GDP: a positive (negative) sign indicates that actual GDP is above (below) potential GDP.
5) The definition conforms to ILO guidelines.
6) A positive (negative) sign indicates an appreciation (depreciation).

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2011			2012		
	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.
HICP						
Annual percentage change	3.0	2.6	2.0	1.9	2.0	1.7
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	2.0	2.1	2.4	1.8	1.7	1.6
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	2.2	2.0	2.0	1.9	1.9	2.1

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2012	2013
HICP, European Commission (spring 2012)	2.6	2.7
CPI, OECD (December 2011)[1)]	-	-
CPI, IMF (April 2012)	2.1	2.3
CPI, Consensus Economics (April 2012)	3.1	3.3

Sources: European Commission, OECD, IMF and Consensus Economics.
1) Bulgaria is not a member of the OECD.

2 FISCAL DEVELOPMENTS

Table 4 General government fiscal position

(as a percentage of GDP)

	2010	2011	2012 [1]
General government surplus (+)/deficit (-)	-3.1	-2.1	-1.9
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure [2]	1.5	1.1	1.4
General government gross debt	16.3	16.3	17.6
Reference value	*60.0*	*60.0*	*60.0*

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

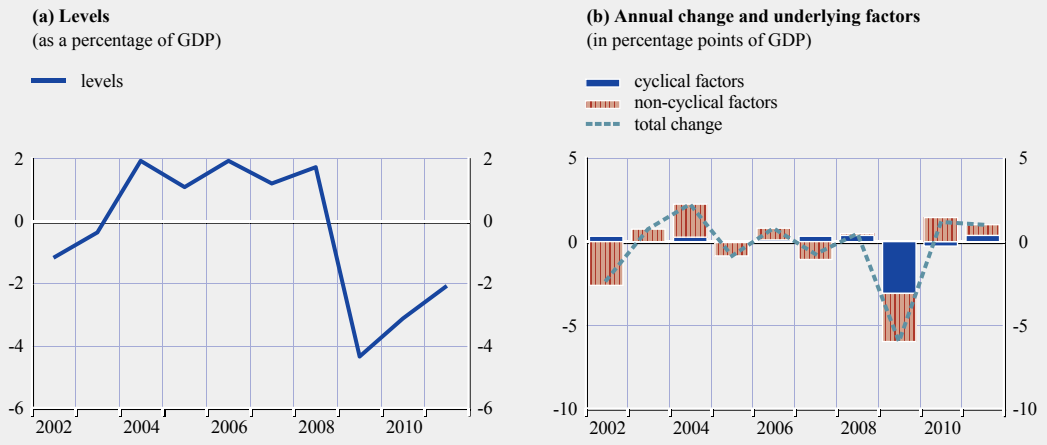
Table 5 General government budgetary position

(as a percentage of GDP)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total revenue	38.4	38.7	40.4	38.3	36.2	40.9	40.0	36.3	34.3	33.1
Current revenue	38.2	38.6	40.2	38.0	35.8	39.9	39.3	35.9	32.8	31.8
Direct taxes	6.2	6.0	5.7	4.7	4.8	7.6	6.1	5.6	5.1	4.8
Indirect taxes	12.6	14.5	16.3	16.6	17.2	16.7	17.4	15.1	14.9	14.6
Social security contributions	9.6	10.3	10.2	9.7	8.3	8.1	7.8	7.7	7.0	7.3
Other current revenue	9.9	7.7	7.9	7.0	5.5	7.5	7.9	7.4	5.8	5.1
Capital revenue	0.1	0.2	0.2	0.3	0.4	1.0	0.7	0.5	1.5	1.3
Total expenditure	39.6	39.1	38.6	37.3	34.4	39.8	38.3	40.7	37.4	35.2
Current expenditure	35.6	35.7	35.0	33.4	30.5	31.5	32.6	35.6	32.5	31.7
Compensation of employees	9.4	10.1	10.0	9.4	8.8	8.8	9.2	9.9	9.3	8.9
Social benefits other than in kind	11.9	11.2	11.2	10.6	10.2	9.6	10.1	12.1	12.6	11.9
Interest payable	2.3	2.2	1.9	1.6	1.3	1.2	0.9	0.8	0.6	0.6
of which: impact of swaps and FRAs [1]	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other current expenditure	12.0	12.1	11.8	11.8	10.2	11.9	12.5	12.8	10.0	10.3
Capital expenditure	4.0	3.4	3.6	3.8	3.9	8.2	5.7	5.1	4.9	3.5
Surplus (+)/deficit (-)	-1.2	-0.4	1.9	1.0	1.9	1.2	1.7	-4.3	-3.1	-2.1
Primary balance	1.1	1.8	3.8	2.7	3.2	2.3	2.5	-3.6	-2.5	-1.5
Surplus/deficit, net of government investment expenditure	1.9	2.5	5.0	4.5	5.9	6.4	7.3	0.6	1.5	1.1

Sources: ESCB and European Commission (Eurostat).
Notes: Differences between totals and the sum of their components are due to rounding. Interest payable as reported under the excessive deficit procedure. The item "impact of swaps and FRAs" is equal to the difference between the interest (or deficit/surplus) as defined in the excessive deficit procedure and in the ESA 95. See Regulation (EC) No 2558/2001 of the European Parliament and of the Council of 3 December 2001 amending Council Regulation (EC) No 2223/96 as regards the reclassification of settlements under swap arrangements and under forward rate agreements (0J L 344, 28.12.2001, p. 1).
1) FRAs stands for forward rate agreements.

Chart 2 General government surplus (+)/deficit (-)



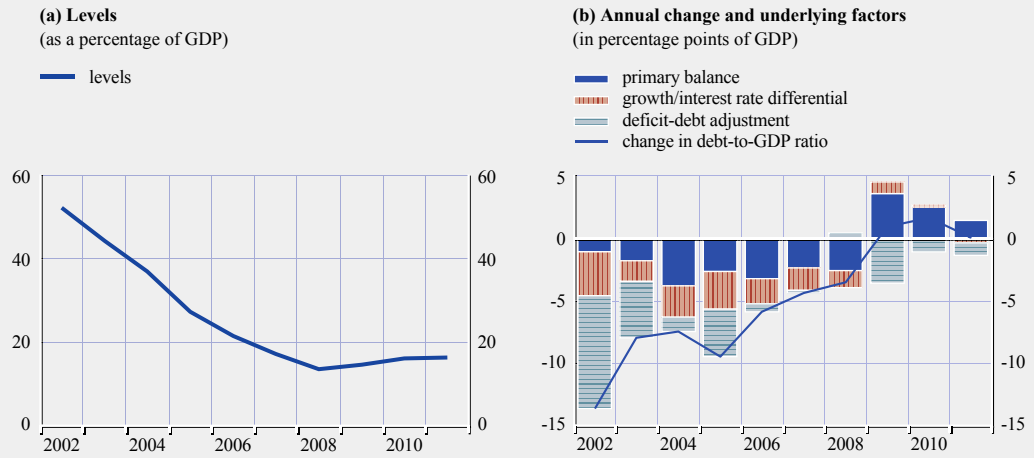
Sources: European Commission (Eurostat) and ECB calculations.
Note: In Chart 2b a negative (positive) value indicates a contribution to an increase (reduction) in a deficit.

Table 6 General government gross debt – structural features

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total debt (as a percentage of GDP)	52.4	44.4	37.0	27.5	21.6	17.2	13.7	14.6	16.3	16.3
Composition by currency (% of total)										
In domestic currency	8.7	9.5	12.5	15.8	19.2	23.1	24.4	23.0	24.6	25.4
In foreign currencies	91.3	90.5	87.5	84.2	80.8	76.9	75.6	77.0	75.4	74.6
Euro [1]	27.7	34.2	39.8	47.8	52.7	53.1	51.9	54.7	54.5	55.0
Other foreign currencies	63.7	56.4	47.7	36.4	28.1	23.8	23.7	22.2	21.0	19.6
Domestic ownership (% of total)	16.2	18.5	20.5	30.3	34.5	40.6	46.9	42.7	50.5	55.4
Average residual maturity (in years)	10.1	9.4	7.9	8.0	7.5	7.7	7.2	7.2	7.1	6.6
Composition by maturity [2] (% of total)										
Short-term (up to and including one year)	0.7	0.5	0.5	0.2	0.0	0.1	0.2	0.2	2.5	2.8
Medium and long-term (over one year)	99.3	99.5	99.5	99.8	100.0	99.9	99.8	99.8	97.5	97.2

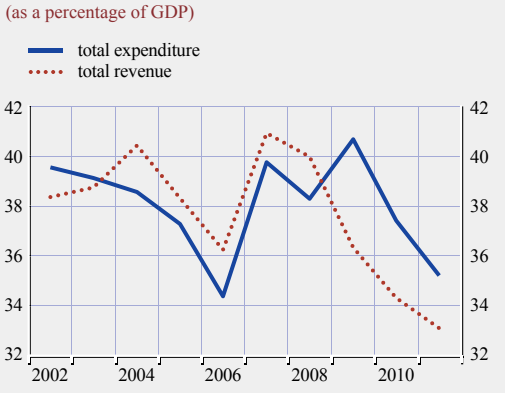
Sources: ESCB and European Commission (Eurostat).
Notes: Year-end data. Differences between totals and the sum of their components are due to rounding.
1) Comprises debt denominated in euro.
2) Original maturity.

Chart 3 General government gross debt



Sources: European Commission (Eurostat) and ECB.
Note: In Chart 3b a negative (positive) value indicates a contribution of the respective factor to a decrease (increase) in the debt ratio.

Chart 4 General government expenditure and revenue



Source: ESCB.

Table 7 General government deficit-debt adjustment

(as a percentage of GDP)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Change in general government debt[1]	-7.9	-4.1	-2.9	-4.9	-2.5	-1.4	-1.3	0.8	2.1	1.1
General government surplus (+)/deficit (-)	-1.2	-0.4	1.9	1.0	1.9	1.2	1.7	-4.3	-3.1	-2.1
Deficit-debt adjustment	-9.1	-4.5	-1.1	-3.8	-0.7	-0.2	0.4	-3.6	-1.0	-1.0
Net acquisitions (+)/net sales (-) of financial assets	-2.5	1.2	0.3	-4.9	1.9	1.0	1.1	-2.0	-2.8	-1.2
Currency and deposits	2.2	2.7	2.6	-1.1	3.0	3.7	1.1	-1.7	-2.3	-1.0
Loans and securities other than shares	-1.8	0.2	-1.3	0.5	0.2	-3.0	-0.7	0.0	-0.3	-0.1
Shares and other equity	-1.1	-2.6	-5.5	-1.5	-1.3	-1.0	-0.1	0.8	0.0	-0.4
Privatisations	-1.3	-2.8	-7.0	-1.6	-1.3	-1.1	-0.8	-0.5	-0.3	-0.5
Equity injections	0.2	0.2	1.5	0.0	0.0	0.0	0.7	1.3	0.4	0.1
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other financial assets	-1.8	0.9	4.5	-2.8	0.0	1.3	0.7	-1.0	-0.3	0.3
Valuation changes of general government debt	-6.3	-4.9	-1.0	1.5	-0.7	-0.5	0.3	0.0	0.4	0.1
Foreign exchange holding gains (-)/losses (+)	-5.5	-4.9	-1.0	1.5	-0.7	-0.5	0.3	-0.1	0.3	0.1
Other valuation effects[2]	-0.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.0
Other changes in general government debt[3]	-0.2	-0.8	-0.3	-0.5	-1.9	-0.8	-0.9	-1.6	1.4	0.1

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

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2010	2020	2030	2040	2050	2060
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	25.7	32.8	38.9	46.5	56.5	60.0
Age-related government expenditure (in percentage points of GDP)[1]	18.2	18.0	18.8	19.5	21.1	21.0

Source: The 2012 Ageing Report: Economic and budgetary projections for the EU27 Member States (2010-2060), joint report prepared by the European Commission (DG ECFIN) and the Economic Policy Committee.
1) The Ageing Working Group (AWG) risk scenario, strictly age-related item.

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

Participation in the exchange rate mechanism (ERM II)	No
Exchange rate level in May 2010 in BGN/EUR	1.95583
Maximum upward deviation [1]	0.0
Maximum downward deviation [1]	0.0

Source: ECB.
1) Maximum percentage deviations of the bilateral exchange rate against the euro from its average level in May 2010 over the period 3 May 2010-30 April 2012, based on daily data at business frequency. An upward (downward) deviation implies that the currency was stronger (weaker) than its exchange rate level in May 2010.

Table 9 (b) Key indicators of exchange rate pressure for the Bulgarian lev

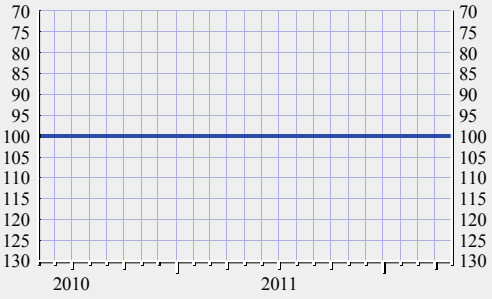
(average of three-month period ending in specified month)

	2010			2011				2012
	June	Sep.	Dec.	Mar.	June	Sep.	Dec.	Mar.
Exchange rate volatility [1]	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Short-term interest rate differential [2]	3.5	3.1	2.9	2.8	2.4	2.2	2.2	2.1

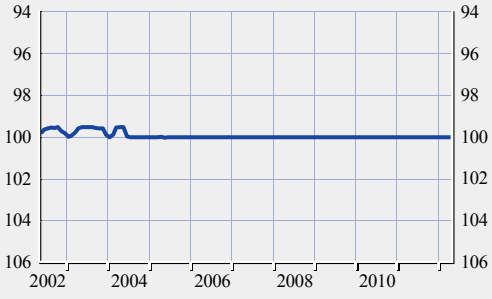
Sources: National data and ECB calculations.
1) Annualised monthly standard deviation (as a percentage) of daily percentage changes of the exchange rate against the euro.
2) Differential (in percentage points) between three-month interbank interest rates and the three-month EURIBOR.

Chart 5 Bulgarian lev: nominal exchange rate development against the euro

(a) Exchange rate over the reference period
(daily data; average of May 2010 = 100;
3 May 2010-30 April 2012)



(b) Exchange rate over the last ten years
(monthly data; average of May 2010 = 100;
May 2002-April 2012)



Source: ECB.
Note: An upward (downward) movement of the line indicates an appreciation (depreciation) of the Bulgarian lev.

Table 10 Bulgarian lev: real exchange rate developments

(monthly data; percentage deviation in March 2012 from the ten-year average calculated for the period April 2002-March 2012)

	Mar. 2012
Real bilateral exchange rate against the euro [1]	13.7
Memo items:	
Nominal effective exchange rate [2]	-0.4
Real effective exchange rate [1), 2)]	11.3

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

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Balance of payments										
Current account and capital account balance [1]	-2.4	-5.3	-5.6	-10.6	-16.9	-27.1	-22.3	-7.6	-0.2	2.2
Current account balance	-2.4	-5.3	-6.4	-11.6	-17.6	-25.2	-23.1	-8.9	-1.0	0.9
Goods balance	-11.1	-13.2	-14.5	-19.0	-21.0	-23.5	-24.3	-11.9	-7.7	-5.1
Services balance	3.0	3.0	3.2	3.5	3.5	3.8	3.7	3.7	5.6	5.9
Income balance	2.4	1.6	1.2	0.3	-2.6	-7.7	-5.0	-3.4	-3.1	-4.3
Current transfers balance	3.3	3.3	3.7	3.5	2.5	2.2	2.4	2.7	4.2	4.4
Capital account balance	0.0	0.0	0.8	1.0	0.7	-1.9	0.8	1.4	0.8	1.3
Combined direct and portfolio investment balance [1]	5.0	8.9	9.0	9.4	24.1	27.0	15.5	5.4	1.0	2.2
Direct investment balance	5.6	10.0	11.1	13.9	23.0	28.7	17.5	7.2	2.9	3.1
Portfolio investment balance	-0.6	-1.0	-2.1	-4.5	1.1	-1.7	-2.1	-1.8	-1.8	-0.9
Other investment balance	5.0	4.8	3.0	7.0	2.1	16.8	17.0	-2.0	-2.9	-5.1
Reserve assets	-3.4	-4.5	-7.3	-1.4	-5.7	-9.5	-1.9	1.9	1.1	-0.4
Exports of goods and services	50.2	51.3	55.2	56.0	61.2	59.4	58.0	47.6	57.5	66.6
Imports of goods and services	58.3	61.5	66.5	71.5	78.7	79.1	78.6	55.8	59.6	65.8
Net international investment position [2]	-25.3	-26.3	-30.1	-44.1	-58.0	-81.1	-98.4	-101.8	-94.7	-85.3
Gross external debt [2]	63.5	58.1	61.7	66.7	78.1	94.3	105.1	108.3	102.8	92.0
Memo item:										
Export market shares [3]	0.10	0.11	0.12	0.13	0.14	0.14	0.15	0.15	0.15	0.16

Source: ECB.
1) Differences between totals and the sum of their components are due to rounding.
2) End-of-period outstanding amounts.
3) As a percentage of total world goods and services exports.

Table 12 Indicators of integration with the euro area

(as a percentage of the total, unless otherwise stated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
External trade with the euro area										
Exports of goods	53.2	54.3	52.3	51.1	49.9	48.9	45.9	49.7	44.7	45.6
Imports of goods	47.0	46.6	45.4	48.4	46.9	43.7	41.3	43.4	41.6	42.8
Investment position with the euro area										
Inward direct investment [1]	69.8	68.1	69.1	70.6	69.1	70.0	67.7	69.2	70.1	70.9
Outward direct investment [1]	26.0	36.9	135.5	26.8	55.9	41.3	54.9	39.9	38.3	38.5
Portfolio investment liabilities [1]	32.4	41.9	54.7	79.3	69.6	83.8	87.5	94.2	99.3	-
Portfolio investment assets [1]	23.1	35.6	62.2	55.7	47.3	60.5	56.6	50.4	50.6	-
Memo items:										
External trade with the EU										
Exports of goods	62.1	63.2	62.2	60.0	60.7	60.8	60.0	64.9	60.9	62.5
Imports of goods	57.7	57.7	57.0	62.6	61.1	58.5	56.7	60.0	58.5	59.2

Sources: ESCB, European Commission (Eurostat) and IMF.
1) End-of-period outstanding amounts.

4 LONG-TERM INTEREST RATE DEVELOPMENTS

Table 13 Long-term interest rates (LTIRs)

(percentages; average of observations through period)

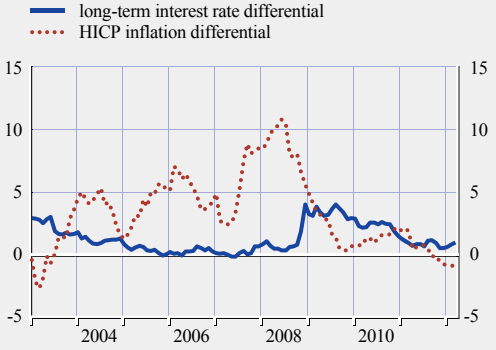
	2011	2012			Apr. 2011
	Dec.	Jan.	Feb.	Mar.	to Mar. 2012
Long-term interest rate	5.2	5.3	5.3	5.1	5.3
Reference value[1]					*5.8*
Euro area[2]	*4.6*	*4.7*	*4.4*	*4.1*	*4.4*
Euro area (AAA)[3]	*2.7*	*2.6*	*2.5*	*2.5*	*2.9*

Sources: ECB and European Commission (Eurostat).
1) The basis of the calculation for the period April 2011-March 2012 is the unweighted arithmetic average of the interest rate levels in Sweden and Slovenia plus 2 percentage points.
2) The euro area average is included for information only.
3) The euro area AAA par yield curve for the ten-year residual maturity is included for information only.

Chart 6 Long-term interest rate (LTIR)

(a) Long-term interest rate (LTIR)
(monthly averages in percentages)

(b) LTIR and HICP inflation differentials vis-à-vis the euro area
(monthly averages in percentage points)



Sources: ECB and European Commission (Eurostat).

Table 14 Selected indicators of financial development and integration

(as a percentage of GDP, unless otherwise stated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Memo item: euro area 2011
Debt securities issued by corporations[1]	0.2	0.7	1.3	2.7	4.6	4.1	3.3	2.9	2.6	2.2	103.0
Stock market capitalisation[2]	4.1	7.6	10.1	18.5	29.6	48.2	18.0	17.3	15.4	16.5	41.5
MFI credit to non-government residents[3]	19.0	26.1	35.1	40.7	44.5	62.3	71.4	75.1	73.6	71.5	134.7
Claims of euro area MFIs on resident MFIs[4]	-	-	-	-	-	14.0	22.6	21.1	16.7	11.7	7.9
Private sector credit flow[5]	5.5	14.3	19.5	21.9	20.5	39.9	41.0	19.0	-0.2	-	3.5
Private sector debt[6]	47.6	58.4	74.0	91.1	100.0	131.8	154.5	174.7	169.2	-	167.0

Sources: ESCB, European Commission (Eurostat), Federation of European Securities Exchanges, OMX and national stock exchanges.
1) Outstanding amount of debt securities issued by resident non-financial corporations, MFIs and other financial corporations.
2) Outstanding amounts of quoted shares issued by residents at the end of the period at market values.
3) MFI (excluding NCB) credit to domestic non-MFI residents other than the general government. Credit includes outstanding amounts of loans and debt securities.
4) Outstanding amount of deposits and debt securities issued by domestic MFIs (excluding the NCB) held by euro area MFIs as a percentage of total liabilities of domestic MFIs (excluding the NCB). Total liabilities exclude capital and reserves and remaining liabilities.
5) Transactions in securities other than shares issued and loans taken out by institutional sectors: non-financial corporations, households and non-profit institutions serving households.
6) Outstanding amounts of securities other than shares issued and loans taken out by institutional sectors: non-financial corporations, households and non-profit institutions serving households.

5.2 CZECH REPUBLIC

5.2.1 PRICE DEVELOPMENTS

Over the reference period from April 2011 to March 2012, the 12-month average rate of HICP inflation in the Czech Republic was 2.7%, i.e. below the reference value of 3.1% for the criterion on price stability (see Table 1). On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to increase somewhat in the coming months.

Looking back over a longer period, annual consumer price inflation in the Czech Republic followed a broad downward trend until 2003, when it reached slightly negative rates. Thereafter it fluctuated mostly in a range between 1.6% and 3% until the end of 2007. Price pressures picked up again in late 2007, mainly as a result of higher food and energy prices and some administrative measures. Inflation rates peaked in early 2008 and remained elevated for most of the year, averaging more than 6%. Driven by the collapse of global and domestic demand and by base effects related to earlier increases, consumer price inflation started to fall sharply in late 2008 and reached 0.6% in 2009. Mainly on the back of global commodity and food prices, but counteracted by weak domestic demand, inflation has gradually accelerated since late 2009, hovering at around 2% in 2011.

The Czech Republic's medium-term inflation performance reflects a number of important policy choices, most notably the orientation of monetary policy towards the achievement of price stability. In 1998 the Czech Republic adopted an inflation targeting framework, having abandoned the fixed peg of the koruna in 1997 in favour of a flexible exchange rate regime. 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. The disinflation process, which has been broadly supported by a number of reforms designed to enhance product market competition, has taken place despite sporadic loose fiscal conditions.

Inflation developments should be viewed against the background of the various cyclical phases the economy went through during the past decade. Between 2003 and 2007 macroeconomic developments were characterised by a sustained upswing in economic activity. However, given its close integration in the international supply chain and specialisation in the export of capital goods, the Czech economy started to slow markedly in 2008 and slid into recession in 2009 as a result of the collapse in world trade in the aftermath of the global financial and economic crisis. While the economy was hit by a significant contraction in exports and domestic demand, particularly in investment, the recession was relatively moderate compared with central and eastern European partners, also thanks to the absence of any major macroeconomic imbalances after controlling for catching-up effects. However, the recovery since 2009 has been rather subdued and heavily dependent on external demand and restocking. By contrast, domestic demand has stagnated, especially in private consumption and investment components. Before the global financial and economic crisis, the sustained high level of growth, driven in particular by an inflow of foreign direct investment into export-oriented industries, contributed to an improvement in the labour market and an increase in the growth of credit to the private sector. Over most of the last decade, with the exception of 2005 and 2010, growth in compensation per employee remained above labour productivity growth. During the period 2002-05 growth in unit labour costs decelerated notably before rising again over the subsequent three years, owing to a tightening labour market. By contrast, in the wake of the global economic crisis, growth in unit labour costs slowed down in 2009 and turned negative in 2010, particularly on account of rising unemployment associated with relatively

moderate increases in compensation per employee. The fall in import prices throughout most of the period under review was largely a by-product of the appreciation of the effective exchange rate. The general pattern of inflation developments is also apparent from other relevant indices, such as the HICP excluding unprocessed food and energy (see Table 2). After a sustained period of growth in the run-up to EU accession, residential property prices stabilised somewhat in the following two years. However, on the back of a strong economy and continuously rising mortgage loans, they picked up again in 2007, fuelling concerns about an overheating property market. In line with the cooling economy, growth in property prices – while still robust – slowed down markedly in 2008 and turned deeply negative in the recession year 2009. The fall continued in 2010, albeit at a slower rate, reflecting the relatively subdued wage growth, persisting high unemployment and restrained mortgage provision.

Looking at recent developments, after hovering at around 2% for most of 2011, inflation started to accelerate gradually in October 2011 to peak at 4.2% in March 2012 (see Table 3a). HICP inflation excluding unprocessed food and energy increased slightly less than headline HICP inflation (see Table 2). The pick-up in headline inflation in the final quarter of 2011 was driven mainly by increases in administered prices (particularly those related to housing, utilities and healthcare items), as well as in energy and food prices. The latter are likely to have risen also in anticipation of the VAT increase, which came into effect in January 2012. A weaker nominal effective exchange rate also contributed to the recent increase in inflation, while feeble domestic demand and subdued cost pressures tended to dampen inflation. While rather weak labour market conditions were reflected in relatively moderate growth in compensation per employee, productivity growth declined continuously in parallel. Consequently, unit labour costs rose for most of 2011, albeit at a low rate. The current inflation picture should be viewed against the background of a muted economic recovery, with real GDP rising by 1.7% in 2011, driven in particular by relatively strong export growth.

The latest available forecasts from major international institutions project inflation to decline from its current high levels in 2012-13, and range between 3.1% and 3.5% in 2012 and between 1.9% and 2.2% in 2013 (see Table 3b). In particular, the increase in the lower VAT rate introduced at the beginning of 2012 as well as the gradually strengthening pressure from administered prices and labour costs are projected to lead to accelerated annual inflation rates during the year, while weak domestic demand is likely to dampen inflationary pressures. Inflation, when adjusted for the first-round effects of changes in indirect taxes, is likely to be close to its 2% target over the forecast horizon. Upside risks to the inflation outlook are associated with larger than expected hikes in commodity prices, in particular global oil and food prices. By contrast, lower than expected increases in administered prices owing to the development of world prices of natural gas and a further weakening of domestic demand constitute a downside risk. Looking further ahead, the catching-up process may have a bearing on inflation and/or on the nominal exchange rate over the coming years given that GDP per capita and price levels are still lower in the Czech Republic than in the euro area (see Table 2). However, it is difficult to assess the exact size of the effect resulting from this catching-up process.

Achieving an environment conducive to sustainable convergence in the Czech Republic requires, inter alia, maintaining price stability-oriented monetary policy and implementing a comprehensive and credible fiscal consolidation path in line with the requirements of the EDP. At the same time, measures should aim at exploring the large potential for public sector savings by improving the efficiency of public services delivery, public procurement and tax administration. Improvements in the functioning of the labour market (for example, by increasing regional labour mobility,

by reducing disincentives for second earners and the low-skilled unemployed to take up work, and by addressing skill mismatches) would also be needed in order to enhance labour market flexibility and participation, thereby supporting potential growth. At the same time, wage increases should reflect labour productivity growth, labour market conditions and developments in competitor countries. In addition, it will be essential to strengthen competition in product markets (in particular, in electricity, gas and telecommunications) and to increase investment in infrastructure. Financial sector policies should be geared towards continued vigilance, a careful monitoring of potential risks and close cross-border cooperation, given the prevalent foreign ownership of the financial sector and the vulnerability of some foreign parent banks. Such measures will help to achieve an environment conducive to sustainable price stability and promote competitiveness and employment growth.

5.2.2 FISCAL DEVELOPMENTS

The Czech Republic is, at present, subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2011 the general government budget balance showed a deficit of 3.1% of GDP, i.e. above the 3% reference value. The general government gross debt-to-GDP ratio was 41.2%, i.e. below the 60% reference value (see Table 4). Compared with the previous year, the budget balance ratio improved by 1.7 percentage point, while the public debt ratio increased by 3.1 percentage points. In 2012 the deficit ratio is forecast by the European Commission to decline to 2.9% and the government debt ratio is projected to increase to 43.9%. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2011 and is not expected to exceed it in 2012 either.

Looking at developments in the Czech Republic's budgetary position over the period from 2002 to 2011, after declining to 0.7% in 2007, the deficit-to-GDP ratio rose sharply to 5.8% in 2009, and declined thereafter to 3.1% in 2011 (see Table 5). As the deficit-to-GDP ratio rose above the 3% of GDP reference value in 2009, the ECOFIN Council decided on 2 December 2009 that an excessive deficit situation existed in the Czech Republic and set the deadline for correcting it at 2013. As shown in greater detail in Chart 2b, European Commission estimates indicate that cyclical factors had a positive impact on the budget balance between 2003 and 2007 and in 2010. In 2009, when the financial and economic crisis affected public finances, cyclical factors had a negative impact on the budget balance. Over the entire period under consideration, non-cyclical factors had a broadly balanced impact on the changes in the deficit ratio. The largest contribution of non-cyclical factors to the deterioration in the budget balance occurred in 2005 and 2008-09, in the latter period owing to a previously adopted tax reform and two fiscal stimulus packages. This trend was reversed in 2010, when the Czech government implemented a fiscal austerity package, consisting, inter alia, of indirect and property tax increases, the freezing of pensions and public wages, the withdrawal of stimulus measures and consolidation measures taken in 2011. In the absence of substantial temporary and one-off factors during 2004-11, the underlying changes in the budget deficit seem to reflect a structural deterioration of the Czech Republic's fiscal position until 2009, and a consolidation thereafter.

Turning to developments in general government gross debt, between 2002 and 2011 the debt-to-GDP ratio increased cumulatively by 14.1 percentage points. After hovering below 30% between 2002 and 2008, it rose significantly over the period 2009-11 (see Chart 3a and Table 6). As shown in greater detail in Chart 3b, the primary budget balance had a debt-increasing effect during the whole period 2002-11, with the exception of 2007. The growth/interest rate differential had a debt-reducing effect between 2004 and 2008. Thereafter, on the back of deteriorating macroeconomic and financial conditions, it contributed to an increase in debt, in particular in 2009

and, to a lesser extent in 2010. By contrast, deficit-debt adjustments had a debt-decreasing effect in 2002-03 and 2009-10. In 2011 the increase in the general government debt-to-GDP ratio mainly reflected a sustained high primary deficit ratio and a growth/interest rate differential.

As regards the Czech Republic's general government debt structure, the share of government debt with a short-term maturity declined from 28.6% in 2002 to 6.3% in 2008, then started to increase, but remained low nonetheless at 9.5% in 2011 (see Table 6). Taking into account the level of the debt ratio, fiscal balances are relatively insensitive to changes in interest rates. At 16.4% in 2011, the proportion of government debt denominated in foreign currency is noticeable, but, given the overall debt level, fiscal balances are relatively insensitive to changes in exchange rates. During the crisis, the share of debt with a short-term maturity remained low, pointing to limited debt-related vulnerabilities. However, the share of debt denominated in foreign currency has increased since 2007, while remaining below 20%. At the same time, the Czech government has not incurred contingent liabilities resulting from government interventions to support financial institutions and financial markets during the crisis (see Section 5.9).

Moving on to examine trends in other fiscal indicators, Chart 4 and Table 5 show that the general government total expenditure-to-GDP ratio decreased overall from 45.6% in 2002 to 43.4% in 2011, with intermediate peaks in 2003 and 2009. These developments occurred mainly on the back of "compensation of employees" and "capital expenditure". The former hovered between 7% and 8% of GDP during 2002-11. Overall, during the period under consideration, and particularly in 2009-11, "social benefits other than in kind" increased their share in GDP and remained at elevated levels when compared with the period 2002-08. Capital spending decreased as a ratio to GDP in 2010 and 2011. Total government revenue as a share of GDP increased slightly over the period from 39.1% of GDP in 2002 to 40.3% in 2011, with intermediate peaks in 2003 and 2007. After another decline in 2008, the revenue ratio started to increase marginally as a consequence of changes to personal income tax and social contributions in 2011.

Looking ahead, the Czech Republic's medium-term fiscal policy strategy indicates the commitment of the current government to bring the ESA 95 deficit below the reference value in 2013 and reduce it gradually thereafter. According to the 2012-15 convergence programme update, the ESA 95 budget deficit will be marginally reduced to 3.0% of GDP in 2012 and further to 2.9% of GDP in 2013, targeting the EDP commitment with a minimum safety margin. The structural deficit is projected to decline below the medium-term objective of 1.0% of GDP (specified in line with the Stability and Growth Pact) in 2015. Based on information submitted in the 2012 convergence programme update, primary expenditure excluding, inter alia, EU fund transfers (relevant expenditure), as a share of GDP, is projected to drop by 1.7 percentage points between 2012 and 2015. The annual growth rate of relevant expenditure is projected to be above the growth rate of potential GDP throughout the projection horizon, albeit fully matched by discretionary revenue measures. According to the European Commission's projections, the structural deficit will remain above the medium-term objective by 2013. If risks to the planned measures were to materialise, further measures would become necessary in order to comply with the medium-term objective in the medium run.

The Czech Republic did not sign the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union and therefore did not commit by means of this Treaty to applying the fiscal rules specified under Title III, "Fiscal Compact", and referred to in Box 2 of Chapter 2.

As regards fiscal governance, the Czech Republic implemented comprehensive reforms of its public finance framework in 2004. However, further efforts appear to be necessary to improve the

coordination between different levels of government, including through a new fiscal rule for local and regional governments. Establishing an independent fiscal council to monitor and regularly assess public finance developments may be a step in the right direction. A stronger enforcement mechanism for the existing fiscal rules, better monitoring and ex post evaluation of budgetary performance, and greater consideration of sustainability in fiscal targeting are also needed. Full compliance with the provisions for an enhanced national governance framework under Council Directive 2011/85/EU should be ensured, as referred to in Box 2 of Chapter 2.

Turning to factors with an impact on the Czech Republic's public finances over the long term, a marked ageing of the population is expected, as highlighted in Table 8. According to the 2012 projections by the European Commission and the EU's Economic Policy Committee, starting from a level of 20.2% of GDP in 2010, the Czech Republic is likely to experience a significant increase in strictly age-related public expenditure amounting to 6.4 percentage points of GDP in the years to 2060.[3] Coping with the overall burden will be facilitated if sufficient room for manoeuvre is created in public finances before the period in which the demographic situation is projected to worsen.

Turning to fiscal challenges, the Czech Republic should avoid a reversal in its effort to ensure a sustainable reduction in the budget deficit to below the 3% reference value in 2013 and beyond, in line with the EDP commitments. This requires the continuation of a prudent expenditure policy in the medium term. The Czech Republic should take more determined measures to improve its fiscal institutional framework in order to strengthen public finance sustainability, while avoiding pro-cyclical fiscal policies, and to reduce waste and ineffectiveness in public investment. Further improvement of the domestic fiscal institutional framework would be particularly important in order to firmly anchor the sustainability of future fiscal policies, given that the Czech Republic did not sign the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union. At the same time, the Czech Republic needs to comply fully with the existing obligations under the enhanced Stability and Growth Pact.

5.2.3 EXCHANGE RATE DEVELOPMENTS

In the two-year reference period from 1 May 2010 to 30 April 2012, the Czech koruna did not participate in ERM II, but traded under a flexible exchange rate regime (see Table 9a). The Czech koruna appreciated gradually against the euro in 2010 and stabilised over the course of 2011, before depreciating somewhat towards the end of the year. Thereafter it recovered some of its losses against the euro. Over the reference period, the Czech currency mostly traded above its May 2010 average exchange rate against the euro, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate. The maximum upward deviation from this benchmark was 6.4%, while the maximum downward deviation amounted to 1.5% (see Chart 5 and Table 9a).

Looking at exchange rate developments in more detail, fluctuations of the Czech koruna during the reference period were partly driven by changes in global risk aversion amid tensions in some euro area sovereign debt markets. The gradual appreciation of the Czech currency in 2010 took place against the background of improving sentiment of financial markets towards the region and the solid recovery from the economic downturn, together with the implementation of fiscal consolidation measures in the absence of large external imbalances. After a stabilisation during the first half of 2011, the appreciation of the Czech koruna was partially reversed reflecting the renewed

3 European Commission and Economic Policy Committee, "The 2012 Ageing Report: Economic and budgetary projections for the EU-27 Member States (2010-2060)".

increase in global risk aversion and developments in euro area sovereign debt markets, but also on account of the slowing economic recovery. The Czech currency traded at 24.867 korunas per euro on 30 April 2012, i.e. 3.1% stronger than its average level in May 2010.

Over the reference period, the exchange rate of the Czech koruna against the euro was subject, on average, to a relatively high degree of volatility, as measured by annualised standard deviations of daily percentage changes. Volatility further increased towards the end of the reference period to the high level of 8.1%. At the same time, short-term interest rate differentials against the three-month EURIBOR were small in 2010 and turned negative in the second half of 2011, and stood at 0.2 percentage point in the three-month period ending in March 2012, while the main policy rate remained at an historically low level throughout the reference period (see Table 9b).

In a longer-term context, in March 2012 both the Czech koruna's real effective exchange rate and its real bilateral exchange rate against the euro stood moderately above the corresponding ten-year historical averages (see Table 10). However, these measures should be interpreted with caution, as in this period the Czech Republic was subject to a process of economic convergence, which complicates any historical assessment of real exchange rate developments.

As regards other external developments, the Czech Republic recorded large deficits in the combined current and capital account of its balance of payments in excess of 5.0% of GDP between 2002 and 2004 (see Table 11). The deficit narrowed rapidly in 2005, to 0.8% of GDP, on account of significant improvements in the balances of trade in goods and in services, as well as a moderate temporary reduction of the deficit of the balance of income. Thereafter, rapidly increasing income payments on direct investment liabilities led to a widening of the current and capital account deficit in 2006 and 2007, but the current and capital account balance adjusted in 2008 and 2009 owing to a strong fall in domestic demand, which led to lower imports. Following the economic recovery, the deficit in the combined capital and current account balance increased to 3.0% of GDP in 2010 and 2.5% in 2011, on account of a decrease in the surplus on trade in goods and rising income payments on foreign liabilities. The shifts recorded in the Czech Republic's balance of payments over the past few years have been associated with a significant rebound of capital inflows and a change in their composition. Large net inflows in direct investment, of on average more than 5.0% of GDP, more than covered the entire financing needs of the Czech economy until 2007, but declined significantly thereafter to about 1.0% of GDP. Foreign direct investment inflows then recovered to 2.5% of GDP in 2010 and 2.0% in 2011, while net inflows of foreign portfolio investment amounted to 4.0% of GDP in 2010 and 0.2% in 2011. Against this background, gross external debt increased from 33.0% of GDP in 2002 to 56.5% in 2010 and 58.4% in 2011. At the same time, the country's net international investment position deteriorated substantially from -15.5% of GDP in 2002 to -48.5% in 2010 and -49.7% in 2011. The Czech Republic is a small open economy; the ratio of foreign trade in goods and services to GDP increased from 57.9% in 2002 to 75.0% in 2011 for exports and from 59.8% in 2002 to 70.8% in 2011 for imports. Over the same period, the Czech Republic's share in world exports increased from 0.55% to 0.75%.

Concerning measures of economic integration with the euro area, in 2011 exports of goods to the euro area constituted 65.6% of total goods exports, whereas the corresponding figure for imports was lower, at 59.9%. The share of euro area countries in the Czech Republic's stock of inward direct investment stood at 82.6% in 2011 and in its stock of portfolio investment liabilities at 55.1% in 2010. The share of the Czech Republic's stock of assets invested in the euro area amounted to 76.9% in the case of direct investment in 2011 and 67.8% for portfolio investment in 2010 (see Table 12).

5.2.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from April 2011 to March 2012, long-term interest rates in the Czech Republic were 3.5% on average and thus well below the 5.8% reference value for the interest rate convergence criterion (see Table 13).

Following a period of decline, long-term interest rates began to follow an upward trend in mid-2003, escalating to 5.2% in July 2004. Long-term interest rates were subsequently put on a downward path, supported by moderate policy easing by monetary authorities amid declining inflation, and edged down to a low of 3.3% in July 2005 (see Chart 6a). However, this respite in long-term interest rates was short-lived, as rates started to rise again towards the latter part of 2005, coinciding with policy tightening by monetary authorities. Long-term interest rates thus fluctuated around 3.8% for most of 2006 and into 2007. Long-term rates embarked on a sustained upward path in mid-2007, coinciding with the intensification of monetary policy tightening by the central bank in a bid to rein in rising inflationary pressures. Interest rates thus edged up to 5.1% in June 2008. During this period, two of the three major credit rating agencies upgraded the country's sovereign credit rating. The external and domestic macroeconomic and financial environment started to turn, and long-term interest rates were once again placed on a downward path. However, in early 2009 the country was affected by the general increase in global uncertainty and, while policy easing by the central bank remained aggressive, interest rates at longer maturities followed an upward trend to peak at 5.5% in June 2009. Since that time, long-term interest rates in the Czech Republic have been on a moderate if uneven decline, with bond yields exhibiting some of the volatile behaviour also observed for other countries in the context of the sovereign debt crisis in the euro area. Central bank policy rates have remained accommodative since mid-2010, and the country's sovereign credit rating was upgraded by Standard & Poor's in August 2011. Long-term interest rates stood at 3.5% at the end of the reference period.

The Czech Republic's long-term interest rate differential with the euro area average rose from negative territory in mid-2003 to around 1% in September 2004 (see Chart 6b). As long-term interest rates started to edge down, the differential also narrowed progressively and subsequently hovered at around zero (even reaching mildly negative values) for most of the 2005-07 period. In early 2008 the long-term interest rate differential between the Czech Republic and the euro area average became positive again before following an erratic pattern for the remainder of the year, albeit remaining in positive territory (at around 0.3 percentage point) on average for 2008 as a whole. The long-term interest rate differential with the euro area average widened somewhat in the first half of 2009 as long-term interest rates in the Czech Republic edged up, peaking at 1.5 percentage points in 2009. Thereafter, the progressive decline in long-term interest rates in recent years, coupled with increasing average euro area long-term interest rates over the same period, implied that the interest rate differential narrowed and ultimately turned significantly negative. Long-term interest rates in the Czech Republic were about 0.5 percentage point lower than those of the euro area average (and 1.0 percentage point higher with respect to the AAA euro area yield) at the end of the reference period.

As regards financial integration and development, the capital markets in the Czech Republic are smaller and much less developed than those of the euro area (see Table 14). Stock market capitalisation declined to 20.0% of GDP in 2011 from a peak of 34.8% in 2007. By contrast, outstanding debt securities issued by corporations (a measure of market-based indebtedness) recovered somewhat over the same period, rising to 24.2% of GDP in 2011 from 18.9% in 2007.

The country's financial system remains heavily bank-based, with credit to non-government residents amounting to 54.5% of GDP in 2011, although the pace of increase of financial depth according to this measure has moderated in recent years. Foreign-owned banks play a dominant role in the Czech banking sector, but the majority of loans are denominated in domestic currency and financed from local deposits. The international claims of euro area banks in the country amounted to 6.6% of total liabilities in 2011.

LIST OF TABLES AND CHARTS

CZECH REPUBLIC

I PRICE DEVELOPMENTS

Table 1 HICP inflation

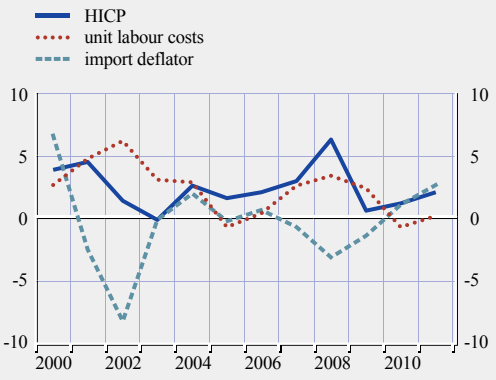
(annual percentage changes)

	2011	2012			Apr. 2011
	Dec.	Jan.	Feb.	Mar.	to Mar. 2012
HICP inflation	2.8	3.8	4.0	4.2	2.7
Reference value [1]					*3.1*
Euro area [2]	*2.7*	*2.7*	*2.7*	*2.7*	*2.8*

Source: European Commission (Eurostat).
1) The basis of the calculation for the period April 2011-March 2012 is the unweighted arithmetic average of the annual percentage changes in the HICP for Sweden, Ireland and Slovenia plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(average annual percentage changes)



Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Measures of inflation										
HICP	1.4	-0.1	2.6	1.6	2.1	3.0	6.3	0.6	1.2	2.1
HICP excluding unprocessed food and energy	2.0	0.4	2.5	0.9	0.9	3.1	5.8	0.5	0.5	1.4
HICP at constant tax rates [1]	-	-	1.8	1.4	1.4	2.4	4.3	0.6	-0.1	2.1
CPI	1.8	0.1	2.8	1.8	2.5	2.9	6.3	1.0	1.5	1.9
Private consumption deflator	1.3	-0.2	3.6	0.8	1.5	2.9	4.8	0.2	0.4	1.8
GDP deflator	2.7	0.9	4.0	-0.3	0.5	3.3	1.9	1.9	-1.7	-0.7
Producer prices [2]	-0.6	-0.4	5.5	3.1	1.5	4.1	4.5	-3.1	1.2	5.5
Related indicators										
Real GDP growth	2.1	3.8	4.7	6.8	7.0	5.7	3.1	-4.7	2.7	1.7
GDP per capita in PPS [3] (euro area = 100)	66.1	69.4	71.6	72.6	73.5	76.0	74.3	75.6	73.6	-
Comparative price levels (euro area = 100)	56.9	53.1	53.7	57.0	60.2	61.6	74.8	69.2	72.2	-
Output gap [4]	-2.5	-2.3	-1.3	1.5	4.7	6.5	5.8	-1.7	-0.9	-0.8
Unemployment rate (%) [5]	7.3	7.8	8.3	7.9	7.2	5.3	4.4	6.7	7.3	6.7
Unit labour costs, whole economy	6.2	3.1	2.9	-0.7	0.4	2.6	3.4	2.4	-0.7	0.2
Compensation per employee, whole economy	7.8	7.9	8.2	3.8	6.0	6.3	4.2	-1.2	3.7	1.6
Labour productivity, whole economy	1.5	4.6	5.1	4.6	5.6	3.5	0.8	-3.5	4.5	1.4
Imports of goods and services deflator	-8.2	-0.1	2.0	-0.2	0.7	-0.7	-3.1	-1.4	1.1	2.7
Nominal effective exchange rate [6]	11.8	0.5	1.2	6.3	5.1	2.9	12.1	-4.4	2.0	2.9
Money supply (M3)	-	7.6	7.0	11.5	14.3	16.9	12.9	0.3	0.2	2.9
Lending from banks	-	11.7	15.5	21.0	21.7	27.5	16.2	1.5	4.2	5.9
Stock prices (PX 50 Index)	16.8	43.1	56.6	42.7	7.9	14.2	-52.7	30.2	9.6	-25.6
Residential property prices	-	-	-	0.8	8.3	31.2	17.1	-12.2	-4.9	-

Sources: European Commission (Eurostat), national data (CPI, money supply, lending from banks and residential property prices) and European Commission (output gap).
1) 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 on the price paid by the consumer.
2) Total industry excluding construction and domestic sales.
3) PPS stands for purchasing power standards.
4) Percentage difference of potential GDP: a positive (negative) sign indicates that actual GDP is above (below) potential GDP.
5) The definition conforms to ILO guidelines.
6) A positive (negative) sign indicates an appreciation (depreciation).

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2011			2012		
	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.
HICP						
Annual percentage change	2.6	2.9	2.8	3.8	4.0	4.2
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	3.4	4.2	4.8	5.3	5.5	5.7
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	2.6	2.9	3.3	3.8	4.2	4.6

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2012	2013
HICP, European Commission (spring 2012)	3.3	2.2
CPI, OECD (December 2011)	3.1	2.0
CPI, IMF (April 2012)	3.5	1.9
CPI, Consensus Economics (April 2012)	3.3	2.1

Sources: European Commission, OECD, IMF and Consensus Economics.

2 FISCAL DEVELOPMENTS

Table 4 General government fiscal position

(as a percentage of GDP)

	2010	2011	2012[1]
General government surplus (+)/deficit (-)	-4.8	-3.1	-2.9
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure[2]	-0.5	0.6	0.8
General government gross debt	38.1	41.2	43.9
Reference value	*60.0*	*60.0*	*60.0*

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

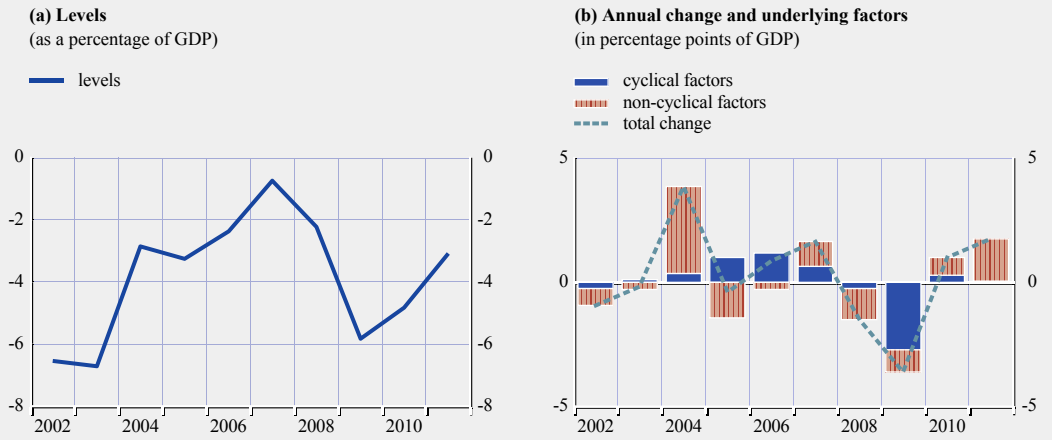
Table 5 General government budgetary position

(as a percentage of GDP)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total revenue	39.1	43.3	40.4	39.8	39.6	40.3	38.9	39.1	39.3	40.3
Current revenue	38.9	39.9	40.1	39.4	39.0	39.5	38.2	37.7	37.8	38.8
Direct taxes	8.7	9.2	9.1	8.9	8.8	9.0	8.0	7.3	7.0	7.5
Indirect taxes	10.3	10.6	11.1	11.0	10.5	10.8	10.6	11.1	11.2	11.5
Social security contributions	15.5	15.7	15.5	15.5	15.7	15.7	15.6	15.0	15.3	15.5
Other current revenue	4.3	4.4	4.4	4.1	4.0	4.0	4.0	4.4	4.3	4.3
Capital revenue	0.1	3.4	0.4	0.4	0.6	0.8	0.8	1.4	1.5	1.5
Total expenditure	45.6	50.0	43.3	43.0	42.0	41.0	41.2	44.9	44.2	43.4
Current expenditure	37.0	38.6	36.2	35.9	35.5	35.1	34.9	38.6	38.5	38.2
Compensation of employees	7.5	8.0	7.6	7.6	7.5	7.3	7.3	7.8	7.6	7.3
Social benefits other than in kind	13.0	12.8	12.3	12.0	12.2	12.5	12.4	13.6	13.8	14.0
Interest payable	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.3	1.4	1.4
of which: impact of swaps and FRAs[1]	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.0
Other current expenditure	15.4	16.7	15.3	15.1	14.7	14.2	14.2	15.8	15.7	15.6
Capital expenditure	8.6	11.4	7.1	7.1	6.5	6.0	6.2	6.4	5.7	5.1
Surplus (+)/deficit (-)	-6.5	-6.7	-2.8	-3.2	-2.4	-0.7	-2.2	-5.8	-4.8	-3.1
Primary balance	-5.4	-5.6	-1.8	-2.2	-1.3	0.4	-1.2	-4.5	-3.4	-1.7
Surplus/deficit, net of government investment expenditure	-3.5	0.1	1.4	1.0	2.1	3.4	2.3	-0.7	-0.5	0.6

Sources: ESCB and European Commission (Eurostat).
Notes: Differences between totals and the sum of their components are due to rounding. Interest payable as reported under the excessive deficit procedure. The item "impact of swaps and FRAs" is equal to the difference between the interest (or deficit/surplus) as defined in the excessive deficit procedure and in the ESA 95. See Regulation (EC) No 2558/2001 of the European Parliament and of the Council of 3 December 2001 amending Council Regulation (EC) No 2223/96 as regards the reclassification of settlements under swap arrangements and under forward rate agreements (0J L 344, 28.12.2001, p. 1).
1) FRAs stands for forward rate agreements.

Chart 2 General government surplus (+)/deficit (-)



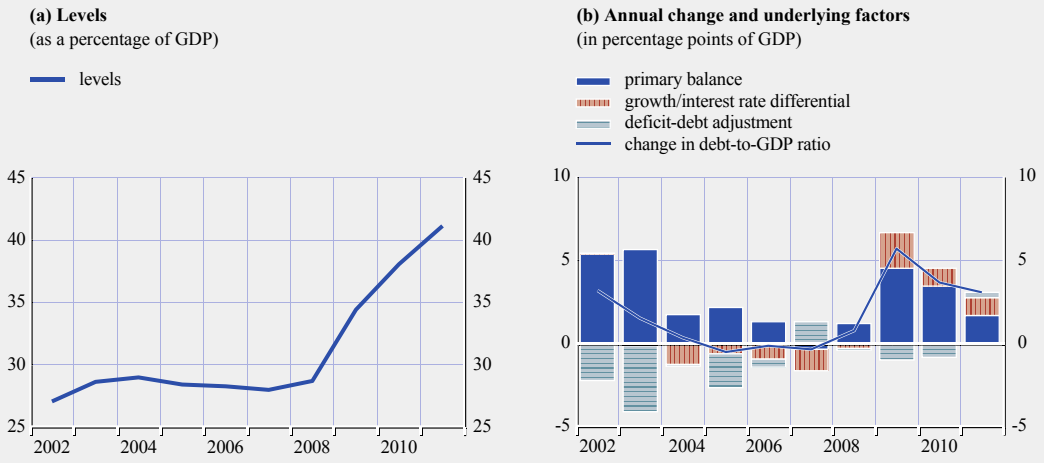
Sources: European Commission (Eurostat) and ECB calculations.
Note: In Chart 2b a negative (positive) value indicates a contribution to an increase (reduction) in a deficit.

Table 6 General government gross debt – structural features

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total debt (as a percentage of GDP)	27.1	28.6	28.9	28.4	28.3	27.9	28.7	34.4	38.1	41.2
Composition by currency (% of total)										
In domestic currency	97.5	96.5	90.7	87.7	88.1	90.6	86.2	83.6	82.1	83.6
In foreign currencies	2.5	3.5	9.3	12.3	11.9	9.4	13.8	16.4	17.9	16.4
Euro[1]	1.8	3.5	9.3	12.3	11.4	8.8	13.1	15.1	16.6	15.2
Other foreign currencies	0.8	0.0	0.0	0.0	0.5	0.5	0.7	1.3	1.3	1.2
Domestic ownership (% of total)	94.9	91.5	82.2	74.7	74.2	72.7	72.2	70.5	67.2	66.9
Average residual maturity (in years)	-	-	-	-	-	-	-	-	-	-
Composition by maturity[2] (% of total)										
Short-term (up to and including one year)	28.6	23.1	16.3	11.3	10.0	8.2	6.3	6.8	7.6	9.5
Medium and long-term (over one year)	71.4	76.9	83.7	88.7	90.0	91.8	93.7	93.2	92.4	90.5

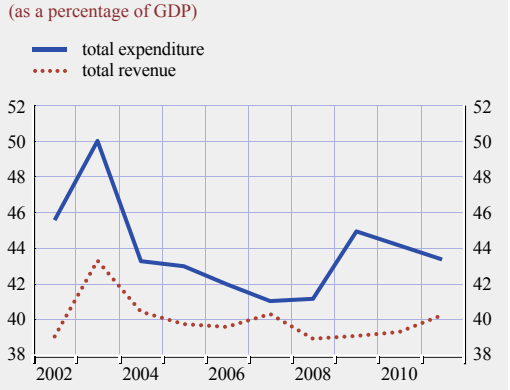
Sources: ESCB and European Commission (Eurostat).
Notes: Year-end data. Differences between totals and the sum of their components are due to rounding.
1) Comprises debt denominated in euro.
2) Original maturity.

Chart 3 General government gross debt



Sources: European Commission (Eurostat) and ECB.
Note: In Chart 3b a negative (positive) value indicates a contribution of the respective factor to a decrease (increase) in the debt ratio.

Chart 4 General government expenditure and revenue



Source: ESCB.

Table 7 General government deficit-debt adjustment

(as a percentage of GDP)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Change in general government debt [1]	4.3	2.7	2.7	1.2	1.9	2.1	2.1	4.8	4.0	3.4
General government surplus (+)/deficit (-)	-6.5	-6.7	-2.8	-3.2	-2.4	-0.7	-2.2	-5.8	-4.8	-3.1
Deficit-debt adjustment	-2.2	-4.0	-0.1	-2.0	-0.5	1.3	-0.1	-1.0	-0.8	0.4
Net acquisitions (+)/net sales (-) of financial assets	-2.4	-2.7	0.5	-0.8	0.0	1.9	1.1	0.0	-0.6	0.0
Currency and deposits	2.0	-0.2	1.0	3.9	-0.6	2.1	2.0	-1.5	-0.3	-1.0
Loans and securities other than shares	0.7	-3.2	0.0	-1.7	-0.3	-0.2	-0.2	0.0	-0.1	0.0
Shares and other equity	-4.3	-0.3	-0.2	-3.4	-0.1	-0.5	-0.6	-0.2	0.0	0.0
Privatisations	-4.7	-0.9	-0.3	-3.1	0.0	-0.3	-0.6	0.0	0.0	0.0
Equity injections	0.1	0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.3	0.2	0.2	-0.3	-0.1	-0.1	0.0	-0.2	0.0	0.0
Other financial assets	-0.7	1.0	-0.3	0.4	0.9	0.5	-0.1	1.8	-0.2	1.0
Valuation changes of general government debt	0.0	0.2	0.0	-0.4	-0.2	-0.1	0.1	-0.2	-0.5	-0.1
Foreign exchange holding gains (-)/losses (+)	0.0	0.0	0.0	-0.3	-0.2	-0.1	0.1	-0.1	-0.1	0.1
Other valuation effects [2]	0.0	0.2	0.1	-0.1	0.0	-0.1	0.0	-0.1	-0.4	-0.2
Other changes in general government debt [3]	0.2	-1.5	-0.7	-0.9	-0.4	-0.5	-1.3	-0.8	0.2	0.4

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

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2010	2020	2030	2040	2050	2060
Elderly dependency ratio (population aged 65 and over as aproportion of the population aged 15-64)	21.8	30.7	34.5	40.7	50.5	54.9
Age-related government expenditure (in percentage points of GDP) [1]	20.2	20.6	21.9	23.1	25.1	26.6

Source: The 2012 Ageing Report: Economic and budgetary projections for the EU27 Member States (2010-2060), joint report prepared by the European Commission (DG ECFIN) and the Economic Policy Committee.
1) The Ageing Working Group (AWG) risk scenario, strictly age-related item.

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

Participation in the exchange rate mechanism (ERM II)	No
Exchange rate level in May 2010 in CZK/EUR	25.6627
Maximum upward deviation [1)]	6.4
Maximum downward deviation [1)]	-1.5

Source: ECB.
1) Maximum percentage deviations of the bilateral exchange rate against the euro from its average level in May 2010 over the period 3 May 2010-30 April 2012, based on daily data at business frequency. An upward (downward) deviation implies that the currency was stronger (weaker) than its exchange rate level in May 2010.

Table 9 (b) Key indicators of exchange rate pressure for the Czech koruna

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

	2010			2011				2012
	June	Sep.	Dec.	Mar.	June	Sep.	Dec.	Mar.
Exchange rate volatility [1)]	6.9	4.2	3.6	4.9	3.7	5.0	8.3	8.1
Short-term interest rate differential [2)]	0.6	0.4	0.2	0.1	-0.2	-0.4	-0.3	0.2

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

Chart 5 Czech koruna: nominal exchange rate development against the euro

(a) Exchange rate over the reference period
(daily data; average of May 2010 = 100;
3 May 2010-30 April 2012)

(b) Exchange rate over the last ten years
(monthly data; average of May 2010 = 100;
May 2002-April 2012)

Source: ECB.
Note: An upward (downward) movement of the line indicates an appreciation (depreciation) of the Czech koruna.

Table 10 Czech koruna: real exchange rate developments

(monthly data; percentage deviation in March 2012 from the ten-year average calculated for the period April 2002-March 2012)

	Mar. 2012
Real bilateral exchange rate against the euro [1]	14.8
Memo items:	
Nominal effective exchange rate [2]	11.4
Real effective exchange rate [1), 2)]	12.4

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

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Balance of payments										
Current account and capital account balance [1]	-5.3	-6.0	-5.5	-0.8	-1.7	-3.7	-1.4	-1.0	-3.0	-2.5
Current account balance	-5.3	-6.0	-5.0	-1.0	-2.0	-4.3	-2.1	-2.4	-3.9	-2.9
Goods balance	-2.8	-2.6	-0.5	1.6	1.8	1.3	0.7	2.3	1.4	2.5
Services balance	0.9	0.5	0.6	1.2	1.5	1.6	1.9	2.0	2.0	1.7
Income balance	-4.5	-4.5	-5.3	-4.1	-4.9	-7.0	-4.5	-6.7	-7.5	-7.1
Current transfers balance	1.1	0.6	0.2	0.4	-0.3	-0.2	-0.2	0.0	0.2	0.1
Capital account balance	0.0	0.0	-0.5	0.2	0.3	0.6	0.7	1.4	0.9	0.4
Combined direct and portfolio investment balance [1]	8.7	0.7	5.3	6.4	1.9	3.3	0.7	5.3	6.5	2.1
Direct investment balance	10.6	2.0	3.5	9.0	2.7	4.9	0.9	1.0	2.5	2.0
Portfolio investment balance	-1.8	-1.3	1.8	-2.6	-0.8	-1.6	-0.2	4.2	4.0	0.2
Other investment balance	5.0	5.0	0.9	-1.2	1.1	0.1	1.7	-1.4	-1.8	0.3
Reserve assets	-8.4	-0.5	-0.2	-3.0	-0.1	-0.4	-1.0	-1.6	-1.1	0.5
Exports of goods and services	57.9	59.2	67.2	64.3	67.1	68.3	64.7	60.0	68.2	75.0
Imports of goods and services	59.8	61.3	67.1	61.5	63.9	65.4	62.1	55.7	64.8	70.8
Net international investment position [2]	-15.5	-19.6	-28.2	-26.9	-32.3	-38.7	-40.1	-46.2	-48.5	-49.7
Gross external debt [2]	33.0	34.9	36.9	40.1	39.9	43.1	48.5	51.6	56.5	58.4
Memo item:										
Export market shares [3]	0.55	0.59	0.71	0.67	0.69	0.74	0.68	0.75	0.72	0.70

Source: ECB.
1) Differences between totals and the sum of their components are due to rounding.
2) End-of-period outstanding amounts. Data published by Česká národní banka follow a slightly different definition, including direct investment inter-company lending on a net basis.
3) As a percentage of total world goods and services exports.

Table 12 Indicators of integration with the euro area

(as a percentage of the total, unless otherwise stated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
External trade with the euro area										
Exports of goods	69.4	71.5	71.4	68.5	67.5	66.2	65.9	67.3	66.3	65.6
Imports of goods	61.3	60.4	68.1	68.3	66.3	65.6	62.6	63.6	60.6	59.9
Investment position with the euro area										
Inward direct investment [1]	84.0	81.3	81.8	82.6	82.8	81.7	84.2	83.0	82.3	82.6
Outward direct investment [1]	64.1	68.3	58.5	59.3	67.2	70.6	78.3	74.6	79.1	76.9
Portfolio investment liabilities [1]	28.1	41.2	53.2	59.3	51.2	52.9	53.9	57.3	55.1	-
Portfolio investment assets [1]	52.3	67.8	69.5	69.9	68.0	72.1	70.8	69.2	67.8	-
Memo items:										
External trade with the EU										
Exports of goods	85.7	87.3	87.2	85.5	85.7	85.3	84.9	84.8	84.0	83.0
Imports of goods	72.5	71.4	80.2	81.4	80.5	80.1	76.9	78.0	74.9	74.4

Sources: ESCB, European Commission (Eurostat) and IMF.
1) End-of-period outstanding amounts.

4 LONG-TERM INTEREST RATE DEVELOPMENTS

Table 13 Long-term interest rates (LTIRs)

(percentages; average of observations through period)

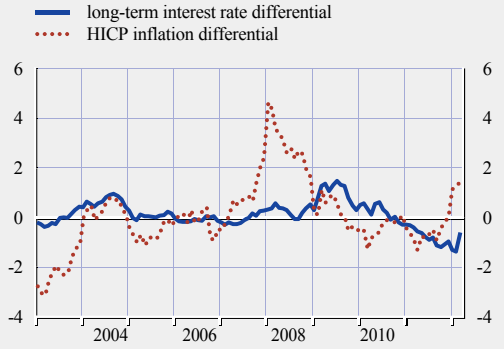
	2011	2012			
	Dec.	Jan.	Feb.	Mar.	Apr. 2011 to Mar. 2012
Long-term interest rate	3.7	3.4	3.1	3.5	3.5
Reference value[1]					*5.8*
Euro area[2]	*4.6*	*4.7*	*4.4*	*4.1*	*4.4*
Euro area (AAA)[3]	*2.7*	*2.6*	*2.5*	*2.5*	*2.9*

Sources: ECB and European Commission (Eurostat).
1) The basis of the calculation for the period April 2011-March 2012 is the unweighted arithmetic average of the interest rate levels in Sweden and Slovenia plus 2 percentage points.
2) The euro area average is included for information only.
3) The euro area AAA par yield curve for the ten-year residual maturity is included for information only.

Chart 6 Long-term interest rate (LTIR)

(a) Long-term interest rate (LTIR)
(monthly averages in percentages)

(b) LTIR and HICP inflation differentials vis-à-vis the euro area
(monthly averages in percentage points)



Sources: ECB and European Commission (Eurostat).

Table 14 Selected indicators of financial development and integration

(as a percentage of GDP, unless otherwise stated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Memo item: euro area 2011
Debt securities issued by corporations[1]	32.9	32.9	20.2	17.8	17.3	18.9	16.6	22.7	22.6	24.2	103.0
Stock market capitalisation[2]	13.9	16.9	22.5	28.9	28.5	34.8	21.6	23.3	21.6	20.0	41.5
MFI credit to non-government residents[3]	27.4	28.7	29.9	33.9	38.5	44.9	49.3	51.1	52.1	54.5	134.7
Claims of euro area MFIs on resident MFIs[4]	7.1	8.1	6.0	5.6	5.1	6.3	6.8	6.2	6.9	6.6	7.9
Private sector credit flow[5]	4.3	-3.5	5.8	3.3	7.2	8.7	8.6	0.7	1.7	-	3.5
Private sector debt[6]	61.4	55.8	56.6	57.2	61.4	65.5	73.0	76.0	77.2	-	167.0

Sources: ESCB, European Commission (Eurostat), Federation of European Securities Exchanges, OMX and national stock exchanges.
1) Outstanding amount of debt securities issued by resident non-financial corporations, MFIs and other financial corporations.
2) Outstanding amounts of quoted shares issued by residents at the end of the period at market values.
3) MFI (excluding NCB) credit to domestic non-MFI residents other than the general government. Credit includes outstanding amounts of loans and debt securities.
4) Outstanding amount of deposits and debt securities issued by domestic MFIs (excluding the NCB) held by euro area MFIs as a percentage of total liabilities of domestic MFIs (excluding the NCB). Total liabilities exclude capital and reserves and remaining liabilities.
5) Transactions in securities other than shares issued and loans taken out by institutional sectors: non-financial corporations, households and non-profit institutions serving households.
6) Outstanding amounts of securities other than shares issued and loans taken out by institutional sectors: non-financial corporations, households and non-profit institutions serving households.

5.3 LATVIA

5.3.1 PRICE DEVELOPMENTS

Over the reference period from April 2011 to March 2012, the 12-month average rate of HICP inflation in Latvia was 4.1%, i.e. well above the reference value of 3.1% for the criterion on price stability (see Table 1). On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to decline in the coming months.

Looking back over a longer period, consumer price inflation in Latvia has been very volatile, ranging between annual averages of -1.2% and 15.3% in the past ten years. Inflation gradually picked up from generally low levels during the first half of the past decade and fluctuated between 6% and 7% for a few years, before accelerating further in 2007 and 2008 (see Chart 1). The pick-up in inflation was initially attributable to an increase in administered prices and import prices caused by the depreciation of the lats vis-à-vis the euro, as well as by adjustments in indirect taxation and a combination of one-off factors. After Latvia's accession to the EU in 2004, excessive demand and credit growth (supported, inter alia, by low, and at times negative, real interest rates), very strong wage increases and hikes in global energy and food prices also contributed increasingly to driving up inflation and led to an erosion of competitiveness. Particularly during the boom years of 2005 to 2007, the Latvian economy exhibited growing signs of serious overheating and rising macroeconomic imbalances. As these macroeconomic developments proved unsustainable, the Latvian economy experienced a deep crisis starting in 2008. After peaking at an annual average rate of 15.3% in 2008, HICP inflation fell sharply to a trough of -1.2% in 2010. This adjustment process helped Latvia to regain competitiveness. However, this adjustment came to an end in the course of 2010, with the annual rate of inflation picking up to around the average of the country's major trading partners.

Economic and monetary policy choices have played an important role in shaping inflation developments over the past decade. Monetary policy is aimed towards the achievement of price stability, which is the primary objective as enshrined in the central bank law. Latvijas Banka aims at achieving this key objective via a strict exchange rate peg, initially to the IMF's special drawing right and since early 2005 to the euro. In May 2005 Latvia joined ERM II at the previously established central rate and unilaterally retained the existing narrow fluctuation band of ±1%. Fiscal consolidation and structural reforms designed to enhance product market competition and labour market reforms helped to stabilise inflation up to 2003, although fiscal policies became increasingly pro-cyclical during subsequent years. At the same time, the country's monetary policy was constrained by the aim of maintaining the unilateral band within ERM II, and the overall policy stance (including fiscal policy) was not tight enough to counter the growing signs of overheating. Although some government measures were introduced to contain credit growth and reduce inflation in 2007, these came too late and were too weak to correct the build-up of significant macroeconomic imbalances and serious overheating. During the subsequent downturn, significant fiscal consolidation measures were implemented, including cuts in public wages, to adjust the imbalances, restore investor confidence and put public finances on a sustainable track.

Inflation developments over the past ten years should be viewed against the background of a volatile macroeconomic environment. Very robust and accelerating real GDP growth until 2007 turned into an abrupt and painful contraction between 2008 and 2010, owing to a build-up and subsequent correction of significant macroeconomic imbalances and vulnerabilities. This turnaround was exacerbated by the impact of the global financial and economic crisis. Liquidity tensions started to cause balance of

payments problems in late 2008, triggering Latvia to seek international financial assistance. As part of this assistance programme led by the EU and the IMF, drastic fiscal adjustment measures were implemented to stabilise the financial sector, restore confidence, ensure the sustainability of public finances and regain competitiveness. Macroeconomic conditions weakened abruptly, in particular in 2009, reflecting the collapse of domestic demand, the unwinding of the credit and housing bubble and the significant deterioration in the external environment. After a cumulative decline of approximately 24%, real GDP started to recover in the course of 2010, with growth gaining strength in 2011. Following a peak of 20%, the unemployment rate started to come down gradually, although the share of long-term unemployment continued to increase. Compensation per employee fell significantly, particularly in 2009, with the decline bottoming out in 2010. Unit labour costs also decreased markedly in both 2009 and 2010 as the fall in labour costs outpaced the decline in labour productivity per person employed in 2009, while labour productivity per person increased in 2010. The decline in labour productivity in 2009 stemmed from a decrease in hours worked, while productivity per hour increased. Consumer prices also declined during the contraction, although the size of the fall was relatively limited as the impact of declines in wage costs was partly offset by higher indirect taxes and rising commodity prices. Other price indices confirm that prices did not adjust to the same degree as unit wage costs (see Table 2). After declining by a cumulative 55% between late 2007 and early 2010, house prices have stabilised following a brief recovery in 2010.

Looking at recent developments, the annual rate of HICP inflation moderated to 3.2% in March 2012, following a pick-up in the first half of 2011 owing to increases in global food and energy prices and higher indirect taxes (see Table 3a). Inflation pressures moderated again in the second half of 2011 as global commodity prices stabilised and demand-side pressures remained muted. After having an upward impact on inflation in 2011, there were no major changes in indirect taxes in early 2012. Some administered prices, such as natural gas and heating tariffs, increased significantly as of January 2012, although their impact on the annual rate of inflation was limited as similar increases were recorded a year earlier (the share of administered prices in Latvia's HICP basket is 14.3%). Nominal unit labour costs started to rise again in 2011, driven by a pick-up in compensation per employee, which was 4.2% higher in the final quarter of 2011 than a year earlier. The renewed pick-up in labour costs reflects an increase in the minimum wage in early 2011, bonus payments in the private sector owing to higher profitability and renewed salary increases in parts of the public sector following strong declines in earlier years. Although unemployment remains high at above 14%, there are some signs of labour shortages and skill mismatches in certain sectors and skill categories.

The latest available forecasts from major international institutions project inflation to decline in 2012-13, and range between 2.5% and 2.6% in 2012 and between 2.1% and 2.5% in 2013 (see Table 3b). Upside risks to the inflation outlook stem in particular from the possibility of higher food or energy prices, to which Latvian inflation is relatively sensitive. In addition, wage developments could pose an upside risk to inflation as labour shortages in certain sectors have appeared, suggesting that unemployment is likely to be close to its natural rate. On the downside, a sharper than expected weakening in economic activity could put profit margins and wage costs under pressure, thereby reducing inflation more than currently envisaged.

Looking further ahead, maintaining low inflation rates at all times in Latvia will be challenging in the medium term, given monetary policy's limited room for manoeuvre under the fixed exchange rate regime. The catching-up process is likely to have a bearing on inflation over the medium term, given that the GDP per capita level is still significantly lower in Latvia than in the euro area and that the price level in Latvia is still approximately 30% lower than in the euro area (see Table 2).

However, it is difficult to assess the exact size of the inflation effect resulting from this catching-up process. Once credit growth resumes, with a fixed exchange rate regime, the underlying trend of real exchange rate appreciation is likely to manifest itself in terms of higher inflation. In the context of the process of economic convergence, it cannot be completely ruled out that significant demand pressure may emerge again, although the ongoing deleveraging process in the private sector reduces this risk for the near future. Given the tightly pegged exchange rate and the limitations of alternative counter-cyclical policy instruments, it may be difficult to prevent macroeconomic imbalances, including high rates of inflation, from building up again.

Achieving an environment conducive to sustainable convergence in Latvia requires the conduct of economic policies geared towards ensuring overall macroeconomic stability, including sustainable price stability. Given monetary policy's limited room for manoeuvre under the current exchange rate peg, it is imperative that other policy areas provide the economy with the wherewithal to cope with country-specific shocks and to avoid the reoccurrence of macroeconomic imbalances. More specifically, it is necessary for Latvia to continue along a path of comprehensive fiscal consolidation in line with the requirements of the EDP and to strengthen its fiscal framework to avoid a return to pro-cyclical policies in the future. In addition, it is important to lock in the competitiveness gains achieved in recent years by avoiding a renewed increase in unit labour costs. Moreover, it is essential to implement further structural reform measures that support a rebalancing of the economy towards the tradable sector and focus in particular on improving the functioning of the labour market, where high unemployment coincides with skill mismatches and labour shortages in some sectors. Such reforms could help to mitigate the potential long-term consequences of the economic contraction during the adjustment and support balanced growth in the future. Finally, confidence in the soundness of the financial sector needs to be strengthened, for example by making further progress in the restructuring of state-owned banks. Financial sector policies should also be geared towards preventing excessive credit growth in the future. Given the potential financial stability risks associated with the very high share of foreign currency-denominated loans in Latvia, the European Systemic Risk Board's recommendations on lending in foreign currencies, released in 2011, need to be adequately taken into account. Close cooperation between home and host country supervisory authorities is important to ensure the effective implementation of these measures. Progress in these areas will help to achieve an environment conducive to sustainable price stability and promote competitiveness and employment growth.

5.3.2 FISCAL DEVELOPMENTS

Latvia is, at present, subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2011 the general government budget balance showed a deficit of 3.5% of GDP, i.e. above the 3% reference value. The general government gross debt-to-GDP ratio was 42.6%, i.e. below the 60% reference value (see Table 4). Compared with the previous year, the budget balance ratio improved by 4.7 percentage points, while the public debt ratio decreased by 2.1 percentage points. In 2012 the deficit ratio is forecast by the European Commission to decline to 2.1% and the government debt ratio is projected to increase to 43.5%. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2011 and is not expected to exceed it in 2012 either.

Looking at developments in Latvia's budgetary position over the period from 2002 to 2011, after declining to 0.4% in 2007, the deficit-to-GDP ratio rose sharply to 4.2% in 2008 and to 9.8% in 2009. This trend has been reversed since 2010 (see Table 5 and Chart 2a). As the deficit-to-GDP ratio rose above the 3% of GDP reference value in 2008, the ECOFIN Council decided on

7 July 2009 that an excessive deficit situation existed in Latvia and set the deadline for correcting it at 2012. As shown in greater detail in Chart 2b, European Commission estimates indicate that cyclical factors had a positive impact on the budget balance until 2007 and during 2010-11. In 2008 and in particular in 2009, when the financial and economic crisis sharply affected public finances, cyclical factors had a strongly negative impact on the budget balance. Non-cyclical factors contributed overall to increasing the budget deficit over the period 2005-09. The largest contribution of non-cyclical factors to the deterioration in the budget balance occurred in 2008, owing to a slow adjustment of government expenditure to the rapidly changing macroeconomic environment. This trend has been reversed since 2009, when the Latvian government forcefully implemented significant fiscal consolidation measures agreed under the financial assistance programme led by the EU and the IMF. The fiscal consolidation package consisted primarily of deep cuts in the compensation of employees and intermediate consumption, increases in VAT, taxation of personal income and property as well as a broadening of the social security contribution bases. The 2011 EU-IMF programme target for the general government budget deficit of no more than 6% of GDP was met by a substantial margin. After adjusting for relatively large deficit-increasing temporary measures in 2009 and, especially, in 2010 owing to capital injections to the banking sector, the underlying changes in the budget deficit seem to reflect a structural deterioration of Latvia's fiscal position until 2008, and thereafter a significant consolidation effort under the EU-IMF programme.

Turning to developments in general government gross debt, between 2002 and 2011 the debt-to-GDP ratio increased cumulatively by 29.0 percentage points, with over 80% of the rise materialising in the 2008-10 period (see Chart 3a and Table 6). As shown in greater detail in Chart 3b, among the factors underlying the annual change in the debt ratio, the primary budget balance was broadly neutral during the period 2002-07 and started to have a debt-increasing impact during the period 2008-11, reaching a peak in 2009. The growth/interest rate differential contributed to the increase in the debt ratio in 2009 and 2010, while its role was rather marginal in the preceding period. By contrast, the deficit-debt adjustment factor made a substantial contribution to the increase in the debt ratio in 2008, and to a lesser extent in 2009, reflecting the financial flows received from, inter alia, the IMF and the EU in the context of balance of payments support. In 2011, the general government debt-to-GDP ratio decreased owing to a positive growth/interest rate differential and favourable deficit-debt adjustment, which more than compensated for a sustained primary deficit ratio.

As regards Latvia's general government debt structure, the share of government debt with a short-term maturity was rather volatile. It hovered between 5% and 13% in the period from 2002 to 2007 and increased sharply to 35.9% in 2008 on account of the issuance of short-term securities to ensure financial stability before the funding under the EU-IMF programme was available. Thereafter, the share of short-term debt started to decline and remained low at 8.4% in 2011 (see Table 6). Taking into account the level of the debt ratio, fiscal balances are relatively insensitive to changes in interest rates. At 82.8% in 2011, the proportion of government debt denominated in foreign currency is high, and, given the overall debt level, fiscal balances would be highly sensitive to changes in exchange rates. However, the debt is largely denominated in euro, against which the Latvian lats fluctuates within a narrow band of ±1%. This leaves fiscal balances relatively insensitive to changes in exchange rates other than the EUR/LVL exchange rate. The share of debt denominated in foreign currency remained broadly stable until 2008, but rose significantly in 2009 on account of the EU-IMF programme, and its composition changed more towards non-euro foreign currencies between 2010 and 2011. During the crisis that hit Latvia in 2008 and until 2011, short-term debt-related vulnerabilities increased initially, but then subsided gradually. At the same time, the Latvian government incurred contingent liabilities resulting from government interventions

to support financial institutions and financial markets during the crisis (see Section 5.9) as well as interventions in state-owned enterprises.

Moving on to examine trends in other fiscal indicators, Chart 4 and Table 5 show that the general government total expenditure-to-GDP ratio increased overall from 36.0% in 2002 to 39.1% in 2011. The expenditure ratio peaked at 44.5% of GDP in 2009, with the increase over the previous two years resulting from the denominator effect, i.e. the significant GDP contraction during 2009 and 2010. Over this period, expenditure declined in nominal terms, thus correcting part of the large increases in the preceding period. The expenditure-to-GDP ratio declined in 2011, mainly as a result of the restraint across practically all expenditure items with the exception of interest payable. In particular, "compensation of employees" decreased its share in GDP and remained below the 2002-10 levels. Capital spending increased as a ratio to GDP in 2010, but declined in 2011. Total government revenue as a share of GDP increased over the period from 33.7% of GDP in 2002 to 35.6% of GDP in 2011. After peaking at 37.8% of GDP in 2006 on the back of rapid economic growth, the total revenue-to-GDP ratio started to decline towards 2009. This trend was reversed in 2010, as a result of significant tax increases implemented in the context of the EU-IMF programme.

Looking ahead, Latvia's medium-term fiscal policy strategy indicates the commitment of the current government to bring the ESA 95 deficit below the 3% of GDP reference value in 2012 and to reduce it gradually thereafter. According to most recent projections by the European Commission, the deficit is expected to be reduced to about 2.1% of GDP in 2012. The projected fiscal consolidation for 2012 is based on continued expenditure restraint and adjustments in real estate taxes as well as adjustments in VAT, such as the application of reverse VAT on scrap-metal purchasing and construction. According to the 2012-15 convergence programme update, the structural deficit over the programme period is likely to remain above the new and more ambitious medium-term budgetary objective of a structural deficit of 0.5% of GDP (specified in line with the Stability and Growth Pact). Moreover, based on information submitted in the 2012 convergence programme update, primary expenditure excluding EU fund transfers (relevant expenditure), as a share of GDP, is projected to drop by 5.4 percentage points between 2012 and 2015. The annual growth rate of relevant expenditure is projected to remain below the growth rate of potential GDP over the projection horizon. According to the European Commission's projections, the structural deficit will remain above the medium-term objective by 2013. More efforts are necessary to meet the medium-term budgetary objective, in particular when taking into account possible adverse effects related to implicit or contingent liabilities stemming from the government intervention in some banks and state-owned or co-owned enterprises.

In this respect, on 2 March 2012 Latvia signed the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, committing, inter alia, to apply (and include in its national legislation) the fiscal rules specified under Title III, "Fiscal Compact", as herein referred to in Box 2 of Chapter 2.

As regards fiscal governance, Latvia introduced a multi-annual budgetary framework in 2007. However, the current fiscal governance framework exhibits several weaknesses and lacks an effective mechanism to limit expenditure growth in good economic times. This calls for a strengthening of the budgetary framework to ensure that sustainable trends can be maintained. In particular, further efforts are necessary to adopt and implement the fiscal discipline law (submitted to Parliament and passed at the first reading) and strengthen medium-term budgetary planning. It should be noted that there are some outstanding statistical issues related to the classification of one bank in the general consolidated budget, which may incur upside risks to the government debt (see also Section 5.9).

Full compliance with the provisions for an enhanced national governance framework under Council Directive 2011/85/EU and with the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, as referred to in Box 2 of Chapter 2, should be ensured.

Turning to factors with an impact on Latvia's public finances over the long term, a rapid ageing of the population is expected, as highlighted in Table 8. However, according to the 2012 projections by the European Commission and the EU's Economic Policy Committee, starting from a level of 18.5% of GDP in 2010, Latvia is likely to experience a notable decrease in strictly age-related public expenditure amounting to 3.0 percentage points of GDP in the years to 2060, as the adverse impact of population ageing on public finances has been mitigated by the implementation of a major pension reform in 2001, which established a state-funded pension scheme and consolidation measures taken in the context of the EU-IMF financial assistance programme during 2009-11.[4]

Turning to fiscal challenges, Latvia must ensure a sustainable reduction in the budget deficit to below the 3% reference value in 2012 and beyond, in line with the EDP requirements, and fully implement the reform previously agreed in the context of the EU-IMF financial assistance programme. In addition, some of the measures taken since 2007 were mainly across the board or were not highly sustainable expenditure cuts and there is a risk that they may be reversed later on. It is therefore necessary that Latvia implement the measures proposed in the 2012 budget, limit the fiscal risks related to government interventions to several banks and state-owned companies and continue a prudent expenditure policy in the medium term. The quality of public finances should be further improved by strengthening medium-term budgetary planning, as well as by implementing and strongly adhering to the fiscal discipline law. At the same time, every effort should be made to fully comply with the obligations under the enhanced Stability and Growth Pact, and to effectively implement the provisions of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union.

5.3.3 EXCHANGE RATE DEVELOPMENTS

The Latvian lats joined ERM II on 2 May 2005 and was therefore participating in ERM II for the entire two-year reference period from 1 May 2010 to 30 April 2012 (see Table 9a). The central rate for the Latvian currency has remained at 0.702804 lats per euro with a standard fluctuation band of ±15%. At the time of ERM II entry, the Latvian authorities unilaterally undertook to maintain the exchange rate of the lats within a fluctuation band of ±1% around the central rate, thus placing no additional obligations on the ECB. The agreement on participation in ERM II was based on a number of policy commitments by the Latvian authorities, relating, among other things, to pursuing sound fiscal policies, promoting wage moderation, reducing inflation, containing credit growth, reducing the current account deficit and implementing structural reforms. This commitment to the ±1% fluctuation band has meant that the lats has always remained close to its central rate within ERM II. Furthermore, Latvia has not devalued its currency's central rate against the euro on its own initiative. While the maximum upward deviation of the exchange rate from the ERM II central rate amounted to 0.9% over the reference period, the maximum downward deviation was 1.0% (see Chart 5 and Table 9a). As implied by its commitment to a ±1% unilateral fluctuation band, Latvijas Banka continued to regularly intervene in the foreign exchange market. Overall, its sales and purchases of foreign currency over the two-year reference period resulted in a net purchase.

4 European Commission and Economic Policy Committee, "The 2012 Ageing Report: Economic and budgetary projections for the EU-27 Member States (2010-2060)".

Between late 2008 and January 2012, an international financial assistance arrangement of €7.5 billion was in place, led by the EU and the IMF. During the reference period, Latvia received disbursements in 2010 but did not draw on the remaining resources of €3.0 billion in 2011. As the international financial assistance helped to reduce financial vulnerabilities, it might also have contributed to reducing exchange rate pressures.

The exchange rate volatility of the Latvian lats vis-à-vis the euro, as measured by annualised standard deviations of daily percentage changes, stood at very low levels in 2010. It increased slightly thereafter, but remained at relatively low levels for the rest of the reference period. Over the reference period, the Latvian lats mostly traded below its central rate, but in late 2011 appreciated towards the stronger end of its ±1% unilateral fluctuation band, also as a result of the Treasury's conversion of foreign exchange into domestic currency. Short-term interest rate differentials against the three-month EURIBOR gradually declined from relatively high levels during the second half of 2010. After temporarily moving into negative territory in mid-2011, the short-term interest rate differential stood at low levels of 0.4 percentage point in the three-month period ending in March 2012 (see Table 9b).

In a longer-term context, in March 2012 both the Latvian lats' real effective exchange rate and its real bilateral exchange rate against the euro stood above the corresponding ten-year historical averages (see Table 10). However, these measures should be interpreted with caution, as in this period Latvia was subject to a process of economic convergence, which complicates any historical assessment of real exchange rate developments.

As regards other external developments, Latvia was characterised by substantially widening deficits in the combined current and capital account of its balance of payments, which tripled from a high level of 6.5% of GDP in 2002 to very large deficits in excess of 20% of GDP in 2006 and 2007 (see Table 11). After a strong fall in domestic demand, which led to lower imports, as well as gains in competitiveness and a strong recovery of exports, the deficit decreased substantially and the combined current and capital account registered a very large surplus of 11.1% of GDP in 2009. This drastic shift reflected a substantial decrease in the goods deficit and, to a lesser extent, increases in the surpluses in services and transfers, as well as a temporary improvement in the income balance. However this surplus narrowed subsequently to 4.9% in 2010 and 0.9% in 2011, reflecting the rebound of domestic demand, particularly investment, with strong growth in imports outpacing growth in exports. The shifts recorded in Latvia's balance of payments over the past two years have also been associated with recovering capital inflows. After a sharp contraction of capital inflows in 2008 led by very large net outflows of other investment, i.e. mostly loans and deposits, net other investment has gradually recovered over the past two years and was close to balance in 2011. Against this background, gross external debt increased sharply from 73.4% of GDP in 2002 to 156.5% in 2009, further rising to 165.4% in 2010, before declining to 145.9% in 2011. At the same time the country's net international investment position deteriorated substantially, from -41.3% of GDP in 2002 to -82.7% in 2009, but stabilised at -80.2% in 2010 and declined thereafter to -72.5% in 2011. The fact that the country's net foreign liabilities are still very high points to the importance of fiscal and structural policies supporting external sustainability. Latvia is a small, open economy; the ratio of foreign trade in goods and services to GDP recently increased markedly, from 40.9% of GDP in 2002 to 58.7% in 2011 for exports, and from 51.1% of GDP in 2002 to 62.1% in 2011 for imports. Over the same period, Latvia's share in world exports increased from 0.05% to 0.07%.

Concerning measures of economic integration with the euro area, in 2011 exports of goods to the euro area constituted 31.4% of total goods exports, whereas the corresponding figure for imports was higher at 40.1%. The share of euro area countries in Latvia's inward direct investment stood at

39.4% in 2011 and that in its portfolio investment liabilities at 72.2% in 2010. The share of Latvia's assets invested in the euro area amounted to 20.4% in the case of direct investment in 2011 and 51.7% for portfolio investment in 2010 (see Table 12).

With regard to the fulfilment of the commitments made by the Latvian authorities upon ERM II entry in May 2005, the following observations can be made. Fiscal policies during the boom years were not prudent enough, as they failed to contribute sufficiently to containing the emergence of significant macroeconomic imbalances. As a consequence, since 2008, against the background of a notable deterioration in the general government budgetary position and a sharp contraction in output, comprehensive fiscal consolidation measures have been necessary to contain a further deterioration of the budget balance and further comprehensive budgetary consolidation was pursued over the reference period. The tightening of reserve and prudential requirements during the boom failed to effectively contain excessive credit growth. Following a significant output contraction and a sharp correction in house prices, particularly in 2009, the ratio of non-performing loans increased strongly and Latvia implemented a number of measures to improve financial supervision. Efforts to contain wage growth were largely ineffective during the economic upturn, which meant that significant adjustments were necessary in 2009 and 2010. Since then, a sizeable decline in both private and public wages and a simultaneous increase in labour productivity per hour have improved competitiveness over the reference period. However, further measures to increase productivity and support the supply of skilled labour will be needed to ensure that the gains in competitiveness achieved over the past few years are sustained.

5.3.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from April 2011 to March 2012, long-term interest rates in Latvia were 5.8% on average and thus at the 5.8% reference value for the interest rate convergence criterion (see Table 13).

From 2003 until mid-2006, long-term interest rates in Latvia declined, mainly reflecting strong economic growth and the entry of the Latvian lats into ERM II in May 2005 (see Chart 6a). From mid-2006 to mid-2007, long-term interest rates in Latvia were on an upward trend, in line with increasing market concerns regarding overheating in the economy and rising inflationary pressures, as well as a downgrade of the country's long-term foreign currency debt rating. In addition, during the first half of 2007 Latvijas Banka increased the main refinancing rate by 1.0 percentage point in response to rising inflation. After some declines in the second half of 2007, long-term interest rates continued to increase during 2008. In late 2008 the situation deteriorated rapidly. The banking system's reliance on foreign funding, mounting liquidity shortages and doubts about the viability of banks triggered deposit outflows from the banking system. The Latvian authorities had to seek international financial assistance and announced drastic adjustment measures. In order to free up liquidity, Latvijas Banka lowered the reserve ratio for bank liabilities. At the same time, all major rating agencies downgraded Latvian long-term sovereign debt. During 2009 financial market pressures remained, reflecting delays in the fiscal policy decision-making process that compounded the economic and financial challenges, as well as further rating downgrades. In view of the weak lending activity and the continued deterioration in economic activity, Latvijas Banka reduced its refinancing and marginal deposit facility rates. After reaching a peak of 13.8% at the beginning of 2010, long-term interest rates started to follow a declining trend which continued throughout 2010. Market sentiment improved, as the Latvian government intensified its efforts to comply with the policy conditionality of the financial assistance programme and as macroeconomic conditions stabilised. Moreover, these developments were also supported by a general improvement in the

global risk appetite, especially towards emerging economies. Latvijas Banka lowered its refinancing and marginal deposit rates further and introduced a seven-day deposit facility to reduce volatility in the money market. During 2011 Latvia regained access to long-term international markets with a successful auction of a US dollar-denominated bond in the middle of the year. The improving market situation was also reflected in rating upgrades by some agencies. Long-term interest rates increased initially in the first quarter of 2011 and later declined again. Towards the end of 2011, temporary increases were observed again, mainly related to the developments in the domestic banking system as well as tensions in international markets.

The interest rate differential with the euro area average was small between 2003 and 2006. From then until October 2008, the spread with the euro increased to around 2.3 percentage points (see Chart 6b), mainly reflecting the significant increase in the inflation differential between Latvia and the euro area. Broadly mirroring the developments in yields on long-term government bonds, the spread with the euro area average increased markedly in late 2008 and throughout 2009 and subsequently recovered during 2010. In 2011 the interest rate differential with the euro area average was broadly in line with the levels observed in the first half of 2008, standing at 1.1 percentage points (and 2.6 percentage points with respect to the euro area AAA yield) at the end of the reference period.

The Latvian capital market is smaller and much less developed than that of the euro area. Corporate sector market-based indebtedness is very low: the value of outstanding fixed-income securities issued by corporations was 4.0% of GDP in 2011 (see Table 14). Stock market capitalisation (4.1% of GDP in 2011) is also very low compared with the euro area. The value of outstanding bank credit to non-government residents increased very rapidly between 2003 and 2009, when its ratio to GDP more than doubled, before declining to 80.3% in 2011. This level is the highest among EU Member States in central and eastern Europe and is comparable with that of some euro area countries. The majority of loans to the private sector are in foreign currency, mostly in euro, the anchor currency. Foreign-owned banks, predominantly Nordic banking groups, play a major role in the Latvian banking sector. Since the start of the financial crisis, international claims of euro area banks in the country have been declining, and reached 10.9% of total liabilities in 2011.

LIST OF TABLES AND CHARTS

LATVIA

1 PRICE DEVELOPMENTS

Table 1 HICP inflation

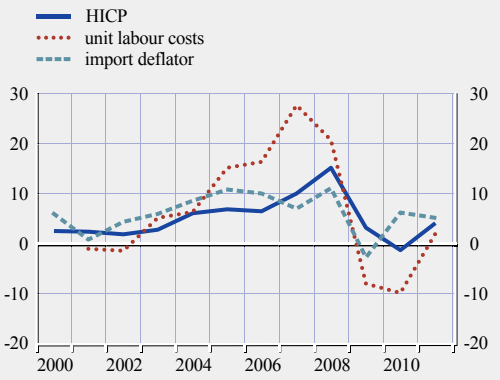
(annual percentage changes)

	2011	2012			Apr. 2011
	Dec.	Jan.	Feb.	Mar.	to Mar. 2012
HICP inflation	3.9	3.4	3.3	3.2	4.1
Reference value [1]					*3.1*
Euro area [2]	*2.7*	*2.7*	*2.7*	*2.7*	*2.8*

Source: European Commission (Eurostat).
1) The basis of the calculation for the period April 2011-March 2012 is the unweighted arithmetic average of the annual percentage changes in the HICP for Sweden, Ireland and Slovenia plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(average annual percentage changes)



Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Measures of inflation										
HICP	2.0	2.9	6.2	6.9	6.6	10.1	15.3	3.3	-1.2	4.2
HICP excluding unprocessed food and energy	1.6	2.9	5.8	5.5	5.1	9.7	13.8	3.5	-2.7	2.4
HICP at constant tax rates [1]	-	-	5.8	6.7	6.2	9.8	13.6	-1.9	-1.4	2.7
CPI	1.9	2.9	6.2	6.7	6.5	10.1	15.4	3.5	-1.1	4.4
Private consumption deflator	1.6	4.2	7.6	8.8	5.9	9.9	16.2	3.2	-0.5	4.9
GDP deflator	3.0	3.8	7.0	10.1	11.2	20.7	13.0	-1.2	-2.2	5.4
Producer prices [2]	0.0	1.8	7.3	7.1	9.6	18.6	15.7	-1.7	-0.2	8.8
Related indicators										
Real GDP growth	7.2	7.6	8.9	10.1	11.2	9.6	-3.3	-17.7	-0.3	5.5
GDP per capita in PPS [3] (euro area = 100)	36.7	39.2	41.7	44.2	47.1	51.0	51.6	47.2	47.4	-
Comparative price levels (euro area = 100)	56.8	52.9	54.5	55.8	59.7	65.7	72.7	72.0	69.3	-
Output gap [4]	-1.2	-0.3	1.5	4.4	9.2	14.2	8.2	-10.3	-9.4	-4.3
Unemployment rate (%) [5]	12.2	10.5	10.4	8.9	6.8	6.0	7.5	17.1	18.7	15.4
Unit labour costs, whole economy	-1.3	5.2	6.4	15.3	16.4	27.7	20.7	-7.9	-9.8	2.1
Compensation per employee, whole economy	2.8	11.0	14.5	25.1	23.2	35.1	15.7	-12.7	-5.5	4.2
Labour productivity, whole economy	4.2	5.5	7.6	8.4	5.9	5.8	-4.2	-5.3	4.7	2.0
Imports of goods and services deflator	4.4	6.0	8.7	10.9	10.1	7.1	11.1	-2.6	6.3	5.3
Nominal effective exchange rate [6]	-3.5	-6.9	-3.0	-5.5	-0.3	-0.3	-0.3	2.0	-2.9	0.1
Money supply (M3)	-	-	25.2	37.3	41.0	15.7	-5.2	-2.7	11.1	0.5
Lending from banks	-	-	43.7	61.2	59.1	34.9	9.8	-6.8	-6.7	-4.9
Stock prices (Riga Stock Exchange Index)	-14.3	47.0	43.5	63.5	-3.1	-9.2	-54.4	2.8	41.1	-5.7
Residential property prices	76.1	26.1	4.1	34.0	75.2	39.4	-10.6	-40.5	-4.2	27.6

Sources: European Commission (Eurostat), national data (CPI, money supply, lending from banks and residential property prices) and European Commission (output gap).
1) 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 on the price paid by the consumer.
2) Total industry excluding construction.
3) PPS stands for purchasing power standards.
4) Percentage difference of potential GDP: a positive (negative) sign indicates that actual GDP is above (below) potential GDP.
5) The definition conforms to ILO guidelines.
6) A positive (negative) sign indicates an appreciation (depreciation).

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2011			2012		
	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.
HICP						
Annual percentage change	4.3	4.0	3.9	3.4	3.3	3.2
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	3.2	2.7	2.5	2.3	2.2	2.0
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	4.5	4.1	3.7	3.4	3.0	2.6

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2012	2013
HICP, European Commission (spring 2012)	2.6	2.1
CPI, OECD (December 2011) [1)]	-	-
CPI, IMF (April 2012)	2.6	2.2
CPI, Consensus Economics (April 2012)	2.5	2.5

Sources: European Commission, OECD, IMF and Consensus Economics.
1) Latvia is not a member of the OECD.

2 FISCAL DEVELOPMENTS

Table 4 General government fiscal position

(as a percentage of GDP)

	2010	2011	2012 [1]
General government surplus (+)/deficit (-)	-8.2	-3.5	-2.1
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure [2]	-4.4	0.7	2.1
General government gross debt	44.7	42.6	43.5
Reference value	*60.0*	*60.0*	*60.0*

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

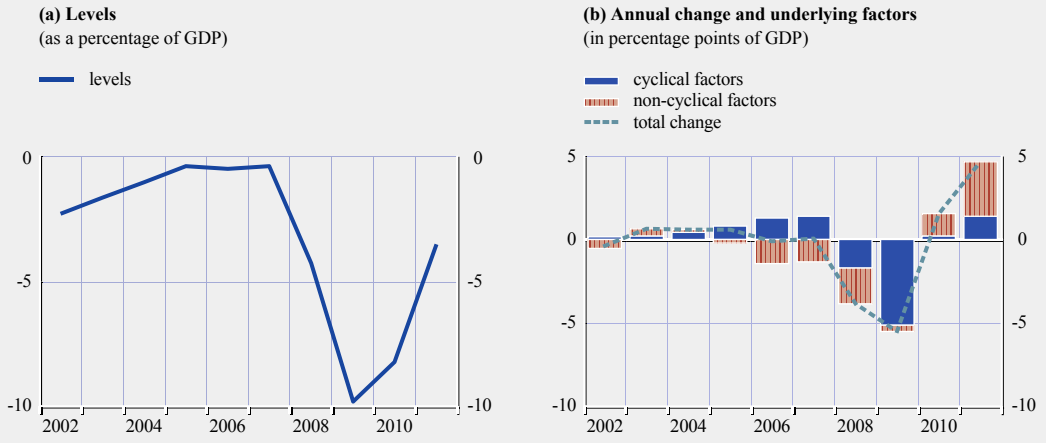
Table 5 General government budgetary position

(as a percentage of GDP)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total revenue	33.7	33.3	34.9	35.4	37.8	35.6	34.9	34.7	35.7	35.6
Current revenue	33.4	33.2	34.4	34.3	36.7	34.8	33.9	32.9	33.9	34.1
Direct taxes	7.9	7.6	7.9	7.9	8.5	9.2	9.8	7.2	7.4	7.4
Indirect taxes	11.3	12.1	11.7	12.5	12.9	12.3	10.9	10.7	11.3	11.5
Social security contributions	9.5	9.1	8.9	8.7	9.0	9.0	8.7	8.9	8.6	8.8
Other current revenue	4.7	4.4	5.8	5.2	6.3	4.4	4.6	6.2	6.6	6.3
Capital revenue	0.3	0.1	0.5	1.1	1.1	0.7	0.9	1.8	1.8	1.5
Total expenditure	36.0	34.9	35.9	35.8	38.3	36.0	39.1	44.5	43.9	39.1
Current expenditure	32.4	32.1	31.7	30.8	31.2	29.1	33.4	37.9	36.1	32.1
Compensation of employees	10.6	10.8	10.5	10.1	10.1	10.7	12.1	12.1	10.2	9.6
Social benefits other than in kind	10.2	9.5	9.2	8.4	8.1	7.1	8.1	12.6	12.5	10.8
Interest payable	0.7	0.7	0.7	0.5	0.4	0.4	0.6	1.5	1.4	1.5
of which: impact of swaps and FRAs [1]	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.0
Other current expenditure	10.9	11.2	11.2	11.7	12.6	10.9	12.6	11.7	12.0	10.3
Capital expenditure	3.6	2.8	4.2	5.0	7.1	6.9	5.7	6.6	7.8	6.9
Surplus (+)/deficit (-)	-2.3	-1.6	-1.0	-0.4	-0.5	-0.4	-4.2	-9.8	-8.2	-3.5
Primary balance	-1.5	-0.9	-0.3	0.1	0.0	0.0	-3.6	-8.3	-6.8	-2.0
Surplus/deficit, net of government investment expenditure	-1.0	0.8	2.1	2.7	4.1	5.3	0.6	-5.5	-4.4	0.7

Sources: ESCB and European Commission (Eurostat).
Notes: Differences between totals and the sum of their components are due to rounding. Interest payable as reported under the excessive deficit procedure. The item "impact of swaps and FRAs" is equal to the difference between the interest (or deficit/surplus) as defined in the excessive deficit procedure and in the ESA 95. See Regulation (EC) No 2558/2001 of the European Parliament and of the Council of 3 December 2001 amending Council Regulation (EC) No 2223/96 as regards the reclassification of settlements under swap arrangements and under forward rate agreements (0J L 344, 28.12.2001, p. 1).
1) FRAs stands for forward rate agreements.

Chart 2 General government surplus (+)/deficit (-)



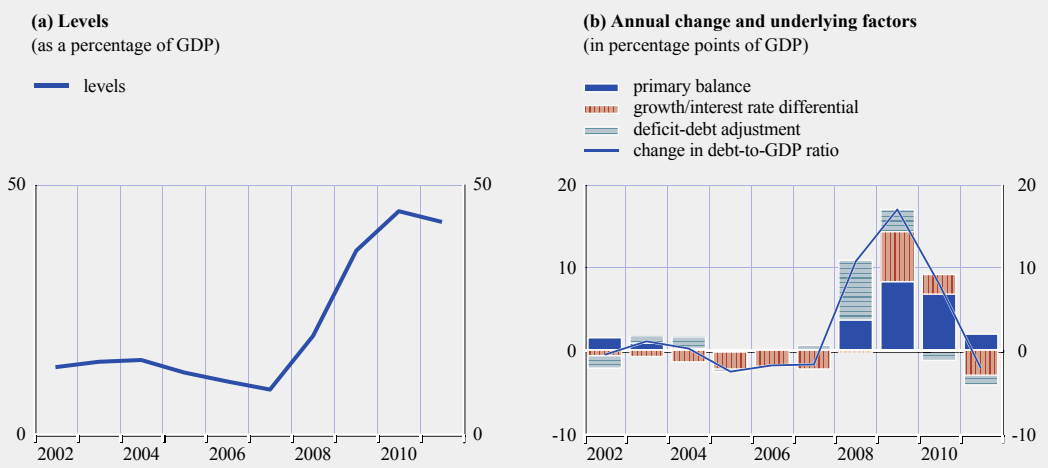
Sources: European Commission (Eurostat) and ECB calculations.
Note: In Chart 2b a negative (positive) value indicates a contribution to an increase (reduction) in a deficit.

Table 6 General government gross debt – structural features

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total debt (as a percentage of GDP)	13.6	14.7	15.0	12.5	10.7	9.0	19.8	36.7	44.7	42.6
Composition by currency (% of total)										
In domestic currency	37.7	41.6	42.6	41.8	39.6	32.6	35.8	20.8	18.3	17.2
In foreign currencies	62.3	58.4	57.4	58.2	60.4	67.4	64.2	79.2	81.7	82.8
Euro[1]	42.5	45.5	51.7	54.6	57.6	65.3	50.6	67.4	67.2	64.8
Other foreign currencies	19.8	12.9	5.7	3.6	2.9	2.1	13.7	11.9	14.5	18.0
Domestic ownership (% of total)	40.5	51.0	47.7	48.1	45.0	38.1	49.5	24.3	22.4	22.5
Average residual maturity (in years)	6.0	4.6	6.2	5.8	7.6	8.8	6.1	6.3	6.1	5.7
Composition by maturity[2] (% of total)										
Short-term (up to and including one year)	4.9	12.5	9.8	9.4	6.6	7.7	35.9	14.7	9.4	8.4
Medium and long-term (over one year)	95.1	87.5	90.2	90.6	93.4	92.3	64.1	85.3	90.6	91.6

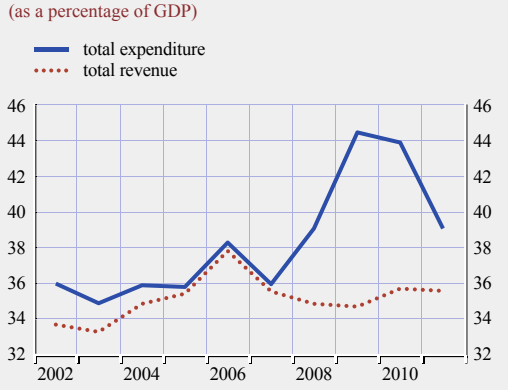
Sources: ESCB and European Commission (Eurostat).
Notes: Year-end data. Differences between totals and the sum of their components are due to rounding.
1) Comprises debt denominated in euro.
2) Original maturity.

Chart 3 General government gross debt



Sources: European Commission (Eurostat) and ECB.
Note: In Chart 3b a negative (positive) value indicates a contribution of the respective factor to a decrease (increase) in the debt ratio.

Chart 4 General government expenditure and revenue



Source: ESCB.

Table 7 General government deficit-debt adjustment

(as a percentage of GDP)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Change in general government debt[1]	0.8	2.5	2.4	0.1	0.6	1.0	11.5	12.4	7.0	2.4
General government surplus (+)/deficit (-)	-2.3	-1.6	-1.0	-0.4	-0.5	-0.4	-4.2	-9.8	-8.2	-3.5
Deficit-debt adjustment	-1.5	0.9	1.3	-0.3	0.1	0.6	7.3	2.6	-1.2	-1.1
Net acquisitions (+)/net sales (-) of financial assets	-0.8	1.0	1.5	-0.3	2.7	1.8	7.6	3.2	-1.3	-1.1
Currency and deposits	-0.8	0.3	1.0	-1.0	1.4	1.1	2.9	3.5	-0.9	-2.5
Loans and securities other than shares	-0.2	0.4	-0.5	0.0	-0.2	0.0	4.2	-0.1	-1.6	0.6
Shares and other equity	-0.4	-0.4	0.1	0.4	-0.5	0.1	0.2	0.1	0.7	0.0
Privatisations	-0.7	-0.1	-0.1	0.0	-0.7	0.0	0.0	0.0	0.0	0.0
Equity injections	0.3	0.1	0.2	0.4	0.2	0.1	0.2	0.1	0.7	0.0
Other	0.0	-0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other financial assets	0.6	0.6	0.8	0.4	2.0	0.6	0.3	-0.3	0.5	0.7
Valuation changes of general government debt	0.3	0.3	0.3	0.1	0.0	0.0	0.1	-0.5	-0.1	0.0
Foreign exchange holding gains (-)/losses (+)	0.3	0.4	0.3	0.1	0.0	0.0	0.0	0.0	0.4	0.1
Other valuation effects[2]	0.0	-0.1	0.0	0.0	0.0	0.0	0.1	-0.5	-0.5	-0.1
Other changes in general government debt[3]	-1.0	-0.5	-0.4	-0.1	-2.6	-1.2	-0.4	0.0	0.3	0.0

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

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2010	2020	2030	2040	2050	2060
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	25.2	29.1	36.4	43.7	55.1	67.9
Age-related government expenditure (in percentage points of GDP)[1]	18.5	16.0	15.2	15.0	15.6	15.5

Source: The 2012 Ageing Report: Economic and budgetary projections for the EU27 Member States (2010-2060), joint report prepared by the European Commission (DG ECFIN) and the Economic Policy Committee.
1) The Ageing Working Group (AWG) risk scenario, strictly age-related item.

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

Participation in the exchange rate mechanism (ERM II)	Yes
Participation since	2 May 2005
ERM II central rate in LVL/EUR	0.702804
ERM II fluctuation band	±15%
Devaluation of bilateral central rate on country's own initiative	No
Maximum upward deviation [1]	0.9
Maximum downward deviation [1]	-1.0

Source: ECB.
1) Maximum percentage deviations from ERM II central rate over the period 3 May 2010-30 April 2012, based on daily data at business frequency. An upward (downward) deviation implies that the currency is on the strong (weak) side of the band.

Table 9 (b) Key indicators of exchange rate pressure for the Latvian lats

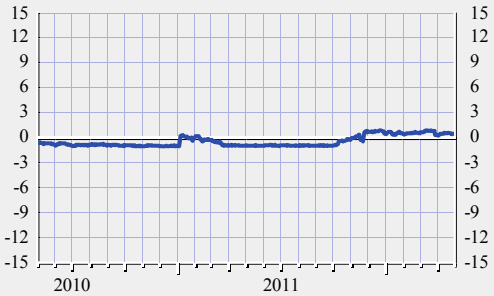
(average of three-month period ending in specified month)

	2010			2011				2012
	June	Sep.	Dec.	Mar.	June	Sep.	Dec.	Mar.
Exchange rate volatility [1]	1.0	0.7	0.5	2.1	0.5	0.4	1.9	1.1
Short-term interest rate differential [2]	1.5	0.5	0.0	-0.2	-0.6	-0.7	-0.1	0.4

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

Chart 5 Latvian lats: nominal exchange rate development against the euro

(a) Deviation from ERM II central rate
(daily data; percentage deviation; 3 May 2010-30 April 2012)



(b) Exchange rate over the last ten years
(monthly data; central rate = 100; May 2002-April 2012)

Source: ECB.
Note: A positive (negative) deviation from the central rate implies that the currency is on the strong (weak) side of the band. For the Latvian lats, the fluctuation band is ±15%.

Table 10 Latvian lats: real exchange rate developments

(monthly data; percentage deviation in March 2012 from the ten-year average calculated for the period April 2002-March 2012)

	Mar. 2012
Real bilateral exchange rate against the euro [1]	12.6
Memo items:	
Nominal effective exchange rate [2]	-3.4
Real effective exchange rate [1), 2)]	9.2

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

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Balance of payments										
Current account and capital account balance [1]	-6.5	-7.6	-11.8	-11.2	-21.3	-20.4	-11.7	11.1	4.9	0.9
Current account balance	-6.7	-8.2	-12.9	-12.6	-22.5	-22.4	-13.1	8.6	3.0	-1.2
Goods balance	-15.9	-17.9	-20.3	-19.1	-25.7	-24.0	-17.8	-7.1	-7.1	-9.9
Services balance	5.8	5.2	4.4	3.8	3.3	3.5	4.0	6.0	6.1	6.6
Income balance	0.6	-0.2	-2.0	-1.1	-2.7	-3.2	-1.6	6.3	0.3	-0.9
Current transfers balance	2.9	4.7	5.0	3.8	2.4	1.3	2.2	3.4	3.6	3.1
Capital account balance	0.2	0.7	1.1	1.3	1.2	2.0	1.5	2.4	1.9	2.1
Combined direct and portfolio investment balance [1]	0.5	0.3	5.5	2.8	7.7	4.5	4.2	1.3	0.6	2.9
Direct investment balance	2.7	2.3	3.8	3.6	7.5	6.8	3.0	0.6	1.5	5.2
Portfolio investment balance	-2.2	-2.0	1.6	-0.8	0.2	-2.4	1.1	0.7	-0.9	-2.3
Other investment balance	6.6	7.9	9.5	14.1	22.7	19.4	7.6	-9.8	-1.1	-8.2
Reserve assets	0.0	-0.6	-2.9	-3.3	-9.9	-3.4	2.0	-5.0	-4.0	4.5
Exports of goods and services	40.9	41.9	43.6	47.3	44.1	41.5	42.0	43.2	53.3	58.7
Imports of goods and services	51.1	54.6	59.5	62.6	66.4	62.0	55.8	44.3	54.3	62.1
Net international investment position [2]	-41.3	-43.8	-52.3	-59.6	-69.9	-74.7	-79.0	-82.7	-80.2	-72.5
Gross external debt [2]	73.4	79.8	93.5	100.0	114.5	128.1	130.0	156.5	165.4	145.9
Memo item:										
Export market shares [3]	0.05	0.05	0.05	0.06	0.06	0.07	0.07	0.07	0.07	0.07

Source: ECB.
1) Differences between totals and the sum of their components are due to rounding.
2) End-of-period outstanding amounts.
3) As a percentage of total world goods and services exports.

Table 12 Indicators of integration with the euro area

(as a percentage of the total, unless otherwise stated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
External trade with the euro area										
Exports of goods	36.2	36.8	35.8	36.0	36.2	35.2	34.7	34.8	33.3	31.3
Imports of goods	48.0	46.5	44.4	42.7	43.9	44.4	40.8	39.9	41.6	40.3
Investment position with the euro area										
Inward direct investment [1]	35.5	37.5	42.3	41.3	42.7	47.9	48.9	50.2	48.5	39.4
Outward direct investment [1]	32.9	31.8	19.8	18.6	16.0	24.3	14.4	22.6	21.5	20.4
Portfolio investment liabilities [1]	69.4	73.6	94.3	90.1	82.8	68.9	62.1	73.3	72.2	-
Portfolio investment assets [1]	-	-	-	-	6.9	11.8	21.1	26.8	51.7	-
Memo items:										
External trade with the EU										
Exports of goods	77.8	79.4	77.3	76.5	72.5	72.5	68.6	67.6	67.2	65.9
Imports of goods	77.5	75.6	75.7	75.3	76.5	77.4	75.5	75.4	76.1	77.4

Sources: ESCB, European Commission (Eurostat) and IMF.
1) End-of-period outstanding amounts.

4 LONG-TERM INTEREST RATE DEVELOPMENTS

Table 13 Long-term interest rates (LTIRs)

(percentages; average of observations through period)

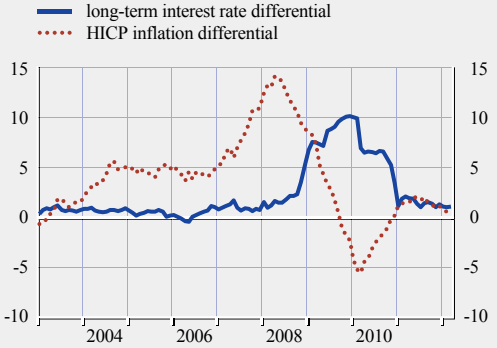
	2011 Dec.	2012 Jan.	2012 Feb.	2012 Mar.	Apr. 2011 to Mar. 2012
Long-term interest rate	5.9	5.7	5.5	5.2	5.8
Reference value [1]					*5.8*
Euro area [2]	*4.6*	*4.7*	*4.4*	*4.1*	*4.4*
Euro area (AAA) [3]	*2.7*	*2.6*	*2.5*	*2.5*	*2.9*

Sources: ECB and European Commission (Eurostat).
1) The basis of the calculation for the period April 2011-March 2012 is the unweighted arithmetic average of the interest rate levels in Sweden and Slovenia plus 2 percentage points.
2) The euro area average is included for information only.
3) The euro area AAA par yield curve for the ten-year residual maturity is included for information only.

Chart 6 Long-term interest rate (LTIR)

(a) Long-term interest rate (LTIR)
(monthly averages in percentages)

(b) LTIR and HICP inflation differentials vis-à-vis the euro area
(monthly averages in percentage points)



Sources: ECB and European Commission (Eurostat).

Table 14 Selected indicators of financial development and integration

(as a percentage of GDP, unless otherwise stated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Memo item: euro area 2011
Debt securities issued by corporations [1]	0.9	1.2	1.2	2.0	3.1	2.5	1.5	1.6	1.6	4.0	103.0
Stock market capitalisation [2]	7.4	9.5	11.4	16.6	12.9	10.0	5.1	7.1	5.2	4.1	41.5
MFI credit to non-government residents [3]	-	39.9	50.4	68.2	87.4	88.7	90.6	103.4	97.3	80.3	134.7
Claims of euro area MFIs on resident MFIs [4]	-	6.2	7.4	11.0	11.5	12.8	15.9	15.0	12.9	10.9	7.9
Private sector credit flow [5]	9.8	14.3	18.1	26.4	43.0	36.6	14.3	-6.1	-8.8	-	3.5
Private sector debt [6]	54.4	61.8	74.5	94.8	122.1	127.5	132.1	147.4	140.9	-	167.0

Sources: ESCB, European Commission (Eurostat), Federation of European Securities Exchanges, OMX and national stock exchanges.
1) Outstanding amount of debt securities issued by resident non-financial corporations, MFIs and other financial corporations.
2) Outstanding amounts of quoted shares issued by residents at the end of the period at market values.
3) MFI (excluding NCB) credit to domestic non-MFI residents other than the general government. Credit includes outstanding amounts of loans and debt securities.
4) Outstanding amount of deposits and debt securities issued by domestic MFIs (excluding the NCB) held by euro area MFIs as a percentage of total liabilities of domestic MFIs (excluding the NCB). Total liabilities exclude capital and reserves and remaining liabilities.
5) Transactions in securities other than shares issued and loans taken out by institutional sectors: non-financial corporations, households and non-profit institutions serving households.
6) Outstanding amounts of securities other than shares issued and loans taken out by institutional sectors: non-financial corporations, households and non-profit institutions serving households.

5.4 LITHUANIA

5.4.1 PRICE DEVELOPMENTS

Over the reference period from April 2011 to March 2012, the 12-month average rate of HICP inflation in Lithuania was 4.2%, i.e. well above the reference value of 3.1% for the criterion on price stability (see Table 1). On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to decline in the coming months.

Looking back over a longer period, consumer price inflation in Lithuania has been volatile, ranging between annual averages of -1.1% and 11.1% in the past ten years. In the early 2000s, inflation was subdued before turning negative in 2003. The subdued rates of inflation early in the decade initially reflected the effects of the Russian crisis, but later a number of more country-specific effects related, among other things, to the appreciation of the litas.[5] Inflation picked up subsequently and increased gradually in the mid-2000s, before accelerating significantly in 2007 and 2008 (see Chart 1). The 2004 increase in inflation was mainly due to a harmonisation of excise duties on fuel and tobacco following Lithuania's accession to the EU, the fading impact on import prices of the earlier appreciation of the litas and higher commodity prices. The further acceleration in inflation in 2007 and 2008 was due to a combination of factors, including higher energy and food prices, as well as an increasingly tight labour market and very strong demand growth, reflecting an overheating economy and rising macroeconomic imbalances. As these macroeconomic developments proved unsustainable, the Lithuanian economy experienced a severe contraction in 2009 before recovering again during the following years. After peaking at 11.1% in 2008, inflation fell sharply, although the annual rate of inflation did not turn negative. Inflation picked up again in 2011, reflecting higher food and energy prices.

Economic and monetary policy choices have played an important role in shaping inflation developments over the past decade. Monetary policy is aimed towards the achievement of price stability, which is the primary objective as enshrined in the central bank law. In 1994 Lietuvos bankas adopted a currency board arrangement, with the litas being first pegged to the US dollar and then re-pegged to the euro in 2002. In June 2004 Lithuania joined ERM II, with its existing currency board arrangement remaining in place as a unilateral commitment. The subdued inflation rates up to 2003 were also supported by fiscal policy reforms designed to enhance product market competition and labour market reforms. During the subsequent boom years, however, the country's monetary policy was constrained by the currency board, and the overall policy stance (including fiscal policy) was not tight enough to counter the build-up of macroeconomic imbalances and growing signs of overheating. The ensuing correction phase was characterised by a downturn during which significant fiscal consolidation measures were implemented, which contributed to the decline in inflation.

Inflation developments over the past ten years should be viewed against the background of a relatively volatile macroeconomic environment. Very robust real GDP growth until 2007 was followed by a pronounced turnaround in the economic cycle, owing to a build-up and subsequent correction of significant macroeconomic imbalances and vulnerabilities. The very strong economic expansion during the boom years was fuelled by rapid wage increases and a surge in capital inflows, which propelled an extremely strong rate of credit growth. The domestic demand and asset price boom came to an end in 2008, reinforced by weakening external demand and the impact of the global financial and economic crisis. Following a sharp decline in real GDP in 2009, economic

5 For details, see the ECB's Convergence Report 2004.

activity started to recover again in 2010 before picking up strongly in 2011 (see Table 2). Although some macroeconomic imbalances were adjusted, the unemployment rate remains high at around 15%. After declining by around 10% in 2009, compensation per employee stabilised and picked up again in the course of 2011 while remaining below its pre-crisis peak. Developments in unit labour costs broadly reflected those in wages, although most of their decline was concentrated in 2010 on account of a recovery in labour productivity. Import prices reinforced the downward impact of wage costs on inflation during 2009, before picking up sharply in subsequent years, reflecting developments in global commodity prices. The acceleration and subsequent decline in inflation over the past decade is also apparent from other relevant price indices, such as the HICP excluding unprocessed food and energy (see Table 2). House prices remained broadly stable in 2011, following a cumulative decline of around 47% since their peak reached in the course of 2007.

Looking at recent developments, the annual rate of HICP inflation eased gradually to 3.4% in January 2012 but picked up to 3.7% in March, after reaching a peak of 5.0% in May 2011 as a result of increases in global food and energy prices (see Table 3a). Whereas the impact of food prices on inflation is gradually moderating, increases in fuel and administered energy prices have had an upward impact on inflation, the latter as higher energy prices are passed on to households via the regulator (the share of administered prices in Lithuania's HICP basket amounts to 16.7%). Skill mismatches have emerged in some sectors, putting some upward pressure on wages. Demand-side pressures have been limited, however, and weaker external demand slowed output growth towards the end of 2011.

The latest available forecasts from major international institutions project inflation to decline in 2012-13, and range between 2.7% and 3.1% in 2012 and between 2.5% and 2.9% in 2013 (see Table 3b). Inflation is projected to remain broadly stable during the coming years, although future developments in global commodity prices remain a key risk. Domestic spending pressures on prices are limited, although recent increases in wages could lead to some upward pressure, in particular if labour productivity growth turns out to be weaker than currently expected, thereby putting upward pressure on unit labour costs.

Looking further ahead, maintaining low inflation rates at all times in Lithuania will be challenging in the medium term, given monetary policy's limited room for manoeuvre under the existing currency board. The catching-up process is likely to have a bearing on inflation over the medium term, given that GDP per capita and price levels are still lower in Lithuania than in the euro area (see Table 2). However, it is difficult to assess the exact size of the inflation effect resulting from this catching-up process. Once credit growth resumes, with a fixed exchange rate regime, the underlying trend of real exchange rate appreciation is likely to manifest itself in terms of higher inflation. In the context of the process of economic convergence, it cannot be completely ruled out that significant demand pressure may emerge again, although the ongoing deleveraging process and the implementation of Lietuvos bankas' "responsible lending guidelines" reduce this risk for the near future. Given the currency board arrangement and the limitations of alternative counter-cyclical policy instruments, it may be difficult to prevent macroeconomic imbalances, including high rates of inflation, from building up again.

Achieving an environment conducive to sustainable convergence in Lithuania requires the conduct of economic policies geared towards ensuring overall macroeconomic stability, including sustainable price stability. Given monetary policy's limited room for manoeuvre under the currency board arrangement, it is imperative that other policy areas provide the economy with the wherewithal to cope with country-specific shocks and to avoid the reoccurrence of macroeconomic imbalances.

More specifically, it is necessary for Lithuania to continue along the comprehensive fiscal consolidation path in line with the requirements of the EDP and to strengthen its fiscal framework to avoid pro-cyclical policies and expenditure slippages in future. As regards labour markets, it is particularly important to reduce the high rate of structural unemployment and counter continued sizeable labour outflows. Moreover, further wage restraint is needed to lock in the competitiveness gains achieved in recent years. Furthermore, it is essential to implement further productivity-enhancing structural reform measures, focusing, for example, on supporting the reorientation of resources towards the tradable sector. Such reforms may also help to attract more foreign direct investment, which could strengthen the competitive position of the tradable sector. Finally, confidence in the soundness of the financial sector needs to be strengthened further. Financial sector policies should also be geared towards preventing excessive credit growth in the future. Given the potential financial stability risks associated with the high shares of foreign currency-denominated loans in Lithuania, the European Systemic Risk Board's recommendations on lending in foreign currencies, released in 2011, need to be adequately taken into account. Close cooperation between home and host country supervisory authorities is important to ensure the effective implementation of the measures. Progress in these areas will help to achieve an environment conducive to sustainable price stability and promote competitiveness and employment growth.

5.4.2 FISCAL DEVELOPMENTS

Lithuania is, at present, subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2011 the general government budget balance showed a deficit of 5.5% of GDP, i.e. well above the 3% reference value. The general government debt-to-GDP ratio was 38.5%, i.e. well below the 60% reference value (see Table 4). Compared with the previous year, the deficit ratio decreased by 1.7 percentage points and the government debt ratio increased by 0.5 percentage point. In 2012 the deficit ratio is forecast by the European Commission to decline to 3.2%, while the government debt ratio is projected to increase to 40.4%. With regard to other fiscal factors, the deficit ratio exceeded the ratio of public investment to GDP in 2011, but it is not expected to exceed it in 2012.

Looking at developments in Lithuania's budgetary position over the period from 2002 to 2011, after declining to 0.4% in 2006, the deficit-to-GDP ratio then started to rise and recorded a sharp increase in 2009, when it reached 9.4%. This upward trend has reversed since 2009 (see Table 5 and Chart 2a). Against the background of the rise in the budget deficit above the reference value in 2008, the ECOFIN Council decided on 7 July 2009 that an excessive deficit situation existed in Lithuania and set the deadline for correcting it at 2011. This deadline was extended to 2012 following the ECOFIN Council's recommendation of 12 February 2010. As shown in greater detail in Chart 2b, European Commission estimates indicate that cyclical factors had an overall positive impact on the budget balance before 2008 and after 2009. Non-cyclical factors tended to contribute to an increase in the budget deficit, particularly between 2007 and 2009, and to a decrease thereafter. Since 2010 the Lithuanian government has implemented more significant consolidation measures in order to reduce the existing fiscal imbalance. These measures mainly reflect expenditure cuts, among other factors, to reduce social benefit payments and to contain public spending in general. Taking into account temporary and one-off factors between 2007 and 2010, the underlying changes in the budget deficit seem to reflect a deterioration in Lithuania's structural budgetary position until 2009 and a consolidation thereafter.

Turning to developments in general government gross debt, between 2002 and 2011 the debt-to-GDP ratio increased cumulatively by 16.3 percentage points, decreasing gradually until 2008 and

recording sharp increases in 2009-10 before rising slightly in 2011 (see Chart 3a and Table 6). As shown in greater detail in Chart 3b, primary deficits were the main driver of the increase in the debt ratio between 2009 and 2011. The impact of deficit-debt adjustments was volatile, with both debt-increasing and debt-decreasing effects in individual years (see Table 7). The growth/interest rate differential had a dampening effect on the debt ratio from 2003 to 2008 and in 2011, but a debt-increasing effect in 2009 and, to a lesser extent, in 2010. In 2011 the slight increase of the general government debt-to-GDP ratio reflected the sustained high primary deficit ratio, which more than offset the impact stemming from the growth/interest rate differential and the deficit-debt adjustment.

As regards Lithuania's general government debt structure, the share of government debt with a short-term maturity was rather volatile, but, with the exception of 2005, it remained low for the entire period and stood at 6.0% in 2011 (see Table 6). Taking into account the level of the debt ratio, fiscal balances are relatively insensitive to changes in interest rates. At the same time, the proportion of foreign currency-denominated government debt is high (86.7% in 2011); however, it is largely denominated in euro, the anchor currency of Lithuania's currency board arrangement. This leaves fiscal balances relatively insensitive to changes in exchange rates other than the EUR/LTL exchange rate. During the financial and economic crisis and until 2010, the share of debt with a short-term maturity and that of debt denominated in euro and other foreign currency increased, despite some fluctuations, pointing to a rise in debt-related vulnerabilities. At the same time, however, the Lithuanian government did not incur contingent liabilities resulting from government interventions to support financial institutions and financial markets during the crisis (see Section 5.9).

Moving on to examine trends in other fiscal indicators, Chart 4 and Table 5 show that the general government total expenditure-to-GDP ratio increased from 34.6% in 2002 to 37.5% in 2011. The expenditure ratio peaked at 43.8% of GDP in 2009, with the increase over the previous year resulting from the denominator effect, i.e. the significant GDP contraction in 2009, while expenditure declined in nominal terms, correcting part of the large increases seen in the preceding period. During the entire period under consideration, "social benefits other than in kind" recorded the largest increase in terms of ratio to GDP. At the same time, total government revenue decreased by 0.7 percentage point, standing at 32.0% of GDP in 2011. Overall, the development in total revenue reflects increases in social security contributions as well as declines in direct and indirect tax receipts.

Looking ahead, Lithuania's medium-term fiscal policy strategy, as presented in the 2012-15 update of the convergence programme, envisages a decline in the deficit ratio to the 3% reference value in 2012. According to this fiscal strategy, total revenues as a share of GDP are projected to decrease until 2015, despite the increase in tax revenues, as this rise is more than offset by a decline in other revenues. The total expenditure ratio is expected to decline significantly as a result of the expenditure-based consolidation strategy, reflecting, inter alia, a reduction in social payments and lower gross fixed capital formation. Moreover, the government gross debt ratio is expected to decrease to 34.9% of GDP in 2014. At the same time, the structural deficit will be above the medium-term objective (specified in line with the Stability and Growth Pact), which has been quantified in the convergence programme as a structural surplus of 0.5% of GDP. Moreover, based on information submitted in the 2012 convergence programme update, primary expenditure excluding, inter alia, EU fund transfers (relevant expenditure), as a share of GDP, is projected to decline by 3.8 percentage points between 2012 and 2015. The annual growth rate of relevant expenditure is projected to be below the growth rate of potential GDP in 2012 and 2013, while remaining above it thereafter. According

to the European Commission's projections, the structural deficit will remain below the medium-term objective by 2013.

In this respect, on 2 March 2012 Lithuania signed the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, committing, inter alia, to apply (and include in its national legislation) the fiscal rules specified under Title III, "Fiscal Compact", as referred to in Box 2 of Chapter 2.

As regards fiscal governance, Lithuania's fiscal framework benefits from the existence of annual numerical fiscal rules. However, the medium-term framework is less developed, which may help explain the frequent expenditure slippages registered in the past. As a consequence, the medium-term budgetary framework should be enhanced by introducing more stringent forward-looking elements and mechanisms to avoid pro-cyclicality. Particular emphasis should be put on reinforcing expenditure discipline through enforceable ceilings in the medium-term budgetary framework, improving the monitoring of the budget execution throughout the year and strengthening transparency by, among other things, the timely reporting of central government and social security expenditure and ensuring comparability of budgetary indicators on a cash and accrual basis. It should be noted that there are outstanding statistical issues related to the classification of public hospitals in the general government sector owing to a lack of reliable source data, which implies that there could be upside risks to the deficit (see also Section 5.9). Full compliance with the provisions for an enhanced national governance framework under Council Directive 2011/85/EU and with the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, as referred to in Box 2 of Chapter 2, should be ensured.

Turning to factors with an impact on Lithuania's public finances over the long term, a marked ageing of the population is expected, as highlighted in Table 8. According to the 2012 projections by the European Commission and the EU's Economic Policy Committee, starting from a level of 19.2% of GDP in 2010, Lithuania is likely to experience a significant increase in strictly age-related public expenditure amounting to 7.4 percentage points of GDP in the years to 2060.[6]

Turning to fiscal challenges, Lithuania must bring its budget deficit below the 3% reference value by 2012, in line with the EDP commitments, and maintain sound fiscal policies thereafter. This requires the continued implementation of the comprehensive expenditure-based consolidation strategy. In this context, the bankruptcy of the Snoras bank at the end of 2011, potentially lower revenues from state-owned enterprises and low tax compliance constitute major risks to the fiscal position. Lithuania's fiscal policy strategy should be embedded in a strengthened fiscal framework, with emphasis on improving the medium-term budgetary framework, and should enforce expenditure ceilings, thus helping to avoid pro-cyclical fiscal policies in the future. At the same time, every effort should be made to fully comply with the obligations under the enhanced Stability and Growth Pact, and to effectively implement the provisions of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union.

5.4.3 EXCHANGE RATE DEVELOPMENTS

The Lithuanian litas joined ERM II on 28 June 2004, and was therefore participating in ERM II for the entire two-year reference period from 1 May 2010 to 30 April 2012 (see Table 9a). Lithuania joined ERM II with its existing currency board arrangement in place, as a unilateral commitment,

6 European Commission and Economic Policy Committee, "The 2012 Ageing Report: Economic and budgetary projections for the EU-27 Member States (2010-2060)".

thus placing no additional obligations on the ECB. A standard fluctuation band of ±15% was adopted around the central rate of 3.45280 litas per euro. The agreement on participation in ERM II was based on a number of policy commitments by the Lithuanian authorities, relating, among other things, to pursuing sound fiscal policies, containing credit growth to ensure the sustainability of the current account position and implementing further structural reforms. Over the reference period, the litas continued to be stable and did not exhibit any deviation from its central rate within ERM II (see Chart 5 and Table 9a). Furthermore, Lithuania has not devalued its currency's central rate against the euro on its own initiative. As implied by the currency board regime, Lietuvos bankas continued to regularly intervene in the foreign exchange market. Overall, its sales and purchases of foreign currency over the two-year reference period resulted in a net sale.

Short-term interest rate differentials against the three-month EURIBOR gradually decreased from modest levels, averaging 0.7 percentage point in 2010, to very low levels throughout 2011, standing at 0.4 percentage point in the three-month period ending in March 2012. This largely reflected improved financial market sentiment amid a more favourable economic outlook and upgrades to Lithuania's sovereign credit rating (see Table 9b).

In a longer-term context, in March 2012 both the Lithuanian litas' real effective exchange rate and its real bilateral exchange rate against the euro stood somewhat above, although close to, the corresponding ten-year historical averages (see Table 10). However, these measures should be interpreted with caution, as in this period Lithuania was subject to a process of economic convergence, which complicates any historical assessment of real exchange rate developments.

As regards other external developments, the deficit in the combined current and capital account of the balance of payments widened progressively from 4.7% of GDP in 2002 to the very high levels in excess of 10% of GDP in 2007 and 2008 (see Table 11). After a strong fall in domestic demand, which led to lower imports, the deficit decreased substantially and the combined current and capital account registered a large surplus of 7.8% of GDP in 2009, which subsequently narrowed to 4.2% in 2010 and 0.9% in 2011. This sudden adjustment in 2009 was predominantly driven by a sharp reduction in the goods deficit, an improvement in the income balance, which temporarily registered a small surplus, as well as an increase in the services surplus. The subsequent narrowing of the combined current and capital account over the past two years reflected the recovery of domestic demand. The shifts recorded in Lithuania's balance of payments over the past two years have also been associated with recovering capital inflows. After a sharp contraction of capital inflows in 2009 led by very large net outflows of other investment, i.e. mostly loans and deposits, net other investment has gradually recovered over the past two years and was close to balance in 2011. Against this background, gross external debt increased substantially from 39.2% of GDP in 2002 to 87.0% in 2009, but stabilised at 87.4% in 2010 and declined thereafter to 80.8% in 2011. At the same time Lithuania's net international investment position deteriorated from -32.6% of GDP in 2002 to -58.6% in 2009, but gradually improved thereafter to -55.9% in 2010 and -52.2% in 2011. Lithuania is a small open economy; the ratio of foreign trade in goods and services to GDP increased, from 52.4% of GDP in 2002 to 77.9% in 2011 for exports and from 57.9% of GDP in 2002 to 79.2% in 2011 for imports. Over the same period, Lithuania's share in world exports increased from 0.09% to 0.15%.

Concerning measures of economic integration with the euro area, in 2011 exports of goods to the euro area constituted 32.9% of total goods exports, whereas the corresponding figure for imports was lower, at 31.3%. The share of euro area countries in Lithuania's stock of inward direct investment stood at 38.9% in 2011 and that in its stock of portfolio investment liabilities at 52.9% in 2010.

The share of Lithuania's stock of assets invested in the euro area amounted to 40.9% in the case of direct investment in 2011 and 75.7% for portfolio investment in 2010 (see Table 12).

With regard to the fulfilment of the commitments made by the Lithuanian authorities upon ERM II entry in June 2004, the following observations can be made. Fiscal policies since ERM II entry have not been sufficiently tight to contain the emergence of significant macroeconomic imbalances up to 2008. As a consequence, since 2009, against the background of a notable deterioration in the general government budgetary position and a sharp output adjustment, comprehensive fiscal consolidation measures have been implemented and budgetary consolidation continued to be pursued over the reference period. During the boom years, i.e. the period up until 2008, reserve and prudential requirements were tightened to help to contain rapid credit growth, although these failed to effectively contain excessive borrowing. Following the contraction in economic activity in 2009, credit growth started to decline and became negative, with the ratio of non-performing loans picking up strongly before stabilising in 2010 and improving in 2011. Lietuvos bankas introduced some further measures to reduce the risk of renewed lending booms, including the "responsible lending guidelines", which came into force in November 2011. As regards structural reforms, Lithuania implemented a number of additional measures over the reference period to enhance the flexibility of the labour market and improve the quality of the education system. However, further measures to increase productivity and support the supply of skilled labour will be needed to ensure that the gains in competitiveness achieved over the past few years are sustained.

5.4.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from April 2011 to March 2012, long-term interest rates in Lithuania were 5.2% on average and thus below the 5.8% reference value for the interest rate convergence criterion (see Table 13).

Long-term interest rates followed a downward trend from 2003 until 2006 (see Chart 6a).[7] At the beginning of 2006 this trend reversed and long-term interest rates increased. In 2008 the global financial and economic crisis, rising domestic imbalances, downgrading of credit ratings and declining liquidity affected markets negatively, and long-term government bond yields picked up rapidly. Subsequently, long-term interest rates reached a plateau of 14.5% in February 2009 and stayed at that level until December 2009, as no trading took place. Since then the economy has bounced back, and there has been some trading in the secondary markets as well as renewed activity in the primary markets. The yields declined, standing just above 5% in 2010 before increasing to 5.8% at the end of 2011. The increases in late 2011 can be partly attributed to risks to the Lithuanian economy that resulted from reliance on external financing becoming more pronounced in the light of the financial turmoil. The yields had fallen back to 5.3% at the end of the reference period. The assessment of long-term interest rates requires caution as the liquidity of the secondary market for domestic bonds during the reference period was low, and as the signalling quality of the yields was affected because the bonds' maturities were shorter than ten years.

The differential between Lithuania's long-term interest rates and the euro area average was relatively low until 2008 (see Chart 6b). The main factors underlying the low stable level of the differential were the positive developments of the Lithuanian economy and Lithuania's smooth entry into the ERM II mechanism, with the existing currency board arrangement remaining in place.

7 The developments should be interpreted with caution as, until October 2007, long-term interest rate statistics in Lithuania were compiled using primary market data.

However, a turning point came towards the end of 2008, when the differential started to rise sharply, reaching 10.0 percentage points in 2009, following the build-up of macroeconomic imbalances, declining appetite for risk among investors, the downgrading of the credit ratings and decreasing liquidity. From 2010 onwards the interest rate differential with the euro area average narrowed down to 1.2 percentage points at the end of the reference period (and 2.8 percentage points with respect to the AAA euro area yield) amid a relatively strong recovery in output and generally stabilised credit ratings.

At the end of 2011 the Lithuanian capital market was smaller and much less developed than that of the euro area. Stock market capitalisation was 10.0% of GDP in 2011 and thus similar to other countries in the region (see Table 14). The corporate sector's market-based indebtedness (1.5% of GDP in 2011) is very low in comparison with the euro area. Banks play a relatively large role in the economy of Lithuania, and foreign-owned banks play a major role in the banking market. The value of outstanding bank credit to the private sector as a percentage of GDP increased significantly until 2009, before declining to 52.5% in 2011. This is less than half of the euro area level. The majority of loans to the private sector are in foreign currencies. The international claims of euro area banks in the country accounted for 12.9% of total liabilities in 2011.

LIST OF TABLES AND CHARTS

LITHUANIA

1 PRICE DEVELOPMENTS

Table 1 HICP inflation

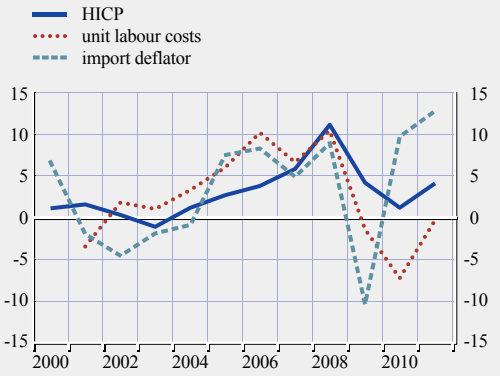
(annual percentage changes)

	2011	2012			Apr. 2011
	Dec.	Jan.	Feb.	Mar.	to Mar. 2012
HICP inflation	3.5	3.4	3.7	3.7	4.2
Reference value [1]					*3.1*
Euro area [2]	*2.7*	*2.7*	*2.7*	*2.7*	*2.8*

Source: European Commission (Eurostat).
1) The basis of the calculation for the period April 2011-March 2012 is the unweighted arithmetic average of the annual percentage changes in the HICP for Sweden, Ireland and Slovenia plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(average annual percentage changes)



Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Measures of inflation										
HICP	0.3	-1.1	1.2	2.7	3.8	5.8	11.1	4.2	1.2	4.1
HICP excluding unprocessed food and energy	0.6	0.7	0.7	1.3	2.4	5.2	9.3	3.7	0.0	2.4
HICP at constant tax rates [1]	-	-	0.5	2.5	3.8	5.5	10.1	0.2	-0.3	4.2
CPI	0.3	-1.1	1.2	2.7	3.7	5.7	10.9	4.5	1.3	4.1
Private consumption deflator	-0.4	-1.6	-0.2	2.3	4.7	5.9	10.9	4.5	1.3	4.0
GDP deflator	0.2	-0.9	2.5	6.6	6.6	8.6	9.8	-3.7	2.0	5.3
Producer prices [2]	-0.6	-0.8	2.5	5.9	6.9	9.4	15.9	-6.6	4.0	10.4
Related indicators										
Real GDP growth	6.8	10.3	7.4	7.8	7.8	9.8	2.9	-14.8	1.4	5.9
GDP per capita in PPS [3] (euro area = 100)	39.9	44.7	46.4	48.7	51.0	54.5	56.5	50.2	53.1	-
Comparative price levels (euro area = 100)	54.0	50.8	51.9	53.8	56.3	59.2	64.0	63.8	62.5	-
Output gap [4]	-1.1	3.4	4.3	5.4	6.4	9.4	7.5	-9.9	-8.4	-3.3
Unemployment rate (%) [5]	13.5	12.5	11.4	8.3	5.6	4.3	5.8	13.7	17.8	15.4
Unit labour costs, whole economy	1.8	1.0	3.3	6.0	10.2	6.6	10.4	-1.4	-7.3	-0.3
Compensation per employee, whole economy	5.0	8.9	10.9	11.5	16.7	13.9	14.3	-9.9	-0.9	3.4
Labour productivity, whole economy	3.1	7.9	7.4	5.2	5.9	6.8	3.6	-8.6	6.9	3.8
Imports of goods and services deflator	-4.6	-1.9	-0.9	7.5	8.3	4.9	8.9	-10.4	9.7	12.8
Nominal effective exchange rate [6]	4.4	4.7	1.3	-1.2	-0.4	0.4	0.1	3.0	-2.8	0.0
Money supply (M3)	-	-	-	30.4	22.8	22.3	-0.3	0.4	8.4	14.7
Lending from banks	-	-	-	63.6	41.4	43.5	18.1	-8.5	-6.5	-1.1
Stock prices (OMX Vilnius Index)	12.2	105.8	65.9	55.1	9.8	4.4	-65.1	46.0	56.5	-27.1
Residential property prices	9.5	18.1	14.8	52.2	41.1	35.7	11.4	-31.2	-12.5	1.3

Sources: European Commission (Eurostat), national data (CPI, money supply, lending from banks and residential property prices) and European Commission (output gap).
1) 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 on the price paid by the consumer.
2) Total industry excluding construction.
3) PPS stands for purchasing power standards.
4) Percentage difference of potential GDP: a positive (negative) sign indicates that actual GDP is above (below) potential GDP.
5) The definition conforms to ILO guidelines.
6) A positive (negative) sign indicates an appreciation (depreciation).

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2011			2012		
	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.
HICP						
Annual percentage change	4.2	4.4	3.5	3.4	3.7	3.7
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	2.1	2.5	2.0	1.8	1.4	2.5
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	4.9	4.2	3.7	3.1	2.6	2.4

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2012	2013
HICP, European Commission (spring 2012)	3.1	2.9
CPI, OECD (December 2011) [1]	-	-
CPI, IMF (April 2012)	3.1	2.5
CPI, Consensus Economics (April 2012)	2.7	2.7

Sources: European Commission, OECD, IMF and Consensus Economics.
1) Lithuania is not a member of the OECD.

2 FISCAL DEVELOPMENTS

Table 4 General government fiscal position

(as a percentage of GDP)

	2010	2011	2012 [1]
General government surplus (+)/deficit (-)	-7.2	-5.5	-3.2
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure [2]	-2.6	-1.3	1.1
General government gross debt	38.0	38.5	40.4
Reference value	*60.0*	*60.0*	*60.0*

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

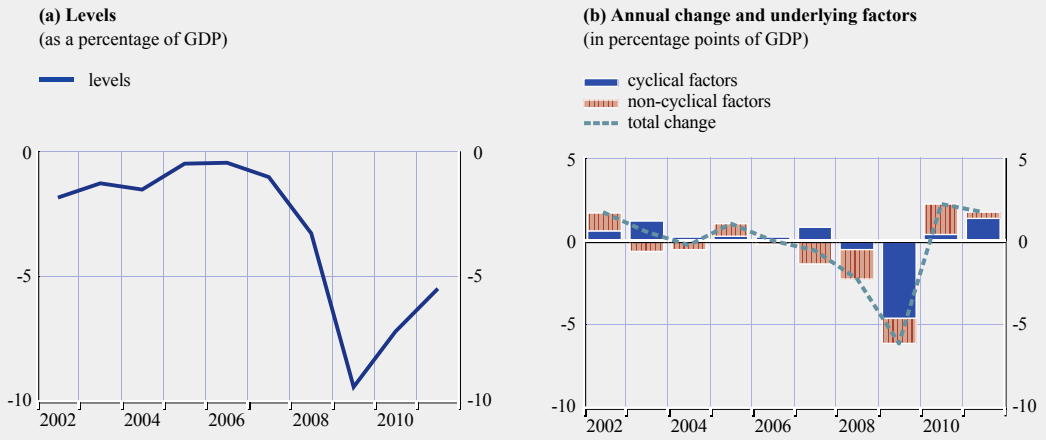
Table 5 General government budgetary position

(as a percentage of GDP)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total revenue	32.7	31.8	31.7	32.7	33.0	33.6	33.9	34.3	33.7	32.0
Current revenue	32.2	31.4	31.2	31.9	32.0	32.2	32.8	32.7	31.0	29.8
Direct taxes	7.4	7.9	8.7	9.0	9.5	9.2	9.3	6.0	4.7	4.4
Indirect taxes	12.4	11.7	11.0	11.0	11.0	11.5	11.4	11.4	11.8	11.6
Social security contributions	8.6	8.5	8.6	8.4	8.7	8.8	9.3	12.1	10.7	10.2
Other current revenue	3.8	3.3	2.9	3.6	2.7	2.7	2.8	3.2	3.8	3.6
Capital revenue	0.5	0.4	0.5	0.8	1.0	1.5	1.1	1.7	2.7	2.1
Total expenditure	34.6	33.0	33.2	33.2	33.5	34.6	37.2	43.8	40.9	37.5
Current expenditure	30.6	29.6	29.2	29.4	28.9	28.5	31.7	39.3	35.8	32.7
Compensation of employees	11.3	10.8	10.8	10.3	10.4	9.9	10.7	12.8	11.1	10.1
Social benefits other than in kind	9.2	9.1	9.0	8.5	8.4	9.1	10.9	15.2	13.0	11.2
Interest payable	1.3	1.2	0.9	0.8	0.7	0.7	0.7	1.3	1.8	1.8
of which: impact of swaps and FRAs [1]	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other current expenditure	8.7	8.5	8.5	9.8	9.4	8.9	9.4	10.0	10.0	9.7
Capital expenditure	4.0	3.5	4.0	3.8	4.5	6.1	5.4	4.5	5.1	4.7
Surplus (+)/deficit (-)	-1.9	-1.3	-1.5	-0.5	-0.4	-1.0	-3.3	-9.4	-7.2	-5.5
Primary balance	-0.6	0.0	-0.6	0.3	0.3	-0.3	-2.6	-8.2	-5.4	-3.7
Surplus/deficit, net of government investment expenditure	1.0	1.7	1.9	3.0	3.7	4.2	1.6	-5.6	-2.6	-1.3

Sources: ESCB and European Commission (Eurostat).
Notes: Differences between totals and the sum of their components are due to rounding. Interest payable as reported under the excessive deficit procedure. The item "impact of swaps and FRAs" is equal to the difference between the interest (or deficit/surplus) as defined in the excessive deficit procedure and in the ESA 95. See Regulation (EC) No 2558/2001 of the European Parliament and of the Council of 3 December 2001 amending Council Regulation (EC) No 2223/96 as regards the reclassification of settlements under swap arrangements and under forward rate agreements (0J L 344, 28.12.2001, p. 1).
1) FRAs stands for forward rate agreements.

Chart 2 General government surplus (+)/deficit (-)



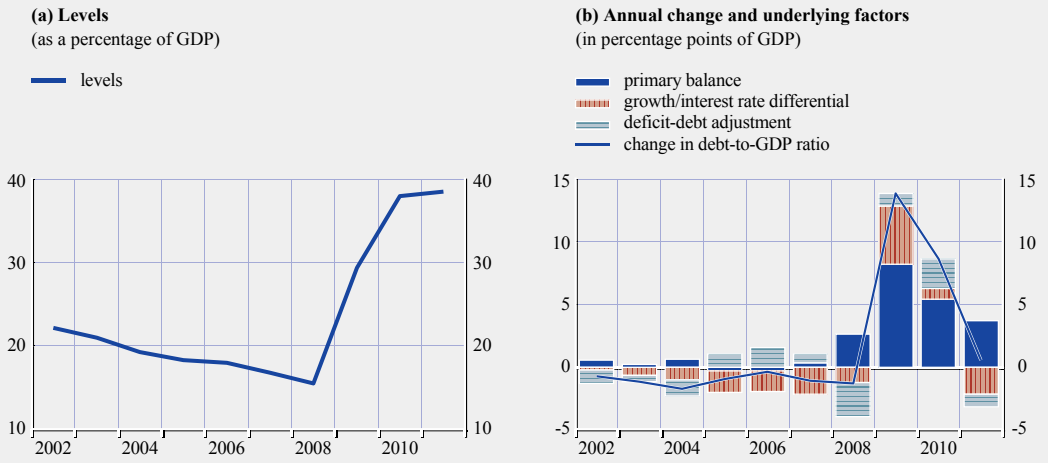
Sources: European Commission (Eurostat) and ECB calculations.
Note: In Chart 2b a negative (positive) value indicates a contribution to an increase (reduction) in a deficit.

Table 6 General government gross debt – structural features

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total debt (as a percentage of GDP)	22.2	21.0	19.3	18.3	17.9	16.8	15.5	29.4	38.0	38.5
Composition by currency (% of total)										
In domestic currency	32.7	33.0	29.1	29.3	19.4	16.8	17.6	8.5	12.1	13.3
In foreign currencies	67.3	67.0	70.9	70.7	80.6	83.2	82.4	91.5	87.9	86.7
Euro[1)]	53.7	56.4	65.4	68.7	79.4	83.2	82.4	91.5	87.9	86.7
Other foreign currencies	13.5	10.6	5.5	1.9	1.2	0.0	0.0	0.1	0.0	0.0
Domestic ownership (% of total)	39.3	39.6	39.2	39.7	31.6	32.8	35.8	29.9	26.8	26.2
Average residual maturity (in years)	4.8	5.2	5.5	5.8	6.4	5.9	5.0	6.2	6.7	6.0
Composition by maturity[2)] (% of total)										
Short-term (up to and including one year)	5.3	6.8	5.5	10.6	2.3	2.5	7.9	4.4	6.3	6.0
Medium and long-term (over one year)	94.7	93.2	94.5	89.4	97.7	97.5	92.1	95.6	93.7	94.0

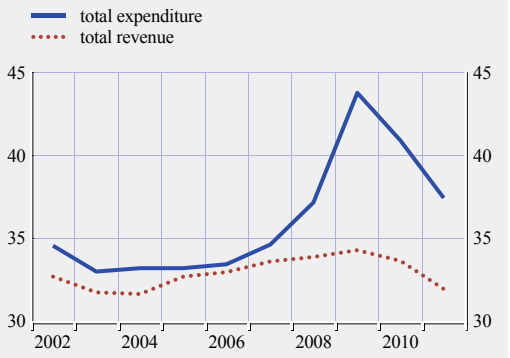
Sources: ESCB and European Commission (Eurostat).
Notes: Year-end data. Differences between totals and the sum of their components are due to rounding.
1) Comprises debt denominated in euro.
2) Original maturity.

Chart 3 General government gross debt



Sources: European Commission (Eurostat) and ECB.
Note: In Chart 3b a negative (positive) value indicates a contribution of the respective factor to a decrease (increase) in the debt ratio.

Chart 4 General government expenditure and revenue



Source: ESCB.

Table 7 General government deficit-debt adjustment

(as a percentage of GDP)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Change in general government debt [1]	0.8	0.7	0.2	1.5	2.0	1.8	0.6	10.5	9.6	4.4
General government surplus (+)/deficit (-)	-1.9	-1.3	-1.5	-0.5	-0.4	-1.0	-3.3	-9.4	-7.2	-5.5
Deficit-debt adjustment	-1.1	-0.5	-1.3	1.0	1.6	0.8	-2.7	1.0	2.4	-1.1
Net acquisitions (+)/net sales (-) of financial assets	0.4	-0.8	-1.1	0.6	0.5	0.9	-2.0	2.0	2.3	-0.8
Currency and deposits	1.2	0.9	-0.5	0.5	3.0	-0.1	-2.3	2.8	1.4	-3.4
Loans and securities other than shares	-0.3	-0.1	-0.3	-0.2	-0.2	0.0	-0.1	-0.1	-0.2	2.2
Shares and other equity	-0.6	-1.6	-0.6	-0.3	-2.7	-0.1	0.0	-0.8	-0.2	0.0
Privatisations	-0.6	-1.6	-0.6	-0.3	-2.7	-0.1	0.0	-0.8	-0.2	0.0
Equity injections	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Other financial assets	0.1	0.1	0.4	0.6	0.4	1.1	0.3	0.2	1.4	0.4
Valuation changes of general government debt	-1.0	-0.5	0.0	0.0	-0.4	0.0	0.0	0.0	0.1	-0.1
Foreign exchange holding gains (-)/losses (+)	-1.0	-0.4	-0.1	0.1	0.0	0.0	0.0	0.0	0.1	0.0
Other valuation effects [2]	0.0	-0.1	0.0	-0.1	-0.4	0.0	0.0	0.0	0.0	-0.1
Other changes in general government debt [3]	-0.5	0.8	-0.2	0.5	1.4	-0.1	-0.7	-0.9	0.1	-0.2

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

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2010	2020	2030	2040	2050	2060
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	23.4	26.9	35.6	42.0	47.8	56.7
Age-related government expenditure (in percentage points of GDP) [1]	19.2	18.3	19.9	21.6	23.9	26.6

Source: The 2012 Ageing Report: Economic and budgetary projections for the EU27 Member States (2010-2060), joint report prepared by the European Commission (DG ECFIN) and the Economic Policy Committee.
1) The Ageing Working Group (AWG) risk scenario, strictly age-related item.

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

Participation in the exchange rate mechanism (ERM II)	Yes
Participation since	28 June 2004
ERM II central rate in LTL/EUR	3.45280
ERM II fluctuation band	±15%
Devaluation of bilateral central rate on country's own initiative	No
Maximum upward deviation [1]	0.0
Maximum downward deviation [1]	0.0

Source: ECB.
1) Maximum percentage deviations from ERM II central rate over the period 3 May 2010-30 April 2012, based on daily data at business frequency. An upward (downward) deviation implies that the currency is on the strong (weak) side of the band.

Table 9 (b) Key indicators of exchange rate pressure for the Lithuanian litas

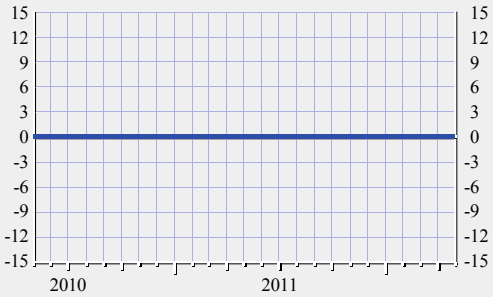
(average of three-month period ending in specified month)

	2010			2011				2012
	June	Sep.	Dec.	Mar.	June	Sep.	Dec.	Mar.
Exchange rate volatility [1]	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Short-term interest rate differential [2]	0.9	0.8	0.6	0.3	0.2	0.3	0.3	0.4

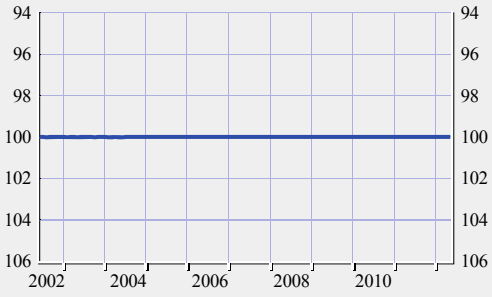
Sources: National data and ECB calculations.
1) Annualised monthly standard deviation (as a percentage) of daily percentage changes of the exchange rate against the euro.
2) Differential (in percentage points) between three-month interbank interest rates and the three-month EURIBOR.

Chart 5 Lithuanian litas: nominal exchange rate development against the euro

(a) Deviation from ERM II central rate
(daily data; percentage deviation; 3 May 2010-30 April 2012)



(b) Exchange rate over the last ten years
(monthly data; central rate = 100; May 2002-April 2012)



Source: ECB.
Note: A positive (negative) deviation from the central rate implies that the currency is on the strong (weak) side of the band. For the Lithuanian litas, the fluctuation band is ±15%.

Table 10 Lithuanian litas: real exchange rate developments

(monthly data; percentage deviation in March 2012 from the ten-year average calculated for the period April 2002-March 2012)

	Mar. 2012
Real bilateral exchange rate against the euro [1]	10.1
Memo items:	
Nominal effective exchange rate [2]	-0.8
Real effective exchange rate [1), 2)]	6.9

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

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Balance of payments										
Current account and capital account balance [1]	-4.7	-6.4	-6.4	-5.8	-9.4	-12.7	-11.1	7.8	4.2	0.9
Current account balance	-5.1	-6.7	-7.6	-7.1	-10.6	-14.4	-12.9	4.4	1.5	-1.6
Goods balance	-9.3	-9.0	-10.5	-11.2	-13.8	-14.9	-12.9	-3.2	-4.6	-4.9
Services balance	3.8	3.3	3.6	4.0	3.6	1.6	1.3	1.9	3.5	3.6
Income balance	-1.2	-2.6	-2.7	-2.4	-2.7	-4.1	-3.4	1.3	-2.3	-3.8
Current transfers balance	1.6	1.6	2.0	2.5	2.4	2.9	2.2	4.4	4.8	3.5
Capital account balance	0.4	0.4	1.2	1.3	1.2	1.7	1.8	3.4	2.7	2.5
Combined direct and portfolio investment balance [1]	5.1	2.2	3.2	1.6	4.2	2.9	2.9	2.5	6.9	6.3
Direct investment balance	5.0	0.8	2.3	2.6	5.0	3.6	3.4	-0.4	1.8	2.5
Portfolio investment balance	0.1	1.5	0.9	-1.0	-0.8	-0.7	-0.5	2.9	5.1	3.8
Other investment balance	1.7	6.3	1.8	7.0	11.0	12.9	5.8	-10.7	-9.0	-2.8
Reserve assets	-3.1	-2.9	0.5	-2.6	-4.9	-3.0	2.4	0.2	-1.9	-4.5
Exports of goods and services	52.4	50.9	51.8	57.2	58.7	53.7	59.5	54.3	68.2	77.9
Imports of goods and services	57.9	56.6	58.7	64.4	68.9	67.0	71.2	55.6	69.2	79.2
Net international investment position [2]	-32.6	-33.1	-34.4	-42.6	-48.9	-55.8	-51.5	-58.6	-55.9	-52.2
Gross external debt [2]	39.2	40.2	42.1	50.5	59.9	71.5	70.9	87.0	87.4	80.8
Memo item:										
Export market shares [3]	0.09	0.10	0.10	0.12	0.12	0.12	0.14	0.13	0.13	0.15

Source: ECB.
1) Differences between totals and the sum of their components are due to rounding.
2) End-of-period outstanding amounts.
3) As a percentage of total world goods and services exports.

Table 12 Indicators of integration with the euro area

(as a percentage of the total, unless otherwise stated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
External trade with the euro area										
Exports of goods	31.1	32.8	35.7	34.6	31.8	31.4	28.8	33.7	30.9	32.9
Imports of goods	38.3	37.4	40.2	36.0	37.1	40.2	32.8	32.9	32.1	31.3
Investment position with the euro area										
Inward direct investment [1]	34.4	35.8	39.4	34.2	32.8	31.5	43.9	41.9	42.3	38.9
Outward direct investment [1]	26.9	32.7	16.1	12.7	15.1	17.0	23.7	30.7	38.3	40.9
Portfolio investment liabilities [1]	65.7	80.7	90.7	99.7	87.7	81.7	75.4	70.1	52.9	-
Portfolio investment assets [1]	-	-	62.2	47.5	65.1	63.7	60.1	73.9	75.7	-
Memo items:										
External trade with the EU										
Exports of goods	69.3	62.8	67.2	65.7	63.6	64.8	60.3	64.3	61.0	61.4
Imports of goods	56.8	56.1	63.5	59.5	62.8	68.3	57.6	59.1	56.6	55.9

Sources: ESCB, European Commission (Eurostat) and IMF.
1) End-of-period outstanding amounts.

4 LONG-TERM INTEREST RATE DEVELOPMENTS

Table 13 Long-term interest rates (LTIRs)

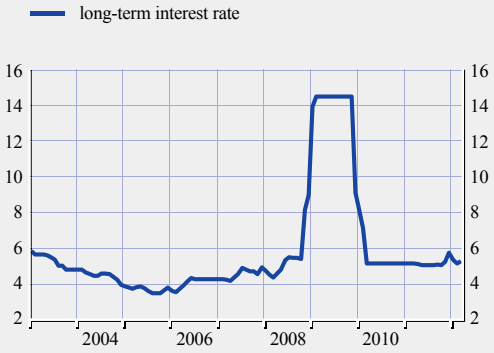
(percentages; average of observations through period)

	2011	2012			
	Dec.	Jan.	Feb.	Mar.	Apr. 2011 to Mar. 2012
Long-term interest rate	5.8	5.4	5.2	5.3	5.2
Reference value [1]					*5.8*
Euro area [2]	*4.6*	*4.7*	*4.4*	*4.1*	*4.4*
Euro area (AAA) [3]	*2.7*	*2.6*	*2.5*	*2.5*	*2.9*

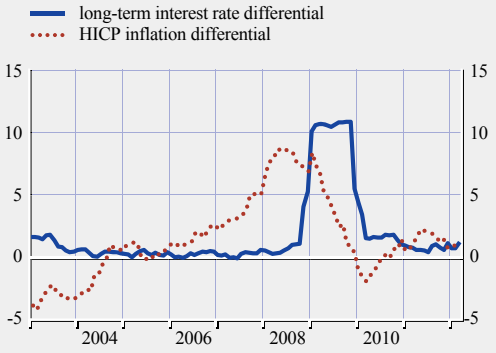
Sources: ECB and European Commission (Eurostat).
1) The basis of the calculation for the period April 2011-March 2012 is the unweighted arithmetic average of the interest rate levels in Sweden and Slovenia plus 2 percentage points.
2) The euro area average is included for information only.
3) The euro area AAA par yield curve for the ten-year residual maturity is included for information only.

Chart 6 Long-term interest rate (LTIR)

(a) Long-term interest rate (LTIR)
(monthly averages in percentages)



(b) LTIR and HICP inflation differentials vis-à-vis the euro area
(monthly averages in percentage points)



Sources: ECB and European Commission (Eurostat).

Table 14 Selected indicators of financial development and integration

(as a percentage of GDP, unless otherwise stated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Memo item: euro area 2011
Debt securities issued by corporations [1]	0.6	0.6	1.4	1.9	2.3	3.6	4.0	4.1	2.1	1.5	103.0
Stock market capitalisation [2]	9.0	16.7	26.1	33.1	32.1	24.0	8.0	12.1	15.3	10.0	41.5
MFI credit to non-government residents [3]	-	-	28.1	40.4	49.4	59.4	62.1	69.3	62.7	52.5	134.7
Claims of euro area MFIs on resident MFIs [4]	-	-	14.3	15.4	15.1	12.3	14.2	13.6	9.4	12.9	7.9
Private sector credit flow [5]	3.7	7.8	10.0	15.5	18.9	27.3	9.5	-11.5	-5.3	-	3.5
Private sector debt [6]	29.9	35.5	41.9	52.5	64.4	81.5	81.8	88.5	80.8	-	167.0

Sources: ESCB, European Commission (Eurostat), Federation of European Securities Exchanges, OMX and national stock exchanges.
1) Outstanding amount of debt securities issued by resident non-financial corporations, MFIs and other financial corporations.
2) Outstanding amounts of quoted shares issued by residents at the end of the period at market values.
3) MFI (excluding NCB) credit to domestic non-MFI residents other than the general government. Credit includes outstanding amounts of loans and debt securities.
4) Outstanding amount of deposits and debt securities issued by domestic MFIs (excluding the NCB) held by euro area MFIs as a percentage of total liabilities of domestic MFIs (excluding the NCB). Total liabilities exclude capital and reserves and remaining liabilities.
5) Transactions in securities other than shares issued and loans taken out by institutional sectors: non-financial corporations, households and non-profit institutions serving households.
6) Outstanding amounts of securities other than shares issued and loans taken out by institutional sectors: non-financial corporations, households and non-profit institutions serving households.

5.5 HUNGARY

5.5.1 PRICE DEVELOPMENTS

Over the reference period from April 2011 to March 2012, the 12-month average rate of HICP inflation in Hungary was 4.3%, i.e. well above the reference value of 3.1% for the criterion on price stability (see Table 1). On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to increase in the coming months.

Looking back over a longer period, consumer price inflation in Hungary has fluctuated between 3.5% and 7.9% on an annual basis over the past ten years (see Chart 1). Annual HICP inflation reached its lowest level, of 3.5%, in 2005, but as a result of administered price and indirect tax increases, among other things, it then accelerated significantly, peaking at 9% in March 2007. Thereafter inflation started to recede, in line with the phasing-out of one-off effects relating to fiscal consolidation measures. However, successive commodity price shocks and further changes in indirect taxes and administered prices have meant that it has mostly remained at elevated levels since then.

These inflation developments reflect a number of important policy choices, most notably the orientation of monetary policy during the period under review towards the achievement of price stability, as enshrined in the central bank law. In 2001 the monetary policy framework was changed by introducing an inflation targeting framework, widening the exchange rate band from ±2.5% to ±15% around the euro as the anchor currency, fully liberalising the capital account and abolishing the crawling peg regime. The inflation targets have been changed a number of times. Since 2007 the medium-term inflation target has been 3%. In February 2008 the Magyar Nemzeti Bank, in agreement with the Hungarian government, decided to abolish the fluctuation bands and adopt a floating exchange rate regime. The process of disinflation has been underpinned by the liberalisation of product markets. Fiscal policy was expansionary between 2001 and mid-2006 and, therefore, it was not supportive of achieving the inflation targets during that period. Following the implementation of successive fiscal consolidation packages since mid-2006, fiscal policy has also added to short-term inflationary impulses through large increases in administered prices and indirect taxes. The share of administered prices in Hungary's HICP basket is relatively high, standing at around 17% in 2012. Most recently, public sector wage constraints have been supportive of disinflation, but VAT and excise tax increases pushed up prices in early 2012.

Hungary experienced robust growth at the beginning of the century until 2006, which was then followed by a strong economic slowdown culminating in a deep recession in 2009 and, more recently, a weak recovery. More specifically, real GDP growth decelerated markedly in 2007 and 2008. In 2009, in the midst of the global slowdown, Hungary experienced a severe fall in GDP of 6.8%. At the beginning of the global financial and economic crisis at the end of 2008, the large external financing needs of the Hungarian economy made it necessary for Hungary to be funded through a financial assistance programme led by the EU and the IMF. This programme went off track in June 2010, following a change of government in April 2010. In 2010 and 2011, Hungary experienced a weak recovery which was driven by external demand, while domestic demand developments remained subdued. Unit labour cost growth was very substantial in the early 2000s, driven by strong growth in compensation per employee, and it decreased only slowly during the early stages of the slowdown in the course of Hungary's fiscal adjustment. Labour market adjustment accelerated in subsequent years, leading to a strong moderation in overall unit labour cost growth, which was followed by a renewed upturn in 2011. However, the growth of

compensation per employee again outpaced productivity growth in 2011, leading to a rise in unit labour cost growth. Import prices have fluctuated substantially in recent years, largely reflecting changes in both the effective exchange rate of the forint and commodity prices. The general pattern of inflation developments is also apparent from other relevant indices, such as the HICP excluding unprocessed food and energy. In recent years, the growth rate of residential housing prices in Hungary has been subdued. Following a period of sustained growth in the run-up to the country's accession to the EU in 2004, residential housing prices have since grown at a rate below the rate of inflation, weighed down by oversupply, the post-2008 decline in interest from foreign buyers and domestic credit tightening.

Looking at recent developments, inflationary pressures increased in the course of 2011 despite continued weak domestic demand conditions. These pressures reflected mainly the impact of commodity prices and the depreciation of the exchange rate in the second half of 2011, along with the inflationary impact of the special taxes that were imposed by the government on various sectors (e.g. the energy sector, retail chains and the telecommunications sector). The annual HICP inflation rate experienced a temporary decline during the summer of 2011, reaching 3.1% in July, supported by a fall in unprocessed food prices owing to a bumper harvest. Inflation, however, increased again thereafter, noticeably towards the end of 2011 (see Table 3a), reflecting mainly the impact of the energy component and the sizeable depreciation of the exchange rate, but also a gradually increasing contribution of services price inflation. Real GDP growth was still relatively robust in the second half of 2011, reflecting temporary factors such as a bumper harvest. In early 2012, inflation picked up further, owing to an array of government measures, including a marked increase (18%) in the minimum wage. A number of indirect tax increases, as well as fuel and processed food price increases, added to the inflationary pressures. At the same time, short-term economic indicators point to a slowdown of economic activity, on the back of weaker external demand, a further tightening of credit conditions and the short-term impact of fiscal consolidation measures.

The latest available forecasts from major international institutions project inflation to accelerate in 2012 to between 4.9% and 5.5%, before subsiding in 2013 to a rate of between 2.9% and 3.9% (see Table 3b). In the first half of 2012 a number of temporary cost increases, tax changes and the lagged effect of the weaker exchange rate are expected to increase inflation, although the weak domestic demand environment is likely to prevent these factors from fully exerting their impact on prices. Annual HICP inflation is expected to decrease significantly towards the end of 2012, reflecting the fading impact of earlier tax increases and a further weakness in economic activity. Domestic demand is expected to recover only slowly, owing to the ongoing balance sheet adjustment of banks and households in an increasingly tight credit environment. At the same time, the high unemployment rate is expected to have a dampening impact on wage formation in the medium term. Regarding risks to the inflation outlook, on the upside, commodity price increases may turn out to be stronger than expected and the recent price shocks may have an impact on inflation expectations. On the downside, domestic demand may pick up at a slower pace than expected (e.g. in case of a faster than expected deleveraging process in the banking sector). Looking further ahead, the catching-up process is likely to have a bearing on inflation and/or on the nominal exchange rate over the coming years, given that GDP per capita and price levels are still lower in Hungary than in the euro area (see Table 2). However, it is difficult to assess the exact size of the effect resulting from this catching-up process.

Achieving an environment conducive to sustainable convergence in Hungary requires, inter alia, a stability-oriented monetary policy including a stable institutional environment that maintains market confidence while fully respecting the independence of the central bank. In addition,

a strict implementation of the fiscal consolidation path in line with the requirements of the EDP is important, including a sustainable reduction in expenditure. This would also help to ensure a permanent reduction of Hungary's public debt-to-GDP ratio. In order to achieve these goals, it is essential for Hungary to progress with reforms aimed at improving the efficiency of the public sector, including pension, healthcare and social transfer systems. In terms of product market reforms, the liberalisation of network industries should be completed. With regard to the labour market, it is essential to strengthen those measures aimed at preventing a significant increase in structural unemployment or a decline in the participation rate. Along with the implementation of labour market measures in the Structural Reform Programme announced in March 2011, these measures also include improving active labour market policies and flexible work arrangements. Moreover, measures should be taken to raise Hungary's relatively low employment rate, for example by lowering the high tax wedge on labour and avoiding reliance on high minimum wages that harmed employment on a number of occasions in the past. These policies could raise potential growth and help contain wage pressures when the economic recovery gains pace. Wage increases should reflect labour productivity growth, labour market conditions and developments in competitor countries. Financial sector policies should be geared towards ensuring the financial sector makes a sound contribution to economic growth, while at the same time preventing excessive credit growth in the future. Given the potential risks to financial stability associated with the high share of foreign currency-denominated loans in Hungary, the European Systemic Risk Board's recommendations on lending in foreign currencies, released in 2011, need to be fully taken into account. The government should actively seek to improve foreign investor sentiment by adopting international best practices on central bank independence and respecting the existing contracts between private parties in the implementation of government policies. Macro-prudential measures to reduce the underlying vulnerabilities related to foreign currency lending should be well targeted and avoid placing undue burden on banks' lending capacity and on public finances. In this respect, the effects of the debt relief scheme for holders of foreign-currency mortgages – put in place in 2011 and early 2012 – would need to be closely monitored. Such measures, along with an increase in the predictability of economic policy, will help to achieve an environment conducive to sustainable price stability and promote competitiveness and employment growth.

5.5.2 FISCAL DEVELOPMENTS

Hungary is, at present, subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2011 the general government budget balance showed a temporary surplus of 4.3% of GDP. The general government gross debt-to-GDP ratio was 80.6%, i.e. well above the 60% reference value (see Table 4). Compared with the previous year, the budget balance ratio temporarily improved by 8.5 percentage points and the public debt ratio declined by 0.8 percentage point. In 2012 the budget balance is forecast by the European Commission to return to a deficit of 2.5% and the government debt ratio is projected to decrease to 78.5%. With regard to other fiscal factors, the deficit ratio is not expected to exceed the ratio of public investment to GDP in 2012.

Looking at developments in Hungary's budgetary position over the period from 2002 to 2011, the deficit-to-GDP ratio stayed generally very high throughout the period (see Chart 2a and Table 5). Starting from 9.0% of GDP in 2002, the deficit ratio declined for two years only, returning to 9.3% of GDP in 2006. In 2007 it improved to 5.1% of GDP, reflecting large revenue-raising and expenditure-reducing consolidation measures. Following the financial and economic crisis, an EU-IMF balance of payments support programme was started in 2008. By the end of the programme, the deficit was reduced to 4.2% of GDP, although underperforming the programme target of 3.8% of GDP. In 2011 Hungary recorded a surplus of 4.3% of GDP thanks to one-off and

temporary revenue measures (of about 10% of GDP), primarily related to the transfer of pension assets from private pension schemes to the state pillar, as well as some extraordinary sectoral levies. Hungary has been subject to an EU Council decision on the existence of an excessive deficit since joining the EU in 2004. The deadline for correction of the excessive deficit was extended twice and set for 2011 following the Council recommendation of 7 July 2009. In January 2012 the EU Council adopted a decision establishing that Hungary had not taken effective action in response to the Council recommendation of 7 July 2009. Overall, it concluded that while Hungary had formally observed the 3% of GDP reference value in 2011, this was not based on a structural and sustainable correction. As a consequence, on 13 March 2012, the Council adopted a decision to suspend part (29%, or 0.5% of GDP) of the 2013 EU cohesion fund commitments for Hungary, as well as a fifth revised recommendation asking the Hungarian authorities to put an end to the excessive deficit by 2012. In this regard, it was recommended that Hungary take the necessary measures, including additional fiscal consolidation, to meet its deficit target of 2.5% of GDP in 2012 and to ensure that the deficit in 2013 remains well below 3% of GDP, even after the phasing-out of one-off measures. As shown in greater detail in Chart 2b, European Commission estimates indicate that cyclical factors made a limited contribution to the change in the deficit ratio, with the notable exception of 2009 when they induced a large increase. Moreover, non-cyclical factors broadly determined the volatile pattern of the general balance. Over the period under consideration, available evidence suggests that temporary and one-off factors made a very sizeable contribution to the improvement of the budget balance in 2011 (as explained above) and had a relatively large effect in 2010 (following the introduction of a large special levy on financial institutions in mid-2010 and of other sectoral levies later in the year). Smaller deficit-increasing temporary measures were taken over the period from 2006 to 2009. The remainder of the non-cyclical changes in the budget balance, as captured by changes in the structural balance, are explained by permanent effects. They seem to reflect a structural deterioration of Hungary's fiscal position until 2006, a consolidation over the period 2007-09, and a reoccurring deterioration thereafter.

Turning to developments in general government gross debt, between 2002 and 2011 the debt-to-GDP ratio increased cumulatively by 24.7 percentage points (see Chart 3a and Table 6). As shown in greater detail in Chart 3b, primary deficits were the major driving factor behind debt developments between 2002 and 2007, while deficit-debt adjustments and the growth/interest rate differential played a less important role. Such a pattern is indicative of the close link between primary deficits and adverse debt dynamics in Hungary before 2008. In 2008 this pattern reversed and the debt-to-GDP ratio rose significantly as a result of deficit-debt adjustment, in part related to the support granted to the banking sector. In 2009 the negative growth/interest rate differential induced the increase in the debt ratio, while the one-off large primary surplus – to a great extent compensated by deficit-debt adjustment – determined the decrease in 2011. The large positive deficit-debt adjustment in 2011 occurred primarily on account of the forint depreciation towards the end of the year, reflecting the high proportion of foreign-currency denominated debt.

As regards developments in Hungary's general government debt structure, the share of government debt with a short-term maturity declined steadily from 21.7% in 2002 to a low level of 8.7% in 2011 (see Table 6). Taking into account the level of the debt ratio, fiscal balances are relatively insensitive to changes in interest rates. The proportion of government debt denominated in foreign currency at 51.81% is high and, given the overall debt level, fiscal balances are highly sensitive to changes in exchange rates. The Hungarian government has not incurred contingent liabilities resulting from government interventions to support financial institutions and financial markets during the crisis (see Section 5.9). The support granted to some domestic credit institutions in 2009 – in the form of foreign exchange loans and acquisitions of shares – was already recovered

by the end of 2011. While no further support has been granted to the financial sector in response to the crisis since 2009 (a capital injection in the Hungarian Development Bank was made as of the fourth quarter of 2011), the current government incurred contingent liabilities in relation to the mortgage relief granted to households under the agreement concluded with the Hungarian Banking Association on 15 December 2011.

Moving on to examine trends in other fiscal indicators, Chart 4 and Table 5 show that the general government total expenditure-to-GDP ratio declined from 51.5% in 2002 to 48.6% in 2011. This level remains high in comparison with other countries with a similar level of per capita income and even compared with some of the highly advanced economies. The pattern of the expenditure ratio has been volatile, broadly reflecting the consecutive fiscal expansion and consolidation periods. During the period between 2002 and 2011, "capital expenditure" recorded a sharp decline as a share in GDP, while a more limited decline was recorded in "compensation of employees". "Other current expenditure" and, in particular, "social benefits other than in kind" (the largest budgetary expenditure item) increased their share in GDP. Government revenue in relation to GDP was relatively stable until 2006, but became very volatile thereafter. It increased cumulatively by close to 3 percentage points to 45.2% of GDP between 2002 and 2010. The jump by close to 8 percentage points in 2011 was due to one-off and temporary revenue measures. After the tax restructuring reform implemented in consultation with the IMF and the European Commission in the second half of 2009, a further reduction in direct taxation took place in 2011 following the introduction of a flat personal income tax rate (of 16%).

Looking ahead, Hungary's medium-term fiscal policy strategy, as presented in the 2012-15 update of the convergence programme (dated April 2012), envisaged a deficit ratio of 2.5% in 2012, with a further decline to 2.2% in 2013 and 1.5% in 2015. According to this fiscal strategy, the Hungarian government is planning a substantial structural consolidation in 2012 of about 2.1 percentage points of GDP (initially focused on the expenditure side, but later supported by substantial revenue measures, including a 2 percentage point increase in the VAT rate to 27%). Moreover, the structural deficit is projected to decline below the medium-term objective of 1.5% of GDP (specified in line with the Stability and Growth Pact) in 2013. According to information submitted in the 2012 convergence programme update, primary expenditure excluding EU fund transfers (relevant expenditure), as a share of GDP, is projected to drop by 2 percentage points between 2012 and 2015. The annual growth rate of relevant expenditure is projected to be below the growth rate of potential GDP in 2012 and above it thereafter. In 2013 only, the difference is matched by discretionary revenue measures. According to the European Commission's projections, the structural deficit will remain, nevertheless, above the medium-term objective by 2013. In November 2011 Hungary requested EU-IMF financial assistance, a prerequisite for which are concrete actions that show the government's strong commitment to engage in all policy issues relevant to macroeconomic stability.

With regard to the fiscal prospects for Hungary, which with 80.6% of GDP in 2011 has a public debt ratio above 60% of GDP, Chart 5 presents calculations of potential future debt ratios using alternative assumptions for the fiscal balance. Assuming that Hungary achieves the overall fiscal position and public debt ratio projected by the European Commission for 2012, a balanced budget from 2013 onwards would reduce public debt to below 60% of GDP by 2019. Furthermore, a constant primary balance ratio at its projected 2012 level of 1.6% of GDP would reduce public debt to below 60% of GDP only by 2023. At the same time, maintaining the overall deficit ratio at its projected 2012 level of 2.5% of GDP would result in a very slow decline of the debt ratio (still at 69.5% in 2024). These calculations are based on the assumption of a constant nominal rate

of interest of 4.2% beyond 2013.[8] The nominal GDP growth rate is as projected by the European Commission in its Spring 2012 forecast for 2012 and 2013 and kept constant at the 2013 level thereafter. Deficit-debt adjustments are not taken into account in the projections. While these calculations are purely illustrative and can by no means be regarded as forecasts, the indication that maintaining the overall deficit ratio at the 2012 level would lead to a very slow decline in the debt ratio highlights the need for effective implementation of further consolidation measures. Moreover, based on preliminary illustrative simulations by the European Commission as of end-2011 and taking into account the available forecast, Hungary would need a larger structural fiscal effort than the minimum stipulated by the Stability and Growth Pact (i.e. 0.5 percentage point of GDP) in order to meet the debt benchmark two years after the end of the transitional period on the basis of the forward-looking element.

On 2 March 2012 Hungary signed the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, committing, inter alia, to apply (and include in its national legislation) the fiscal rules specified under Title III, "Fiscal Compact", as referred to in Box 2 of Chapter 2.

As regards fiscal governance, the fiscal responsibility law adopted by the previous government under the joint EU-IMF programme was substantially altered in late 2010 and not implemented as recommended by the Council in 2009 under the EDP. Most importantly, the independent status and supervisory capacity of the Fiscal Council was weakened. While a debt ceiling of 50% of GDP was included in the Constitution, the new operational rules approved as of the end of 2011 provide for important escape clauses. Full compliance with the provisions for an enhanced national governance framework under Council Directive 2011/85/EU and with the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, as referred to in Box 2 of Chapter 2, should be ensured.

Turning to factors with an impact on Hungary's public finances over the long term, a sharp ageing of the population is expected, as highlighted in Table 8. According to the 2012 projections by the European Commission and the EU's Economic Policy Committee, starting from a level of 22.0% of GDP in 2010, Hungary is likely to experience a notable increase in strictly age-related public expenditure amounting to 4.9 percentage points of GDP in the years to 2060.[9] The de facto abolishment of the mandatory private pension pillar as of 2011 and the resulting takeover of the pension liabilities by the National Pension Insurance Fund has been included in this estimate. The growth of public pension expenditures will be mitigated to a certain degree by recent legislation which increases the statutory retirement age, tightens the conditions for early retirement, introduces CPI indexation of benefits and reforms the disability pension scheme.

Turning to fiscal challenges, Hungary must bring its budget deficit below the 3% reference value in a sustainable manner, in line with the renewed EDP requirements, and ensure that the debt ratio is put on a clear downward path. The structural consolidation envisaged for the medium term in the 2012-15 convergence programme update, after two years of fiscal stance loosening, should be strictly adhered to. The full implementation of structural reforms relating to the health sector, early retirement, the labour market and social security, passed in 2011, is necessary to reduce further

8 This assumption reflects past trends in the cost of outstanding public debt. However, under the current market circumstances and given Hungary's current sovereign risk premium, this assumption, and (ceteris paribus) the path of government debt projections, is subject to upside risks.

9 European Commission and Economic Policy Committee, "The 2012 Ageing Report: Economic and budgetary projections for the EU-27 Member States (2010-2060)".

pressures on age-related government expenditure. Fiscal governance remains problematic in Hungary and is weakening investor confidence in the transparency, predictability and sustainability of Hungarian fiscal policies. In particular, concerns over the role and independent status of the Fiscal Council, as well as the potentially loose implementation of Hungary's numerical fiscal rules, need to be swiftly addressed by the government. Moreover, every effort should be made to fully comply with the obligations under the enhanced Stability and Growth Pact, and to effectively implement the provisions of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union.

5.5.3 EXCHANGE RATE DEVELOPMENTS

In the two-year reference period from 1 May 2010 to 30 April 2012, the Hungarian forint did not participate in ERM II, but traded under a flexible exchange rate regime (see Table 9a). After appreciating gradually against the euro between mid-2010 and July 2011, the forint was subject to strong depreciation pressures until the end of 2011. Thereafter, it recovered some of the losses against the euro. Overall, the Hungarian currency often traded substantially weaker than its May 2010 average exchange rate against the euro, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate (see Table 9a). The maximum upward deviation from this benchmark was 5.0%, while the maximum downward deviation amounted to 15.9% (see Chart 6 and Table 9a).

Between November 2008 and late 2010, an international financial assistance arrangement of €20 billion was in place, led by the EU and the IMF. During the reference period, Hungary did not receive any disbursements. On 16 October 2008 the Magyar Nemzeti Bank and the ECB jointly announced that they had established an agreement on repurchase transactions to support Hungary's liquidity needs. As these arrangements helped to reduce financial vulnerabilities, they might also have contributed to reducing exchange rate pressures. On the other hand, the interruption of negotiations between the Hungarian authorities and the EU and the IMF on a possible new financial package in late 2011 was a factor that contributed to the depreciation of the forint in late 2011, with the fact that the follow-up talks have dragged on possibly having added to the forint's volatility since then.

Looking at exchange rate developments in more detail, the relatively large fluctuations of the Hungarian forint during the reference period were partly driven by changes in global risk aversion amid tensions in some euro area sovereign debt markets. Between May 2010 and July 2011 the forint appreciated gradually by around 5% in relation to improving sentiment of financial markets towards the region, robust external demand and a rather large positive interest rate differential vis-à-vis euro area assets. In the second half of 2011 financial market conditions worsened again, reflecting not only the deteriorating economic outlook and downgrades of the sovereign credit rating, as government policies eroded foreign investor confidence, but also the renewed increase in global risk aversion and developments in euro area sovereign debt markets. After a depreciation of the Hungarian forint by 17% between the beginning of August 2011 and late December, the authorities asked for further international financial assistance from the EU and the IMF. A gradual normalisation of global financial market conditions subsequently contributed to a partial reversal of this depreciation. On 30 April 2012 the Hungarian currency traded at 286.750 forint per euro, i.e. 3.6% weaker than its average level in May 2010.

During the reference period, the exchange rate of the Hungarian forint against the euro showed a high degree of volatility, as measured by annualised standard deviations of daily percentage changes.

Volatility peaked in the three-month period ending in December 2011 at the very high level of 14.1% and declined only slightly thereafter. At the same time short-term interest rate differentials against the three-month EURIBOR stood at high levels over the reference period on account of both the inflation differential vis-à-vis the euro and the prevailing uncertainty in global financial markets. The spread increased from 4.6 percentage points in the three-month period ending in June 2010 to 6.4 percentage points in the three-month period ending in March 2012 (see Table 9b).

In a longer-term context, in March 2012 both the Hungarian forint's real effective exchange rate and its real bilateral exchange rate against the euro stood close to the corresponding ten-year historical averages (see Table 10). However, these measures should be interpreted with caution, as in this period Hungary was subject to a process of economic convergence, which complicates any historical assessment of real exchange rate developments.

As regards other external developments, Hungary's current and capital account has adjusted sharply in recent years. After reporting a large average deficit of 7.1% of GDP between 2002 and 2008, the combined current and capital account of the balance of payments reversed to reach a surplus of 1.0% in 2009 and widened gradually thereafter to 3.6% in 2011 (see Table 11). The recent improvement in the current account primarily reflected a large increase in the goods and services balance, mainly owing to robust export growth and the sustained weakness in domestic demand, which continued to decrease in 2010 and 2011. By contrast, the income deficit was broadly unchanged. The large current and capital account deficit had been financed mainly by net inflows in direct and portfolio investment between 2002 and 2006, and, at the later stage of the strong growth period, also by very large inflows of other investment, mainly in the form of bank loans. The sharp adjustment in Hungary's balance of payments was associated with a significant contraction of these capital inflows. In 2010 and 2011 foreign direct investment flows were broadly balanced, while the large net inflows in portfolio investments in 2011 were related to government sales of assets of private pension funds. Meanwhile there were large net outflows from other investments. Against this background, the sharp increase in gross external debt from 53.1% of GDP in 2002 to 144.9% in 2009 came to a halt, stabilising at 144.0% in 2010 and 145.3% in 2011. At the same time, Hungary's net international investment position deteriorated sharply, from -65.2% of GDP in 2002 to -117.9% in 2009 before improving to -112.7% in 2010 and -105.2% in 2011. The fact that the country's net foreign liabilities are still very high – also owing to the significant revaluations of the foreign exchange-denominated part of the external debt as a result of the depreciation of the forint exchange rate – points to the importance of fiscal and structural policies supporting external sustainability. Hungary is a small, open economy; the ratio of foreign trade in goods and services to GDP increased from 63.3% of GDP in 2002 to 91.9% in 2011 for exports and from 65.6% in 2002 to 84.7% in 2011 for imports. Over the same period, Hungary's share in world exports increased from 0.53% to 0.58%.

Concerning measures of economic integration with the euro area, in 2011 exports of goods to the euro area constituted 55.0% of total goods exports, whereas the corresponding figure for imports amounted to 54.0%. The share of euro area countries in Hungary's inward direct investment stood at 72.1% in 2011 and in its portfolio investment liabilities at 55.1% in 2010. The share of Hungary's assets invested in the euro area amounted to 20.1% in the case of direct investment in 2011 and 63.2% for portfolio investment in 2010 (see Table 12).

5.5.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from April 2011 to March 2012, long-term interest rates in Hungary were 8.0% on average and thus well above the 5.8% reference value for the interest rate convergence criterion (see Table 13).

Over the past ten years, Hungary's long-term interest rates have been affected by, among other factors, the domestic fiscal situation and financial developments, as well as the global appetite for risk. In late 2003 and 2004 long-term interest rates increased on the back of increasing inflationary pressures and subsequently declined until September 2005 (see Chart 6a). Long-term interest rates increased during 2006 as inflation concerns rose again, the budget deficit increased markedly and Hungary's long-term credit rating was downgraded by several rating agencies. Plans for fiscal consolidation and favourable sentiment in financial markets fostered declines of long-term interest rates in 2007, but in 2008 long-term interest rates increased again, reflecting increasing global risk aversion and significant turbulence in international financial markets, as well as further downgrades of the credit rating at the end of 2008. In November 2008 an international financial assistance arrangement – designed to restore market confidence and shore up the economy, while redressing fiscal imbalances – was put in place, but went off track in June 2010. As tensions in international financial markets gradually eased and liquidity recovered, government bond yields declined in 2009. In 2010 long-term interest rates were volatile, especially during increased sovereign market tensions in that year. During 2011, especially in the second half of the year, concerns about the country's fiscal situation and government policies that had eroded foreign investor confidence were reflected in rating downgrades, declining investor demand for Hungarian sovereign bonds, a weakening currency and steadily increasing long-term interest rates. At the end of 2011 Hungary requested further possible EU-IMF financial assistance. At the end of 2011 and the beginning of 2012, long-term interest rates increased substantially. They declined afterwards and stood at 8.7% at the end of the reference period.

The long-term interest rate differential with the euro area average fluctuated, largely in line with long-term interest rate developments, between 2.0 and 4.5 percentage points between 2003 and September 2008 (see Chart 6b). The spread increased in late 2008 and reached the historically high level of 7.8 percentage points in March 2009, indicating increased risk aversion and concerns about domestic economic imbalances. From then until the beginning of 2011, the interest rate differential declined. During the reference period it has been increasing again, reflecting renewed economic tensions and government policies, and it stood at 4.7 percentage points with respect to the euro area average (and 6.2 percentage points with respect to the AAA euro area yield) in March 2012.

Regarding the market structure, the Hungarian capital market is smaller and much less developed than the euro area average (see Table 14). The outstanding amount of debt securities issued by corporations has declined in recent years, after a series of increases before the crisis, and stood at 27.2% of GDP in 2011. The importance of the stock market for the financing of the corporate sector is limited compared with the financing provided by the banking sector. Foreign-owned banks play a major role in the banking sector, and the majority of loans to the private sector are in foreign currencies. Stock market capitalisation stood at 16.2% of GDP, while the value of outstanding bank loans to the private sector was equal to 63.6% of GDP at the end of 2011. However, all of these ratios remain low in comparison with the euro area. The international claims of euro area banks on banks in Hungary stood at 20.5% of total liabilities in 2011.

LIST OF TABLES AND CHARTS

HUNGARY

I PRICE DEVELOPMENTS

Table 1 HICP inflation

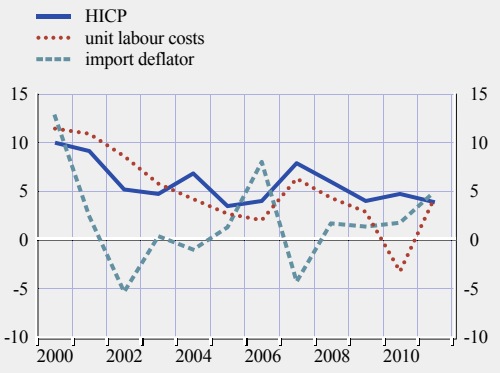
(annual percentage changes)

	2011	2012			Apr. 2011
	Dec.	Jan.	Feb.	Mar.	to Mar. 2012
HICP inflation	4.1	5.6	5.8	5.5	4.3
Reference value[1]					*3.1*
Euro area[2]	*2.7*	*2.7*	*2.7*	*2.7*	*2.8*

Source: European Commission (Eurostat).
1) The basis of the calculation for the period April 2011-March 2012 is the unweighted arithmetic average of the annual percentage changes in the HICP for Sweden, Ireland and Slovenia plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(average annual percentage changes)



Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Measures of inflation										
HICP	5.2	4.7	6.8	3.5	4.0	7.9	6.0	4.0	4.7	3.9
HICP excluding unprocessed food and energy	5.8	4.9	6.4	2.7	2.5	6.7	5.1	4.1	3.3	3.0
HICP at constant tax rates[1]	-	-	5.0	3.3	5.3	6.6	6.0	2.2	2.5	3.7
CPI	5.3	4.7	6.8	3.6	3.9	8.0	6.1	4.2	4.9	3.9
Private consumption deflator	5.8	4.2	5.6	3.6	3.4	6.9	5.2	3.7	4.3	4.4
GDP deflator	8.5	5.4	5.2	2.5	3.5	5.4	5.3	3.6	3.1	3.5
Producer prices[2]	2.8	5.2	8.4	6.1	8.4	6.4	11.6	1.2	7.3	6.1
Related indicators										
Real GDP growth	4.5	3.9	4.8	4.0	3.9	0.1	0.9	-6.8	1.3	1.7
GDP per capita in PPS[3] (euro area = 100)	55.1	56.8	57.7	57.9	57.8	56.5	58.7	59.5	59.9	-
Comparative price levels (euro area = 100)	57.3	56.7	60.1	62.1	59.6	65.8	67.2	60.0	62.3	-
Output gap[4]	0.6	0.8	2.1	2.9	4.5	2.8	2.3	-5.1	-3.9	-2.3
Unemployment rate (%)[5]	5.8	5.9	6.1	7.2	7.5	7.4	7.8	10.0	11.2	10.9
Unit labour costs, whole economy	8.6	5.8	4.2	2.7	2.0	6.3	4.3	2.9	-3.2	4.4
Compensation per employee, whole economy	13.6	9.9	10.3	7.1	5.6	6.4	6.8	-1.4	-2.3	5.8
Labour productivity, whole economy	4.6	3.9	5.8	4.3	3.5	0.1	2.4	-4.2	0.9	1.4
Imports of goods and services deflator	-5.3	0.4	-1.0	1.3	8.0	-4.3	1.7	1.4	1.8	5.0
Nominal effective exchange rate[6]	6.9	0.3	2.3	0.3	-6.4	6.1	0.9	-9.5	-1.1	-1.3
Money supply (M3)	-	-	12.6	13.6	13.7	11.7	6.8	3.3	2.2	2.2
Lending from banks	-	-	21.9	17.9	19.5	17.7	8.3	-5.4	-5.2	-13.2
Stock prices (Budapest BUX Index)	9.4	20.3	57.2	41.0	19.5	5.6	-53.3	73.4	0.5	-20.4
Residential property prices	-	10.9	9.1	0.9	-1.1	2.0	2.1	2.1	0.0	-0.7

Sources: European Commission (Eurostat), national data (CPI, money supply, lending from banks and residential property prices) and European Commission (output gap).
1) 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 on the price paid by the consumer.
2) Total industry excluding construction.
3) PPS stands for purchasing power standards.
4) Percentage difference of potential GDP: a positive (negative) sign indicates that actual GDP is above (below) potential GDP.
5) The definition conforms to ILO guidelines.
6) A positive (negative) sign indicates an appreciation (depreciation).

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2011			2012		
	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.
HICP						
Annual percentage change	3.8	4.3	4.1	5.6	5.8	5.5
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	4.8	5.8	6.2	7.9	9.4	10.6
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	3.0	3.3	3.8	4.8	5.7	6.5

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2012	2013
HICP, European Commission (spring 2012)	5.5	3.9
CPI, OECD (December 2011)	4.9	2.9
CPI, IMF (April 2012)	5.2	3.5
CPI, Consensus Economics (April 2012)	5.4	3.3

Sources: European Commission, OECD, IMF and Consensus Economics.

2 FISCAL DEVELOPMENTS

Table 4 General government fiscal position

(as a percentage of GDP)

	2010	2011	2012 [1]
General government surplus (+)/deficit (-)	-4.2	4.3	-2.5
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure [2]	-0.9	7.2	1.8
General government gross debt	81.4	80.6	78.5
Reference value	*60.0*	*60.0*	*60.0*

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

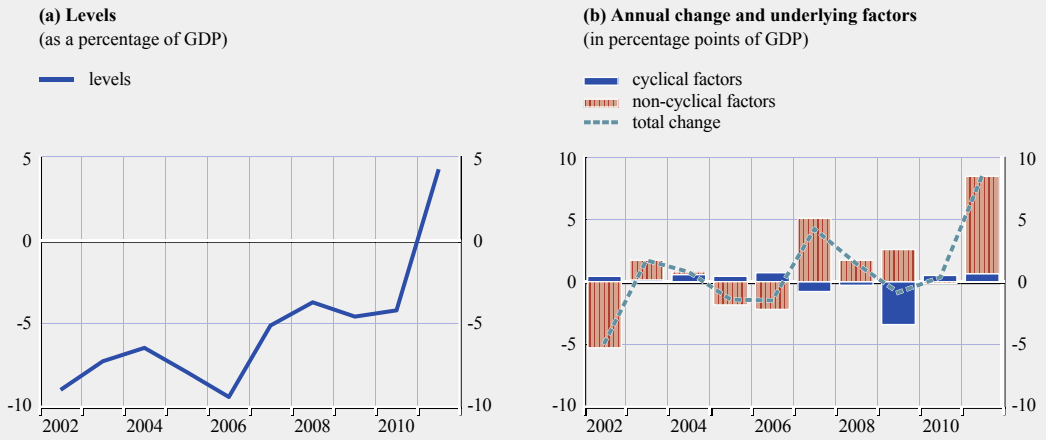
Table 5 General government budgetary position

(as a percentage of GDP)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total revenue	42.5	42.4	42.6	42.2	42.7	45.6	45.5	46.9	45.2	52.9
Current revenue	42.0	42.0	42.2	41.5	41.8	44.7	44.9	45.4	42.5	41.1
Direct taxes	10.1	9.5	9.0	9.0	9.4	10.3	10.6	9.9	8.0	6.4
Indirect taxes	15.0	15.8	16.1	15.5	15.0	15.9	15.6	16.6	16.9	16.6
Social security contributions	12.9	12.7	12.4	12.6	12.7	13.9	13.8	13.3	12.1	13.0
Other current revenue	4.0	3.9	4.7	4.4	4.8	4.6	4.9	5.5	5.5	5.2
Capital revenue	0.5	0.4	0.4	0.6	0.9	0.9	0.6	1.5	2.7	11.7
Total expenditure	51.5	49.7	49.1	50.1	52.1	50.7	49.2	51.5	49.4	48.6
Current expenditure	42.5	44.1	44.3	44.7	45.8	45.1	45.1	47.1	44.8	43.6
Compensation of employees	12.3	13.3	12.6	12.6	12.2	11.7	11.6	11.5	10.9	10.1
Social benefits other than in kind	13.3	13.9	14.0	14.5	15.0	15.5	15.9	16.5	15.9	15.3
Interest payable	4.1	4.1	4.4	4.1	3.9	4.2	4.2	4.7	4.1	4.1
of which: impact of swaps and FRAs [1]	0.0	0.0	0.0	0.0	-0.1	0.0	0.0	0.1	-0.1	-0.1
Other current expenditure	12.9	12.8	13.2	13.4	14.7	13.8	13.4	14.3	14.0	14.1
Capital expenditure	9.0	5.6	4.8	5.4	6.3	5.6	4.1	4.4	4.6	5.0
Surplus (+)/deficit (-)	-9.0	-7.3	-6.5	-7.9	-9.4	-5.1	-3.7	-4.6	-4.2	4.3
Primary balance	-4.9	-3.2	-2.0	-3.8	-5.5	-1.0	0.5	0.1	-0.1	8.3
Surplus/deficit, net of government investment expenditure	-4.0	-3.8	-2.9	-4.0	-4.9	-1.5	-0.8	-1.4	-0.9	7.2

Sources: ESCB and European Commission (Eurostat).
Notes: Differences between totals and the sum of their components are due to rounding. Interest payable as reported under the excessive deficit procedure. The item "impact of swaps and FRAs" is equal to the difference between the interest (or deficit/surplus) as defined in the excessive deficit procedure and in the ESA 95. See Regulation (EC) No 2558/2001 of the European Parliament and of the Council of 3 December 2001 amending Council Regulation (EC) No 2223/96 as regards the reclassification of settlements under swap arrangements and under forward rate agreements (0J L 344, 28.12.2001, p. 1).
1) FRAs stands for forward rate agreements.

Chart 2 General government surplus (+)/deficit (-)



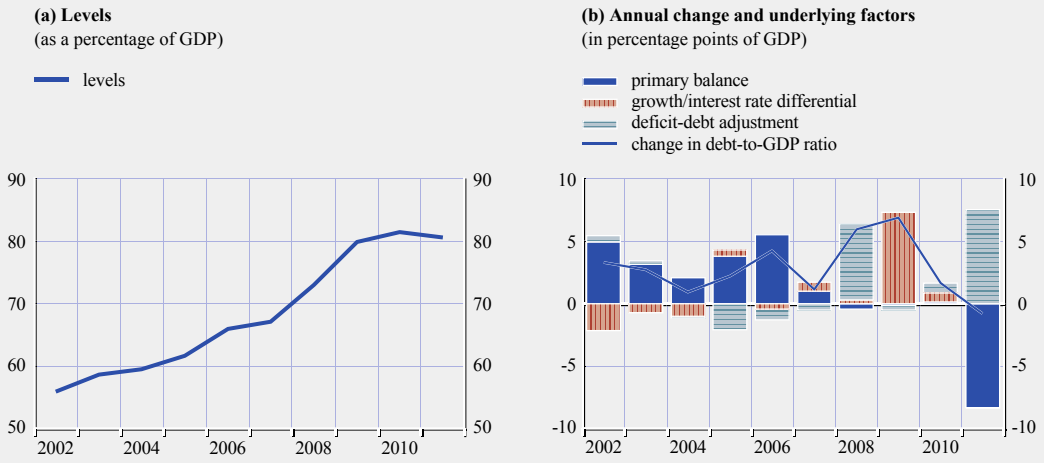
Sources: European Commission (Eurostat) and ECB calculations.
Notes: In Chart 2b a negative (positive) value indicates a contribution to an increase (reduction) in a deficit. The positive impact from non-cyclical factors in 2011 primarily reflects one-off and temporary measures (of about 10% of GDP), as explained in Section 5.2 of Chapter 5.

Table 6 General government gross debt – structural features

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total debt (as a percentage of GDP)	55.9	58.6	59.5	61.7	65.9	67.1	73.0	79.8	81.4	80.6
Composition by currency (% of total)										
In domestic currency	75.2	75.5	73.5	71.0	70.8	68.4	59.9	53.7	52.9	48.2
In foreign currencies	24.8	24.5	26.5	29.0	29.2	31.6	40.1	46.3	47.1	51.8
Euro [1]	23.8	23.6	24.5	26.5	28.6	29.6	37.9	44.3	44.6	49.8
Other foreign currencies	0.9	0.8	2.0	2.5	0.6	2.0	2.1	2.1	2.4	2.1
Domestic ownership (% of total)	67.3	61.5	57.8	54.3	53.5	51.0	48.4	44.5	43.2	34.8
Average residual maturity (in years)	3.5	3.9	4.1	4.6	4.6	4.7	4.5	4.6	4.6	5.1
Composition by maturity [2] (% of total)										
Short-term (up to and including one year)	21.7	19.6	17.7	15.9	16.1	13.3	10.5	10.5	9.6	8.7
Medium and long-term (over one year)	78.3	80.4	82.3	84.1	83.9	86.7	89.5	89.5	90.4	91.3

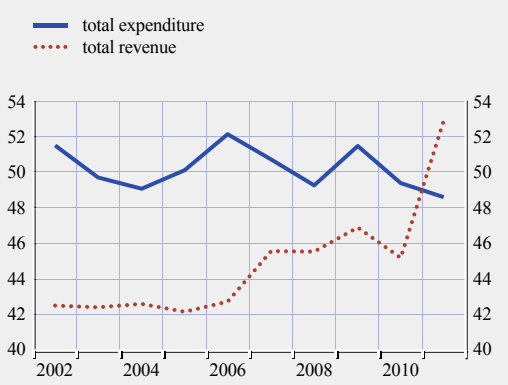
Sources: ESCB and European Commission (Eurostat).
Notes: Year-end data. Differences between totals and the sum of their components are due to rounding.
1) Comprises debt denominated in euro.
2) Original maturity.

Chart 3 General government gross debt



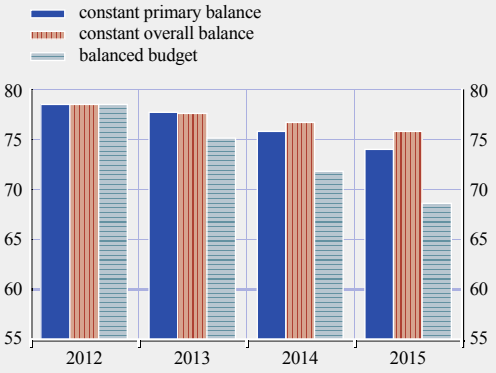
Sources: European Commission (Eurostat) and ECB.
Note: In Chart 3b a negative (positive) value indicates a contribution of the respective factor to a decrease (increase) in the debt ratio.

Chart 4 General government expenditure and revenue



Source: ESCB.

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



Sources: European Commission spring 2012 economic forecast and ECB calculations.
Notes: The three scenarios assume that the debt ratio for 2012 is 78.5% of GDP and that the overall balance of -2.5% of GDP or the primary balance of 1.6% of GDP for 2012 will be kept constant over the period considered (as a percentage of GDP), or, alternatively, that a balanced budget is maintained from 2013 onwards. The nominal GDP growth rate and the implicit interest rate are as projected by the European Commission for 2012-13. Thereafter, the nominal GDP growth rate is kept constant at the 2013 level and the implicit interest rate at 4.2%. Deficit-debt adjustments are assumed to be equal to zero.

Table 7 General government deficit-debt adjustment

(as a percentage of GDP)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Change in general government debt [1]	9.5	7.5	6.4	5.8	8.5	4.6	9.9	4.2	5.0	3.2
General government surplus (+)/deficit (-)	-9.0	-7.3	-6.5	-7.9	-9.4	-5.1	-3.7	-4.6	-4.2	4.3
Deficit-debt adjustment	0.5	0.2	-0.1	-2.1	-0.9	-0.5	6.1	-0.4	0.8	7.5
Net acquisitions (+)/net sales (-) of financial assets	-0.7	-0.5	1.9	-2.1	-0.5	0.1	5.0	-0.4	-1.6	4.0
Currency and deposits	-1.8	0.1	1.1	-0.1	0.5	0.6	6.0	-2.7	-0.8	0.5
Loans and securities other than shares	-0.1	-0.2	0.4	0.3	0.0	-0.5	-0.4	2.1	-0.7	-0.4
Shares and other equity	1.0	-0.6	-0.5	-2.3	-1.2	-0.3	-0.6	0.1	0.0	4.4
Privatisations	-0.6	-0.8	-0.3	-2.5	-0.1	-0.5	-0.6	-0.1	-0.1	-0.1
Equity injections	1.5	0.1	0.1	0.2	0.1	0.0	0.0	0.2	0.1	0.4
Other	0.1	0.1	-0.3	0.0	-1.2	0.1	-0.1	0.0	0.1	4.2
Other financial assets	0.3	0.2	0.9	0.1	0.2	0.3	0.0	0.0	-0.2	-0.5
Valuation changes of general government debt	-0.4	1.3	-1.2	0.1	0.0	-0.3	0.9	-0.1	1.7	4.8
Foreign exchange holding gains (-)/losses (+)	-0.6	1.2	-1.0	0.6	-0.1	-0.1	0.8	0.2	1.8	4.8
Other valuation effects [2]	0.2	0.1	-0.2	-0.4	0.1	-0.2	0.1	-0.2	-0.2	0.0
Other changes in general government debt [3]	1.6	-0.6	-0.9	-0.1	-0.4	-0.4	0.2	0.1	0.7	-1.3

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

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2010	2020	2030	2040	2050	2060
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	24.3	30.5	33.7	40.2	50.6	58.1
Age-related government expenditure (in percentage points of GDP) [1]	22.0	21.7	21.5	23.0	25.1	26.9

Source: The 2012 Ageing Report: Economic and budgetary projections for the EU27 Member States (2010-2060), joint report prepared by the European Commission (DG ECFIN) and the Economic Policy Committee.
1) The Ageing Working Group (AWG) risk scenario, strictly age-related item.

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

Participation in the exchange rate mechanism (ERM II)	No
Exchange rate level in May 2010 in HUF/EUR	276.782
Maximum upward deviation [1]	5.0
Maximum downward deviation [1]	-15.9

Source: ECB.
1) Maximum percentage deviations of the bilateral exchange rate against the euro from its average level in May 2010 over the period 3 May 2010-2 May 2012, based on daily data at business frequency. An upward (downward) deviation implies that the currency was stronger (weaker) than its exchange rate level in May 2010.

Table 9 (b) Key indicators of exchange rate pressure for the Hungarian forint

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

	2010			2011				2012
	June	Sep.	Dec.	Mar.	June	Sep.	Dec.	Mar.
Exchange rate volatility [1]	15.1	12.5	9.2	8.4	6.2	9.5	14.1	12.1
Short-term interest rate differential [2]	4.6	4.5	4.5	4.9	4.7	4.5	5.0	6.4

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

Chart 6 Hungarian forint: nominal exchange rate development against the euro

(a) Exchange rate over the reference period
(daily data; average of May 2010 = 100;
3 May 2010-2 May 2012)

(b) Exchange rate over the last ten years
(monthly data; average of May 2010 = 100;
May 2002-May 2012)

Source: ECB.
Note: An upward (downward) movement of the line indicates an appreciation (depreciation) of the Hungarian forint.

Table 10 Hungarian forint: real exchange rate developments

(monthly data; percentage deviation in March 2012 from ten-year average calculated for the period April 2002-March 2012)

	Mar. 2012
Real bilateral exchange rate against the euro [1]	3.1
Memo items:	
Nominal effective exchange rate [2]	-12.6
Real effective exchange rate [1, 2]	-0.1

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

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Balance of payments										
Current account and capital account balance [1]	-6.7	-8.1	-8.5	-6.8	-6.6	-6.6	-6.3	1.0	3.0	3.6
Current account balance	-7.0	-8.0	-8.6	-7.5	-7.4	-7.3	-7.3	-0.2	1.2	1.4
Goods balance	-3.1	-3.9	-3.8	-2.9	-2.8	-0.7	-1.1	2.6	3.3	4.0
Services balance	0.8	0.1	0.6	1.4	1.6	1.3	1.4	2.2	3.0	3.2
Income balance	-5.4	-5.0	-5.2	-5.7	-5.9	-7.4	-7.1	-5.3	-5.5	-6.3
Current transfers balance	0.7	0.8	-0.2	-0.3	-0.3	-0.5	-0.6	0.4	0.4	0.5
Capital account balance	0.3	0.0	0.1	0.7	0.8	0.7	1.0	1.2	1.8	2.2
Combined direct and portfolio investment balance [1]	6.6	4.2	9.7	8.9	8.2	-1.4	0.0	-4.2	0.5	6.3
Direct investment balance	4.1	0.6	3.1	5.0	2.6	0.2	2.7	0.1	0.8	0.1
Portfolio investment balance	2.6	3.6	6.6	3.9	5.6	-1.6	-2.6	-4.2	-0.3	6.2
Other investment balance	-3.2	3.8	2.4	4.7	1.4	7.3	16.9	9.1	0.5	-3.6
Reserve assets	2.8	-0.5	-1.9	-4.4	-1.0	-0.1	-7.6	-6.2	-3.0	-3.7
Exports of goods and services	63.3	62.4	64.7	67.7	77.3	80.8	81.3	77.3	86.1	91.9
Imports of goods and services	65.6	66.2	67.9	69.1	78.5	80.2	81.0	72.5	79.8	84.7
Net international investment position [2]	-65.2	-78.1	-85.4	-94.4	-102.8	-105.0	-106.0	-117.9	-112.7	-105.2
Gross external debt [2]	53.1	64.4	71.1	82.4	92.4	105.4	123.1	144.9	144.0	145.3
Memo item:										
Export market shares [3]	0.53	0.56	0.58	0.58	0.58	0.63	0.63	0.62	0.59	0.58

Source: ECB.
1) Differences between totals and the sum of their components are due to rounding.
2) End-of-period outstanding amounts. Data published by the Magyar Nemzeti Bank follow a different definition by excluding direct investment inter-company lending.
3) As a percentage of total world goods and services exports.

Table 12 Indicators of integration with the euro area

(as a percentage of the total, unless otherwise stated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
External trade with the euro area										
Exports of goods	68.0	68.0	65.3	62.6	60.3	58.8	57.1	58.1	56.4	55.0
Imports of goods	54.1	53.3	56.3	56.7	55.4	55.1	54.6	55.1	52.8	54.0
Investment position with the euro area										
Inward direct investment [1]	62.4	67.2	67.6	63.2	62.2	66.3	73.3	66.8	71.2	72.1
Outward direct investment [1]	40.7	39.0	51.0	51.7	42.3	35.8	39.6	30.7	21.2	20.1
Portfolio investment liabilities [1]	60.9	71.9	71.7	76.6	69.8	66.6	59.8	64.3	55.1	-
Portfolio investment assets [1]	50.4	35.4	46.7	49.4	72.5	77.8	73.2	66.3	63.2	-
Memo items:										
External trade with the EU										
Exports of goods	84.5	84.1	83.1	80.9	79.2	79.0	78.2	78.7	77.2	75.9
Imports of goods	65.0	64.5	68.5	69.9	70.2	69.5	68.2	68.7	67.7	69.4

Sources: ESCB, European Commission (Eurostat) and IMF.
1) End-of-period outstanding amounts.

4 LONG-TERM INTEREST RATE DEVELOPMENTS

Table 13 Long-term interest rates (LTIRs)

(percentages; average of observations through period)

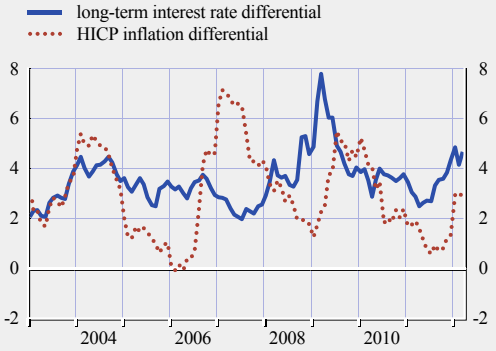
	2011 Dec.	2012 Jan.	2012 Feb.	2012 Mar.	Apr. 2011 to Mar. 2012
Long-term interest rate	9.0	9.5	8.6	8.7	8.0
Reference value[1]					*5.8*
Euro area[2]	*4.6*	*4.7*	*4.4*	*4.1*	*4.4*
Euro area (AAA)[3]	*2.7*	*2.6*	*2.5*	*2.5*	*2.9*

Sources: ECB and European Commission (Eurostat).
1) The basis of the calculation for the period April 2011-March 2012 is the unweighted arithmetic average of the interest rate levels in Sweden and Slovenia plus 2 percentage points.
2) The euro area average is included for information only.
3) The euro area AAA par yield curve for the ten-year residual maturity is included for information only.

Chart 7 Long-term interest rate (LTIR)

(a) Long-term interest rate (LTIR)
(monthly averages in percentages)

(b) LTIR and HICP inflation differentials vis-à-vis the euro area
(monthly averages in percentage points)



Sources: ECB and European Commission (Eurostat).

Table 14 Selected indicators of financial development and integration

(as a percentage of GDP, unless otherwise stated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Memo item: euro area 2011
Debt securities issued by corporations[1]	11.0	13.1	10.4	11.4	13.1	14.3	20.6	29.1	27.6	27.2	103.0
Stock market capitalisation[2]	17.2	18.5	24.8	31.7	33.8	32.0	13.3	22.1	21.5	16.2	41.5
MFI credit to non-government residents[3]	-	41.5	44.8	50.0	54.5	60.6	68.2	68.1	67.3	63.6	134.7
Claims of euro area MFIs on resident MFIs[4]	-	-	-	18.5	19.5	21.4	26.2	23.6	22.4	20.5	7.9
Private sector credit flow[5]	15.3	18.3	12.8	17.4	17.8	22.1	29.2	5.2	-18.7	-	3.5
Private sector debt[6]	71.1	84.9	86.4	102.2	110.7	125.7	155.7	169.9	155.1	-	167.0

Sources: ESCB, European Commission (Eurostat), Federation of European Securities Exchanges, OMX and national stock exchanges.
1) Outstanding amount of debt securities issued by resident non-financial corporations, MFIs and other financial corporations.
2) Outstanding amounts of quoted shares issued by residents at the end of the period at market values.
3) MFI (excluding NCB) credit to domestic non-MFI residents other than the general government. Credit includes outstanding amounts of loans and debt securities.
4) Outstanding amount of deposits and debt securities issued by domestic MFIs (excluding the NCB) held by euro area MFIs as a percentage of total liabilities of domestic MFIs (excluding the NCB). Total liabilities exclude capital and reserves and remaining liabilities.
5) Transactions in securities other than shares issued and loans taken out by institutional sectors: non-financial corporations, households and non-profit institutions serving households.
6) Outstanding amounts of securities other than shares issued and loans taken out by institutional sectors: non-financial corporations, households and non-profit institutions serving households.

5.6 POLAND

5.6.1 PRICE DEVELOPMENTS

Over the reference period from April 2011 to March 2012, the 12-month average rate of HICP inflation in Poland was 4.0%, i.e. well above the reference value of 3.1% for the criterion on price stability (see Table 1). On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to remain broadly stable in the coming months.

Looking back over a longer period, annual consumer price inflation in Poland has fluctuated within a range of 0.7% and 4.2% over the past ten years, mainly reflecting the impact of external price shocks and exchange rate fluctuations (see Chart 1). More specifically, annual HICP inflation followed a sharp downward trend from double-digit rates at the beginning of 2000 to low rates in 2003. In 2004 there was a temporary rise in inflation, resulting mainly from Poland's accession to the EU. Following a period of low inflation in 2005 and 2006, price pressures picked up again at the end of 2006 as a result of rising food prices, higher administered prices and indirect taxes, and growing wage dynamics. Inflation increased to levels of above 4.0% in 2008, reflecting higher unit labour cost growth and changes in administered prices, as well as global food and energy price shocks. Inflation remained elevated in 2009, partly reflecting the lagged impact of the sharp depreciation of the zloty after the collapse of Lehman Brothers, but declined gradually in 2010 supported by lower growth in import prices. In 2011, the surge in global commodity prices, the depreciation of the nominal exchange rate and a VAT increase amid robust domestic demand contributed to a renewed rise in inflation.

Poland's medium-term inflation performance reflects a number of important policy choices, most notably the orientation of monetary policy towards the achievement of price stability, which is the primary objective of monetary policy, as enshrined in the central bank law. Narodowy Bank Polski operates a floating exchange rate system and since 1998 has had an inflation-targeting 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, to a more limited degree, enhance product market competition. A mildly restrictive fiscal policy stance supported the achievement of Narodowy Bank Polski's inflation targets during 2005-07. While fiscal policy did not contribute sufficiently to the achievement of price stability between 2008 and 2010, fiscal policy tightening supported limiting inflationary pressures in 2011.

Inflation developments over the past ten years should be viewed against the background of sustained economic growth. Macroeconomic developments up to mid-2008 were characterised by a sustained upswing in economic activity, which was only partly interrupted in the first half of 2005. In 2006 and 2007 real GDP expanded at an annual rate well above 6%, driven mainly by domestic demand which, in turn, was supported by improved labour market conditions and a strong growth in credit to the private sector. Capacity pressures became apparent in 2007-08, in the form of noticeable rises in unit labour cost growth, increasing current account deficits and a historically low unemployment rate. The latter reflected a notable increase in labour demand and employment, which resulted in labour shortages in some sectors and regions. In addition, a sharp rise in food prices, strong gains in house prices and increases in administered prices contributed to the rebound in inflation from late 2006 until 2009. Capacity pressures declined with the start of the global economic and financial crisis. A relatively short-lived economic slowdown – Poland was the only EU country that avoided an output decline in 2009 – and lower global commodity prices resulted in a temporary decline in

annual HICP inflation to levels below 2% in the summer of 2010. Thereafter, inflationary pressures resulting mainly from external factors emerged again, bringing inflation to levels well above the central bank's target, which provoked Narodowy Bank Polski to increase rates by 1 percentage point in the first half of 2011, in order to prevent elevated inflation from becoming entrenched. In the housing market, following sharp increases during 2007-09, prices have broadly stabilised after a slight decrease in 2010. The degree of exchange rate volatility has been mostly rather high and has therefore influenced inflation through subsequent changes in import prices. The general pattern of inflation developments has also been reflected in other relevant indices, such as the HICP excluding unprocessed food and energy (see Table 2).

Looking at recent developments, annual HICP inflation remained at an elevated level close to 4% throughout most of 2011. This trend continued at the beginning of 2012, with annual HICP inflation standing at 3.9% in March 2012 (see Table 3a). HICP inflation excluding unprocessed food and energy also stood at relatively high levels (3.1%) in March 2012. The relatively high inflation rate in 2011, which was partly attributable to the pass-through of higher global commodity prices, the weaker exchange rate of the zloty, as well as the VAT increase in January 2011, occurred despite contained growth in unit labour costs. The contribution of administered prices (including energy prices) to HICP inflation – with a share of almost 13% in Poland's HICP basket – remained constant at around 0.7 percentage point in 2011. The strong performance of the Polish economy, with real GDP growth estimated at a robust 4.3% in 2011, can also be explained by the momentum of both private consumption and public investment, which is being supported by substantial inflows of EU funds, particularly in the non-residential construction sector.

The latest available forecasts from major international institutions project inflation to decline in 2012-13, and range between 2.5% and 3.8% in 2012 and between 2.5% and 2.9% in 2013 (see Table 3b). It is anticipated that several factors will contribute to a decline in inflation in the Polish economy. In particular, the expected deceleration in real GDP growth in 2012, resulting partly from fiscal and monetary policy tightening, is likely to support a gradual decline in inflation towards the central bank's inflation target. Risks to the inflation outlook are balanced. Upside risks relate mainly to higher than expected commodity prices, whereas downside risks are associated mostly with weaker than expected economic activity. Looking further ahead, the catching-up process is likely to have a bearing on inflation and/or on the nominal exchange rate over the coming years, given that GDP per capita and price levels are still lower in Poland than in the euro area (see Table 2). However, it is difficult to assess the exact size of the effect resulting from this catching-up process.

Achieving an environment conducive to sustainable convergence in Poland requires, inter alia, maintaining a price stability-oriented monetary policy in the medium term. Although the Polish economy managed to weather the global crisis well in comparative terms, a number of fiscal and structural issues remain unresolved. Specifically, comprehensive expenditure-based fiscal consolidation, in line with the requirements of the EDP, should be implemented to reduce the large structural deficit and contain public debt growth in a sustainable manner. Regarding structural reforms, efforts to speed up the privatisation process (particularly in key state-owned sectors such as mining, chemicals and energy), which are needed to enhance economic efficiency, should be complemented with steps to increase competition in product markets. More competitive product markets would support higher potential growth, while at the same time strengthening the economy's resilience to potential shocks. In addition, improvements in the business environment could contribute to attracting much-needed private investment (e.g. by diminishing barriers to entry). In the labour market, a number of structural weaknesses need to be addressed, for example,

by strengthening education and reducing labour market mismatches as well as boosting the labour force participation rate. Wage increases should reflect labour productivity growth, labour market conditions and developments in competitor countries. Increasing reliance on potentially volatile portfolio inflows presents vulnerabilities, particularly at the current juncture. It would therefore be important to encourage the financial sector to rely more heavily on domestic sources of funding. Given the potential financial stability risks associated with the high share of foreign currency-denominated loans in Poland, the European Systemic Risk Board's recommendations on lending in foreign currencies, released in 2011, need to be fully taken into account. Financial sector policies should also be geared towards preventing excessive credit growth in the future. Finally, modernising the country's infrastructure would boost potential output and would support a more efficient allocation of resources. Enhancing the absorption of EU funds could help reach that goal. Such measures will contribute to the achievement of an environment conducive to sustainable price stability and promote competitiveness and employment growth.

5.6.2 FISCAL DEVELOPMENTS

Poland is, at present, subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2011 the general government budget balance showed a deficit of 5.1% of GDP, i.e. well above the 3% reference value. The general government gross debt-to-GDP ratio was 56.3%, i.e. below the 60% reference value (see Table 4). Compared with the previous year, the budget balance ratio improved by 2.7 percentage points, while the public debt ratio increased by 1.5 percentage points. In 2012 the deficit ratio is forecast by the European Commission to decline to 3.0% and the government debt ratio is projected to decline to 55.0%. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2011 and is not expected to exceed it in 2012 either.

Looking at developments in Poland's budgetary position over the period from 2002 to 2011, after rising to 6.2% of GDP in 2003, the budget deficit declined to 1.9% in 2007, before increasing sharply to 7.8% of GDP in 2010. This upward trend was reversed in 2011 (see Table 5 and Chart 2a). As the deficit-to-GDP ratio rose above the 3% of GDP reference value in 2008 – in a still favourable economic environment – the ECOFIN Council decided on 7 July 2009 that an excessive deficit situation existed in Poland and set the deadline for correcting it at 2012. As shown in greater detail in Chart 2b, European Commission estimates indicate that cyclical factors contributed overall to reducing the budget deficit between 2003 and 2008. In 2009 cyclical factors had a negative impact on the budget balance, but a broadly neutral impact in 2010 and 2011. Non-cyclical factors, which contributed to a reduction of the budget deficit in 2005 and 2007, brought about the strong deterioration of the budget balance between 2008 and 2010. These factors relate to the reduction in labour taxation intended to increase incentives to work, which acted as a fiscal stimulus as the global financial and economic crisis took hold. The impact of non-cyclical factors on the budget balance turned positive in 2011, when the Polish government implemented comprehensive fiscal consolidation measures. On the expenditure side, consolidation measures included a wage freeze for government employees as well as a temporary rule limiting the real growth of central government discretionary expenditure. On the revenue side, the measures comprised adjustments in pension contributions between the private and public pillars and a temporary increase in the standard VAT rate. In the absence of substantial temporary and one-off factors during 2004-11, the underlying changes in the budget deficit seem to reflect a structural deterioration of Poland's fiscal position until 2010 and a consolidation thereafter.

Turning to developments in general government gross debt, between 2002 and 2011 the debt-to-GDP ratio increased cumulatively by 14.1 percentage points, although it was relatively stable until 2007 (see Chart 3a and Table 6). As shown in greater detail in Chart 3b, this increase relates, in particular, to the development in primary deficits, indicating a persistent link between primary deficits and adverse debt dynamics. At the same time, the impact of the deficit-debt adjustment was volatile, with both debt-increasing and debt-decreasing effects in individual years. The growth/interest rate differential had, on aggregate, a small dampening effect on the debt ratio between 2004 and 2011. In 2011 the increase in the general government debt-to-GDP ratio reflected a continued primary deficit, which was only partly counterweighed by deficit-debt adjustments related to privatisation receipts and a centralisation of liquidity management.

As regards Poland's general government debt structure, the share of government debt with a short-term maturity declined from 19.5% in 2002 to 1.1% in 2011 (see Table 6). Taking into account the level of the debt ratio, fiscal balances are insensitive to changes in interest rates. At 30.8% in 2011, the proportion of government debt denominated in foreign currency is high, and, given the overall debt level, the sensitivity of fiscal balances to changes in the exchange rate is noticeable. During the crisis, the share of debt with a short-term maturity declined markedly, pointing to a decline in debt-related vulnerabilities. The share of debt denominated in foreign currency increased noticeably. At the same time, the Polish government has not incurred contingent liabilities resulting from government interventions to support financial institutions and financial markets during the crisis (see Section 5.9).

Moving on to examine trends in other fiscal indicators, Chart 4 and Table 5 show that the general government total expenditure-to-GDP ratio declined overall from 44.3% in 2002 to 43.6% in 2011. After peaking at 45.4% of GDP in 2010, the expenditure ratio declined in 2011, as a result of declines in all categories of current primary expenditure on the back of a wage freeze in the public sector, a temporary expenditure rule in the central budget and a tightening of access to early retirement, legislated in 2009. Total government revenue as a share of GDP was volatile over the period under consideration and decreased slightly from 39.3% of GDP in 2002 to 38.5% of GDP in 2011. After peaking at 40.3% of GDP in 2007, the revenue-to-GDP ratio declined to 37.5% of GDP in 2010 on the back of lower direct tax revenue as a percentage of GDP, lower social security contributions intended to increase work incentives and a decline in other current revenues. These developments were outweighed in part by higher capital revenues. In 2011 the revenue-to-GDP ratio increased owing to higher capital revenue, related to EU fund absorption, and a rise in social security contributions. The latter represents a shift of part of the mandatory private pension pillar's contributions to the public "pay-as-you-go" pension scheme.

Looking ahead, Poland's medium-term fiscal policy strategy indicates the commitment of the government to bring the deficit to just below the reference value in 2012 and to reduce it gradually thereafter. According to the 2012-15 convergence programme update, the deficit is planned to be reduced to 2.9% of GDP in 2012 and further to 0.9% of GDP in 2015. According to the 2012 budget, the planned fiscal consolidation for 2012 will be largely revenue-based, owing to an increase in the social security contribution rate by 2 percentage points, higher dividends from state-owned and co-owned companies, as well as a levy on minerals. According to the 2012-15 convergence programme update, the structural deficit over the programme period is expected to reach the medium-term objective of 1.0% of GDP (specified in line with the Stability and Growth Pact) by 2015. Moreover, based on information submitted in the 2012 convergence programme update, primary expenditure excluding, inter alia, EU fund transfers (relevant expenditure), as a share of GDP, is projected to drop by 2.6 percentage points between 2012 and 2015. The annual growth rate

of relevant expenditure is projected to be below the growth rate of potential GDP over the period 2012-14 and to turn above it in 2015. According to the European Commission's projections, the structural deficit will remain above the medium-term objective by 2013.

In this respect, on 2 March 2012 Poland signed the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, committing, inter alia, to apply (and include in its national legislation) the fiscal rules specified under Title III, "Fiscal Compact", as referred to in Box 2 of Chapter 2.

Overall, as regards fiscal governance, Poland has strengthened its fiscal framework over recent years, introducing a temporary expenditure rule and medium-term fiscal planning, to complement the constitutional debt ceiling, which has been in force since 1999. Looking ahead, the transparency and enforceability of the rules should be enhanced. Moreover, the temporary expenditure rule for the central government, which will be in place as long as Poland is subject to an EDP, needs to be replaced by a comprehensive, transparent and binding permanent rule. Full compliance with the provisions for an enhanced national governance framework under Council Directive 2011/85/EU and the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, as referred to in Box 2 of Chapter 2, should be ensured.

Turning to factors with an impact on Poland's public finances over the long term, a marked ageing of the population is expected, as highlighted in Table 8. According to the 2012 projections by the European Commission and the EU's Economic Policy Committee, starting from a level of 21.4% of GDP in 2010, Poland is likely to experience a moderate increase in strictly age-related public expenditure amounting to 1.9 percentage points of GDP in the years to 2060.[10] This reflects in large part the implementation of a major pension reform in 1999, which established a second, privately funded pension pillar.

Turning to fiscal challenges, Poland must ensure a sustainable reduction in the budget deficit and correct the excessive deficit by 2012, in line with the EDP requirements. In particular, a more comprehensive expenditure-based approach is needed to reduce the large structural deficit and to contain the rise in the debt ratio in a sustainable manner, while avoiding undue cuts in public investment. Poland's fiscal policy strategy should be supported by a further strengthened fiscal framework, including a strict permanent expenditure rule in support of the necessary fiscal consolidation, as proposed in the 2012 Convergence Programme update. At the same time, every effort should be made to comply fully with the obligations under the enhanced Stability and Growth Pact, and to implement effectively the provisions of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union.

5.6.3 EXCHANGE RATE DEVELOPMENTS

In the two-year reference period from 1 May 2010 to 30 April 2012, the Polish zloty did not participate in ERM II, but traded under a flexible exchange rate regime (see Table 9a). After appreciating modestly against the euro in the second half of 2010 and remaining broadly stable in the first two quarters of 2011, the zloty was subject to substantial depreciation pressures in the second half of 2011. From December 2011 it recovered some of its losses against the euro. Over the reference period the Polish currency often traded close to its May 2010 average exchange rate against the euro, which is used as a benchmark for illustrative purposes in the absence of an ERM II

10 European Commission and Economic Policy Committee, "The 2012 Ageing Report: Economic and budgetary projections for the EU-27 Member States (2010-2060)".

central rate. The maximum upward deviation from this benchmark was 5.3%, while the maximum downward deviation amounted to 12.4% (see Chart 5 and Table 9a). As the Polish zloty depreciated in the second half of 2011, Narodowy Bank Polski occasionally sold foreign currency for zloty between September and December 2011.

A Flexible Credit Line (FCL) arrangement by the IMF has been in place since mid-2009. The precautionary arrangement totalling SDR[11] 14 billion had initially been approved in May 2009 for a one-year period, but was prolonged in mid-2010 for another six months. At the beginning of 2011 the IMF decided to prolong the existing FCL for a further two years and augment it to a total of SDR 19 billion. Poland has not received any disbursements from the FCL since its establishment. In late 2008 Narodowy Bank Polski and the ECB agreed on repurchase transactions, which would provide Narodowy Bank Polski with a facility to borrow up to €10 billion. As these arrangements helped to reduce risks related to financial vulnerabilities, they might also have contributed to reducing the risk of exchange rate pressures.

Looking at exchange rate developments in more detail, the relatively large fluctuations of the Polish zloty during the reference period were partly driven by changes in global risk aversion amid tensions in some euro area debt markets. Between May 2010 and January 2011 the zloty appreciated gradually by around 8% on account of strong domestic growth momentum and a rather large positive interest rate differential vis-à-vis euro area assets amid improving sentiment of financial markets towards the region. In the second half of 2011 a sharp depreciation of the zloty took place against the renewed increase in global risk aversion and developments in euro area sovereign debt markets and also on account of a deteriorating outlook for the Polish economy. Overall, between late July and mid-December 2011 the Polish currency depreciated by almost 15%. The gradual normalisation of global financial market conditions contributed thereafter to a reversal of the depreciation of the zloty. The Polish currency strengthened, to trade at 4.171 zloty per euro on 30 April 2012, i.e. 2.8% weaker than its average level in May 2010.

During the reference period, the exchange rate of the Polish zloty against the euro showed a high degree of volatility, as measured by annualised standard deviations of daily percentage changes. Volatility peaked in the three-month period ending in December 2011 at the very high level of 12.8%, but declined thereafter. At the same time short-term interest rate differentials against the three-month EURIBOR remained at relatively wide levels, on average, over the reference period on account of relatively high monetary policy rates in Poland. The spread increased from 3.1 percentage points in the three-month period ending in June 2010 to 3.9 percentage points in the three-month period ending in March 2012 (see Table 9b).

In a longer-term context, in March 2012 both the Polish zloty's real effective exchange rate and its real bilateral exchange rate against the euro stood close to the corresponding ten-year historical averages (see Table 10). However, these measures should be interpreted with caution, as in this period Poland was subject to a process of economic convergence, which complicates any historical assessment of real exchange rate developments.

As regards other external developments, between 2002 and 2011 Poland reported relatively large deficits, of 3.3% of GDP on average, in the combined current and capital account of its balance of payments (see Table 11). The current account deficit increased gradually from 2.1% of GDP in 2005 to 5.4% in 2008 on account of the rising deficit in the goods balance associated with rapid growth in

11 "Special Drawing Right", the standard unit of account used by the IMF.

domestic demand. Following a strong depreciation of the zloty and a decline in domestic demand, the combined current and capital account deficit adjusted markedly in 2009 to 2.2% of GDP and stood at 2.8% of GDP in 2010 and 2.1% in 2011. This mainly reflected a renewed increase in the goods deficit on account of strengthening domestic demand. Between 2002 and 2009 the external deficit was largely financed by net inflows in direct investment. Against this background, gross external debt increased from 40.3% of GDP in 2002 to 59.4% in 2009, before further rising to 66.0% of GDP in 2010 and 72.2% in 2011. At the same time Poland's net international investment position deteriorated substantially, from -34.9% of GDP in 2002 to -64.0% in 2010 and -63.5% in 2011. Poland is an open economy; the ratio of foreign trade in goods and services to GDP increased from 28.6% in 2002 to 44.8% in 2011 for exports and from 31.9% in 2002 to 46.4% in 2011 for imports. Over the same period, Poland's share in world exports increased from 0.70% to 1.04%.

Concerning measures of economic integration with the euro area, in 2011 exports of goods to the euro area constituted 54.1% of total goods exports, whereas the corresponding figure for imports was slightly higher, at 55.3%. The share of euro area countries in Poland's inward direct investment stood at 73.2% in 2011 and that in its portfolio investment liabilities at 51.4% in 2010. The share of Poland's assets invested in the euro area amounted to 47.7% in the case of direct investment in 2011 and 56.5% for portfolio investment in 2010 (see Table 12).

5.6.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from April 2011 to March 2012, long-term interest rates in Poland were 5.8% on average and thus at the 5.8% reference value for the interest rate convergence criterion (see Table 13).

Long-term interest rates in Poland declined until mid-2003 and subsequently increased until mid-2004 in parallel with rising inflationary pressures and growing fiscal uncertainty. From mid-2004, long-term interest rates declined until September 2005, on the back of favourable inflation dynamics and an exchange rate appreciation, mirroring developments in euro area yields (see Chart 6a). The reverse upward trend emerged towards the end of 2005 and lasted until mid-2008 in an environment of rising inflationary pressures and increasing bond yields in the developed markets. The global financial and economic crisis pushed up the country's risk premium and triggered foreign capital outflows as well as liquidity strains in the government bond market. Between November 2008 and June 2009, Narodowy Bank Polski cut the reference interest rate by a total of 250 basis points, to 3.5%, in an environment of economic slowdown and falling inflationary pressures. High volatility of long-term interest rates from the end of 2008 to the beginning of 2009 reflected high levels of risk aversion and uncertainty among investors. In May 2009 the IMF approved a precautionary arrangement under the Flexible Credit Line for Poland to provide support during the global financial crisis. Subsequently, the resilience of the Polish economy, reflected in positive growth figures during the global crisis, coupled with a significant improvement in the external balance, brought capital inflows to the local market, stabilising long-term interest rates in 2009 and fostering their declines in 2010 amid high international investor demand for Polish sovereign bonds. At the end of 2010 and the beginning of 2011, long-term interest rates increased somewhat, reflecting broader financial market tensions. Since the middle of 2011, long-term interest rates have generally followed a downward trend. Narodowy Bank Polski increased the reference interest rate in four steps during 2011, reflecting increasing inflationary pressures. International investor demand continued to be strong, which was reflected by relatively stable long-term interest rates. Still, tensions in the euro area debt markets, the increasing risk compensation demanded by investors and the country's declining but still sizeable fiscal imbalances were reflected in

some temporary increases of long-term interest rates towards the end of 2011, after which their downward trend continued. At the end of the reference period, the long-term interest rate for Poland stood at 5.4%.

The spread between long-term interest rates in Poland and average bond yields in the euro area has declined since mid-2004 (see Chart 6b). From July 2007, in the wake of the two rounds of the global financial market turmoil, the interest rate differential widened considerably, but remained below the highs of 2004. From 2010 the long-term interest rate differential was on a declining trend and amounted to 1.3 percentage points with respect to the euro area average (and 2.8 percentage points with respect to the euro area AAA yield) at the end of the reference period, close to the historical low observed in June 2007.

The Polish financial sector can be regarded as smaller and much less developed compared with the euro area (see Table 14). Foreign-owned banks, primarily from the euro area, play a major role in the Polish banking sector. The amount outstanding of bank loans was relatively low, but increased to stand at 54.5% of GDP at the end of 2011. The majority of loans to the private sector are denominated in local currency. Market-based credit to the corporate sector, as measured by the value of outstanding fixed-income securities issued by corporations, has increased in recent years and was 13.3% of GDP at the end of 2011. Stock market capitalisation partly recovered from declines during the crisis and stood at 29.0% of GDP in 2011, relatively high in comparison with other central European stock markets. The increased participation of pension and investment funds has contributed to the development of the stock market. The international claims of euro area banks in the country gradually increased over time until 2008 and subsequently declined somewhat, standing at 11.7% of total liabilities in 2011.

LIST OF TABLES AND CHARTS

POLAND

I PRICE DEVELOPMENTS

Table 1 HICP inflation

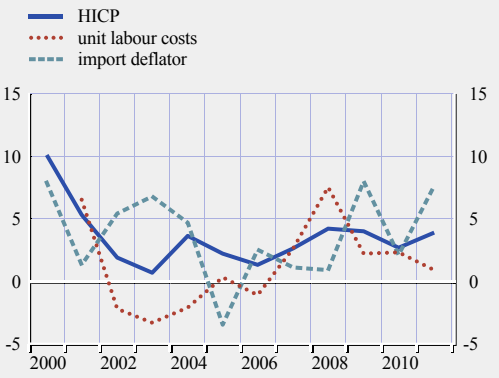
(annual percentage changes)

	2011	2012			Apr. 2011
	Dec.	Jan.	Feb.	Mar.	to Mar. 2012
HICP inflation	4.5	4.1	4.4	3.9	4.0
Reference value[1]					*3.1*
Euro area[2]	*2.7*	*2.7*	*2.7*	*2.7*	*2.8*

Source: European Commission (Eurostat).
1) The basis of the calculation for the period April 2011-March 2012 is the unweighted arithmetic average of the annual percentage changes in the HICP for Sweden, Ireland and Slovenia plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(average annual percentage changes)



Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Measures of inflation										
HICP	1.9	0.7	3.6	2.2	1.3	2.6	4.2	4.0	2.7	3.9
HICP excluding unprocessed food and energy	2.0	0.6	2.8	1.2	0.6	2.0	3.6	3.3	2.0	3.1
HICP at constant tax rates[1]	-	-	3.1	1.6	1.1	2.1	3.5	3.2	2.5	3.1
CPI	1.9	0.8	3.5	2.1	1.0	2.5	4.2	3.5	2.6	4.3
Private consumption deflator	3.3	0.4	3.0	2.1	1.1	2.5	4.4	2.5	2.5	4.3
GDP deflator	2.3	0.4	4.2	2.7	1.5	3.9	3.1	3.6	1.4	3.2
Producer prices[2]	0.2	1.8	7.7	2.5	3.4	4.0	5.4	2.4	3.7	7.7
Related indicators										
Real GDP growth	1.4	3.9	5.3	3.6	6.2	6.8	5.1	1.6	3.9	4.3
GDP per capita in PPS[3] (euro area = 100)	43.5	44.3	46.4	47.0	47.6	50.0	51.8	55.9	57.9	-
Comparative price levels (euro area = 100)	61.0	52.9	51.7	59.8	61.3	60.9	67.1	55.1	59.4	-
Output gap[4]	-1.8	-1.1	0.4	-0.2	1.0	2.4	2.2	-0.7	-0.8	-0.2
Unemployment rate (%)[5]	20.0	19.7	19.0	17.8	13.9	9.6	7.1	8.2	9.6	9.7
Unit labour costs, whole economy	-2.2	-3.3	-2.1	0.3	-1.1	2.6	7.5	2.2	2.3	0.9
Compensation per employee, whole economy	2.3	1.6	1.9	1.7	1.9	4.9	8.9	3.5	5.7	4.3
Labour productivity, whole economy	4.6	5.1	4.1	1.4	2.9	2.3	1.3	1.3	3.4	3.3
Imports of goods and services deflator	5.4	6.8	4.7	-3.5	2.5	1.1	0.9	8.0	2.1	7.6
Nominal effective exchange rate[6]	-4.4	-9.4	-1.6	11.7	3.1	3.8	9.2	-18.4	5.8	-3.1
Money supply (M3)	-	-	-	14.2	16.8	15.1	16.6	8.1	9.0	10.8
Lending from banks	-	-	-	15.8	26.7	37.1	24.4	8.0	5.9	6.6
Stock prices (Warsaw General Index)	3.2	44.9	27.9	33.7	41.6	10.4	-51.1	46.9	18.8	-20.8
Residential property prices	-	-	-6.1	20.0	3.8	45.3	42.4	20.5	-1.2	-

Sources: European Commission (Eurostat), national data (CPI, money supply, lending from banks and residential property prices) and European Commission (output gap).
1) 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 on the price paid by the consumer.
2) Total industry excluding construction and domestic sales.
3) PPS stands for purchasing power standards.
4) Percentage difference of potential GDP: a positive (negative) sign indicates that actual GDP is above (below) potential GDP.
5) The definition conforms to ILO guidelines.
6) A positive (negative) sign indicates an appreciation (depreciation).

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2011			2012		
	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.
HICP						
Annual percentage change	3.8	4.4	4.5	4.1	4.4	3.9
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	3.7	4.6	5.8	6.3	5.9	4.6
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	3.5	3.5	3.7	4.2	4.4	4.7

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2012	2013
HICP, European Commission (spring 2012)	3.7	2.9
CPI, OECD (December 2011)	2.5	2.5
CPI, IMF (April 2012)	3.8	2.7
CPI, Consensus Economics (April 2012)	3.6	2.7

Sources: European Commission, OECD, IMF and Consensus Economics.

2 FISCAL DEVELOPMENTS

Table 4 General government fiscal position

(as a percentage of GDP)

	2010	2011	2012 [1]
General government surplus (+)/deficit (-)	-7.8	-5.1	-3.0
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure [2]	-2.2	0.7	2.6
General government gross debt	54.8	56.3	55.0
Reference value	*60.0*	*60.0*	*60.0*

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

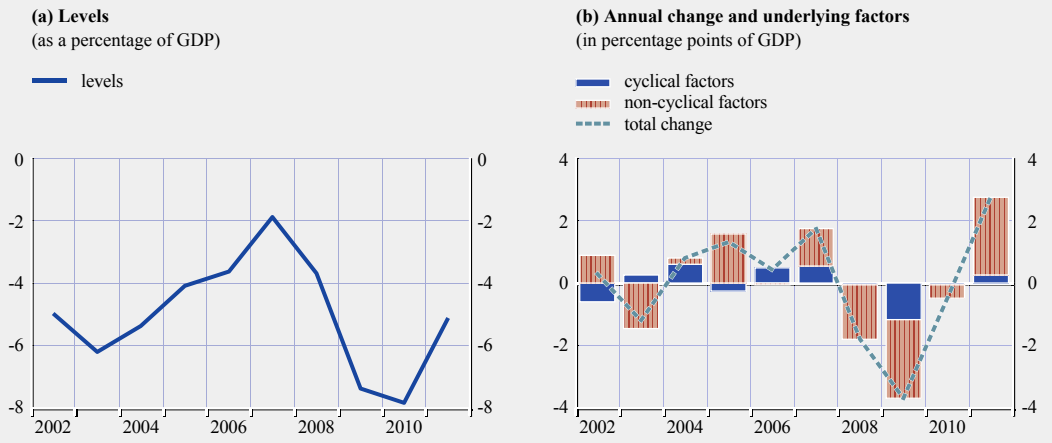
Table 5 General government budgetary position

(as a percentage of GDP)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total revenue	39.3	38.5	37.2	39.4	40.2	40.3	39.5	37.2	37.5	38.5
Current revenue	39.3	38.4	37.2	38.8	39.7	39.8	39.1	36.6	36.2	36.7
Direct taxes	6.7	6.5	6.5	7.0	7.5	8.6	8.6	7.4	6.9	7.0
Indirect taxes	13.2	13.2	12.9	13.6	14.2	14.1	14.2	12.8	13.6	13.7
Social security contributions	12.9	12.8	12.3	12.3	12.2	12.0	11.3	11.3	11.1	11.4
Other current revenue	6.4	6.0	5.5	5.9	5.8	5.2	5.0	5.0	4.6	4.5
Capital revenue	0.0	0.0	0.1	0.6	0.5	0.5	0.5	0.6	1.3	1.8
Total expenditure	44.3	44.7	42.6	43.4	43.9	42.2	43.2	44.5	45.4	43.6
Current expenditure	40.2	40.2	38.7	39.0	39.0	37.3	37.7	38.4	39.0	37.2
Compensation of employees	10.8	10.7	10.1	10.0	9.8	9.6	10.0	10.3	10.2	9.8
Social benefits other than in kind	17.0	16.9	16.0	15.7	15.2	14.2	14.0	14.7	14.8	14.1
Interest payable	2.9	3.0	2.8	2.8	2.7	2.3	2.2	2.6	2.7	2.7
of which: impact of swaps and FRAs [1]	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other current expenditure	9.6	9.6	9.9	10.5	11.4	11.2	11.5	10.7	11.3	10.6
Capital expenditure	4.0	4.5	3.9	4.4	4.8	4.8	5.5	6.2	6.4	6.4
Surplus (+)/deficit (-)	-5.0	-6.2	-5.4	-4.1	-3.6	-1.9	-3.7	-7.4	-7.8	-5.1
Primary balance	-2.1	-3.2	-2.6	-1.3	-1.0	0.4	-1.5	-4.7	-5.2	-2.4
Surplus/deficit, net of government investment expenditure	-1.5	-2.9	-2.0	-0.7	0.3	2.3	0.9	-2.2	-2.2	0.7

Sources: ESCB and European Commission (Eurostat).
Notes: Differences between totals and the sum of their components are due to rounding. Interest payable as reported under the excessive deficit procedure. The item "impact of swaps and FRAs" is equal to the difference between the interest (or deficit/surplus) as defined in the excessive deficit procedure and in the ESA 95. See Regulation (EC) No 2558/2001 of the European Parliament and of the Council of 3 December 2001 amending Council Regulation (EC) No 2223/96 as regards the reclassification of settlements under swap arrangements and under forward rate agreements (0J L 344, 28.12.2001, p. 1).
1) FRAs stands for forward rate agreements.

Chart 2 General government surplus (+)/deficit (-)



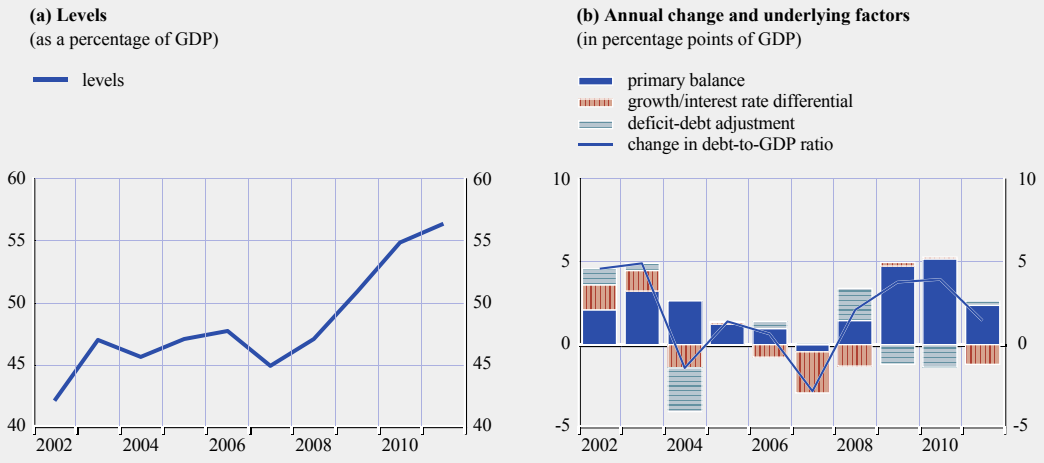
Sources: European Commission (Eurostat) and ECB calculations.
Note: In Chart 2b a negative (positive) value indicates a contribution to an increase (reduction) in a deficit.

Table 6 General government gross debt – structural features

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total debt (as a percentage of GDP)	42.2	47.1	45.7	47.1	47.7	45.0	47.1	50.9	54.8	56.3
Composition by currency (% of total)										
In domestic currency	66.1	67.4	73.3	72.3	73.9	75.8	73.6	73.9	73.0	69.2
In foreign currencies	33.9	32.6	26.7	27.7	26.1	24.2	26.4	26.1	27.0	30.8
Euro [1]	15.0	18.3	16.7	18.4	18.8	17.7	19.3	18.7	19.8	21.3
Other foreign currencies	19.0	14.3	10.0	9.4	7.3	6.5	7.1	7.4	7.2	9.5
Domestic ownership (% of total)	59.5	58.3	59.3	58.4	60.6	62.9	65.9	62.5	57.1	51.6
Average residual maturity (in years)	4.0	4.0	4.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Composition by maturity [2] (% of total)										
Short-term (up to and including one year)	19.5	20.7	13.5	7.1	5.9	4.3	8.4	6.9	3.4	1.1
Medium and long-term (over one year)	80.5	79.3	86.5	92.9	94.1	95.7	91.6	93.1	96.6	98.9

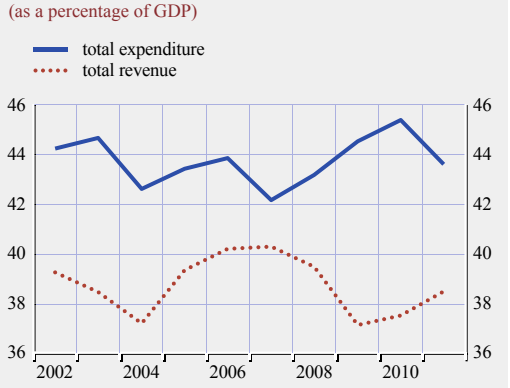
Sources: ESCB and European Commission (Eurostat).
Notes: Year-end data. Differences between totals and the sum of their components are due to rounding.
1) Comprises debt denominated in euro.
2) Original maturity.

Chart 3 General government gross debt



Sources: European Commission (Eurostat) and ECB.
Note: In Chart 3b a negative (positive) value indicates a contribution of the respective factor to a decrease (increase) in the debt ratio.

Chart 4 General government expenditure and revenue



Source: ESCB.

Table 7 General government deficit-debt adjustment

(as a percentage of GDP)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Change in general government debt[1]	5.9	6.6	2.8	4.1	4.1	2.0	5.6	6.2	6.5	5.4
General government surplus (+)/deficit (-)	-5.0	-6.2	-5.4	-4.1	-3.6	-1.9	-3.7	-7.4	-7.8	-5.1
Deficit-debt adjustment	1.0	0.4	-2.6	0.1	0.4	0.1	1.9	-1.2	-1.3	0.3
Net acquisitions (+)/net sales (-) of financial assets	0.3	-0.4	-0.7	1.1	1.4	1.5	0.4	-1.1	-1.1	-1.4
Currency and deposits	0.0	0.4	0.0	0.8	0.6	1.0	0.4	0.1	-0.6	-1.3
Loans and securities other than shares	0.0	0.0	0.0	0.1	0.0	0.4	-0.1	0.0	0.2	0.1
Shares and other equity	-0.5	-0.6	-1.2	-0.3	0.1	-0.1	-0.1	-0.4	-1.7	-1.3
Privatisations	-0.4	-0.5	-1.1	-0.4	-0.1	-0.2	-0.2	-0.5	-1.8	-1.4
Equity injections	0.0	0.0	0.0	0.1	0.1	0.0	0.0	0.1	0.1	0.0
Other	-0.1	-0.1	-0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0
Other financial assets	0.8	-0.2	0.4	0.5	0.6	0.3	0.2	-0.7	0.9	1.0
Valuation changes of general government debt	0.4	1.0	-1.9	-0.9	-0.7	-1.0	2.1	-0.1	0.1	1.8
Foreign exchange holding gains (-)/losses (+)	0.8	1.3	-2.2	-0.3	-0.4	-0.9	2.0	-0.3	0.0	1.9
Other valuation effects[2]	-0.4	-0.3	0.3	-0.5	-0.3	-0.1	0.1	0.2	0.1	-0.1
Other changes in general government debt[3]	0.3	-0.2	0.0	-0.2	-0.2	-0.4	-0.6	0.0	-0.3	-0.1

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

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2010	2020	2030	2040	2050	2060
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	19.0	27.5	35.4	40.4	53.8	64.8
Age-related government expenditure (in percentage points of GDP)[1]	21.4	20.9	21.8	21.8	22.5	23.3

Source: The 2012 Ageing Report: Economic and budgetary projections for the EU27 Member States (2010-2060), joint report prepared by the European Commission (DG ECFIN) and the Economic Policy Committee.
1) The Ageing Working Group (AWG) risk scenario, strictly age-related item.

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

Participation in the exchange rate mechanism (ERM II)	No
Exchange rate level in May 2010 in PLN/EUR	4.05673
Maximum upward deviation [1]	5.3
Maximum downward deviation [1]	-12.4

Source: ECB.
1) Maximum percentage deviations of the bilateral exchange rate against the euro from its average level in May 2010 over the period 3 May 2010-30 April 2012, based on daily data at business frequency. An upward (downward) deviation implies that the currency was stronger (weaker) than its exchange rate level in May 2010.

Table 9 (b) Key indicators of exchange rate pressure for the Polish zloty

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

	2010			2011				2012
	June	Sep.	Dec.	Mar.	June	Sep.	Dec.	Mar.
Exchange rate volatility [1]	14.4	8.6	9.1	8.6	5.7	9.2	12.8	8.2
Short-term interest rate differential [2]	3.1	3.0	2.8	3.0	3.0	3.2	3.4	3.9

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

Chart 5 Polish zloty: nominal exchange rate development against the euro

(a) Exchange rate over the reference period
(daily data; average of May 2010 = 100;
3 May 2010-30 April 2012)

(b) Exchange rate over the last ten years
(monthly data; average of May 2010 = 100;
May 2002-April 2012)

Source: ECB.
Note: An upward (downward) movement of the line indicates an appreciation (depreciation) of the Polish zloty.

Table 10 Polish zloty: real exchange rate developments

(monthly data; percentage deviation in March 2012 from the ten-year average calculated for the period April 2002-March 2012)

	Mar. 2012
Real bilateral exchange rate against the euro [1]	3.5
Memo items:	
Nominal effective exchange rate [2]	-3.8
Real effective exchange rate [1), 2)]	1.0

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

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Balance of payments										
Current account and capital account balance [1]	-2.8	-2.5	-4.8	-2.1	-3.2	-5.1	-5.4	-2.2	-2.8	-2.1
Current account balance	-2.8	-2.5	-5.3	-2.4	-3.8	-6.2	-6.6	-3.9	-4.6	-4.3
Goods balance	-3.7	-2.6	-2.4	-1.0	-2.1	-4.4	-5.8	-1.7	-2.5	-2.7
Services balance	0.4	0.1	0.0	0.2	0.2	1.1	1.0	1.1	0.7	1.2
Income balance	-0.5	-1.1	-3.3	-2.2	-2.8	-3.8	-2.4	-3.8	-3.6	-3.9
Current transfers balance	1.0	1.1	0.4	0.6	0.9	1.0	0.6	0.6	0.8	1.1
Capital account balance	0.0	0.0	0.5	0.3	0.6	1.1	1.1	1.6	1.8	2.2
Combined direct and portfolio investment balance [1]	2.9	3.1	8.4	6.3	2.3	2.8	1.3	5.2	6.2	4.8
Direct investment balance	2.0	2.0	4.7	2.3	3.1	4.3	2.0	1.9	0.7	1.8
Portfolio investment balance	1.0	1.1	3.7	4.1	-0.8	-1.5	-0.6	3.2	5.4	3.0
Other investment balance	1.2	1.3	-5.0	-1.4	1.8	6.5	6.0	3.1	2.0	0.5
Reserve assets	-0.3	-0.6	-0.4	-2.7	-0.8	-3.0	0.8	-3.3	-3.3	-1.2
Exports of goods and services	28.6	33.3	37.5	37.1	40.3	40.8	39.9	39.4	42.2	44.8
Imports of goods and services	31.9	35.8	39.8	37.9	42.3	44.1	44.7	40.0	44.1	46.4
Net international investment position [2]	-34.9	-41.7	-41.6	-42.5	-45.7	-50.1	-56.3	-58.8	-64.0	-63.5
Gross external debt [2]	40.3	47.6	42.0	44.1	46.6	48.4	56.8	59.4	66.0	72.2
Memo item:										
Export market shares [3]	0.70	0.77	0.84	0.87	0.93	1.00	1.07	1.08	1.05	1.04

Source: ECB.
1) Differences between totals and the sum of their components are due to rounding.
2) End-of-period outstanding amounts.
3) As a percentage of total world goods and services exports.

Table 12 Indicators of integration with the euro area

(as a percentage of the total, unless otherwise stated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
External trade with the euro area										
Exports of goods	59.8	60.2	58.9	57.0	55.8	55.0	54.2	56.7	55.8	54.1
Imports of goods	55.7	55.6	60.1	60.7	58.6	58.8	58.2	58.5	56.7	55.3
Investment position with the euro area										
Inward direct investment [1]	73.1	73.6	75.0	74.5	74.3	74.0	74.4	74.1	76.3	73.2
Outward direct investment [1]	47.5	46.0	46.7	23.5	43.2	35.7	41.2	44.6	51.4	47.7
Portfolio investment liabilities [1]	40.5	49.0	50.8	58.3	57.3	54.2	48.8	47.9	51.4	-
Portfolio investment assets [1]	16.0	27.9	26.0	26.6	35.0	53.5	53.0	52.9	56.5	-
Memo items:										
External trade with the EU										
Exports of goods	81.1	81.9	80.5	78.6	79.0	78.9	77.8	79.6	79.1	77.8
Imports of goods	69.7	69.6	75.2	75.3	73.0	73.3	71.8	72.6	70.8	69.4

Sources: ESCB, European Commission (Eurostat) and IMF.
1) End-of-period outstanding amounts.

4 LONG-TERM INTEREST RATE DEVELOPMENTS

Table 13 Long-term interest rates (LTIRs)

(percentages; average of observations through period)

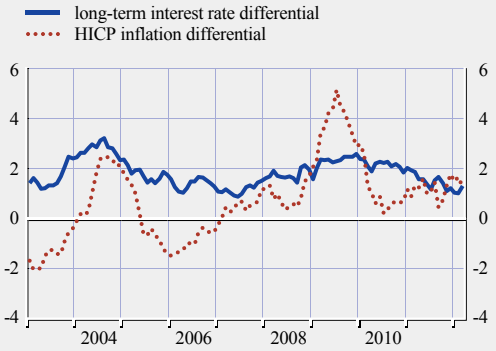
	2011 Dec.	2012 Jan.	2012 Feb.	2012 Mar.	Apr. 2011 to Mar. 2012
Long-term interest rate	5.8	5.7	5.5	5.4	5.8
Reference value [1]					*5.8*
Euro area [2]	*4.6*	*4.7*	*4.4*	*4.1*	*4.4*
Euro area (AAA) [3]	*2.7*	*2.6*	*2.5*	*2.5*	*2.9*

Sources: ECB and European Commission (Eurostat).
1) The basis of the calculation for the period April 2011-March 2012 is the unweighted arithmetic average of the interest rate levels in Sweden and Slovenia plus 2 percentage points.
2) The euro area average is included for information only.
3) The euro area AAA par yield curve for the ten-year residual maturity is included for information only.

Chart 6 Long-term interest rate (LTIR)

(a) Long-term interest rate (LTIR)
(monthly averages in percentages)

(b) LTIR and HICP inflation differentials vis-à-vis the euro area
(monthly averages in percentage points)



Sources: ECB and European Commission (Eurostat).

Table 14 Selected indicators of financial development and integration

(as a percentage of GDP, unless otherwise stated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Memo item: euro area 2011
Debt securities issued by corporations [1]	6.1	6.4	5.3	6.9	6.4	5.8	5.7	7.2	10.6	13.3	103.0
Stock market capitalisation [2]	13.7	16.6	23.2	31.4	41.3	43.3	20.6	30.3	35.7	29.0	41.5
MFI credit to non-government residents [3]	-	-	27.4	28.4	32.8	39.0	49.3	50.0	51.5	54.5	134.7
Claims of euro area MFIs on resident MFIs [4]	-	-	4.4	3.8	4.8	7.6	12.5	12.4	12.4	11.7	7.9
Private sector credit flow [5]	0.9	2.4	2.2	4.3	10.1	12.4	11.8	3.9	3.8	-	3.5
Private sector debt [6]	49.2	48.0	42.7	44.1	52.2	58.8	72.0	72.0	74.2	-	167.0

Sources: ESCB, European Commission (Eurostat), Federation of European Securities Exchanges, OMX and national stock exchanges.
1) Outstanding amount of debt securities issued by resident non-financial corporations, MFIs and other financial corporations.
2) Outstanding amounts of quoted shares issued by residents at the end of the period at market values.
3) MFI (excluding NCB) credit to domestic non-MFI residents other than the general government. Credit includes outstanding amounts of loans and debt securities.
4) Outstanding amount of deposits and debt securities issued by domestic MFIs (excluding the NCB) held by euro area MFIs as a percentage of total liabilities of domestic MFIs (excluding the NCB). Total liabilities exclude capital and reserves and remaining liabilities.
5) Transactions in securities other than shares issued and loans taken out by institutional sectors: non-financial corporations, households and non-profit institutions serving households.
6) Outstanding amounts of securities other than shares issued and loans taken out by institutional sectors: non-financial corporations, households and non-profit institutions serving households.

5.7 ROMANIA

5.7.1 PRICE DEVELOPMENTS

Over the reference period from April 2011 to March 2012, the 12-month average rate of HICP inflation in Romania was 4.6%, i.e. well above the reference value of 3.1% for the criterion on price stability (see Table 1). On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to decrease in the coming months.

Looking back over a longer period, annual consumer price inflation in Romania decreased from very high levels in the early 2000s until 2007, when the downward trend was reversed. In 2009 inflation fell again and broadly stabilised thereafter, albeit remaining elevated (see Chart 1). Annual HICP inflation declined from more than 20% in 2002 to 4.9% in 2007, before picking up to 7.9% in 2008 owing to the combined effect of supply-side shocks and demand pressures. In 2009 inflation again slowed down somewhat, reflecting lower commodity prices and the contraction of economic activity, which more than offset the impact of significant exchange rate depreciation. From 2009 to 2011 average annual HICP inflation fluctuated between 5.6% and 6.1% and was heavily influenced by energy and food prices, which together made up roughly 50% of Romania's HICP basket[12], as well as by increases in excise duties in 2009-10 and VAT in 2010.

These inflation developments have taken place against the background of a number of important policy choices, most notably the orientation of monetary policy towards the achievement of price stability, as enshrined in the central bank law. Between 2000 and 2004 Banca Națională a României focused on gradual disinflation, while also considering other policy goals, including the rebuilding of foreign exchange reserves and the prevention of excessive currency appreciation. In 2005 the central bank 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 3.5% in 2009 and 2010, 3.0% in 2011 and 2012, and 2.5% from 2013 onwards, with a 1 percentage point variation band around the central target. Although initially fiscal policy was rather loose and did not support the disinflation process, there was a certain amount of fiscal consolidation between 2002 and 2005. Thereafter, the fiscal deficit started to rise and recorded sharp increases in 2008 and 2009. However, from 2010 onwards the Romanian government implemented more forcefully the fiscal consolidation measures agreed in the context of the financial assistance programme led by the EU and the IMF, which was replaced by a precautionary standby programme in March 2011.

Inflation dynamics over the past ten years should be viewed against a background of overheating in the economy between 2004 and 2008, followed by a sharp contraction in economic activity in 2009 and 2010 and a moderate recovery in 2011 (see Table 2). Labour market conditions reflected economic developments, although the impact of the business cycle on unemployment was more muted. Between 2004 and 2008 unemployment declined and wage growth significantly outpaced productivity growth, which in turn drove unit labour cost growth to double-digit levels. Thereafter, however, the unemployment rate picked up again, from 5.8% in 2008 to 7.3% in 2010, while during the same period wage growth moderated from 31.9% to 7.6%, supported by a 25% cut in public wages in 2010. In 2011 the unemployment rate remained virtually unchanged despite the economic recovery, while wage growth slowed to 3.7%, bringing unit labour cost growth down to 1.7%.

12 This 50% weight in the HICP basket refers to energy and food excluding tobacco and alcohol items, while the overall weight of the energy and food components in Romania's HICP basket is 60%.

These developments reflect, inter alia, a reduction in public sector employment, a partial restoration of public sector wages and labour market rigidities. In addition, there are uncertainties regarding the quality of private sector wage data, particularly given the large share of the informal economy. After having recorded very strong increases for several years during the economic boom, house prices declined by a cumulative 47% from their peak in 2007 until 2010. Overall, import prices were rather volatile during the period under review, mainly reflecting developments in commodity prices, as well as the volatility of the effective exchange rate.

Looking at recent developments, HICP inflation broadly followed a downward path from its peak of 8.5% in May 2011 to 2.5% in March 2012 (see Table 3a). The marked decline reflects the fading-out of the impact of the 5 percentage point VAT increase in July 2010, easing pressures from energy and food prices as a result of global price developments, a very good harvest and the disinflation pressures exerted by the negative output gap. Accordingly, HICP inflation excluding unprocessed food and energy also decelerated, although it remained above overall inflation. This partly reflects increases in administered prices, which in Romania accounted for 15% of the HICP basket, following an adjustment in heating prices owing to the removal of subsidies from the central government budget. However, the nominal effective exchange rate of the Romanian currency depreciated after mid-2011, thus adding to import price inflation. Recent inflation developments should be viewed against a weak macroeconomic environment. After an exceptionally strong third quarter as a result of a very good harvest and increasing exports, real GDP contracted slightly during the fourth quarter of 2011, resulting in an average growth rate of 2.5% for the year as a whole.

The latest available forecasts from major international institutions project inflation to increase in 2012-13 from historically low levels, and range between 2.9% and 3.1% in 2012 and between 3.1% and 3.7% in 2013. Inflationary pressures in Romania are likely to remain rather contained in an environment of weak domestic demand and a fragile international environment, which should also contribute to moderate wage increases in the private sector. However, there are upside risks to this outlook, relating mainly to the dynamics of commodity and administered prices. Administered price changes will play a bigger role in the more medium term, especially owing to the planned deregulation of electricity and gas prices. Furthermore, risks stem from possible fiscal slippages in the context of the elections planned for autumn 2012, including the public sector wage outlook. An increase in the cost of external funding, following a further escalation of the financial crisis, may also add to inflationary pressures. On the downside, a weaker external environment and greater difficulty obtaining external funding pose the main risks, together with private sector balance sheet adjustments. Looking further ahead, the catching-up process is likely to have a bearing on inflation and/or the nominal exchange rate over the coming years, given that GDP per capita and price levels are still significantly lower in Romania than in the euro area (see Table 2). However, it is difficult to assess the exact magnitude of the effect resulting from this catching-up process.

Achieving an environment conducive to sustainable convergence in Romania requires, inter alia, stability-oriented monetary policy as well as further fiscal consolidation and structural reforms in line with Romania's commitments under the economic programme led by the EU and the IMF and the requirements of the EDP. As regards structural reforms, it is of paramount importance to increase the efficiency of state-owned enterprises. It is also crucial to improve the absorption capacity of EU funds. In view of product markets, efforts should be made to complete the liberalisation of regulated sectors, boost energy efficiency and improve the country's still underdeveloped infrastructure, in particular in the energy and transportation sector. Moreover, the quality of the business and institutional environment should be improved, inter alia, to help attract foreign direct investment inflows. Also, tax efficiency should be increased, including

by continuing the fight against tax evasion. In addition, the quality of statistics should be enhanced. With regard to the labour market, the reforms in the context of the new Labour Code should now be implemented. For the competitiveness of the economy, it is essential to increase labour flexibility and bring wage negotiations to the firm level. Measures should be taken to enhance the quantity and quality of the labour supply and tackle sectoral, skill, educational and regional mismatches. This is particularly important to avoid a significant increase in structural unemployment or a decline in the participation rate. Moreover, wage increases should reflect labour productivity growth, the unemployment rate and developments in competitor countries. Financial sector policies should be geared towards preventing boom-bust cycles in credit developments in the future. Given the potential risks to financial stability associated with the high share of foreign currency-denominated loans in Romania, the European Systemic Risk Board's recommendations on lending in foreign currencies, released in 2011, need to be fully taken into account. Close cooperation with supervisors across EU countries is important to ensure the effective implementation of such measures. All of these measures will help to achieve an environment conducive to sustainable price stability and promote competitiveness and employment growth.

5.7.2 FISCAL DEVELOPMENTS

Romania is, at present, subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2011 the general government budget balance showed a deficit of 5.2% of GDP, i.e. well above the 3% reference value. The general government gross debt-to-GDP ratio was 33.3%, i.e. well below the 60% reference value (see Table 4). Compared with the previous year, the budget balance ratio improved by 1.6 percentage points, while the public debt ratio increased by 2.8 percentage points. In 2012 the deficit ratio is forecast by the European Commission to decline to 2.8% and the government debt ratio is projected to increase to 34.6%. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2011 and is not expected to exceed it in 2012 either.

Looking at developments in Romania's budgetary position over the period from 2002 to 2011, after declining to 1.2% in 2004 and 2005, the deficit-to-GDP ratio then started to rise and recorded sharp increases in 2008 and 2009 (when it reached 9.0%). This upward trend has been reversed since 2010 (see Table 5 and Chart 2a). As the deficit-to-GDP ratio rose above the 3% of GDP reference value in 2008, the ECOFIN Council decided on 7 July 2009 that an excessive deficit situation existed in Romania and initially set the deadline for correcting it at 2011. This deadline was extended to 2012 following the ECOFIN Council's recommendation of 12 February 2010. As shown in greater detail in Chart 2b, European Commission estimates indicate that cyclical factors had a continuous positive impact on the budget balance between 2002 and 2008. Since 2009, when the financial and economic crisis sharply affected public finances, cyclical factors had a negative, albeit declining, impact on the budget balance. Non-cyclical factors contributed overall to an increase in the budget deficit from 2004 to 2009, particularly in 2008. This trend has been reversed since 2010, when the Romanian government more forcefully implemented fiscal consolidation measures agreed under the financial assistance programme led by the EU and the IMF. In particular, a fiscal consolidation package approved in mid-2010 included sizeable increases in indirect tax rates (most importantly, a 5 percentage point increase in the VAT rate), as well as substantial nominal cuts in public wages and most social transfers, excluding pensions. A significantly faster than programmed adjustment in public employment took place in 2011. In the absence of substantial temporary and one-off factors during 2003-10, the underlying changes in the budget deficit seem to reflect a structural deterioration of Romania's fiscal position until 2009 and a consolidation thereafter. In 2011, the deficit was affected by a one-off expenditure item worth 1.1% of GDP related to the court ruling on the historical wage claims of public sector employees.

Turning to developments in general government gross debt, between 2002 and 2011 the debt-to-GDP ratio increased cumulatively by 8.4 percentage points, declining until 2006 and rising thereafter, particularly over 2009-10 (see Chart 3a and Table 6). As shown in greater detail in Chart 3b, among the factors underlying the annual change in the debt ratio, the primary budget balance was broadly neutral during the period 2001-05 and started to have a debt-increasing impact from 2006 onwards, reaching a peak in 2009. The growth/interest rate differential contributed to the reduction in the debt ratio during the whole period until 2008, and to an increase in the debt ratio thereafter, most importantly in 2009 on the back of deteriorating macroeconomic and financial conditions. By contrast, the deficit-debt adjustment factor had a more volatile pattern, with a debt-increasing effect until 2004 and during 2009-10, while the impact remained relatively muted during the crisis period. In 2011 the notable increase in the general government debt-to-GDP ratio, though much lower compared with the previous two years, mainly reflected a primary deficit ratio which was still high.

As regards Romania's general government debt structure, the share of government debt with a short-term maturity declined from 24.8% in 2002 to 9.6% in 2006, but started to increase thereafter and remained relatively high at 23.0% in 2011 (see Table 6). Taking into account the level of the debt ratio, fiscal balances are relatively insensitive to changes in interest rates. At 57.8% in 2011, the proportion of government debt denominated in foreign currency is high, and, given the overall debt level, fiscal balances are relatively sensitive to changes in exchange rates. During the crisis that hit Romania in 2009, the share of debt with a short-term maturity continued to rise, pointing to an increase in debt-related vulnerabilities, before starting to decline again in 2011. The share of debt denominated in foreign currency remained relatively stable. At the same time, the Romanian government has not incurred contingent liabilities resulting from government interventions to support financial institutions and financial markets during the crisis (see Section 5.9).

Moving on to examine trends in other fiscal indicators, Chart 4 and Table 5 show that the general government total expenditure-to-GDP ratio increased overall from 35.0% in 2002 to 37.7% in 2011. After peaking at 41.1% of GDP in 2009, the expenditure ratio declined during 2010-11, mainly as a result of lower compensation of employees on the back of sizeable wage and employment reductions, as well as social benefits other than in kind. Capital spending increased as a ratio to GDP over the period of analysis, but started to decline over the crisis. Total government revenue as a share of GDP decreased slightly over the period from 33.0% of GDP in 2002 to 32.5% in 2011. After peaking at 35.3% of GDP in 2007 on the back of rapid economic growth, which more than compensated for the significant reduction in taxation introduced in 2005 under the flat tax reform, the total revenue-to-GDP ratio started to decline towards the end of 2008 and in 2009 following the financial and economic crisis. This trend was reversed in 2010 as a result of significant indirect tax hikes implemented halfway through the year. These measures, supported by strengthened tax compliance actions, had a positive carry-over effect in 2011, but overall the 2011 revenue-to-GDP ratio was affected by the better than expected, though less tax-rich, GDP growth.

Looking ahead, Romania's medium-term fiscal policy strategy, as presented in the 2012-15 update of the convergence programme (dated April 2012), indicates the commitment of the government to bring the ESA 95 deficit below the reference value in 2012 and reduce it gradually thereafter. According to the 2012 budget and Romania's commitments under the EU-IMF financial assistance programme as of end-April, the deficit is to be reduced in 2012 to 1.9% of GDP in cash terms (2.1% of GDP including some off-budget expenditure). Given the gap between the cash and accrual fiscal data (historically standing at about 0.5% of GDP), the convergence programme update projects a budget deficit of 2.3% of GDP in ESA 95 terms for 2012 (the EDP

correction deadline) and a gradual reduction in the deficit ratio to 0.9% by 2015. The projected fiscal consolidation for 2012 is based on continued expenditure restraint, in particular lower social spending, intermediate consumption and savings on capital spending (through a temporary reduction in the national co-financing of EU-funded projects according to a new EU regulation for programme countries). In contrast to what was approved in the 2012 budget, compensation of employees is now projected to increase slightly as a share of GDP compared to 2011 on the back of measures to restore the wage cut implemented in 2010, albeit that a further reduction in public employment is still envisaged. The detailed fiscal plans for 2012 and beyond are subject to uncertainty given the recent government change[13] and further possible political changes after the parliamentary (and local) elections in 2012. Subject to this caveat, according to the 2012-15 convergence programme update, the structural deficit is projected to decline and reach the medium-term objective of 0.7% of GDP (specified in line with the Stability and Growth Pact) in 2013. According to information submitted in the 2012 convergence programme update, primary expenditure, as a share of GDP, is projected to drop by 1.8 percentage points between 2012 and 2015. The annual growth rate of primary expenditure (considered as relevant expenditure in the absence of clearly reported data on EU fund transfers) is projected to be above the growth rate of potential GDP over the entire period. According to the European Commission's projections, the structural deficit will remain, however, above the medium-term objective by 2013.

In this respect, on 2 March 2012 Romania signed the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, committing, inter alia, to apply (and include in its national legislation) the fiscal rules specified under Title III, "Fiscal Compact", as referred to in Box 2 of Chapter 2.

As regards fiscal governance, Romania implemented several reforms during 2010 as part of the EU-IMF financial assistance programme, including the setting-up of an independent fiscal council and the introduction of new fiscal rules. Further efforts are necessary to ensure a proper functioning of the new institutional fiscal framework. This should include efforts to improve fiscal accounting and statistical reporting according to ESA 95 standards, thus preventing Eurostat from having further reservations in the future with respect to Romania's fiscal data. In this respect, it should be noted that there are some outstanding statistical issues related to the delineation of the general government accounts, which is still not completed. The recording of transactions between government and public companies needs continued scrutiny, as this may incur upside risk to the government deficit and debt (see Section 5.9). Full compliance with the provisions for an enhanced national governance framework under Council Directive 2011/85/EU and with the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, as referred to in Box 2 of Chapter 2, should be ensured.

Turning to factors with an impact on Romania's public finances over the long term, a steep ageing of the population is expected, as highlighted in Table 8. According to the 2012 projections by the European Commission and the EU's Economic Policy Committee, starting from a level of 17.6% of GDP in 2010, Romania is likely to experience a significant increase in strictly age-related public expenditure amounting to 6.5 percentage points of GDP in the years to 2060.[14] Under the EU-IMF financial assistance programme, a comprehensive pension reform was adopted in 2010 and a reform of the health sector is currently under preparation.

13 A no-confidence motion against the government was approved in the Parliament on 27 April 2012.
14 European Commission and Economic Policy Committee, "The 2012 Ageing Report: Economic and budgetary projections for the EU-27 Member States (2010-2060)".

Turning to fiscal challenges, Romania must ensure a sustainable reduction in the budget deficit to below the 3% reference value in 2012 and beyond, in line with the EDP requirements, and fulfil the commitments agreed in the context of the EU-IMF financial assistance programme. This requires the continuation of a prudent expenditure policy in the medium term. Despite some recent progress, Romania should take more determined measures to reduce the arrears (as defined in ESA 95 terms) of the general consolidated budget and prevent the accumulation of new arrears, in particular in the health sector. On the revenue side, the government should significantly strengthen its efforts to improve the still very low absorption rate of EU funds, which could support adjustment in a growth-friendly way. Romania's fiscal policy strategy should be supported by the rigorous implementation of its revised fiscal framework. At the same time, every effort should be made to fully comply with the obligations under the enhanced Stability and Growth Pact and to effectively implement the provisions of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union.

5.7.3 EXCHANGE RATE DEVELOPMENTS

In the two-year reference period from 1 May 2010 to 30 April 2012, the Romanian leu did not participate in ERM II, but traded under a flexible exchange rate regime (see Table 9a). The leu was broadly stable in the course of 2010, then appreciated modestly in the first half of 2011, and has thereafter gradually depreciated against the euro. Over the reference period, the Romanian currency mostly traded significantly below its May 2010 average exchange rate against the euro, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate. The maximum upward deviation from this benchmark was 2.5%, while the maximum downward deviation amounted to 5.6% (see Chart 5 and Table 9a).

In March 2009 an international financial assistance package, led by the EU and the IMF, was agreed for Romania, totalling around €20 billion over the period to the first quarter of 2011. In March 2011 this programme was replaced by a precautionary financial assistance programme by the EU and the IMF, totalling €5 billion. During the reference period, Romania received disbursements in 2010 and in the first half of 2011, but did not draw on the resources of the precautionary arrangement. As these agreements helped reduce financial vulnerabilities, they might also have contributed to reducing exchange rate pressures.

Looking at exchange rate developments in more detail, the fluctuations of the Romanian leu during the reference period were partly driven by changes in global risk aversion amid tensions in some euro area sovereign debt markets. Between January and May 2011 the leu appreciated gradually by around 5% in relation to improving sentiment of financial markets towards the region, a gradual pick-up in economic growth and a rather large positive interest rate differential vis-à-vis euro area assets. In the second half of 2011 the depreciation of the leu took place against the background of a renewed increase in global risk aversion and developments in euro area sovereign debt markets, but also on account of a deteriorating outlook for the Romanian economy. Overall, between May and November 2011 the Romanian currency depreciated by almost 7%. After a gradual normalisation of global financial market conditions the leu strengthened somewhat to trade on 30 April 2012 at 4.410 lei per euro, i.e. 5.6% weaker than its average level in May 2010.

Over the reference period, the exchange rate of the Romanian leu against the euro showed a relatively high degree of volatility, as measured by annualised standard deviations of daily percentage changes. However, compared with the other inflation-targeting countries of the region, volatility was substantially lower on average. At the same time short-term interest rate differentials

against the three-month EURIBOR remained, on average, at a high level on account of both the inflation differential vis-à-vis the euro and the prevailing uncertainty in global financial markets. The spread decreased modestly over the reference period, from 5.2% in the three-month period ending in June 2010 to 3.7% in the three-month period ending in March 2012 (see Table 9b).

In a longer-term context, in March 2012 both the Romanian leu's real effective exchange rate and its real bilateral exchange rate against the euro stood close to the corresponding ten-year historical averages (see Table 10). However, these measures should be interpreted with caution, as in this period Romania was subject to a process of economic convergence, which complicates any historical assessment of real exchange rate developments.

As regards other external developments, Romania's current and capital account has adjusted substantially in recent years. After reporting a progressive increase in the external deficit between 2002 and 2007, reaching double-digit levels in the period from 2006 to 2008, the combined current and capital account deficit declined to -3.6% of GDP in 2009 and stood at -4.2% in 2010 and -4.1% in 2011 (see Table 11). The improvement in the current and capital account balance primarily reflected the sharp decline in the goods deficit, mainly driven by strong export performance, moderate domestic demand and – to a lesser extent – the reduction in the income deficit. The external deficit has been mainly financed by net inflows in direct and other investment. By contrast, net inflows in portfolio investment were rather volatile and did not contribute significantly to financing Romania's current account deficit. The substantial adjustment in Romania's balance of payments was associated with a significant contraction of capital inflows. Over the past decade, gross external debt increased substantially from 37.3% of GDP in 2002 to 75.8% in 2010 and 73.5% in 2011. At the same time, the country's net international investment position deteriorated substantially from -21.2% of GDP in 2002 to -63.8% in 2010 and -61.6% in 2011. Romania is a small, open economy; the ratio of its foreign trade in goods and services to GDP increased from 35.3% in 2002 to 38.4% in 2011 for exports and from 41.0% in 2002 to 43.6% in 2011 for imports. Over the same period, Romania's share in world exports increased from 0.20% to 0.33%.

Concerning measures of economic integration with the euro area, in 2011 exports of goods to the euro area constituted 53.4% of total goods exports, whereas the corresponding figure for imports amounted to 50.8%. The share of euro area countries in Romania's inward direct investment stood at 82.3% in 2011 and in its portfolio investment liabilities at 90.0% in 2010. The share of Romania's assets invested in the euro area amounted to 18.4% in the case of direct investment in 2011 and 64.2% for portfolio investment in 2010 (see Table 12).

5.7.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from April 2011 to March 2012, long-term interest rates in Romania were 7.3% on average and thus well above the 5.8% reference value for the interest rate convergence criterion (see Table 13).

Long-term interest rates in Romania followed an upward trend from late 2005 until the first quarter of 2007 (see Chart 6a)[15], edging down thereafter in a context of moderate policy easing by monetary authorities. The respite in long-term rates was relatively short-lived, as interest rates started to increase slowly again as of December 2007. This upward trend sharply intensified from August 2008 against the backdrop of a deterioration in economic activity as well as owing to the

15 Data are available on the reference long-term interest rate for Romania from 2005 onwards.

pass-through of an upward trend in the monetary policy interest rate. The eruption of severe tensions in global financial markets towards the latter part of 2008 also contributed to a rise in the country risk premium as well as to liquidity strains in the market, which led to a high volatility of the long-term interest rate. Romania's vulnerability to significant external and internal imbalances and its poorer economic outlook at the time were further reflected in the downgrade of its sovereign credit rating by some rating agencies to below investment grade level. Long-term interest rates peaked at 11.5% in July 2009. Also in this period, the joint EU-IMF multilateral adjustment programme was approved. Long-term interest rates were subsequently placed on a downward trend, supported by easing inflationary pressures and a decline in the monetary policy rate, reaching a low of 6.7% in January 2011, shortly before the expiration of the multilateral adjustment programme. Romanian authorities have since signed a new programme with the EU and IMF which they are treating as precautionary, signalling their intention not to draw on the available funds. The improved outlook for the economy, including the health of public finances, also led one major credit rating agency to restore the rating of Romania's sovereign long-term debt back to investment grade in mid-2011. However, further declines in long-term interest rates were hampered by developments in both the inflation and monetary policy rates, such that long-term interest rates remained modestly above 7% for the remainder of the year. Long-term interest rates stood at 6.5% at the end of the reference period.

The long-term interest rate differential between Romania and the euro area average fluctuated between 2.2 and 4.0 percentage points from 2005 to 2007, with the lowest differential thus far being reached in July 2007 (see Chart 6b). In parallel with changes in the inflation differential between Romania and the euro area, the long-term interest rate differential also increased from the second half of 2007 until the summer of 2009, peaking at 7.7 percentage points in August 2009. Subsequently, the long-term interest rate differential embarked on a sharp downward trend, before stabilising in a range between 2.5 and 3.5 percentage points, where it has remained since November 2010. The long-term interest rate differential with the euro area average stood at 2.4 percentage points (and 4.0 percentage points with respect to the AAA euro area yield) at the end of the reference period.

As regards financial market developments, capital markets in Romania are much smaller and still underdeveloped relative to those of the euro area (see Table 14). By international standards, the corporate bond market is still at an early stage in terms of issuance volume, with the amount of outstanding debt securities issued by corporations (a measure of market-based indebtedness) reaching just 0.2% of GDP at the end of 2011. Stock market capitalisation stood at 8.6% of GDP in 2011, compared with the 17%-18% ratio which Romania typically posted during the 2005-07 period marked by financial and credit expansion. Bank financing as measured by credit to non-government residents has been moderately trending up in recent years, but remains less developed than in other peer countries, amounting to 38.6% of GDP at the end of 2011. Foreign-owned banks, primarily from the euro area, play a major role in the Romanian banking sector, with the majority of loans to the private sector denominated in foreign currency. The international claims of euro area banks in the country are relatively high, at 27.2% of total domestic liabilities in 2011.

LIST OF TABLES AND CHARTS

ROMANIA

I PRICE DEVELOPMENTS

Table 1 HICP inflation

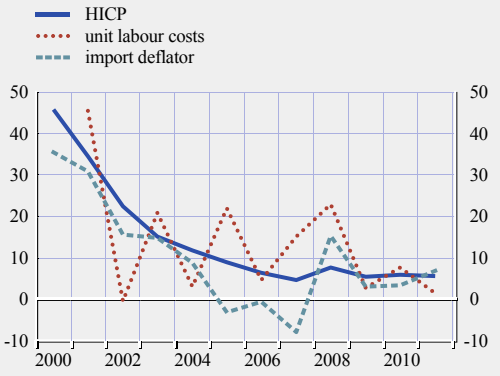
(annual percentage changes)

	2011	2012			Apr. 2011
	Dec.	Jan.	Feb.	Mar.	to Mar. 2012
HICP inflation	3.2	2.8	2.7	2.5	4.6
Reference value[1]					*3.1*
Euro area[2]	*2.7*	*2.7*	*2.7*	*2.7*	*2.8*

Source: European Commission (Eurostat).
1) The basis of the calculation for the period April 2011-March 2012 is the unweighted arithmetic average of the annual percentage changes in the HICP for Sweden, Ireland and Slovenia plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(average annual percentage changes)



Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Measures of inflation										
HICP	22.5	15.3	11.9	9.1	6.6	4.9	7.9	5.6	6.1	5.8
HICP excluding unprocessed food and energy	19.0	15.1	12.2	6.3	5.8	5.5	7.6	6.6	6.4	5.0
HICP at constant tax rates[1]	-	-	10.8	8.3	5.4	4.2	7.1	4.0	1.8	3.8
CPI	22.5	15.3	11.9	9.0	6.6	4.8	7.9	5.6	6.1	5.8
Private consumption deflator	20.3	15.8	12.7	6.9	4.9	4.8	10.0	3.7	7.9	5.8
GDP deflator	22.7	23.4	15.5	12.2	10.6	13.5	15.3	4.2	6.0	8.1
Producer prices[2]	25.3	18.3	19.2	10.8	10.3	8.4	12.8	2.1	5.8	8.1
Related indicators										
Real GDP growth	5.1	5.2	8.5	4.2	7.9	6.3	7.3	-6.6	-1.6	2.5
GDP per capita in PPS[3] (euro area = 100)	26.5	28.4	31.3	32.0	35.2	38.1	43.1	43.3	43.1	-
Comparative price levels (euro area = 100)	42.8	42.2	42.0	53.4	56.5	63.0	61.1	54.5	56.4	-
Output gap[4]	-2.6	-0.9	3.6	3.6	6.8	7.9	10.3	0.4	-3.2	-2.8
Unemployment rate (%)[5]	7.4	6.8	8.0	7.2	7.3	6.4	5.8	6.9	7.3	7.4
Unit labour costs, whole economy	-0.2	20.9	3.2	22.1	4.9	15.2	22.9	3.0	7.9	1.7
Compensation per employee, whole economy	16.7	27.4	13.8	29.1	12.4	22.0	31.9	-1.9	7.6	3.7
Labour productivity, whole economy	16.9	5.3	10.3	5.7	7.2	5.9	7.3	-4.7	-0.3	2.1
Imports of goods and services deflator	15.7	14.9	8.9	-2.9	-0.4	-7.6	15.4	3.3	3.5	7.1
Nominal effective exchange rate[6]	-16.4	-14.1	-6.5	11.0	2.6	6.5	-9.1	-11.9	-1.3	-0.6
Money supply (M3)	-	-	-	40.0	31.1	3.8	12.9	7.2	6.6	6.1
Lending from banks	-	-	-	52.2	61.4	55.2	23.8	-2.0	6.3	7.6
Stock prices (The Bucharest Exchange BET Index)	126.9	26.0	103.8	38.0	28.5	32.6	-70.3	37.3	14.6	-15.7
Residential property prices[7]	-	39.4	30.7	63.8	53.2	51.5	-10.9	-27.8	-7.8	-14.2

Sources: European Commission (Eurostat), national data (CPI, money supply, lending from banks and residential property prices) and European Commission (output gap).
1) 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 on the price paid by the consumer.
2) Total industry excluding construction and domestic sales.
3) PPS stands for purchasing power standards.
4) Percentage difference of potential GDP: a positive (negative) sign indicates that actual GDP is above (below) potential GDP.
5) The definition conforms to ILO guidelines. The data for the reference period 2000-2004 are provided by the Romanian national statistical institute.
6) A positive (negative) sign indicates an appreciation (depreciation).
7) Data up to 2009 reflect changes in prices for Bucharest (series has been discontinued); data for 2010 show changes in prices of all dwellings.

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2011			2012		
	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.
HICP						
Annual percentage change	3.6	3.5	3.2	2.8	2.7	2.5
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	-0.9	0.6	2.9	3.0	3.2	3.1
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	3.3	2.3	1.4	1.2	1.2	1.8

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2012	2013
HICP, European Commission (spring 2012)	3.1	3.4
CPI, OECD (December 2011)[1)]	-	-
CPI, IMF (April 2012)	2.9	3.1
CPI, Consensus Economics (April 2012)	3.1	3.7

Sources: European Commission, OECD, IMF and Consensus Economics.
1) Romania is not a member of the OECD.

2 FISCAL DEVELOPMENTS

Table 4 General government fiscal position

(as a percentage of GDP)

	2010	2011	2012 [1]
General government surplus (+)/deficit (-)	-6.8	-5.2	-2.8
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure [2]	-1.1	0.0	2.7
General government gross debt	30.5	33.3	34.6
Reference value	*60.0*	*60.0*	*60.0*

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

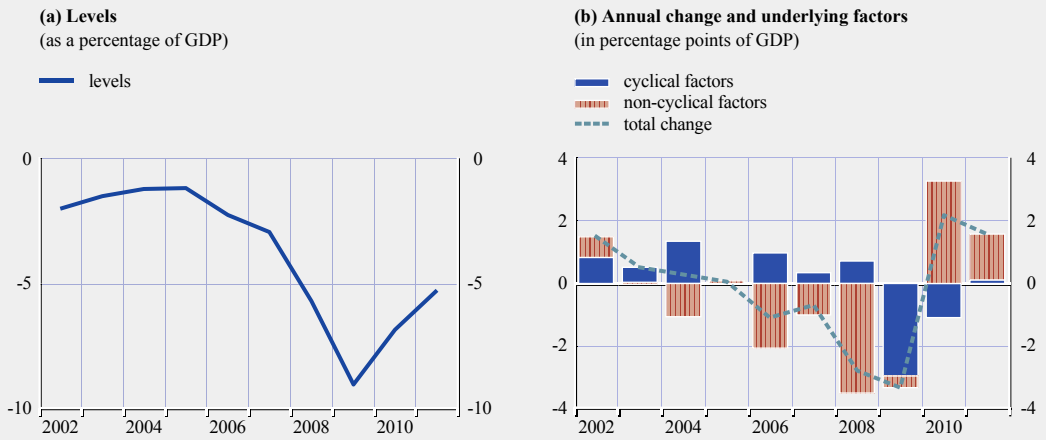
Table 5 General government budgetary position

(as a percentage of GDP)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total revenue	33.0	32.0	32.3	32.4	33.3	35.3	33.6	32.1	33.4	32.5
Current revenue	32.9	31.9	31.9	32.1	33.2	34.1	32.8	31.8	32.7	32.0
Direct taxes	5.8	6.0	6.4	5.3	6.0	6.7	6.7	6.5	6.1	5.8
Indirect taxes	11.6	12.3	11.7	12.9	12.8	12.3	11.7	10.7	11.9	12.6
Social security contributions	11.1	9.9	9.7	10.3	10.3	10.5	10.1	10.2	9.5	8.8
Other current revenue	4.4	3.8	4.2	3.6	4.0	4.6	4.3	4.3	5.2	4.8
Capital revenue	0.1	0.0	0.4	0.3	0.1	1.2	0.8	0.3	0.7	0.5
Total expenditure	35.0	33.5	33.6	33.6	35.5	38.2	39.3	41.1	40.2	37.7
Current expenditure	31.6	29.9	30.6	29.7	30.4	32.0	32.6	35.1	34.4	32.5
Compensation of employees	8.5	8.2	8.1	8.7	9.3	9.7	10.5	10.9	9.7	7.5
Social benefits other than in kind	9.3	8.4	8.7	8.9	8.8	9.2	10.4	12.7	13.0	11.5
Interest payable	2.5	1.6	1.5	1.2	0.9	0.7	0.7	1.5	1.5	1.6
of which: impact of swaps and FRAs [1]	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other current expenditure	11.3	11.6	12.2	10.9	11.5	12.3	11.0	9.9	10.3	11.9
Capital expenditure	3.5	3.6	3.0	3.9	5.1	6.2	6.7	6.0	5.8	5.3
Surplus (+)/deficit (-)	-2.0	-1.5	-1.2	-1.2	-2.2	-2.9	-5.7	-9.0	-6.8	-5.2
Primary balance	0.5	0.1	0.3	0.1	-1.4	-2.2	-5.0	-7.5	-5.3	-3.7
Surplus/deficit, net of government investment expenditure	1.4	2.0	1.8	2.7	2.9	3.2	0.9	-3.1	-1.1	0.0

Sources: ESCB and European Commission (Eurostat).
Notes: Differences between totals and the sum of their components are due to rounding. Interest payable as reported under the excessive deficit procedure. The item "impact of swaps and FRAs" is equal to the difference between the interest (or deficit/surplus) as defined in the excessive deficit procedure and in the ESA 95. See Regulation (EC) No 2558/2001 of the European Parliament and of the Council of 3 December 2001 amending Council Regulation (EC) No 2223/96 as regards the reclassification of settlements under swap arrangements and under forward rate agreements (0J L 344, 28.12.2001, p. 1).
1) FRAs stands for forward rate agreements.

Chart 2 General government surplus (+)/deficit (-)



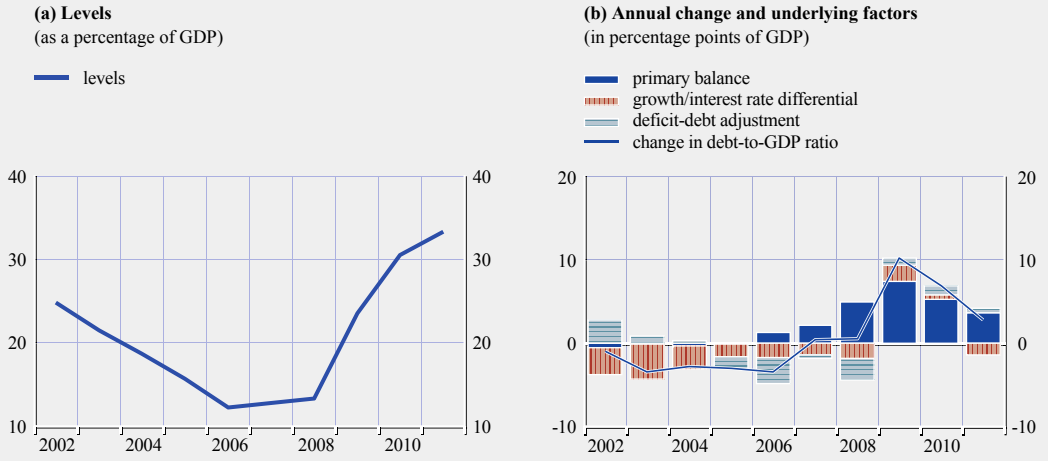
Sources: European Commission (Eurostat) and ECB calculations.
Note: In Chart 2b a negative (positive) value indicates a contribution to an increase (reduction) in a deficit.

Table 6 General government gross debt – structural features

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total debt (as a percentage of GDP)	24.9	21.5	18.7	15.8	12.4	12.8	13.4	23.6	30.5	33.3
Composition by currency (% of total)										
In domestic currency	27.9	19.2	24.1	19.0	21.5	34.4	41.6	41.7	40.7	42.2
In foreign currencies	72.1	80.8	75.9	81.0	78.5	65.6	58.4	58.3	59.3	57.8
Euro[1)]	33.1	44.8	48.3	51.5	50.1	47.4	42.8	47.2	47.1	47.7
Other foreign currencies	39.0	36.0	27.6	29.5	28.4	18.2	15.5	11.1	12.2	10.1
Domestic ownership (% of total)	35.1	28.4	28.2	30.0	20.7	31.6	42.7	51.5	51.2	50.7
Average residual maturity (in years)	4.1	4.7	4.8	5.6	7.6	5.9	4.0	5.7	5.7	5.0
Composition by maturity[2)] (% of total)										
Short-term (up to and including one year)	24.8	12.9	16.2	6.4	9.4	13.1	18.5	22.8	24.5	23.0
Medium and long-term (over one year)	75.2	87.1	83.8	93.6	90.6	86.9	81.5	77.2	75.5	77.0

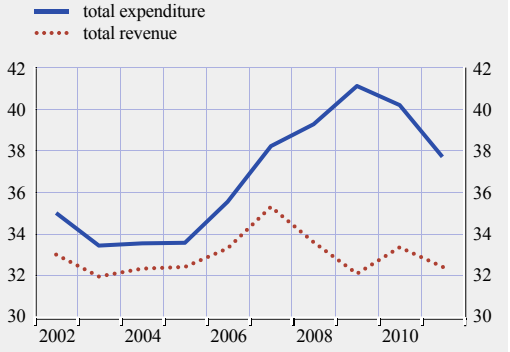
Sources: ESCB and European Commission (Eurostat).
Notes: Year-end data. Differences between totals and the sum of their components are due to rounding.
1) Comprises debt denominated in euro.
2) Original maturity.

Chart 3 General government gross debt



Sources: European Commission (Eurostat) and ECB.
Note: In Chart 3b a negative (positive) value indicates a contribution of the respective factor to a decrease (increase) in the debt ratio.

Chart 4 General government expenditure and revenue



Source: ESCB.

Table 7 General government deficit-debt adjustment

(as a percentage of GDP)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Change in general government debt[1]	4.9	2.3	1.6	-0.3	-0.9	2.6	3.1	9.9	7.8	5.8
General government surplus (+)/deficit (-)	-2.0	-1.5	-1.2	-1.2	-2.2	-2.9	-5.7	-9.0	-6.8	-5.2
Deficit-debt adjustment	2.9	0.9	0.4	-1.4	-3.1	-0.3	-2.6	0.9	1.0	0.5
Net acquisitions (+)/net sales (-) of financial assets	1.0	0.8	1.7	0.6	-0.5	1.3	-1.4	1.4	0.1	1.7
Currency and deposits	0.3	0.3	1.8	0.4	1.7	-0.1	-1.2	1.7	-0.4	1.0
Loans and securities other than shares	0.8	0.0	0.4	0.0	0.0	0.0	0.0	0.0	0.1	0.0
Shares and other equity	-0.3	-0.3	-1.2	-0.3	-2.3	0.1	-0.1	-0.2	0.1	0.2
Privatisations	-0.3	-0.3	-1.2	-0.3	-2.4	-0.1	-0.1	0.0	0.0	0.0
Equity injections	0.0	0.0	0.0	0.0	0.1	0.1	0.0	0.0	0.1	0.1
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.2	0.0	0.1
Other financial assets	0.3	0.8	0.8	0.6	0.1	1.4	-0.1	-0.1	0.3	0.5
Valuation changes of general government debt	2.4	1.1	-0.6	-0.4	-1.3	0.1	1.0	0.5	0.3	0.1
Foreign exchange holding gains (-)/losses (+)	2.1	1.3	-0.8	-0.3	-1.3	0.1	1.0	0.5	0.3	0.1
Other valuation effects[2]	0.3	-0.2	0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Other changes in general government debt[3]	-0.5	-1.0	-0.7	-1.6	-1.3	-1.8	-2.3	-1.1	0.7	-1.3

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

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2010	2020	2030	2040	2050	2060
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	21.3	26.1	30.3	41.3	54.5	64.8
Age-related government expenditure (in percentage points of GDP)[1]	17.6	17.0	18.5	20.5	22.5	24.1

Source: The 2012 Ageing Report: Economic and budgetary projections for the EU27 Member States (2010-2060), joint report prepared by the European Commission (DG ECFIN) and the Economic Policy Committee.
1) The Ageing Working Group (AWG) risk scenario, strictly age-related item.

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

Participation in the exchange rate mechanism (ERM II)	No
Exchange rate level in May 2010 in RON/EUR	4.17675
Maximum upward deviation [1]	2.5
Maximum downward deviation [1]	-5.6

Source: ECB.
1) Maximum percentage deviations of the bilateral exchange rate against the euro from its average level in May 2010 over the period 3 May 2010-2 May 2012, based on daily data at business frequency. An upward (downward) deviation implies that the currency was stronger (weaker) than its exchange rate level in May 2010.

Table 9 (b) Key indicators of exchange rate pressure for the Romanian leu

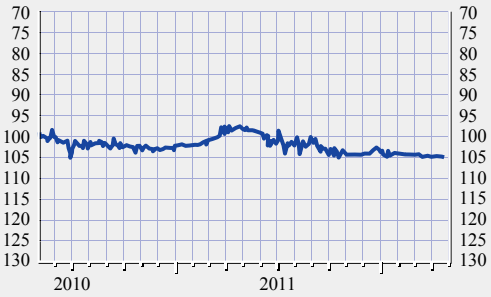
(average of three-month period ending in specified month)

	2010			2011				2012
	June	Sep.	Dec.	Mar.	June	Sep.	Dec.	Mar.
Exchange rate volatility [1]	4.8	5.4	3.5	2.7	5.0	7.2	4.5	2.9
Short-term interest rate differential [2]	5.2	5.6	5.1	4.4	3.9	3.9	4.5	3.7

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

Chart 5 Romanian leu: nominal exchange rate development against the euro

(a) Exchange rate over the reference period
(daily data; average of May 2010 = 100;
3 May 2010-2 May 2012)



(b) Exchange rate over the last ten years
(monthly data; average of May 2010 = 100;
May 2002-May 2012)

Source: ECB.
Note: An upward (downward) movement of the line indicates an appreciation (depreciation) of the Romanian leu.

Table 10 Romanian leu: real exchange rate developments

(monthly data; percentage deviation in March 2012 from the ten-year average calculated for the period April 2002-March 2012)

	Mar. 2012
Real bilateral exchange rate against the euro [1]	5.0
Memo items:	
Nominal effective exchange rate [2]	-13.8
Real effective exchange rate [1), 2)]	2.7

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

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Balance of payments										
Current account and capital account balance [1]	-3.1	-5.6	-7.5	-7.9	-10.5	-12.8	-11.1	-3.6	-4.2	-4.1
Current account balance	-3.3	-5.9	-8.3	-8.6	-10.4	-13.5	-11.5	-4.2	-4.4	-4.4
Goods balance	-5.7	-7.6	-8.7	-9.8	-12.0	-14.3	-13.6	-5.8	-6.1	-5.5
Services balance	0.0	0.1	-0.3	-0.4	0.0	0.3	0.5	-0.2	0.3	0.3
Income balance	-1.0	-2.3	-4.2	-2.9	-3.3	-3.3	-2.6	-1.6	-1.5	-1.7
Current transfers balance	3.3	3.9	4.9	4.5	4.9	3.9	4.3	3.5	2.9	2.6
Capital account balance	0.2	0.4	0.8	0.7	0.0	0.7	0.4	0.5	0.2	0.3
Combined direct and portfolio investment balance [1]	5.0	4.6	7.7	7.5	8.7	6.0	6.2	3.4	2.5	2.7
Direct investment balance	3.5	3.7	8.4	6.6	8.9	5.7	6.7	3.0	1.8	1.4
Portfolio investment balance	1.5	1.0	-0.7	1.0	-0.2	0.4	-0.4	0.4	0.7	1.3
Other investment balance	3.9	3.6	6.3	6.6	6.3	11.2	6.5	2.3	4.7	1.5
Reserve assets	-3.9	-1.9	-7.9	-6.6	-5.3	-3.5	0.1	-1.0	-2.6	-0.7
Exports of goods and services	35.3	34.7	35.8	33.0	32.3	29.2	30.3	30.6	35.5	38.4
Imports of goods and services	41.0	42.2	44.8	43.2	44.3	43.2	43.5	36.6	41.3	43.6
Net international investment position [2]	-21.2	-27.1	-26.4	-29.5	-36.2	-47.1	-53.4	-62.2	-63.8	-61.6
Gross external debt [2]	37.3	37.2	34.5	39.4	40.4	50.9	56.0	68.5	75.8	73.5
Memo item:										
Export market shares [3]	0.20	0.22	0.24	0.25	0.27	0.29	0.31	0.32	0.31	0.33

Source: ECB.
1) Differences between totals and the sum of their components are due to rounding.
2) End-of-period outstanding amounts.
3) As a percentage of total world goods and services exports.

Table 12 Indicators of integration with the euro area

(as a percentage of the total, unless otherwise stated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
External trade with the euro area										
Exports of goods	61.7	61.1	59.4	54.7	54.0	54.4	53.5	57.6	54.8	53.4
Imports of goods	54.6	54.5	52.3	49.3	49.9	53.8	51.3	52.9	51.3	50.8
Investment position with the euro area										
Inward direct investment [1]	-	70.4	71.0	76.3	80.9	80.8	82.7	84.2	81.5	82.3
Outward direct investment [1]	-	0.0	0.0	1.2	6.0	5.2	13.5	17.8	19.5	18.4
Portfolio investment liabilities [1]	52.5	52.3	66.1	71.9	72.1	78.4	65.6	75.7	90.0	-
Portfolio investment assets [1]	50.2	76.4	98.2	98.5	70.7	82.6	75.3	57.6	64.2	-
Memo items:										
External trade with the EU										
Exports of goods	73.7	75.3	74.7	70.1	70.3	72.0	70.6	74.2	72.2	71.1
Imports of goods	68.2	68.2	65.9	63.0	63.4	71.3	69.7	73.1	72.5	72.7

Sources: ESCB, European Commission (Eurostat) and IMF.
1) End-of-period outstanding amounts.

4 LONG-TERM INTEREST RATE DEVELOPMENTS

Table 13 Long-term interest rates (LTIRs)

(percentages; average of observations through period)

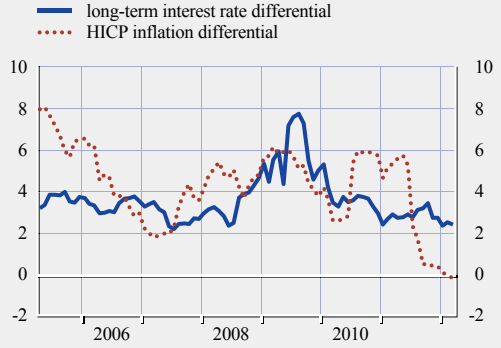
	2011	2012			Apr. 2011
	Dec.	Jan.	Feb.	Mar.	to Mar. 2012
Long-term interest rate	7.4	7.0	7.0	6.5	7.3
Reference value[1]					*5.8*
Euro area[2]	*4.6*	*4.7*	*4.4*	*4.1*	*4.4*
Euro area (AAA)[3]	*2.7*	*2.6*	*2.5*	*2.5*	*2.9*

Sources: ECB and European Commission (Eurostat).
1) The basis of the calculation for the period April 2011-March 2012 is the unweighted arithmetic average of the interest rate levels in Sweden and Slovenia plus 2 percentage points.
2) The euro area average is included for information only.
3) The euro area AAA par yield curve for the ten-year residual maturity is included for information only.

Chart 6 Long-term interest rate (LTIR)

(a) Long-term interest rate (LTIR)
(monthly averages in percentages)

(b) LTIR and HICP inflation differentials vis-à-vis the euro area
(monthly averages in percentage points)



Sources: ECB and European Commission (Eurostat).

Table 14 Selected indicators of financial development and integration

(as a percentage of GDP, unless otherwise stated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Memo item: euro area 2011
Debt securities issued by corporations[1]	1.7	1.1	0.8	6.2	1.4	0.7	0.2	0.2	0.2	0.2	103.0
Stock market capitalisation[2]	5.5	5.6	12.8	17.1	18.8	18.1	8.2	10.1	10.5	8.6	41.5
MFI credit to non-government residents[3]	-	-	-	20.7	26.9	35.7	38.5	39.9	40.1	38.6	134.7
Claims of euro area MFIs on resident MFIs[4]	-	-	-	-	-	27.2	33.0	27.2	28.4	27.2	7.9
Private sector credit flow[5]	8.8	8.0	9.2	12.0	22.7	34.3	27.9	7.9	1.7	-	3.5
Private sector debt[6]	34.4	36.1	36.0	42.0	67.7	106.6	115.0	122.9	77.7	-	167.0

Sources: ESCB, European Commission (Eurostat), Federation of European Securities Exchanges, OMX and national stock exchanges.
1) Outstanding amount of debt securities issued by resident non-financial corporations, MFIs and other financial corporations.
2) Outstanding amounts of quoted shares issued by residents at the end of the period at market values.
3) MFI (excluding NCB) credit to domestic non-MFI residents other than the general government. Credit includes outstanding amounts of loans and debt securities.
4) Outstanding amount of deposits and debt securities issued by domestic MFIs (excluding the NCB) held by euro area MFIs as a percentage of total liabilities of domestic MFIs (excluding the NCB). Total liabilities exclude capital and reserves and remaining liabilities.
5) Transactions in securities other than shares issued and loans taken out by institutional sectors: non-financial corporations, households and non-profit institutions serving households.
6) Outstanding amounts of securities other than shares issued and loans taken out by institutional sectors: non-financial corporations, households and non-profit institutions serving households.

5.8 SWEDEN

5.8.1 PRICE DEVELOPMENTS

Over the reference period from April 2011 to March 2012, the 12-month average rate of HICP inflation in Sweden was 1.3%, i.e. well below the reference value of 3.1% for the criterion on price stability (see Table 1). Looking ahead, the 12-month average rate of HICP inflation is expected to decrease in the next few months.

Looking back over a longer period, inflation developments in Sweden have generally been moderate, with the rate of inflation averaging 1.8% over the past ten years (see Chart 1), reflecting the credibility of monetary policy underpinned by moderate wage formation and the country's advanced economy status. Annual HICP inflation has occasionally deviated from 2.0%, mirroring developments in global commodity and foreign exchange markets, and wage growth out of line with productivity developments. Nevertheless, the periods when inflation has deviated from 2.0% have been sporadic, with large discrepancies rare. On average in 2011, annual HICP inflation stood at 1.4%.

Sweden's long-term inflation performance reflects a number of economic policy choices, most notably the orientation of monetary policy towards the achievement of price stability. Sveriges Riksbank follows an inflation target, quantified as an annual rise of 2% in the CPI. The monetary policy strategy changed slightly in June 2010 as the tolerance margin of ±1 percentage point was removed from the policy objective. Prudent fiscal policy and moderate wage formation have generally been supportive in achieving price stability in Sweden.

Inflation dynamics over the past ten years should be viewed against the background of very robust economic growth driven by external demand in the period leading up to the global financial and economic crisis, which was followed by a strong V-shaped recovery in economic activity. In the first part of the period, stable domestic credit and global financial markets, together with a relatively stable krona exchange rate, created an environment conducive to new investment. House prices gained momentum while productivity gains, along with relatively moderate compensation per employee growth, kept inflation stable. From the mid-2000s, a series of labour market reforms facilitated a gradual increase in labour supply and a steady decline in the unemployment rate, which in turn boosted private consumption growth and supported the housing market. HICP inflation rose from 0.8% in 2005 to 3.3% in 2008, as accelerating unit labour cost growth, the global energy and food price shock and the sharp depreciation of the krona exerted upward pressure on inflation. The presence of demand factors during this period driving the increase in inflation is also evident from the other relevant indices, such as the HICP excluding unprocessed food and energy (see Table 2). Since 2009 the gradual appreciation of the krona, together with a strong rebound in productivity, has contained inflationary pressure in Sweden. Following a small correction in the course of 2008, house price growth regained momentum, although it slowed down again in 2010 and by the end of 2011 annual house price growth turned negative.

Looking at recent developments, the annual rate of HICP inflation continued to moderate in the course of 2011. Inflation reached a trough of 0.4% in December 2011 before increasing at the beginning of 2012 to stand at 1.1% in March 2012. Although fuel prices had an upward impact on inflation at the beginning of 2012, inflation remained firmly on a downward path (see Table 3a). The reaction of inflation to the strong increases in economic activity was moderate, owing to a gradual appreciation of the krona and the lagged impact of past decreases in unit labour costs.

Sweden, and in particular its export-oriented manufacturing sector, has benefited from the sharp rebound in external demand, particularly owing to the strong pick-up in the investment goods industry and strong growth in emerging markets. Employment growth in the last couple of years has been less pronounced than the increase in production and has led to strong productivity growth. Together with moderate developments in compensation per employee, growth in unit labour costs decelerated sharply and began to decline in 2010-11. The Swedish economy expanded by 3.9% in 2011 and operated close to its potential. At the same time, inflationary pressures in Sweden remained low, reflecting limited cost pressures in the economy and the strengthening exchange rate of the krona. After several quarters of strong economic performance, signs of a slowdown in domestic demand emerged in the course of 2011, triggered by weakness in the housing market and the intensified euro area sovereign debt crisis.

The latest available forecasts from major international institutions project inflation to increase in 2012-13, and range between 1.1% and 2.5% in 2012 and between 1.4% and 2.0% in 2013 (see Table 3b). This inflation outlook is expected to be the result of capacity utilisation in the economy close to its potential. Furthermore, recently concluded wage negotiations for the 14-month period starting February 2012 indicate wage increases only slightly above the average of the past ten years and should therefore also contribute to stable inflation. Upside risks to inflation relate to a stronger than expected rebound in domestic demand, while a possible further appreciation of the krona constitutes a source of downside risk. Moreover, a potential correction of house prices could dampen domestic demand and HICP inflation. The fact that the price level in Sweden is still relatively high compared with the euro area average (see Table 2) suggests that further trade integration and increased competition may have a downward effect on price dynamics.

Maintaining price stability is a prerequisite for sustainable economic growth in Sweden over the medium term. This requires, inter alia, maintaining stability-oriented monetary policy and the continuation of prudent fiscal policy and moderate wage formation. It is essential to further improve the functioning of the labour market, which has been severely affected by the global financial and economic crisis. Reforms should continue to increase both incentives to take up employment and the number of hours worked by those already employed. In addition, more flexible employment protection legislation as regards regular employment could encourage the hiring of new workers. Financial sector policies should ensure that the banking sector is robust enough to withstand potential negative shocks stemming, in a context of high indebtedness of the private sector, from a possible correction of buoyant house prices, which have brought commonly used misalignment indicators of house prices well into positive territory. Banks' reporting of liquidity risks, related to the heavy reliance on short-term market funding in foreign currencies, particularly US dollars, should be made more transparent. Finally, it is also important that economic policy focuses on strengthening the competitiveness of the corporate sector by further removing administrative barriers and fostering competition in product markets.

5.8.2 FISCAL DEVELOPMENTS

Sweden is not subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2011 the general government budget balance showed a surplus of 0.3% of GDP, i.e. it comfortably met the 3% deficit reference value. The general government debt-to-GDP ratio was 38.4% of GDP, i.e. well below the 60% reference value (see Table 4). Compared with the previous year, the budget balance remained unchanged and the government debt ratio declined by 1 percentage point. In 2012 the budget balance is forecast by the European Commission to turn to a deficit of 0.3% of GDP and the government debt ratio is projected to decline to 35.6%.

Looking at developments in Sweden's budgetary position over the period from 2002 to 2011, the budget was in surplus over the entire period, with the exception of 2002-03 and 2009 (see Table 5 and Chart 2a). As shown in greater detail in Chart 2b, European Commission estimates indicate that cyclical factors had a positive impact overall on the budget balance, with the notable exception of 2008-09. Non-cyclical factors tended to contribute to an improvement in the budgetary position over the period 2003-09. During the financial and economic crisis in 2008 and 2009, the Swedish government gave the automatic stabilisers room to operate, which partly explains the large deficit-increasing impact of cyclical factors in those years. In addition, the Swedish government implemented fiscal stimulus measures, particularly in 2009. Since 2010 the increase in the surplus ratio has been determined by positive cyclical developments, while non-cyclical factors have had a surplus-decreasing effect. In the absence of substantial temporary and one-off factors, the underlying changes in the fiscal position reflected primarily a sizeable structural improvement in Sweden's structural budgetary position until 2009, and somewhat of a deterioration thereafter.

Turning to developments in general government gross debt, between 2002 and 2011 the debt-to-GDP ratio declined cumulatively by 14.1 percentage points (see Chart 3a and Table 6). This can be mainly explained by the primary surpluses over the whole period (see Chart 3b). Moreover, the growth/interest rate differential contributed to a debt reduction from 2003 to 2007 and in 2010 and 2011. By contrast, it contributed to the increase in the debt ratio in 2008 and, significantly so, in 2009. Noticeable debt-increasing deficit-debt adjustments occurred in 2004 and 2005, mainly reflecting government purchases of financial assets (see Table 7 and Section 5.9), and in 2008 and 2009, mainly reflecting other changes in general government debt. In 2011 the general government debt-to-GDP ratio decreased slightly owing to a positive growth/interest rate differential and the primary surplus ratio.

As regards Sweden's general government debt structure, the share of public debt with a short-term maturity was relatively high in the period under review, standing at 25.4% in 2011 (see Table 6). Fiscal balances are, however, relatively insensitive to changes in interest rates given the low level of debt. At the same time, at 20.3%, the proportion of government debt denominated in foreign currency was relatively high in 2011. Given the level of the government debt-to-GDP ratio, the fiscal balances are, however, relatively insensitive to changes in exchange rates. At the same time, the Swedish government has incurred a sizeable amount of contingent liabilities resulting from government interventions to support financial institutions and financial markets during the crisis (see Section 5.9).

Moving on to examine trends in other fiscal indicators, Chart 4 and Table 5 show that the general government total expenditure ratio declined from 55.4% of GDP in 2002 to 51.1% in 2011. The ratio declined steadily until 2007, reflecting a fall in current expenditure (by 4.3 percentage points) related to, inter alia, a downsizing of public administration, lower interest payable (by 1.1 percentage points) and reductions in social benefits other than in kind (by 1.5 percentage points). Thereafter, the downward trend reversed and the expenditure ratio increased steeply to 54.7% of GDP in 2009, which was primarily and broadly equally attributable to the decline in GDP (via the denominator effect) and to an increase in social benefits and other expenditure. Since 2009 the expenditure ratio has declined, largely owing to lower social benefits other than in kind. At 51.1% of GDP in 2011, the expenditure ratio is high in comparison with other countries with a similar level of per capita income. Government revenue in relation to GDP fluctuated around 54% of GDP between 2002 and 2009. Since 2009 the total revenue-to-GDP ratio has declined notably to 51.4% of GDP in 2011, mainly reflecting lower revenues from direct taxes and social security contributions.

Looking ahead, according to Sweden's medium-term fiscal strategy, as presented in the 2012-15 update of the convergence programme, the government envisages a gradual increase in the budget surplus to 3.0% of GDP by 2015. For 2012, the convergence programme suggests that the government expects a slight improvement of the budget deficit to 0.1% of GDP. The total revenue-to-GDP ratio is anticipated to decrease by 0.6 percentage point to 50.8% of GDP in 2015 compared with 2011. At the same time, the total expenditure ratio is expected to decline by 3.3 percentage points to 47.8% of GDP over the programme horizon, reflecting, inter alia, a reduction in compensation of employees and social payments. Furthermore, government gross debt is projected to decrease strongly over the programme horizon, reaching 27.5% of GDP in 2015. According to this fiscal strategy, the target to achieve the medium-term budgetary objective of a general surplus of 1% of GDP (specified in line with the Stability and Growth Pact) over the cycle is projected to be achieved in 2012 and to be maintained over the programme period. Moreover, based on information submitted in the 2012 convergence programme update, primary expenditure excluding, inter alia, EU fund transfers (relevant expenditure), as a share of GDP, is projected to drop by 3.9 percentage points between 2012 and 2015. The annual growth rate of relevant expenditure is projected to be above the growth rate of potential GDP in 2012 and below it in 2013 and 2014. According to the European Commission's projections, the structural surplus will remain, however, below the medium-term objective by 2013.

In this respect, on 2 March 2012 Sweden signed the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, committing, inter alia, to apply (and include in its national legislation) the fiscal rules specified under Title III, "Fiscal Compact", as referred to in Box 2 of Chapter 2.

Overall, as regards fiscal governance, Sweden has a strong rules-based fiscal framework consisting, inter alia, of an expenditure ceiling for the central government, a general government structural surplus target and a balanced budget requirement for the local governments. However, further clarification could be given to what relative weight the government puts on the indicators used to assess the fulfilment of the surplus target. This uncertainty raises the risk of an "opportunistic" interpretation of these indicators.

Turning to factors with an impact on Sweden's public finances over the long term, the country is facing a marked increase in the old-age dependency ratio, as indicated in Table 8. According to the 2012 projections of the European Commission and the EU's Economic Policy Committee, starting from a level of 27.3% of GDP in 2010, Sweden is likely to experience a notable increase in strictly age-related government expenditure between 2010 and 2060, amounting to 4.4 percentage points.[16]

Turning to fiscal challenges, the rules-based fiscal framework, which has so far been beneficial to fiscal performance, should also anchor Sweden's budgetary consolidation strategy in the years to come. However, further improvements in fiscal performance should aim to reduce the supply-side repercussions of fiscal policies on the economy, which, in particular, stem from labour market developments.

5.8.3 EXCHANGE RATE DEVELOPMENTS

In the two-year reference period from 1 May 2010 to 30 April 2012, the Swedish krona did not participate in ERM II, but traded under a flexible exchange rate regime (see Table 9a). In this period

16 European Commission and Economic Policy Committee, "The 2012 Ageing Report: Economic and budgetary projections for the EU-27 Member States (2010-2060)".

the krona appreciated strongly against the euro until March 2011, weakening somewhat during the summer, but strengthening again from the end of 2011. Over the reference period, the Swedish currency mostly traded substantially above its May 2010 average exchange rate against the euro, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate. The maximum upward deviation from this benchmark was 9.9%, while the maximum downward deviation amounted to 1.7% (see Chart 5 and Table 9a).

Over the reference period, 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 helped to reduce financial vulnerabilities, it might also have had an impact on the exchange rate of the Swedish krona.

Looking at exchange rate developments in more detail, the relative strength of the Swedish krona during the reference period reflected, primarily, the strong economic recovery of the Swedish economy and the favourable economic outlook in the absence of major external vulnerabilities. At the same time, the Swedish currency may have been supported by safe haven flows amid the large uncertainty in global financial markets. At the beginning of March 2011 the krona reached a ten-year high vis-à-vis the euro of around 8.7 kronor per euro. Thereafter, the Swedish currency stabilised and on 30 April 2012 traded at 8.92 kronor per euro, i.e. 7.7% stronger than its average level in May 2010.

The exchange rate of the Swedish krona against the euro displayed, on average, a high degree of volatility over the review period, as measured by annualised standard deviations in daily percentage changes. At the same time, short-term interest rate differentials against the three-month EURIBOR increased gradually from -0.1 percentage point in the three-month period ending in June 2010 to 1.4 percentage points in the three-month period ending in March 2012 (see Table 9b).

In a longer-term context, in March 2012 both the Swedish krona's real effective exchange rate and its real bilateral exchange rate against the euro stood close to the corresponding ten-year historical averages (see Table 10). As regards other external developments, since 2002 Sweden has accumulated large surpluses – around 7% of GDP, on average – in its combined current and capital account of the balance of payments, which reached 7.1% of GDP in 2011 (see Table 11). As a result, Sweden has recorded persistently large net capital outflows in its financial account. Gross external debt increased sharply from 130.1% of GDP in 2002 to 210.5% in 2009, but decreased thereafter to 191.3% in 2010 and 194.7% in 2011. At the same time, the country's net international investment position improved gradually from -22.1% of GDP in 2002 to -8.5% in 2010 and -6.8% in 2011. Sweden is a small, open economy; the ratio of foreign trade in goods and services to GDP increased from 43.0% of GDP in 2002 to 49.1% in 2011 for exports and from 36.6% in 2002 to 42.9% in 2011 for imports. Over the same period, Sweden's share in world exports decreased from 1.35% to 1.20%.

Concerning measures of economic integration with the euro area, in 2011 exports of goods to the euro area constituted 38.1% of total goods exports, whereas the corresponding figure for imports was higher at 48.3%. The share of euro area countries in Sweden's inward direct investment stood at 56.0% in 2011 and in its portfolio investment liabilities at 41.1% in 2010. The share of Sweden's assets invested in the euro area amounted to 43.0% in the case of direct investment in 2011 and 41.3% for portfolio investment in 2010 (see Table 12).

5.8.4 LONG-TERM INTEREST RATE DEVELOPMENTS

Over the reference period from April 2011 to March 2012, long-term interest rates in Sweden were 2.2% on average and thus well below the 5.8% reference value for the interest rate convergence criterion (see Table 13).

Swedish long-term interest rates declined and reached 3% by the middle of 2005 (see Chart 6a). This downward movement reflected, among other things, relatively contained inflation. From late 2005, Sweden's long-term interest rates increased and reached 4.5% in mid-2007 owing mostly to strong growth. Amid the global financial and economic crisis, inflation in Sweden started to fall at the end of 2008, and long-term interest rates declined to 2.7% in December 2008. In the course of the euro area sovereign debt crisis, Swedish long-term interest rates declined to historically low levels and were 2.0% at the end of the reference period, partly reflecting the high perceived creditworthiness of the Swedish government and strong demand for Swedish krona assets amid safe-haven portfolio shifts.

The interest rate differential between Swedish and average euro area long-term interest rates (see Chart 6b) was slightly positive between 2002 and 2004, reflecting mostly a more pronounced fall in euro area bond rates. From mid-2005 to 2007, the differential was slightly negative and relatively stable. From 2008 onwards, the interest rate differential with the euro area average widened significantly and stood at -2.1 percentage points at the end of the reference period (and -0.6 percentage point with respect to the AAA euro area yield), owing to a continued fall in Swedish long-term interest rates and a rise in euro area long-term interest rates.

The Swedish capital market is highly developed. The debt securities issued by corporations stood at 128.2% of GDP at the end of 2011, above the euro area average (see Table 14). Similarly, stock market capitalisation (95.5% of GDP) was well above the euro area average. In terms of bank credit to non-government residents, the indicator for the Swedish financial sector approached that of the euro area and amounted to 133.8% of GDP at the end of 2011. Foreign-owned banks have only a limited role in the Swedish banking sector, and the majority of loans to the private sector are in local currency. Loans of euro area banks to banks in the country stood at 9.3% of total liabilities in 2011.

LIST OF TABLES AND CHARTS

SWEDEN

1 PRICE DEVELOPMENTS

Table 1 HICP inflation

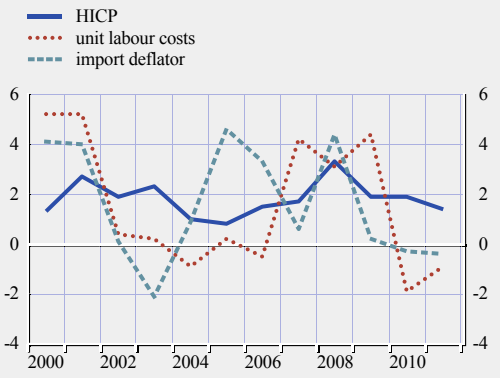
(annual percentage changes)

	2011 Dec.	2012 Jan.	2012 Feb.	2012 Mar.	Apr. 2011 to Mar. 2012
HICP inflation	0.4	0.7	1.0	1.1	1.3
Reference value [1]					*3.1*
Euro area [2]	*2.7*	*2.7*	*2.7*	*2.7*	*2.8*

Source: European Commission (Eurostat).
1) The basis of the calculation for the period April 2011-March 2012 is the unweighted arithmetic average of the annual percentage changes in the HICP for Sweden, Ireland and Slovenia plus 1.5 percentage points.
2) The euro area is included for information only.

Chart 1 Price developments

(average annual percentage changes)



Source: European Commission (Eurostat).

Table 2 Measures of inflation and related indicators

(annual percentage changes, unless otherwise stated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Measures of inflation										
HICP	1.9	2.3	1.0	0.8	1.5	1.7	3.3	1.9	1.9	1.4
HICP excluding unprocessed food and energy	1.7	1.3	0.8	0.2	0.5	1.8	2.3	2.3	1.5	1.1
HICP at constant tax rates [1]	-	-	0.9	0.7	1.4	1.3	2.7	1.8	1.9	1.4
CPI	2.2	1.9	0.4	0.5	1.4	2.2	3.4	-0.5	1.2	3.0
Private consumption deflator	1.5	1.7	0.8	1.1	1.2	1.4	3.1	2.1	1.4	1.3
GDP deflator	1.5	1.8	0.3	0.9	1.9	2.8	3.1	2.1	1.0	1.0
Producer prices [2]	2.2	2.8	1.8	3.9	6.1	3.6	6.1	-0.3	3.0	0.9
Related indicators										
Real GDP growth	2.5	2.3	4.2	3.2	4.3	3.3	-0.6	-5.0	6.1	3.9
GDP per capita in PPS [3] (euro area = 100)	110.0	112.5	115.8	111.6	112.7	114.8	113.8	110.2	114.7	-
Comparative price levels (euro area = 100)	121.3	120.1	117.8	116.7	116.3	114.1	109.4	102.7	116.7	-
Output gap [4]	-0.3	-0.7	0.9	1.4	2.8	3.4	0.6	-5.6	-1.4	0.4
Unemployment rate (%) [5]	5.9	6.6	7.4	7.6	7.0	6.1	6.2	8.3	8.4	7.5
Unit labour costs, whole economy	0.4	0.2	-0.9	0.2	-0.5	4.2	3.1	4.4	-1.9	-0.9
Compensation per employee, whole economy	2.9	3.2	4.0	3.1	2.1	5.2	1.5	1.6	3.0	0.8
Labour productivity, whole economy	2.4	2.9	5.0	2.9	2.6	1.0	-1.5	-2.7	5.0	1.7
Imports of goods and services deflator	0.1	-2.1	0.9	4.6	3.3	0.6	4.4	0.2	-0.3	-0.4
Nominal effective exchange rate [6]	1.9	5.8	1.9	-2.5	0.3	1.4	-2.2	-8.8	8.0	5.6
Money supply (M3)	9.7	29.4	4.5	9.5	18.8	18.6	2.6	-0.8	8.5	6.3
Lending from banks	6.2	4.9	5.9	11.0	11.4	14.4	7.2	3.3	7.4	5.5
Stock prices (Sweden OMX Index)	-41.7	29.0	16.6	29.4	19.5	-5.7	-38.8	43.7	21.4	-14.5
Residential property prices	6.3	6.6	9.3	9.0	12.2	10.4	3.3	1.6	7.8	0.7

Sources: European Commission (Eurostat), national data (CPI, money supply, lending from banks and residential property prices) and European Commission (output gap).
1) 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 on the price paid by the consumer.
2) Total industry excluding construction and domestic sales.
3) PPS stands for purchasing power standards.
4) Percentage difference of potential GDP: a positive (negative) sign indicates that actual GDP is above (below) potential GDP.
5) The definition conforms to ILO guidelines.
6) A positive (negative) sign indicates an appreciation (depreciation).

Table 3 Recent inflation trends and forecasts

(annual percentage changes)

(a) Recent trends in the HICP

	2011			2012		
	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.
HICP						
Annual percentage change	1.1	1.1	0.4	0.7	1.0	1.1
Change in the average of the latest three months from the previous three months, annualised rate, seasonally adjusted	0.9	1.0	0.6	0.7	0.6	1.0
Change in the average of the latest six months from the previous six months, annualised rate, seasonally adjusted	0.8	0.7	0.9	0.8	0.8	0.8

Sources: European Commission (Eurostat) and ECB calculations.

(b) Inflation forecasts

	2012	2013
HICP, European Commission (spring 2012)	1.1	1.5
CPI, OECD (December 2011)	1.1	1.4
CPI, IMF (April 2012)	2.5	2.0
CPI, Consensus Economics (April 2012)	-	-

Sources: European Commission, OECD, IMF and Consensus Economics.

2 FISCAL DEVELOPMENTS

Table 4 General government fiscal position

(as a percentage of GDP)

	2010	2011	2012 [1]
General government surplus (+)/deficit (-)	0.3	0.3	-0.3
Reference value	*-3.0*	*-3.0*	*-3.0*
Surplus/deficit, net of government investment expenditure [2]	3.7	3.7	3.2
General government gross debt	39.4	38.4	35.6
Reference value	*60.0*	*60.0*	*60.0*

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

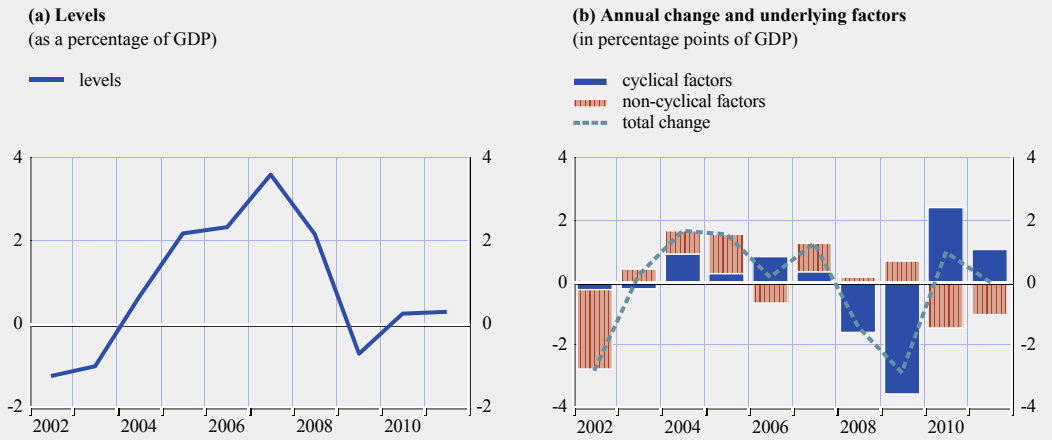
Table 5 General government budgetary position

(as a percentage of GDP)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total revenue	54.1	54.4	54.6	55.8	54.9	54.5	53.9	54.0	52.4	51.4
Current revenue	53.9	54.2	54.4	55.7	54.9	54.4	53.8	53.9	52.4	51.3
Direct taxes	19.4	20.1	20.8	22.0	22.2	21.2	19.8	19.6	19.2	18.7
Indirect taxes	16.3	16.4	16.2	16.3	16.5	16.5	17.9	18.7	17.9	18.4
Social security contributions	11.7	11.4	11.1	10.7	9.8	9.9	9.0	8.7	8.7	7.6
Other current revenue	6.5	6.4	6.3	6.7	6.4	6.8	7.1	7.0	6.5	6.6
Capital revenue	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Total expenditure	55.4	55.4	54.0	53.6	52.6	50.9	51.7	54.7	52.2	51.1
Current expenditure	52.1	52.3	50.9	50.4	49.4	47.8	48.4	51.1	48.7	47.6
Compensation of employees	15.7	16.0	15.8	15.6	15.1	14.9	14.8	15.2	14.6	14.0
Social benefits other than in kind	15.9	16.4	16.0	15.7	15.2	14.4	14.4	15.7	14.7	14.1
Interest payable	2.8	2.0	1.6	1.6	1.6	1.7	1.7	1.0	0.8	1.0
of which: impact of swaps and FRAs [1]	-0.2	-0.2	-0.2	-0.2	-0.1	0.0	0.0	-0.3	-0.3	-0.2
Other current expenditure	17.7	17.9	17.5	17.5	17.5	16.8	17.6	19.3	18.5	18.5
Capital expenditure	3.3	3.1	3.0	3.3	3.2	3.2	3.3	3.6	3.5	3.5
Surplus (+)/deficit (-)	-1.3	-1.0	0.6	2.2	2.3	3.6	2.2	-0.7	0.3	0.3
Primary balance	1.6	1.0	2.2	3.8	3.9	5.3	3.8	0.2	1.1	1.3
Surplus/deficit, net of government investment expenditure	1.8	1.9	3.6	5.2	5.4	6.7	5.5	2.8	3.7	3.7

Sources: ESCB and European Commission (Eurostat).
Notes: Differences between totals and the sum of their components are due to rounding. Interest payable as reported under the excessive deficit procedure. The item "impact of swaps and FRAs" is equal to the difference between the interest (or deficit/surplus) as defined in the excessive deficit procedure and in the ESA 95. See Regulation (EC) No 2558/2001 of the European Parliament and of the Council of 3 December 2001 amending Council Regulation (EC) No 2223/96 as regards the reclassification of settlements under swap arrangements and under forward rate agreements (0J L 344, 28.12.2001, p. 1).
1) FRAs stands for forward rate agreements.

Chart 2 General government surplus (+)/deficit (-)



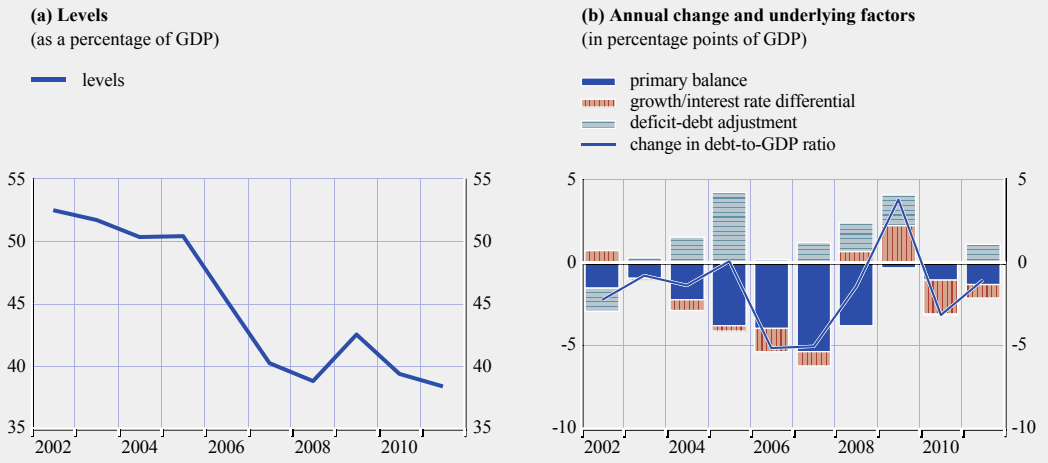
Sources: European Commission (Eurostat) and ECB calculations.
Note: In Chart 2b a negative (positive) value indicates a contribution to an increase (reduction) in a deficit.

Table 6 General government gross debt – structural features

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total debt (as a percentage of GDP)	52.5	51.7	50.3	50.4	45.3	40.2	38.8	42.6	39.4	38.4
Composition by currency (% of total)										
In domestic currency	69.4	73.1	75.7	76.3	78.6	80.0	80.6	73.7	78.0	79.7
In foreign currencies	30.6	26.9	24.3	23.7	21.4	20.0	19.4	26.3	22.0	20.3
Euro[1)]	11.3	11.4	9.8	10.4	7.9	5.5	7.6	11.6	10.2	9.2
Other foreign currencies	19.2	15.4	14.5	13.3	13.5	14.4	11.8	14.7	11.8	11.1
Domestic ownership (% of total)	63.9	63.5	65.4	70.6	78.0	74.9	72.2	74.3	73.0	70.4
Average residual maturity (in years)	-	-	-	-	-	-	-	-	-	-
Composition by maturity[2)] (% of total)										
Short-term (up to and including one year)	25.6	26.0	22.1	28.6	28.9	27.4	24.9	27.1	24.2	25.4
Medium and long-term (over one year)	74.4	74.0	77.9	71.4	71.1	72.6	75.1	72.9	75.8	74.6

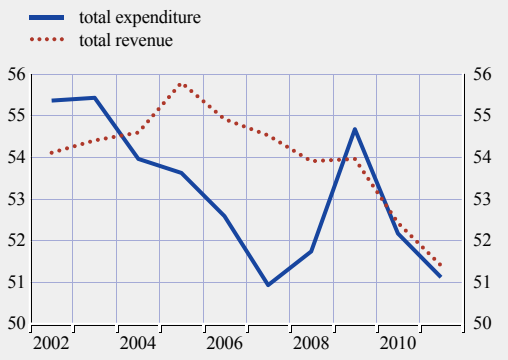
Sources: ESCB and European Commission (Eurostat).
Notes: Year-end data. Differences between totals and the sum of their components are due to rounding.
1) Comprises debt denominated in euro.
2) Original maturity.

Chart 3 General government gross debt



Sources: European Commission (Eurostat) and ECB.
Note: In Chart 3b a negative (positive) value indicates a contribution of the respective factor to a decrease (increase) in the debt ratio.

Chart 4 General government expenditure and revenue



Source: ESCB.

Table 7 General government deficit-debt adjustment

(as a percentage of GDP)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Change in general government debt [1]	-0.1	1.3	0.9	2.0	-2.1	-2.4	-0.4	2.5	-0.3	0.8
General government surplus (+)/deficit (-)	-1.3	-1.0	0.6	2.2	2.3	3.6	2.2	-0.7	0.3	0.3
Deficit-debt adjustment	-1.4	0.3	1.5	4.2	0.2	1.2	1.7	1.8	0.0	1.1
Net acquisitions (+)/net sales (-) of financial assets	0.9	2.8	2.4	2.4	0.8	0.0	-2.3	0.0	0.2	-1.9
Currency and deposits	-0.2	-0.2	0.1	0.1	0.8	-0.2	1.6	-1.2	-0.4	0.7
Loans and securities other than shares	0.2	0.9	1.4	2.3	1.9	1.9	-1.0	3.3	1.5	0.5
Shares and other equity	1.4	1.1	0.5	-1.0	-0.6	-0.5	-0.2	0.2	-0.3	-0.1
Privatisations	0.0	0.0	0.0	0.0	0.0	0.0	-2.3	-0.1	0.0	0.0
Equity injections	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.0	0.0
Other	1.4	1.1	0.5	-1.0	-0.6	-0.5	2.0	0.3	-0.4	-0.1
Other financial assets	-0.4	0.9	0.4	1.0	-1.4	-1.2	-2.7	-2.2	-0.5	-3.1
Valuation changes of general government debt	-0.9	-0.8	-0.5	1.0	-0.5	0.6	0.9	-1.5	-0.8	0.2
Foreign exchange holding gains (-)/losses (+)	-	-	-	-	-	-	-	-	-	-
Other valuation effects [2]	-	-	-	-	-	-	-	-	-	-
Other changes in general government debt [3]	-1.4	-1.7	-0.5	0.9	-0.1	0.6	3.1	3.3	0.5	2.8

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

Table 8 Projections of the ageing-induced fiscal burden

(percentages)

	2010	2020	2030	2040	2050	2060
Elderly dependency ratio (population aged 65 and over as a proportion of the population aged 15-64)	28.1	33.7	37.5	40.5	41.9	46.2
Age-related government expenditure (in percentage points of GDP) [1]	27.3	27.6	29.5	30.4	30.5	31.7

Source: The 2012 Ageing Report: Economic and budgetary projections for the EU27 Member States (2010-2060), joint report prepared by the European Commission (DG ECFIN) and the Economic Policy Committee.
1) The Ageing Working Group (AWG) risk scenario, strictly age-related item.

3 EXCHANGE RATE DEVELOPMENTS

Table 9 (a) Exchange rate stability

Participation in the exchange rate mechanism (ERM II)	No
Exchange rate level in May 2010 in SEK/EUR	9.66413
Maximum upward deviation [1]	9.9
Maximum downward deviation [1]	-1.7

Source: ECB.
1) Maximum percentage deviations of the bilateral exchange rate against the euro from its average level in May 2010 over the period 3 May 2010-30 April 2012, based on daily data at business frequency. An upward (downward) deviation implies that the currency was stronger (weaker) than its exchange rate level in May 2010.

Table 9 (b) Key indicators of exchange rate pressure for the Swedish krona

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

	2010			2011				2012
	June	Sep.	Dec.	Mar.	June	Sep.	Dec.	Mar.
Exchange rate volatility [1]	7.6	6.6	7.0	6.7	5.8	8.2	6.7	4.5
Short-term interest rate differential [2]	-0.1	0.1	0.6	1.1	1.0	1.0	1.1	1.4

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

Chart 5 Swedish krona: nominal exchange rate development against the euro

(a) Exchange rate over the reference period
(daily data; average of May 2010 = 100;
3 May 2010-30 April 2012)

(b) Exchange rate over the last ten years
(monthly data; average of May 2010 = 100;
May 2002-April 2012)

Source: ECB.
Note: An upward (downward) movement of the line indicates an appreciation (depreciation) of the Swedish krona.

Table 10 Swedish krona: real exchange rate developments

(monthly data; percentage deviation in March 2012 from the ten-year average calculated for the period April 2002-March 2012)

	Mar. 2012
Real bilateral exchange rate against the euro [1]	3.4
Memo items:	
Nominal effective exchange rate [2]	3.9
Real effective exchange rate [1), 2)]	1.0

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

Table 11 External developments

(as a percentage of GDP, unless otherwise stated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Balance of payments										
Current account and capital account balance [1]	4.7	7.0	6.6	6.9	7.8	9.2	8.6	6.9	6.7	7.1
Current account balance	4.7	7.0	6.6	6.8	8.4	9.2	8.8	7.0	6.9	7.2
Goods balance	6.2	5.9	6.3	5.3	5.4	3.8	3.2	3.2	2.5	2.4
Services balance	0.2	0.5	1.5	2.0	2.4	3.4	3.4	3.3	3.9	3.8
Income balance	-0.5	1.2	0.0	0.8	1.9	3.1	3.5	1.8	1.9	2.3
Current transfers balance	-1.3	-0.7	-1.3	-1.2	-1.3	-1.1	-1.3	-1.3	-1.3	-1.3
Capital account balance	0.0	0.0	0.0	0.1	-0.7	-0.1	-0.2	-0.1	-0.1	-0.1
Combined direct and portfolio investment balance [1]	-4.4	-8.1	-9.4	-4.3	-4.4	0.8	-5.2	11.8	0.1	1.9
Direct investment balance	0.7	-5.1	-2.8	-4.3	0.6	-2.4	1.2	-3.9	-4.2	-3.0
Portfolio investment balance	-5.0	-3.0	-6.6	-0.1	-5.0	3.2	-6.4	15.7	4.2	4.9
Other investment balance	1.5	1.5	1.9	-3.0	-3.4	-3.1	9.4	-10.0	-8.8	-9.6
Reserve assets	-0.3	-0.6	0.3	-0.2	-0.4	0.1	0.1	-3.7	0.1	-0.1
Exports of goods and services	43.0	42.1	44.6	47.0	50.0	50.7	52.1	47.2	48.9	49.1
Imports of goods and services	36.6	35.7	36.7	39.8	42.2	43.5	45.5	40.7	42.5	42.9
Net international investment position [2]	-22.1	-19.7	-24.5	-21.4	-12.9	-1.2	-10.5	-11.4	-8.5	-6.8
Gross external debt [2]	130.1	132.5	140.9	160.1	160.5	176.3	205.7	210.5	191.3	194.7
Memo item:										
Export market shares [3]	1.35	1.42	1.43	1.35	1.34	1.35	1.29	1.21	1.20	1.20

Source: ECB.
1) Differences between totals and the sum of their components are due to rounding.
2) End-of-period outstanding amounts.
3) As a percentage of total world goods and services exports.

Table 12 Indicators of integration with the euro area

(as a percentage of the total, unless otherwise stated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
External trade with the euro area										
Exports of goods	41.1	41.2	41.3	40.0	41.1	41.6	40.6	39.1	38.5	38.1
Imports of goods	50.4	51.1	51.3	48.8	48.2	48.9	47.1	47.3	47.2	48.3
Investment position with the euro area										
Inward direct investment [1]	44.1	47.9	46.7	47.5	46.7	49.1	54.9	57.7	59.1	56.0
Outward direct investment [1]	42.4	43.7	45.0	42.5	47.9	45.6	48.0	46.1	43.5	43.0
Portfolio investment liabilities [1]	36.3	38.7	36.8	34.5	35.3	38.5	44.9	43.6	41.1	-
Portfolio investment assets [1]	41.8	41.6	44.2	41.8	40.4	41.9	42.3	40.4	41.3	-
Memo items:										
External trade with the EU										
Exports of goods	58.5	58.7	59.0	59.0	60.2	61.2	60.0	58.3	57.1	56.0
Imports of goods	71.1	71.9	72.2	70.4	69.7	71.1	69.1	67.9	67.0	68.2

Sources: ESCB, European Commission (Eurostat) and IMF.
1) End-of-period outstanding amounts.

4 LONG-TERM INTEREST RATE DEVELOPMENTS

Table 13 Long-term interest rates (LTIRs)

(percentages; average of observations through period)

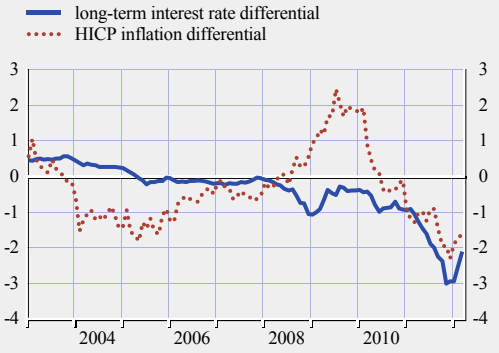
	2011	2012			Apr. 2011
	Dec.	Jan.	Feb.	Mar.	to Mar. 2012
Long-term interest rate	1.7	1.7	1.9	2.0	2.2
Reference value [1]					*5.8*
Euro area [2]	*4.6*	*4.7*	*4.4*	*4.1*	*4.4*
Euro area (AAA) [3]	*2.7*	*2.6*	*2.5*	*2.5*	*2.9*

Sources: ECB and European Commission (Eurostat).
1) The basis of the calculation for the period April 2011-March 2012 is the unweighted arithmetic average of the interest rate levels in Sweden and Slovenia plus 2 percentage points.
2) The euro area average is included for information only.
3) The euro area AAA par yield curve for the ten-year residual maturity is included for information only.

Chart 6 Long-term interest rate (LTIR)

(a) Long-term interest rate (LTIR)
(monthly averages in percentages)

(b) LTIR and HICP inflation differentials vis-à-vis the euro area
(monthly averages in percentage points)



Sources: ECB and European Commission (Eurostat).

Table 14 Selected indicators of financial development and integration

(as a percentage of GDP, unless otherwise stated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Memo item: euro area 2011
Debt securities issued by corporations [1]	57.9	69.3	70.5	83.7	88.4	101.8	115.5	136.7	123.6	128.2	103.0
Stock market capitalisation [2]	72.8	90.9	101.4	126.7	145.2	126.6	63.9	101.4	117.9	95.5	41.5
MFI credit to non-government residents [3]	97.8	98.1	98.7	105.8	110.2	119.0	126.1	134.0	133.0	133.8	134.7
Claims of euro area MFIs on resident MFIs [4]	7.8	7.4	11.0	9.4	9.7	10.2	10.5	9.8	9.4	9.3	7.9
Private sector credit flow [5]	-4.9	-1.8	3.1	12.3	10.7	23.3	20.0	4.8	2.5	6.3	3.5
Private sector debt [6]	201.7	197.3	172.9	183.6	192.9	210.3	236.7	248.3	235.0	232.8	167.0

Sources: ESCB, European Commission (Eurostat), Federation of European Securities Exchanges, OMX and national stock exchanges.
1) Outstanding amount of debt securities issued by resident non-financial corporations, MFIs and other financial corporations.
2) Outstanding amounts of quoted shares issued by residents at the end of the period at market values. For historical periods the national data have been derived directly from the national stock exchange without further adjustments.
3) MFI (excluding NCB) credit to domestic non-MFI residents other than the general government. Credit includes outstanding amounts of loans and debt securities.
4) Outstanding amount of deposits and debt securities issued by domestic MFIs (excluding the NCB) held by euro area MFIs as a percentage of total liabilities of domestic MFIs (excluding the NCB). Total liabilities exclude capital and reserves and remaining liabilities.
5) Transactions in securities other than shares issued and loans taken out by institutional sectors: non-financial corporations, households and non-profit institutions serving households.
6) Outstanding amounts of securities other than shares issued and loans taken out by institutional sectors: non-financial corporations, households and non-profit institutions serving households.

5.9 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 political considerations. Member States are invited to consider the quality and integrity of their statistics as a matter of priority, to ensure that a proper system of checks and balances is in place when compiling these statistics and to apply certain standards with respect to governance and quality in the domain of statistics.

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, Regulation (EC) No 223/2009 of the European Parliament and of the Council of 11 March 2009 on European Statistics (Regulation on European Statistics) and the European Statistics Code of Practice endorsed by the Commission in 2005 and revised in September 2011 (the Code of Practice). Article 2(1) of the Regulation on European Statistics states that the development, production and dissemination of European statistics shall be governed by the following statistical principles: a) professional independence; b) impartiality; c) objectivity; d) reliability; e) statistical confidentiality; and f) cost effectiveness. Pursuant to Article 11 of the Regulation, these statistical principles are further elaborated on in the Code of Practice.[17]

Against this background, the quality and integrity of the convergence indicators in terms of the underlying statistics are reviewed in the statistical section. This section refers to some institutional features of the national statistical institutes (NSIs) concerned and 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. Moreover, sub-section 3.2 reviews in particular the public interventions to support financial institutions and financial markets during the financial crisis, as well as the financial support provided by international institutions or countries during the financial crisis.

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

In recent years, the governance of the European Statistical System (ESS) has been improved, in particular with the adoption of the Code of Practice in 2005. Initially the implementation and monitoring of the Code relied to a large extent on a self-regulatory approach (self-assessments, peer reviews and national implementation plans). Since 2009, when the European Statistical Governance Advisory Board (ESGAB) was established, the ESS has been enhanced by the addition of an external assessment and by the entry into force of the Regulation on European Statistics.

However, the experience gained in recent years has highlighted some remaining weaknesses in the governance framework of the ESS. These weaknesses were described in the Communication from

17 See Articles 2(1) and 11 of Regulation (EC) No 223/2009 of the European Parliament and of the Council of 11 March 2009 on European Statistics.

the Commission to the European Parliament and the Council of 15 April 2011 entitled "Towards robust quality management for European Statistics".[18]

In the specific context of the EU fiscal surveillance system and of the EDP exercise, Council Regulation (EU) No 679/2010[19] granted Eurostat new competences for regularly monitoring and verifying public finance data, which it will exercise 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 NSIs.

Furthermore, the legislative package of six legal texts adopted to strengthen the economic governance structure of the euro area and the EU as a whole relies on high quality statistical information, which needs to be produced under robust quality management.[20]

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.

Moreover, the Regulation on European Statistics is currently under revision with a view to clarifying, among other things, 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.

Table 3 provides an overview of some of the institutional features relating to the quality of the statistics, namely the specification of the legal independence of the national statistical authority, its administrative supervision and budget autonomy, its legal mandate for data collection and its legal provisions governing statistical confidentiality.[21]

18 COM/2011/0211 final.

19 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.

20 On 13 December 2011, the reinforced Stability and Growth Pact (SGP) entered into force with a new set of rules for economic and fiscal surveillance. These new measures, known as the "six-pack", consist of five regulations and one directive, proposed by the European Commission and approved by all 27 EU Member States and the European Parliament in October 2011.

21 Information on the institutional set-up of national statistical authorities has been taken from their websites (April 2012).

Table 3 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	According to the Law on Statistics, statistics are based on the principles of professional independence, impartiality, objectivity, reliability, statistical confidentiality and cost effectiveness. According to 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).	According to Article 5 of the State Statistical Service Act, statistics are based on objectivity, impartiality and independency. According to 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	According to Articles 25 to 27a of the Law on Statistics, the confidentiality of the statistical data is secured.	According to Articles 16, 17 and 18 of the State Statistical Service Act, the confidentiality of the statistical data is secured.
HICP inflation [1]		
Compliance with legal minimum standards	Eurostat made a compliance-monitoring visit in 2007 and confirmed that in general the methods used for producing the HICP are satisfactory. There were no apparent instances of non-compliance with the HICP methodology.	Eurostat made a compliance-monitoring visit in 2008 and confirmed 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 representativity of the HICP in terms of accuracy and reliability to be generally adequate.	Eurostat considered the representativity 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 2002-11.	Revenue, expenditure, deficit and debt data are provided for the period 2002-11.
Outstanding statistical issues	A Eurostat dialogue visit revealed that the time-adjusted cash method used for tax (particularly for indirect taxes) needs to be scrutinised.	Small discrepancies between the financial and non-financial accounts need to be analysed.
Deficit-debt adjustment	High and negative cumulative amount of DDA due to privatisation and high tax refunds.	Cumulative amount of DDA is moderate and negative. This refers to privatisations, but also to valuation effects due to fluctuation in value of debt denominated in foreign currency.
Institution responsible for the compilation of EDP data	The NSI compiles the actual EDP data and the Ministry of Finance provides the forecasts. The Ministry of Finance compiles the actual EDP data concerning debt. The NCB is not directly involved in the compilation of these statistics.	The NSI, in cooperation with the Ministry of Finance, compiles the actual EDP data, and the Ministry of Finance provides the forecasts. The NCB is not directly involved in the compilation of these statistics.

1) The full report of the findings and recommendations of the HICP compliance-monitoring visits for each country are available at http://epp.eurostat.ec.europa.eu/portal/page/portal/hicp/methodology/compliance_monitoring

Table 3 Quality and integrity of convergence statistics (cont'd)

	Latvia	Lithuania	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	According to Article 3 of the Official Statistics Law, statistics are based on objectivity, reliability, relevancy, efficiency, confidentiality and transparency. The Head of the NSI is appointed by the Cabinet of Ministers on the basis of a recommendation by the Minister for Economy. The term of office is fixed (five years; reappointment is possible).	According to Article 4 of the Law on Statistics, statistics are based on the principles of objectivity and professional independence, transparency of methods and methodologies, necessity and appropriateness of statistical indicators, use of statistical data exclusively for statistical purposes, compliance with international classifications and standards, and confidentiality. The Head of the NSI is a state official who is appointed by the Government on the recommendation of the Minister of Finance for a period of four years (no more than two successive terms of office). The Head of the NSI is accountable to the Government and the Minister of Finance.	According to Article 1 and 3/A of the Act XLVI on Statistics, statistics are based on objectivity, independence and confidentiality. The Head of the NSI is appointed by the Prime Minister. The term of office is fixed (six years; reappointment is possible, only twice).
Administrative supervision and budget autonomy	The NSI is a public institution under the supervision of the Ministry of Economy. It has budget autonomy, financed by the state budget, by own income and by financial resources received from foreign countries.	The NSI is a government agency participating in the shaping and implementing of state policy in the field of statistics management and is assigned to the Minister of Finance. It has budget autonomy on the basis of an annual amount assigned from the state budget.	The NSI is a public administration organ 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 Law determines the main principles of data collection.	The Law on Statistics determines the main principles of data collection.	Act XLVI on Statistics determines the main principles of data collection.
Legal provisions regarding statistical confidentiality	According to Article 18 of the Official Statistics Law, the confidentiality of the statistical data is secured.	According to Article 15 of the Law on Statistics, the confidentiality of statistical data is secured.	According to Article 17 of Act XLVI on Statistics, the confidentiality of the statistical data is secured.
HICP inflation			
Compliance with legal minimum standards	Eurostat made a compliance-monitoring visit in 2007 and confirmed that in general the methods used for producing the HICP are satisfactory. There were no apparent instances of non-compliance with the HICP methodology.	Eurostat made a compliance-monitoring visit in 2006 and confirmed that in general the methods used for producing the HICP are satisfactory. There were no apparent instances of non-compliance with the HICP methodology.	Eurostat made a compliance-monitoring visit in 2008 and confirmed that in general the methods used for producing the HICP are satisfactory. Some instances of non-compliance with the HICP methodology were identified, but were considered by Eurostat to be limited and unlikely to have a major impact in practice on the HICP annual average rates of change.
Other issues	Eurostat considered the representativity of the HICP in terms of accuracy and reliability to be generally adequate.	Eurostat considered the representativity of the HICP in terms of accuracy and reliability to be generally adequate.	Eurostat considered the representativity of the HICP in terms of accuracy and reliability to be generally adequate.

Table 3 Quality and integrity of convergence statistics (cont'd)

	Latvia	Lithuania	Hungary
Government finance statistics			
Data coverage	Revenue, expenditure, deficit and debt data are provided for the period 2002-11.	Revenue, expenditure, deficit and debt data are provided for the period 2002-11.	Revenue, expenditure and deficit data are provided for the period 2002-11.
Outstanding statistical issues	Classification of Parex Bank needs to be analysed.	Recording of deficit/surplus for public hospitals needs to be improved.	No outstanding statistical issues identified.
Deficit-debt adjustment	High and positive cumulative amount of DDA due to the acquisition of deposits and loans in 2008 and 2009 in connection with the financial crisis.	Moderate and positive cumulative amount of DDA due to acquisition of deposits and due to time of recording adjustments and other differences.	High and positive cumulative amount of DDA due to acquisition of deposits from the IMF, valuation effects and the transfer of private pension funds to the Government.
Institution responsible for the compilation of EDP data	The NSI compiles the actual EDP data, and the Ministry of Finance provides the forecasts. The NCB is not directly involved in the compilation of these statistics, but closely monitors the compilation process via methodological discussions and participation in the inter-institutional working group for the compilation of EDP data.	The NSI, in cooperation with the Ministry of Finance, compiles the actual EDP data, and the Ministry of Finance provides the forecasts. The NCB is not directly involved in the compilation of these statistics, but closely monitors the compilation process via methodological discussions.	A working group composed of the NSI, the Ministry of Finance and the NCB compiles the actual EDP data, and the Ministry of Finance provides the forecasts. The NSI is responsible for the non-financial accounts and the NCB for the financial accounts and the debt; the Ministry of Finance is responsible for the data of the current year (t).
	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	According to Article 1 of the Law on Official Statistics, statistics are based on reliability, objectivity and transparency. The Head of the NSI is selected by open competition and appointed by the President of the Council of Ministers. The term of office is fixed (five years).	The autonomy of official statistics is stated in the Statistical Law, together with the principles of confidentiality, transparency, reliability, proportionality, statistical deontology and cost/efficiency ratio. The Head of the NSI is appointed by the Prime Minister. The term of office is fixed (six years; reappointment is possible only once).	According to Section 3 of the Official Statistics Act, statistics are objective and available to the public. The Head of the NSI is appointed by the Government. The term of office is fixed (for a maximum of three years).
Administrative supervision and budget autonomy	The NSI is a central 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.	According to the Statistical Law, the NSI is a specialised institution, subordinated to the Government. It is financed via the state budget.	The NSI is a central statistics agency, subordinated to, but not part of, the Ministry of Finance. Approximately half of its turnover is provided by the Ministry of Finance, the other half by charging government agencies and commercial customers for statistical production and advice.
Legal mandate for data collection	The Law on Official Statistics determines the main principles of data collection.	According to the Statistical Law, "the official statistics in Romania are implemented and coordinated by the NSI".	The Official Statistics Act determines the main principles of data collection.

Table 3 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 provisions regarding statistical confidentiality	According to 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".	According to Sections 5 and 6 of the Official Statistics Act, the confidentiality of the statistical data is secured.
HICP inflation			
Compliance with legal minimum standards	Eurostat made a compliance-monitoring visit in 2007 and confirmed that in general the methods used for producing the HICP are satisfactory. Some instances of non-compliance with the HICP methodology were found, but were considered by Eurostat to be limited and unlikely to have a major impact in practice on the HICP annual average rates of change.	Eurostat made a compliance-monitoring visit in 2007 and confirmed that in general the methods used for producing the HICP are satisfactory. There were no apparent instances of non-compliance with the HICP methodology.	No recent compliance-monitoring visit has been conducted by Eurostat. Nevertheless, the ECB is not aware of any issue of non-compliance regarding the Swedish HICP.
Other issues	Eurostat considered the representativity of the HICP in terms of accuracy and reliability to be generally adequate.	Eurostat considered the representativity of the HICP in terms of accuracy and reliability to be generally adequate.	No outstanding statistical issues identified.
Government finance statistics			
Data coverage	Revenue, expenditure, deficit and debt data are provided for the period 2002-11.	Revenue, expenditure, deficit and debt data are provided for the period 2002-11.	Revenue, expenditure, deficit and debt data are provided for the period 2002-11.
Outstanding statistical issues	No outstanding statistical issues identified.	The review of the delineation of the government sector is still not complete. The recording of transactions between government and public companies is being carefully scrutinised.	No outstanding statistical issues identified.
Deficit-debt adjustment	Cumulative amount of DDA for considered period was equal to zero.	High and negative cumulative amount of DDA due to decrease in shares and other remaining factors.	Positive cumulative amount of DDA due to sales of financial assets (loans and securities other than shares).
Institution responsible for the compilation of EDP data	The NSI, in cooperation with the Ministry of Finance, compiles the actual EDP data, and the Ministry of Finance provides the forecasts. The NCB is not directly involved in the compilation of these statistics.	The NSI, in cooperation with the Ministry of Finance, compiles the non-financial accounts data. The Ministry of Finance compiles the debt data. The forecast is provided by the National Commission of Prognosis. The NCB is directly involved in the compilation of the financial accounts.	The NSI, in cooperation with the Ministry of Finance, compiles the actual EDP data, and the Ministry of Finance provides the forecasts. The NCB is not directly involved in the compilation of these statistics.

ESGAB's annual reports to the European Parliament and the Council[22] provide further details on the situation in individual countries along with specific recommendations, and include summaries from Eurostat's annual monitoring reports on NSI compliance with the Code of Practice. In its monitoring report of October 2011, Eurostat stated in particular that progress in terms of improvement actions was continuing and that more than two-thirds of the original peer-review improvement actions had been implemented. The Eurostat report also provides details on the improvement actions not yet implemented.[23]

5.9.2 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.[24] The HICP covering the euro area as a whole has been the main measure of price developments for the single monetary policy of the ECB since January 1999.

Article 1 of Protocol (No 13) on the convergence criteria referred to in Article 140(1) of the Treaty requires price convergence to be measured by means of the CPI on a comparable basis, taking into account differences in national definitions. In October 1995, Council Regulation (EC) No 2494/95 concerning harmonised indices of consumer prices was adopted. Furthermore, the harmonisation measures introduced for HICPs have been based on several EU Council and European Commission regulations. HICPs 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 does not have a significant effect on the index). They cover all goods and services included in household final monetary consumption expenditure, which is derived from the national accounts domestic concept of household final consumption expenditure, but currently excludes owner-occupied housing costs. The prices observed are the prices households actually pay for goods and services in monetary transactions and thus include all taxes (minus subsidies) on products, e.g. VAT and excise duties. Expenditure on health, education and social services are covered to the extent that they are financed (directly or through private insurance) by households and not reimbursed by the government.

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

COMPLIANCE WITH LEGAL MINIMUM STANDARDS

In 2004 and 2006 Eurostat validated and confirmed the compliance of all Member States under consideration (except Bulgaria and Romania, which were not yet Member States) with the legal minimum standards for the HICP on the basis of a self-assessment made by the national statistical authorities of the countries concerned. However, as the HICP has been harmonised in stages, HICP

22 See ESGAB's website (http://epp.eurostat.ec.europa.eu/portal/page/portal/esgab).
23 See Eurostat's website (http://epp.eurostat.ec.europa.eu).
24 For details on methodological aspects of the HICP, see *Harmonized Indices of Consumer Prices (HICPs) – A Short Guide for Users,* Publications Office for Official Publications of the European Union, Luxembourg, 2004.

data before 2001 are not fully comparable with the most recent data, with the exception of the data for Sweden, which has participated in the compilation of the HICP from the outset in 1996.

Since 2006 Eurostat has carried out compliance-monitoring visits to all countries covered by this Convergence Report (including Bulgaria and Romania), with the exception of Sweden. For Hungary and Poland, some instances of non-compliance with the HICP methodology were found, but were considered by Eurostat to be limited and unlikely to have a major impact in practice on the HICP annual average rates of change used in this report. For the remaining countries, Eurostat concluded that the methods used for producing the HICP were satisfactory and, in most cases, revealed no apparent instances of non-compliance with the HICP methodology.

5.9.3 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 and should comply with the ESA 95[25] and Council Regulation (EU) No 679/2010.[26] Concepts such as "government", "surplus/deficit", "interest expenditure", "investment", "debt" and "gross domestic product (GDP)" with reference to the ESA 95 are defined in Protocol (No 12) on the excessive deficit procedure, as well as in Council Regulation (EU) No 679/2010. The ESA 95 is consistent with other international statistical standards, such as the System of National Accounts 1993 (1993 SNA).[27] EDP statistics refer to the ESA 95 institutional sector "general government". 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 EDP general government deficit (-)/surplus (+) is equal to the ESA 95 "net lending (+)/net borrowing (-)" plus "net settlements under swaps and forward rate agreements".[28] ESA 95 net lending (+)/ net borrowing (-) is equal to "total revenue" minus "total expenditure". While most transactions among general government units related to revenue and expenditure are not consolidated, the distributive transactions "interest", "other current transfers", "investment grants" and "other capital transfers" are consolidated. The primary government deficit/surplus is the government deficit/surplus excluding interest expenditure.

The EDP general government debt is the sum of the outstanding gross liabilities at nominal value (face value) as classified in the ESA 95 categories "currency and deposits", "securities other than shares excluding financial derivatives" (e.g. government bills, notes and bonds) and "loans". It excludes financial derivatives, such as swaps, as well as trade credits and other liabilities not represented by a financial document, such as overpaid tax advances. However, in March 2008 Eurostat released a guidance note that includes accounting rules on the treatment of lump sums received by government under "off-market interest rate swaps". This guidance states that such transactions are basically borrowing in disguise. The lump sum paid to government at the inception of an off-market swap should therefore be recorded as a loan to government in national accounts, and thus has an impact on government debt. The EDP debt also excludes contingent liabilities, such

25 See Council Regulation (EC) No 2223/96 of 25 June 1996 on the European system of national and regional accounts in the Community, OJ L 310, 30.11.1996, pp. 1-469.

26 See footnote 19.

27 In recent years, the 2008 SNA has been prepared by the United Nations Statistics Division and is available on the website (http://unstats.un.org). The ESA 95 is currently under revision to bring it up to date with this.

28 The inclusion of "net settlements under swaps and forward rate agreements" in the EDP deficit implies a discrepancy between the two balancing items, the EDP general government deficit (-)/surplus (+) and the ESA 95 net lending (+)/net borrowing (-). Settlements received by government reduce the EDP deficit, whereas settlements paid by government increase the EDP deficit.

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

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

5.9.3.1 DATA COVERAGE

In April 2012 the European Commission transmitted to the ECB data on general government financial positions (general government deficit/surplus and debt) for the period 2002-11, as well as forecasts for 2012. The NCBs of the Eurosystem provide the ECB with detailed GFS data under the ECB's GFS Guideline.[29] Although the Guideline is only legally binding for the euro area NCBs, the non-euro area NCBs also transmit GFS data to the ECB by the same deadlines and using the same procedures. The GFS Guideline lays down requirements for the transmission of annual data with detailed breakdowns of annual revenue and expenditure, debt, and deficit-debt adjustment. In addition, it requests figures on general government debt with breakdowns by instrument, by initial and residual maturity and by holder.

As regards compliance with the legal requirement for EU Member States to transmit GFS data to the European Commission, annual revenue, expenditure, deficit/surplus and debt data for the period 2002-11 have been transmitted by most of the Member States under consideration.

5.9.3.2 METHODOLOGICAL ISSUES

The statistics for the EDP must reflect decisions taken by Eurostat in line with the ESA 95 for specific cases involving the general government sector. On 15 July 2009 Eurostat published a decision on the statistical recording of public interventions to support financial institutions and financial markets during the financial crisis. The public interventions to support the financial sector have covered a wide range of operations, for which the methodologies applied are based on ESA 95. These operations refer to recapitalisations of banks and other financial institutions, provisions of loans, asset purchases and securities lending. Furthermore, Eurostat's decision also covered the issue of how to classify specific institutional units, such as government-owned special purpose entities (SPEs), and how to treat guarantees which the government has provided in order to support the financial sector.

Table 4 summarises the impact of the government interventions to support the financial sector during the financial and economic crisis. In order to restore confidence in the banking sector, governments have provided support in the form of recapitalisations and by providing liquidity (purchasing impaired assets, issuing loans, and performing asset exchanges/swaps). Half of the countries under consideration in this report have conducted such interventions. By the end of 2011 the impact on government debt as a percentage of GDP was 6.6 in Latvia, 2.9 in Lithuania, 0.6 in Hungary, and only 0.2 in Sweden. Moreover, in some countries the support to the financial sector has taken the form of guarantees of interbank lending and guarantees of debt issued by SPEs. These guarantees are contingent government liabilities and are normally recorded off-balance-sheet in the ESA 95 unless there is complete certainty that a guarantee will be called in the future. In the case of Sweden, the Government had granted guarantees of 2.6% of GDP to the banking system by the end of 2011. Guarantees of 0.6% of GDP had been granted by the Government of Latvia.

29 Guideline of the European Central Bank of 31 July 2009 on government finance statistics (recast) (ECB/2009/20), OJ L 228, 1.9.2009, p. 25.

Table 4 Government interventions to support the financial sector during the financial crisis

(cumulative amounts for 2008-11 as a percentage of GDP)

Country	Measures impacting government deficit/ surplus [1]	Measures impacting government debt						Measures impacting government contingent liabilities [3]
		Capital injections		Asset purchases	Other measures [2]	Total impact		
		Acquisition of shares	Loans				of which redemptions	
Bulgaria	**0.0**	0.0	0.0	0.0	0.0	**0.0**	0.0	**0.0**
Czech Republic	**0.0**	0.0	0.0	0.0	0.0	**0.0**	0.0	**0.0**
Latvia	**-3.3**	2.6	2.5	0.0	1.5	**6.6**	5.1	**0.6**
Lithuania	**-0.1**	0.1	2.8	0.0	0.0	**2.9**	0.0	**0.0**
Hungary	**0.0**	0.0	0.6	0.0	0.0	**0.6**	1.9	**0.0**
Poland	**0.0**	0.0	0.0	0.0	0.0	**0.0**	0.0	**0.0**
Romana	**0.0**	0.0	0.0	0.0	0.0	**0.0**	0.0	**0.0**
Sweden	**0.2**	0.2	0.0	0.0	0.0	**0.2**	0.1	**2.6**

Source: ESCB.
1) A negative sign indicates that the government measures increased the government deficit (or decreased the government surplus), while a positive sign indicates that the government measures increased the government surplus (or decreased the government deficit).
2) For instance, debt assumptions/cancellations and deposits with private banks.
3) Government contingent liabilities are contractual arrangements, which specify one or more conditions that must be fulfilled before government assumes the liabilities of the other party to the contract. Contingent liabilities are off-balance-sheet items and are not part of government debt.

Latvia, Hungary and Romania have received international financial assistance to deal with the effects of the financial crisis from the IMF, the European Commission and the World Bank in various instalments since the end of 2008. The funds granted by the international institutions have been transferred to a deposit account of the Treasury at the NCB in question. Two different types of case may be identified. First, cases in which the beneficiary of the loan is central government (as with most of these loans). Accordingly, the recording is rather straightforward as the granting of the loans increases (immediately) government debt and (gradually) government deficit due to accruing interest payable. Second, complex cases, when loans are granted to NCBs. Usually, these loans are recorded as lending to NCBs. However, they are classified as government debt if: (i) the funds are taken to finance activities usually performed by general government; (ii) the own resources of an NCB are not sufficient to cover all costs related to the repayment of the loan (principal and interest); or (iii) government is bearing the risks associated with the borrowing. In these cases, loans granted by the IMF or other international organisations should be re-routed and classified as government debt.

Table 5 shows that, by the end of 2011, Latvia had borrowed loans equalling 22.2% of GDP from the European Commission, the IMF and the World Bank. Outstanding loans from the European Commission to Hungary amounted to 13.9% of GDP by the end of 2011. The corresponding outstanding loans provided to Romania were 13.8% of GDP. Poland has entered into a Flexible Credit Line agreement with the IMF, which so far has not been drawn upon.

Table 5 Financial support provided by international institutions or countries during the financial crisis [1)]

(cumulative amounts for 2008-11 as a percentage of GDP)

Country	Loan to the government	Loan to the national central bank	Total loan	of which provided by			Ceiling [3)]
				European Commission [2)]	IMF	World Bank	
Bulgaria	**0.0**	0.0	**0.0**	0.0	0.0	0.0	**0.0**
Czech Republic	**0.0**	0.0	**0.0**	0.0	0.0	0.0	**0.0**
Latvia	**22.2**	0.0	**22.2**	14.4	5.8	2.0	**37.8**
Lithuania	**0.0**	0.0	**0.0**	0.0	0.0	0.0	**0.0**
Hungary	**12.2**	1.7	**13.9**	3.9	10.0	0.0	**22.1**
Poland	**0.0**	0.0	**0.0**	0.0	0.0	0.0	**6.6**
Romania	**6.2**	7.6	**13.8**	3.7	9.4	0.7	**14.6**
Sweden	**0.0**	0.0	**0.0**	0.0	0.0	0.0	**0.0**

Source: ESCB.
1) The exchange rate used is that from the end of 2011.
2) The European Commission is responsible for implementing the disbursement and the conditionality.
3) Referring to total loan and including provisions of future financial support.

In **Bulgaria**, the classification of two public companies which are currently not part of the government sector needs to be further scrutinised. Their impact on government debt in case of a reclassification is unknown.

In the **Czech Republic**, small discrepancies between the financial and non-financial accounts are observed, which raise doubts about the accrual adjustments made to the cash-based non-financial accounts.

In **Lithuania**, a zero deficit/surplus is recorded for all public hospitals classified under the general government sector owing to a lack of reliable source data. Additional work is needed, including a comparison of the data available from the government investment programme, the Health Insurance Fund and the Ministry of Health.

In **Romania**, the review of the delineation of government is still not complete. The recording of transactions between government and public companies is being carefully scrutinised. The estimated impact on the government debt in case of a reclassification of public companies into the government sector is 0.4% of GDP in 2011.

In **Hungary**, former members ceased to count as members of private pension funds on 1 March 2011. Consequently, transactions related to transfers from private pension funds to social security funds (which are part of the general government sector) were recorded for the first quarter of 2011, in accordance with the relevant law. In the national accounts, these withdrawals were recorded as a capital transfer to the central government on 1 March 2011, thus having a positive impact on the 2011 government deficit/surplus in the amount of HUF 2,678 billion (9.6% of GDP). In addition, the central government granted a HUF 130 billion (0.5% of GDP) capital injection to the Hungarian Development Bank in 2011, in part to cover the losses incurred in earlier periods and in part to stimulate banking activity developments. Part of this capital injection (HUF 40.6 billion) was treated as a capital transfer by the Hungarian statistical authorities, thus having a negative impact on the 2011 government budget balance.

In **Latvia**, transactions with the financial sector and state-owned companies need to be carefully monitored; in particular, the classification of Parex Bank needs to be analysed because its banking

licence was revoked in March 2012. If the characteristics of Parex Bank correspond to those of a defeasance structure (i.e. if it only manages impaired/illiquid assets, with the Government exposed to the majority of the risks associated with its activities), it has to be reclassified into the government sector. The estimated impact on the government debt in case of reclassification into the government sector is 0.4% of GDP.

5.9.3.3 DEFICIT-DEBT ADJUSTMENT

The change in government debt outstanding at the end of two consecutive years may diverge from the government deficit/surplus for the respective year for reasons explained in Box 6. A large or volatile deficit-debt adjustment does not necessarily indicate a quality issue, as long as its components are fully explained.

Box 6

DEFICIT-DEBT ADJUSTMENT

The change in the debt level in any given period can be larger or smaller than the deficit. The difference between the change in debt and the deficit is known as the "deficit-debt adjustment" (DDA) or, more generally, as the "stock-flow adjustment" (SFA). As long as the components of the DDA are sound, the difference between the change in debt and the deficit does not raise concerns regarding data quality. Unexplained differences between the deficit and change in debt, however, could signal statistical shortages.

A positive DDA means that the increase in debt exceeds the deficit or that the reduction in debt is lower than the surplus. A negative DDA means that the increase in debt is less than the deficit or that the reduction in debt is greater than the surplus.

The DDA can be described in terms of three main pillars:

(i) The first and most important pillar in terms of amplitude consists of the *transactions in main financial assets*. These transactions include the net accumulation of currency and deposits held by the ministry of finance or other government units at the central bank and other MFIs, shares held by government in public corporations, securities held by social security funds (investment in shares excluding privatisations), and loans. With a given deficit, government financial investment increases the borrowing requirement (the amount that government needs to borrow to finance its activities) and thereby also government debt. Conversely, a reduction in financial assets (as a result of privatisations for instance) tends to reduce the borrowing requirement as it generates cash, while leaving the deficit unchanged.

(ii) The second pillar consists of the *valuation effects and other changes in the volume of debt*. Government debt is measured at nominal value (or face value), even though new borrowings and the repayment of debt may be at prices which differ from the nominal value (issuances and redemptions below or above par). Moreover, as government debt is measured in the national currency, exchange rate changes modify the debt denominated in foreign currencies without affecting the deficit. Changes in the debt related to reclassification are recorded under

other changes in the volume of debt. These include changes in the statistical classification of units from the government to a non-government sector (or the reverse).

(iii) The third pillar, named *time of recording and other differences*, refers to the time difference between the recording of expenditure and the related payments and between the recording of revenue and the related cash flow to government. For instance, taxes are recorded as government revenue at the time they are assessed, even though payment may take place somewhat later. The delayed payment of taxes does not reduce the government borrowing requirement, although the taxes themselves decrease the deficit. A large accumulation of delayed taxes may lead to concerns as to whether tax revenue is overstated owing to amounts that are unlikely to be collected. Other time of recording differences may arise on account of advance or delayed EU reimbursement of funds spent by the government on its behalf, or the gap between the delivery of military equipment (at which time the deficit is affected) and the time of payment.

This third pillar also includes the statistical discrepancy between the calculation of the deficit in the non-financial and financial government accounts, and also any unexplained remaining factors, which may lead to doubts about the quality of the government accounts.

The cumulative amounts of the DDA over the period 2006 to 2011 were positive in Hungary (12.6% of GDP), Latvia (8.4% of GDP), Sweden (5.1% of GDP), Lithuania (1.9% of GDP) and Poland (0.3% of GDP).

In **Hungary**, there were relatively high and exceptional acquisitions of currency and deposits (4.1% of GDP) due to the IMF and EU deposit in 2008 and government loans to commercial banks as a result of the financial crisis. The DDA was also high due to valuation effects and other changes in the volume of debt. A positive value of 7.1% of GDP is recorded for the valuation effects of the debt due to the fluctuation in the value of government debt denominated in foreign currencies. Furthermore, the transfer of private pension funds to the Government (about 10% of GDP in 2011), recorded as an acquisition of shares (about 4.4% of GDP in 2011), also contributed to the high level of DDA. This increase in the DDA has been partly offset by privatisations (-1.5% of GDP).

The DDA for **Latvia** was high, mainly owing to the acquisition of deposits and loans in 2008 and 2009 in connection with the financial crisis. First, the Latvian Government received a considerable amount of loans in 2008 and 2009 through the special borrowing agreements granted by international institutions (EU, IMF and World Bank), and these loans were not fully spent in this period, thus increasing deposits (5.6% of GDP). Second, the Government provided Parex Bank with a sizeable loan (4.2% of GDP) in 2008. On the other hand, the rise in trade credits associated with various instances of government expenditure (e.g. the construction of hospitals) – which is included in the remaining factors – contributed to reducing the DDA. The development of trade credits over time ought to be monitored further.

In the case of **Sweden**, the cumulative DDA was explained by the transactions in main financial assets (7.9% of GDP), and in particular by the acquisition of loans (6.1% of GDP), due to the issuance of a central government loan to Sveriges Riksbank (about 3.3% of GDP) in 2009 and the acquisition of securities other than shares (1.9% of GDP).

In **Lithuania**, the DDA was above 1.9% of GDP in the period under consideration. This increase in DDA derived only marginally from the net acquisition of financial assets, as the acquisition of

currency and deposits was predominantly due to the proceeds of privatisation and the subsequent increase in currency and deposits. The increase in fiscal receivables (0.6% of GDP) and the high level of non-tax components (1.2% of GDP, related to the delay in the EU reimbursement of funds spent by the Government on its behalf) are the main reasons for the positive DDA.

In **Poland** the cumulative DDA for the period under consideration was slightly above zero. The negative DDA due to the privatisation of public companies (-4.1% of GDP) was partially compensated for by the valuation effects of debt (2.1% of GDP), which were due to the impact of exchange rate fluctuations on government debt denominated in foreign currency (mainly in 2008 and 2011).

Negative cumulative amounts of the DDA over the last five years could be observed for Bulgaria, Czech Republic and Romania.

In **Bulgaria** the cumulative amount of the DDA amounted to -6.1% of GDP, which means that the increase in debt was smaller than the deficit. The transactions in main financial assets were mainly explained by the acquisition of currency and deposits (2.8% of GDP) due to the proceeds from privatisation (-4.6% of GDP). However, the moderate cumulative change in fiscal receivables (1.1% of GDP) may suggest that tax revenues are overstated. Furthermore, the relatively high "other remaining factors" explaining the difference between the deficit and change in debt (-2.5% of GDP) were due to an accumulation of tax refunds (-1.1% of GDP) and other unexplained factors.

In the **Czech Republic**, the cumulative amount of the DDA amounted to a reduced value of -0.7% of GDP. This total is the sum of various elements which offset each other in magnitude. The small accumulation in currency and deposits corresponds to the size of the perceived proceeds from privatisations. A negative value of slightly above 1% of GDP is recorded for the valuation effects of the debt due to the fluctuation in value of the debt denominated in foreign currencies against the Czech koruna. This is compensated for by the Government's accumulation of receipts from

Table 6 Deficit-debt adjustment

(cumulative amounts for 2006-11 as a percentage of GDP)

Country	Deficit-debt adjustment [1]											
	Total	Transactions in main financial assets				Valuation effects and other changes in the volume of debt	Time of recording and other differences					
		Total	Transactions in currency and deposits	Transactions in shares	of which privatisations		Total	Change in fiscal receivables	Non-tax components	Remaining factors		
										Total	Statistical discrepancy	Other [2]
Bulgaria	-6.1	-3.1	2.8	-2.1	-4.6	-0.2	-0.8	1.1	-1.4	-2.6	-0.1	-2.5
Czech Republic	-0.7	-1.5	0.6	-1.3	-1.0	-1.1	2.0	0.1	2.8	-0.9	-0.3	-0.6
Latvia	8.4	9.1	5.6	0.5	-0.8	-0.6	-0.1	0.9	1.7	-2.7	-0.1	-2.7
Lithuania	1.9	-0.9	1.4	-3.9	-3.9	-0.4	3.2	0.6	1.2	1.5	-0.1	1.6
Hungary	12.6	6.7	4.1	2.4	-1.5	7.1	-1.3	0.5	0.0	-1.8	-0.3	-1.5
Poland	0.3	-2.6	0.2	-3.5	-4.1	2.1	0.8	0.6	0.3	-0.1	0.0	0.0
Romania	-3.7	0.6	2.6	-2.1	-2.6	0.9	-5.2	0.0	-0.9	-4.3	-0.1	-4.2
Sweden	5.1	7.9	1.4	-1.5	-2.4	-1.0	-1.8	0.7	0.0	-2.5	-0.3	-2.2

Source: ESCB.
1) Deficit-debt adjustment refers to the difference between the annual change in gross nominal consolidated debt and the deficit as a percentage of GDP. A positive figure means that the increase in debt exceeds the deficit or that the reduction in debt is lower than the surplus. A negative figure means that the decrease in debt is smaller than the surplus or that the debt has decreased despite a deficit.
2) "Other" refers to transactions in derivatives and specific transactions explained in the text for each country individually.

the EU budget, which have not yet been fully spent (explaining a positive value of 2.8% of GDP in non-tax components).

In **Romania** the cumulative amount of the DDA was -3.7% of GDP. The transactions in main financial assets were explained by the acquisition of currency and deposits (above 1.0% of GDP in 2006, 2009 and 2011) and the decrease in shares due to participation in foreign financial institutions (2007) and guarantee funds (2010). The high amount of "other remaining factors" (-4.2% of GDP) reveals important unexplained differences between the financial and non-financial accounts that may point to data quality issues.

5.9.4 EXCHANGE RATES

Article 3 of Protocol (No 13) on the convergence criteria referred to in Article 140(1) of the Treaty defines what is meant by the criterion on participation in the ERM of the European Monetary System. In a policy position dated 18 December 2003, the Governing Council of the ECB specified that this criterion refers to participation in ERM II for a period of at least two years prior to the convergence assessment without severe tensions, in particular without devaluing against the euro.

The bilateral exchange rates of the Member States' currencies vis-à-vis the euro are daily reference rates recorded by the ECB at 2.15 p.m. (following the daily concertation procedure between central banks), which are published on the ECB's website. Real bilateral exchange rates are constructed by deflating the nominal exchange rate index using the HICP or the CPI. Nominal and real EERs are constructed by applying overall trade weights (based on a geometric weighting) to the bilateral nominal and real exchange rates of the Member States' currencies vis-à-vis the currencies of selected trading partners. Both nominal and real EER statistics are calculated by the ECB. An increase in these indices corresponds to an appreciation of the Member State's currency. Overall trade weights refer to trade in manufactured goods and are calculated to account for third-market effects. The EER indices are based on moving weights for the periods 1995-97, 1998-2000, 2001-03, 2004-06 and 2007-09. The EER indices are obtained by chain-linking the indicators based on each of these five sets of trade weights at the end of each three-year period. The base period of the resulting EER index is the first quarter of 1999. The group of trading partners comprises the euro area, non-euro area EU Member States, Australia, Canada, China, Hong Kong, Japan, Norway, Singapore, South Korea, Switzerland and the United States.

5.9.5 LONG-TERM INTEREST RATES

Article 4 of Protocol (No 13) on the convergence criteria referred to in Article 140(1) of the Treaty requires interest rates to be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions. While Article 5 assigns the responsibility for providing the statistical data for the application of the Protocol to the European Commission, the ECB, given its expertise in the area, assists in this process by defining representative long-term interest rates and collecting the data from 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 7. Long-term interest rates refer to bonds denominated in national currency.

Table 7 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.

5.9.6 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 b.o.p. 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".

Concerning the results of the integration of markets, two sets of indicators are used, namely: i) statistics on financial development and integration referring to the structure of the financial system;[30] and ii) statistics on (external) financial and non-financial integration with the euro area.[31]

The indicator concerning the debt securities issued by resident corporations has been reported by the respective NCBs in accordance with the methodology set out in Guideline ECB/2007/9, as amended. The indicator relating to the stock market capitalisation refers to quoted 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 under Regulation ECB/2001/13, as amended. Historical data have been compiled by the relevant NCBs, where appropriate. For the indicators mentioned, the statistical data relating to the euro area cover the countries that had adopted the euro at the time to which the statistics relate.

The private sector debt and credit flow indicators are derived from the annual sector accounts reported by the national statistical authorities under the ESA 95 Transmission Programme. Private sector debt includes outstanding amounts at the end of the year of securities issued and loans taken out by institutional sectors, non-financial corporations (NFCs) and households (including non-profit institutions serving households – NPISH). The private sector debt-to-GDP ratio is defined as the ratio of private sector debt to GDP at current market prices. Private sector credit flow includes

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

31 External trade and investment position with the euro area.

annual transactions on securities issued and loans taken out by institutional sectors, NFCs and households (including NPISH). The private sector credit flow to GDP ratio is defined as the ratio of private sector credit flow to GDP at current market prices.

The classification of entities into the NFC sector is carried out in accordance with the ESA 95, and the sector therefore includes all resident NFCs carrying out economic activities in the country in question. In this respect those special purpose entities (SPEs) that are classified as resident NFCs are also included in the private sector debt/credit flow indicators, although they may have only international financial links. This is the case for SPEs included in the NFC sector in Hungary, which account for about 30% of the private sector debt-to-GDP ratio. These SPEs may be reclassified into the financial sector following further investigation.

With regard to the b.o.p. and the international investment position (i.i.p.), the statistics are compiled in accordance with the concepts and definitions laid down in the BPM5 and with methodological standards set out by the ECB and Eurostat. However, high priority should continue to be given to a review of the residency criterion, which treats corporations without a physical presence in a country as resident institutional units if they are registered in that country. This report examines the sum of the current account balance and the balance on the capital account, which corresponds to the net lending/net borrowing of the total economy. In addition, it is worth noting that the distinction between current and capital transfers is not always straightforward in practice, as it depends on the recipient's use of the transfer. In particular, this applies to the classification of the current and capital components of transfers between EU institutions and EU Member States.[32]

As far as foreign trade statistics are concerned, Member States provide Eurostat with harmonised data according to the so-called community concept (i.e. for imports, the breakdown by trading partners is based on the country of consignment) and may therefore publish a different geographical breakdown at national level.

With regard to producer price indices, these data refer to domestic sales of total industry excluding construction. The statistics are collected on a harmonised basis under the EU regulation concerning short-term statistics.[33] Data for Poland prior to 2001 refer to total sales, including non-domestic sales.

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 95 Transmission Programme.

Statistics on the harmonised unemployment rate (calculated as the number of unemployed over the labour force) take into account persons between the ages of 15 and 74.

32 For more details, see *European Union balance of payments/international investment position statistical methods*, ECB, Frankfurt am Main, May 2007.

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

6 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 either from the perspective of an NCB's independence within the ESCB or from the perspective of its subsequent integration into the Eurosystem.

6.1 BULGARIA

6.1.1 COMPATIBILITY OF NATIONAL LEGISLATION

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

– the Bulgarian Constitution,[1]

– the Law on Българска народна банка (Bulgarian National Bank) (hereinafter the "Law").[2]

The Law on the prevention and ascertainment of conflicts of interests (hereinafter the "Law on the prevention of conflicts of interests")[3] applies to public office holders.

There have been only limited changes in relation to the points identified in the ECB's Convergence Report of May 2010, and those comments are therefore largely repeated in this year's assessment.

6.1.2 INDEPENDENCE OF THE NCB

With regard to the independence of Българска народна банка (Bulgarian National Bank), the Law and the Law on the prevention of conflicts of interests need to be adapted as set out below.

6.1.2.1 INSTITUTIONAL INDEPENDENCE

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

6.1.2.2 PERSONAL INDEPENDENCE

Article 14(1) of the Law lists the grounds for dismissal of the members of the Governing Council, according to which the National Assembly or Bulgaria's President may relieve a member of the Governing Council from office, including the Governor, if they: (i) no longer fulfil the conditions

1 Constitution of the Republic of Bulgaria, *Darjaven vestnik* issue 56, 13.6.1991.
2 Law on Българска народна банка (Bulgarian National Bank), *Darjaven vestnik* issue 46, 10.6.1997.
3 *Darjaven vestnik* issue 94, 31.10.2008.

required for the performance of their duties under Article 11(4);[4] (ii) are in practice unable to perform their duties for more than six months; or (iii) have been guilty of serious professional misconduct.

The first sub-paragraph of Article 14(1) of the Law cross-refers to the conditions of appointment and election in Article 11(4). To avoid any circumvention of the conditions for dismissal of Governors as established by Article 14.2 of the Statute, the first sub-paragraph of Article 14(1) of the Law should only foresee conditions that are objective, clearly defined and linked to the performance of duties of the members of the Governing Council. Therefore, this provision needs to be revised so that it mirrors the wording of Article 14.2 of the Statute.

The second sub-paragraph of Article 14(1) of the Law is in addition to the two grounds for dismissal provided for in Article 14.2 of the Statute. The third sub-paragraph narrows the concept of "serious misconduct" in Article 14.2 of the Statute to "serious professional misconduct". Article 14(1) of the Law needs to be adapted further in these respects to fully comply with Article 14.2 of the Statute.

The Law on the prevention of conflicts of interests provides that breach of its provisions and the existence of a conflict of interests are grounds for dismissal of the Governor, Deputy Governors and the other members of the Governing Council of Българска народна банка (Bulgarian National Bank). Thus, the Law on the prevention of conflicts of interests specifies grounds for dismissal that are in addition to the two grounds contained in Article 14.2 of the Statute. Therefore, the Law on the prevention of conflicts of interests is incompatible with the Treaty and the Statute and needs to be brought into line with them.[5]

Article 14(2) of the Law provides that if the duties of a Governing Council member cease before the expiry of the member's term of office, another person will be elected or appointed for the remainder of the term of office. Article 14(2) of the Law is incompatible with Article 14.2 of the Statute establishing a minimum term of office of five years and should be adapted accordingly.

The Law 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 could increase legal certainty.

Article 12(1) and (2) of the Law provide for the National Assembly's powers to elect the Governor and the Deputy Governors of Българска народна банка (Bulgarian National Bank). In a 2009 case, the National Assembly claimed and acted upon the claim that it has the power to annul or amend its previous decisions, including decisions concerning the election of the Governor and Deputy Governors of Българска народна банка (Bulgarian National Bank) taken under Article 12(1) and (2) of the Law. 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

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

5 See also Opinion CON/2009/13.

Българска народна банка (Bulgarian National Bank) may not be dismissed under conditions other than those mentioned in Article 14.2 of the Statute, even if they have not yet taken up their duties.

6.1.3 CONFIDENTIALITY

Article 4(2) of the Law provides that Българска народна банка (Bulgarian National Bank) may not disclose or pass to third parties any information obtained which is of a confidential banking or commercial nature for banks and the other participants in the money turnover and credit relations, except in the cases provided for by the Law on the protection of classified information. Under Article 23(2) of the Law, the employees of Българска народна банка (Bulgarian National Bank) may not disclose any information concerning negotiations, contracts entered into, the level of assets on customers' deposits and their operations, information received by Българска народна банка (Bulgarian National Bank), as well as any circumstances concerning the activities of Българска народна банка (Bulgarian National Bank) or its customers which constitute official, banking, commercial or other secrecy protected by law, even after the termination of their contracts of employment. Under Article 37 of the Statute, professional secrecy is an ESCB-wide matter. Therefore, the ECB assumes that Articles 4(2) and 23(2) of the Law are without prejudice to the confidentiality obligations towards the ECB and the ESCB.

6.1.4 MONETARY FINANCING AND PRIVILEGED ACCESS

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

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

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

6.1.5 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 needs to be adapted in the respects set out below.

6.1.5.1 TASKS

Monetary policy

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

Article 33 of the Law, 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, 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, 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, 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, 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.

6.1.5.2 FINANCIAL PROVISIONS

Appointment of independent auditors

Article 49(4) of the Law, 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 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.

6.1.5.3 EXCHANGE RATE POLICY

Articles 28 to 31 of the Law, 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.

6.1.5.4 INTERNATIONAL COOPERATION

Article 5, Article 16, item 12 and Article 37(4) of the Law, 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.

6.1.5.5 MISCELLANEOUS

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

6.1.6 CONCLUSIONS

The Law and the Law on the prevention of conflicts of interest 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.

6.2 CZECH REPUBLIC

6.2.1 COMPATIBILITY OF NATIONAL LEGISLATION

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

– the Czech Constitution,[6]

– the Law on Česká národní banka (hereinafter the "Law"),[7]

– Law No 442/2000 Coll. as amended by Law No 127/2002 Coll.

There have been only limited legislative changes in relation to the points identified in the ECB's Convergence Report of May 2010, and those comments are therefore largely repeated in this year's assessment.

6.2.2 INDEPENDENCE OF THE NCB

With regard to Česká národní banka's independence, the Law and Law No 442/2000 Coll. need to be adapted in the respects set out below.

6.2.2.1 INSTITUTIONAL INDEPENDENCE

Article 3 of the Law 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 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

6 Constitutional law No 1/1993 Coll.
7 Law No 6/1993 Coll.

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. Article 9(1) of the Law in conjunction with Article II(1)(c) of Law No 442/2000 Coll. prohibit Česká národní banka and its Board from taking instructions from the President of the Czech Republic, Parliament, the Government, administrative authorities, EU institutions, any government of a Member State or any other body. Article 3 of the Law is 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. Article 9(1) of the Law in conjunction with Article II(1)(c) of Law No 442/2000 expressly prohibit Česká národní banka and its Board from taking instructions from the President of the Czech Republic, Parliament, the Government, administrative authorities, EU institutions, any government of a Member State or any other body, but they do not expressly prohibit the Government from seeking to influence the members of the 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 needs to be adapted to be fully consistent with Article 130 of the Treaty and Article 7 of the Statute.

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

Pursuant to Law No 166/1993 Coll. on the Supreme Audit Office (hereinafter the "NKU Law"), 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,[8] 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.

6.2.2.2 PERSONAL INDEPENDENCE

Article 6(13) of the Law includes a legal basis for the President of the Czech Republic to relieve Česká národní banka's Governor from his office, namely "failure to perform his functions for a period of more than six months", which is in addition to the two grounds for dismissal provided for in Article 14.2 of the Statute. Article 6(13) should therefore be brought into line with Article 14.2 of the Statute.

The grounds for dismissal set out in Article 14.2 of the Statute are not mentioned in the Law in respect of the other Board members who are involved in ESCB-related tasks. Article 6(11) and (12) of the Law should be brought into line with Article 14.2 of the Statute.

The Law is silent on the right of national courts to review a decision to dismiss any member, other than the Governor, of the NCB's decision-making bodies who is involved in the performance

8 In conjunction with Section II(1)(c) of Law No 442/2000 Coll.

of ESCB-related tasks. Even though this right may be available under general law, providing specifically for such a right of review could increase legal certainty.

6.2.2.3 FINANCIAL INDEPENDENCE

Česká národní banka is faced with accumulated losses beyond the level of its capital and reserves, which have 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. In order to comply with the principle of financial independence and with a view to the future adoption of the euro, Česká národní banka should be provided with an appropriate amount of capital within a reasonable period of time so as to comply with the principle of financial independence.

6.2.3 CONFIDENTIALITY

Pursuant to the provisions on confidentiality in Article 50(2) of the Law, the Governor may release employees and members of Česká národní banka's advisory bodies from the duty of confidentiality "on the grounds of public interest". 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.

Additionally, the NKU Law does not fully respect the provisions of Article 37 of the Statute concerning professional secrecy. Under Article 4(2) of the NKU Law, matters under investigation are subject to NKU's audit, regardless of the type or degree of secrecy involved. The auditors are generally obliged to maintain confidentiality;[9] however, the NKU's President may release such persons from the duty of confidentiality "on the grounds of important State interest", which is not further defined. A safeguard clause should be inserted into the NKU Law so that any such requirement on the part of Česká národní banka employees and Board members to disclose confidential information to the NKU is without prejudice to Article 37 of the Statute.

6.2.4 MONETARY FINANCING AND PRIVILEGED ACCESS

The ECB notes that in the Czech Republic the monetary financing prohibition is currently provided for in two separate legal provisions, namely Article 30(2) of the Law and points 1(d) and 2 of Section II of Law No 442/2000 Coll.[10] These provisions are not fully compatible with the Treaty. In particular, Article 30(2) of the Law, according to which publicly-owned banks are exempted from the monetary financing prohibition contained in the same article, is not aligned with Article 123(2) of the Treaty, which exempts publicly owned credit institutions only "in the context of the supply of reserves by central banks". The exemption contained in Article 30(2) is thus wider than that provided for in the Treaty. Moreover, point 1(d) of Section II of Law No 442/2000 Coll. does not cover the prohibition on a direct purchase by Česká národní banka of debt instruments from public sector entities and thus is not fully in line with Article 123(1) of the Treaty. In the interest of legal certainty, the ECB recommends clarifying the relationship between the two provisions and adapting their wording to ensure the correct application of the monetary financing provision laid down in EU law.

9 Article 22(2)(f) of the NKU Law.

10 Article 30(2) provides for the monetary financing provision in the national context. Points 1(d) and 2 of Section II of Law No 442/2000 Coll., which came into effect on the day the Treaty of Accession of the Czech Republic to the EU entered into force, provides for the monetary financing prohibition in the EU context.

6.2.5 LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

With regard to Česká národní banka's legal integration into the Eurosystem, the Law 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.

6.2.5.1 TASKS

Monetary policy

Article 2(2)(a), Article 5(1) and Part V, namely Articles 23 to 26a of the Law, 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, which empower Česká národní banka to enter into certain financial transactions, also fail to recognise the ECB's powers in this field.

Collection of statistics

Article 41 of the Law, which provides for Česká národní banka's powers relating to the collection of statistics, do not recognise the ECB's powers in this field.

Official foreign reserve management

Articles 1(4) and 35(d) and Article 36 of the Law, 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 38 of the Law, which provides for Česká národní banka's powers relating to the smooth operation of payment systems, does 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, which empowers Česká národní banka to issue banknotes and coins, and Part IV of the Law, namely Articles 12 to 22 of the Law, 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.

6.2.5.2 FINANCIAL PROVISIONS

Appointment of independent auditors

Article 48(2) of the Law, 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 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.

6.2.5.3 EXCHANGE RATE POLICY

Article 35 of the Law, 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 should also recognise the Council's and the ECB's powers in this field.

6.2.5.4 INTERNATIONAL COOPERATION

Article 40 of the Law, which empowers Česká národní banka to negotiate payment and other agreements with foreign banks and international financial institutions, does not recognise the ECB's powers in this field.

6.2.5.5 MISCELLANEOUS

Article 37 of the Law, 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 46b of the Law, 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.

6.2.6 CONCLUSIONS

The Law, Law No 442/2000 Coll., the NKU Law and the Law on competences do not comply with all the requirements for central bank independence, confidentiality, 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.

6.3 LATVIA

6.3.1 COMPATIBILITY OF NATIONAL LEGISLATION

The following legislation forms the legal basis for Latvijas Banka and its operations:

– the Law on Latvijas Banka (hereinafter the "Law").[11]

No new legislation has been enacted in relation to the points identified in the ECB's Convergence Report of May 2010, and those comments are therefore largely repeated in this year's assessment.

6.3.2 INDEPENDENCE OF THE NCB

With regard to Latvijas Banka's independence, the Law needs to be adapted in the respects set out below.

11 Law on Latvijas Banka, *Ziņotājs*, 22/23, 4.6.1992.

6.3.2.1 FUNCTIONAL INDEPENDENCE

Article 3 of the Law provides that Latvijas Banka's main objective is to maintain price stability in Latvia. The ECB's Convergence Reports since December 2006 noted that the objective of price stability should not be confined to the territory of the Member State concerned. Therefore, a further adjustment is needed to ensure full compliance with Article 127 of the Treaty and Article 2 of the Statute.

6.3.2.2 INSTITUTIONAL INDEPENDENCE

Article 13(1) of the Law provides that when carrying out its tasks in accordance with the Law and the Law on credit institutions, Latvijas Banka may not seek or take instructions from the Government or any other institution. The ECB understands that the provision encompasses both national and foreign institutions in line with Article 130 of the Treaty and Article 7 of the Statute. For legal certainty reasons, the next amendment to the Law should bring this provision fully in line with Article 130 of the Treaty and Article 7 of the Statute.

Further, Article 13 of the Law does not expressly prohibit the Government from seeking to influence the members of the Latvijas Banka's decision-making bodies in situations where this may have an impact on Latvijas Banka's fulfilment of its ESCB-related tasks. In this respect the Law needs to be adapted to be fully consistent with Article 130 of the Treaty and Article 7 of the Statute.

6.3.2.3 PERSONAL INDEPENDENCE

Article 22 of the Law provides that the Latvian Parliament may only remove from office the Governor, Deputy Governor and other Council members of Latvijas Banka before the end of their term if at least one of the following conditions is met:

– they have tendered their resignation,

– they have been found guilty of a deliberate crime,

– they are unable to perform their functions for a period exceeding six successive months due to illness.

Article 22 of the Law includes two legal grounds for relieving the Governor from office, namely being found guilty of a "deliberate crime" and the inability to perform his/her functions for a period of more than six months, which are in addition to the two grounds for dismissal provided for in Article 14.2 of the Statute. Article 22 needs to be adapted further to fully comply with Article 14.2 of the Statute.

The Law is silent on the right of national courts to review a decision to dismiss any member, other than the Governor, of Latvijas Banka's decision-making bodies who is involved in the performance of ESCB-related tasks. Even though this right may be available under general Latvian law, providing specifically for such a right of review in the Law or another legal act could increase legal certainty.

Article 28(5) of the Law provides that if Latvijas Banka's Governor is absent, his or her rights and obligations are exercised by the Deputy Governor or by the person appointed by an express order. The ECB also notes that only a person who is subject to the same rules for the security of tenure and grounds of dismissal as the Governor should be appointed to deputise for the Governor. Article 28 of the Law therefore needs to be adapted to fully comply with Article 14.2 of the Statute.

Article 31 of the Law provides that restrictions on members of the Council holding other positions are specified in the Law on the prevention of the conflict of interest in public officials' activities.[12] According to Section 7(3) of this Law members of the Council are permitted to hold other offices if that is foreseen in other laws or international agreements, ratified by the Parliament, and Government regulations and orders. Such public officials may also work as a teacher, scientist, professional sportsperson and in creative work, defined as journalistic, literary or artistic work for which royalties or fees are received. The ECB understands that the abovementioned provisions do not permit the Government to authorise the Governor or other members of the Council of Latvijas Banka to hold other offices if that would create a conflict of interest.

6.3.2.4 FINANCIAL INDEPENDENCE

According to Article 18[1] of the Law, within 15 days following the approval of the annual report by the Council of Latvijas Banka, Latvijas Banka transfers to the state budget part of its profit calculated by applying the tax rate for residents under the Law on corporate income tax and 50% of the profit as payment for the use of state capital. Furthermore, according to Article 19 of the Law, the profits are transferred to Latvijas Banka's reserve capital after the part of its profits specified in Article 18[1] of the Law has been transferred to the State budget.

To safeguard an NCB's financial independence, profits should be distributed to the state budget only after any accumulated losses from previous years have been covered and financial provisions deemed necessary to safeguard the real value of the NCB's capital and assets have been created.

The ECB stresses that Latvijas Banka should be in a position to carry out its functions independently. Latvijas Banka is still in the process of building up its reserve capital to a level corresponding to that of the Eurosystem NCBs. The ECB understands that the current profits distribution rule reduces the financial means available to Latvijas Banka for allocation to its reserve capital. It is for a Member State to ensure that an NCB's financial independence is not weakened or undermined and, taking into account the NCB's opinion, to ensure its independent functioning. Latvia should therefore ensure that Latvijas Banka can continue to increase the level of its reserve capital and create financial provisions deemed necessary to safeguard the real value of its capital and assets.

6.3.3 MONETARY FINANCING AND PRIVILEGED ACCESS

Article 36 of the Law provides that Latvijas Banka may not issue loans to the Government or buy government securities on the primary market. The range of public sector entities referred to in this paragraph needs to be significantly extended to be consistent with Article 123 of the Treaty to also cover local and other public authorities, other bodies governed by public law and public undertakings in Latvia as well as central, regional, local and other public authorities, other bodies governed by public law and public undertakings of the other Member States and EU institutions and bodies.

6.3.4 SINGLE SPELLING OF THE EURO

Until December 2007 all Latvian legal and non-legal acts referred to the single currency as the "eiro". This was consistent with Regulation No 564 of the Cabinet of Ministers on the name of the single currency in Latvian, adopted on 26 July 2005, which provided that the name of the single European currency in Latvian must be the masculine non-declinable form "eiro". On 18 December 2007 the Latvian Cabinet of Ministers adopted Regulation No 933 amending Regulation No 564. While the

12 *Latvijas Vēstnesis*, 69 (2644), 9.5.2002.

original provision establishing the name "eiro" in Latvian for the single currency remains intact, as a result of the 2007 amendment, Regulation No 564 now provides that specifically in legal acts the name of the single currency is the "*euro"* written in italics.

The ECB understands that the requirement to write the name of the single currency in italics has no legal consequences and that failure to write it in italics would not invalidate the legal act concerned. Furthermore, the ECB understands that the concept of a legal act (*tiesību akts*) covers not only legislative provisions but also other documents establishing legal rights and obligations: for example, court rulings, contracts and other legal instruments. From this perspective the ECB considers that the provision introduced on 18 December 2007 specifying that the single currency must be given the name "euro" in legal acts is compatible with EU law.

The ECB notes, however, that a discrepancy remains between the name of the single currency in Latvian retained for non-legal acts in the amended Regulation No 564 ("eiro") and the name of the single currency in Latvian as established by EU law ("euro"). The ECB considers that this discrepancy does not hinder the overall functioning of monetary union. It constitutes an imperfection that has to be corrected. The need to correct this discrepancy between Latvian and EU law is without prejudice to the use of variants of the name of the single currency in common usage in Latvia, consistent with Latvia's cultural and linguistic heritage.

6.3.5 LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

With regard to the legal integration of Latvijas Banka into the Eurosystem, the Law needs to be adapted in the respects set out below.

6.3.5.1 ECONOMIC POLICY OBJECTIVES

Article 3 of the Law provides that Latvijas Banka's primary objective is to maintain price stability in Latvia. Article 9(1) provides that Latvijas Banka promotes the smooth operation of the payments system in Latvia. The primary objective of price stability should not be confined to the territory of the Member State. In addition, the secondary objectives of Latvijas Banka should be subordinated to the ESCB's primary and secondary objectives in line with Article 127(1) of the Treaty and Article 2 of the Statute. The Law should be adapted in these respects.

6.3.5.2 TASKS

Monetary policy

Article 26 and Articles 34 to 38 of the Law, which establish Latvijas Banka's powers with regard to monetary policy, do not recognise the ECB's powers in this field.

Collection of statistics

Articles 39 and 40 of the Law, which provide for Latvijas Banka's powers relating to the collection of statistics, do not recognise the ECB's powers in this field.

Official foreign reserve management

Article 5 of the Law, which provides for Latvijas Banka's powers relating to foreign reserve management, does not recognise the ECB's powers in this field. In addition, Article 5(2) of the Law, which provides that the Government maintains foreign currency gold reserves with Latvijas Banka, is not in line with Article 31.2 of the Statute in accordance with which the Government is to maintain only foreign exchange working balances.

Payment systems

Article 9 of the Law, which provides for Latvijas Banka's powers with regard to the smooth operation of payment systems, does not recognise the ECB's powers in this field.

Issue of banknotes

Articles 4 and 34 of the Law, which empower Latvijas Banka to issue banknotes and coins, do not recognise the Council's and the ECB's powers in this field.

6.3.5.3 FINANCIAL PROVISIONS

Appointment of independent auditors

Article 43 provides that Latvijas Banka's economic activity and documents should be audited by the Audit Commission, whose members are approved by the State Audit Office. This provision does not recognise the Council's and the ECB's powers under Article 27.1 of the Statute. As noted by the ECB,[13] the scope of control by the State Audit Office or a similar body should, for legal certainty reasons, be clearly defined by the law and should be without prejudice to the activities of Latvijas Banka's independent external auditors, as laid down in Article 27.1 of the Statute.

Financial reporting

Pursuant to Article 15 of the Law, Latvijas Banka publishes monthly and annual balance sheets in accordance with central banking standards. This provision does not reflect Latvijas Banka's obligation to comply with the Eurosystem's regime for financial reporting of operations under Article 26 of the Statute.

6.3.5.4 INTERNATIONAL COOPERATION

The second sentence of Article 7 of the Law empowers Latvijas Banka, inter alia, to participate in the activities of international monetary and credit organisations. This provision does not recognise the ECB's powers in this field.

6.3.6 CONCLUSIONS

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

6.4 LITHUANIA

6.4.1 COMPATIBILITY OF NATIONAL LEGISLATION

The following legislation forms the legal basis for Lietuvos bankas and its operations:

– the Lithuanian Constitution,[14]

– the Law on Lietuvos bankas (hereinafter the "Law")[15].

13 Opinion CON/2009/77.
14 *Lietuvos Respublikos Konstitucija*, adopted by the referendum of 25 October 1992, *Valstybės žinios*, 30.11.1992, No 33-1014.
15 *Lietuvos banko įstatymas* Law No I-678 of 1 December 1994, *Valstybės žinios*, 23.12.1994, No 99-1957.

No new legislation has been enacted in relation to the Lithuanian Constitution; therefore there is no need to re-assess it.

The Law on Lietuvos bankas has been amended four times since the ECB's Convergence Report of May 2010.[16] The ECB's Convergence Report of May 2010 considered that the Law does not comply with all the requirements for central bank independence. There have been no major changes to the legislation in this respect therefore this comment is repeated in this year's assessment.

6.4.2 INDEPENDENCE OF THE NCB

With regard to Lietuvos bankas' independence, the Law and the Law on the State Audit Office need to be adapted in the respects set out below.

6.4.2.1 INSTITUTIONAL INDEPENDENCE

6.4.2.2 FINANCIAL INDEPENDENCE

Article 14(4) of the Law on the State Audit Office[17] expressly empowers the State Audit Office to conduct the public audit of Lietuvos bankas, i.e. to audit the performance of the activities provided for in the Law, including the activities related to the exercise of financial market supervision, insofar as this does not conflict with EU legal acts and the objectives and tasks of the ESCB established therein, and does not infringe the ESCB's confidentiality and independence regime. As noted by the ECB,[18] the scope of control by the State Audit Office should, for legal certainty reasons, be clearly defined by the legislation and should be without prejudice to the activities of Lietuvos bankas' independent external auditors.[19]

The ECB understands that the Lithuanian State is currently considered to be the legal owner of Lietuvos bankas' real property and that there is a risk that Lietuvos bankas would only be able to dispose of its property with the approval of government authorities. This situation undermines both the institutional and financial independence of Lietuvos bankas. Instructions from the state authorities to Lietuvos bankas or intervention by such authorities with regard to the assets held by Lietuvos bankas would be contrary to Lietuvos bankas' institutional independence. Lietuvos bankas' financial independence would also be undermined, since it would no longer be entirely free to decide on the allocation of its resources, and it could be unable to secure sufficient means for the performance of its tasks.[20] Therefore, the Law should explicitly state that Lietuvos bankas should be the legal owner of Lietuvos bankas' real property.

The ECB considers that the current legal status of Lietuvos bankas' immovable property is incompatible with the central bank independence requirement.

16 See Opinions CON/2010/42, CON/2011/46, CON/2011/91 and CON/2011/99.

17 New Article 14(4) adopted by *Lietuvos Respublikos valstybės kontrolės įstatymo 14 straipsnio papildymo ir pakeitimo įstatymas*, Law No XI-497 of 19 November 2009, *Valstybės žinios*, 5.12.2009, No 144-6349, as last amended by *Lietuvos Respublikos valstybės kontrolės įstatymo 14 straipsnio pakeitimo įstatymas*, Law No XI-1706 of 17 November 2011, *Valstybės žinios*, 01.12.2011, No 146-6850. The ECB was not consulted on this amendment and sent a non-consultation letter to the national authorities in this regard.

18 Opinion CON/2009/77.

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

20 CON/2010/42, paragraph 2.1, CON/2011/91, paragraph 4.3.1 and CON/2011/99, paragraph 3.4.2

6.4.3 CONCLUSIONS

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

6.5 HUNGARY

6.5.1 COMPATIBILITY OF NATIONAL LEGISLATION

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

– the Fundamental Law of Hungary,[21]

– Law CCVIII of 2011 on the Magyar Nemzeti Bank (hereinafter the "Law"),[22]

– Transitional Provisions to the Fundamental Law of Hungary[23].

Law LVIII of 2001 on the Magyar Nemzeti Bank has been amended several times since the ECB Convergence Report in May 2010. Law XC of 2010 implemented an approximately HUF 2 000 000 monthly wage ceiling in the public sector, which also applied to the Magyar Nemzeti Bank's Governor.[24] Article 2(50) of Law CLII of 2010 re-defined a deadline in MNB's administrative proceedings.[25] Article 39 of Law CLIII of 2010 fixed the salary of the Members of the Supervisory Board.[26] Article 122(6) of Law CLVIII of 2010 modified MNB's disclosure of information and its reporting obligation to the Hungarian Financial Supervisory Authority.[27] Law I of 2011 amended the rules for appointing and dismissing the members of the Monetary Council. Article 38(2)(f) of Law LXVI of 2011 repealed Article 45(2) of the Law on the supervisory competence of the State Audit Office over the Magyar Nemzeti Bank.[28] Law CCVIII of 2011 on the Magyar Nemzeti Bank, repealing Law LVIII of 2001, entered into force on 1 January 2012.

On 1 January 2012 Transitional Provisions to the Fundamental Law of Hungary concerning the Magyar Nemzeti Bank entered into force.

6.5.2 INDEPENDENCE OF THE NCB

With regard to the Magyar Nemzeti Bank's independence, the Law and the Transitional Provisions to the Fundamental Law of Hungary need to be adapted as set out below.

21 *Magyarország Alaptörvénye, Magyar Közlöny 2011/43 (IV. 25.).*
22 *2011. évi CCVIII. törvény a Magyar Nemzeti Bankról, Magyar Közlöny 2011/166 (XII. 31.).*
23 Magyarország Alaptörvényének Átmeneti Rendelkezései, *Magyar Közlöny 2011/166 (XII. 31.).*
24 See Opinion CON/2010/56.
25 *Egyes törvényeknek a naptári napban való határidő-számítással összefüggésben történő módosításáról szóló 2010. évi CLII. törvény, Magyar Közlöny 2010/192 (XII. 17.)*
26 See Opinion CON/2010/91.
27 *A Pénzügyi Szervezetek Állami Felügyeletéről szóló 2010. évi CLVIII. törvény, Magyar Közlöny 2011/1 (II. 04.)*
28 See Opinion CON/2011/53.

6.5.2.1 INSTITUTIONAL INDEPENDENCE

The legislation and the institutional framework for the Magyar Nemzeti Bank have been changed several times,[29] culminating with a change in the procedure for appointing and dismissing the members of the Monetary Council,[30] an increase in the number of Monetary Council members, under Article 46(3) of the Law and in the number of Deputy Governors under Article 48(1) of the Law, and the addition of the Executive Board as a new body of the Magyar Nemzeti Bank under Article 49 of the Law. The combination of the changes to the institutional framework of the Magyar Nemzeti Bank, including the possibility of the merger of the Magyar Nemzeti Bank with the Hungarian Financial Authority under the newly adopted Transitional Provisions to the Fundamental Law of Hungary, with the changes to the remuneration of the members of the decision-making bodies of the Magyar Nemzeti Bank and changes to the powers of the Governor, indicate signs of pressure being exercised on the Magyar Nemzeti Bank and the members of its decision-making bodies, in particular on the Governor.

Central bank independence needs a stable legal framework for the central bank's functioning. Such frequent changes, 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 could therefore have an impact on its institutional independence.

6.5.2.2 PERSONAL INDEPENDENCE

Article 30 of the Transitional Provisions to the Fundamental Law of Hungary allows for a merger of the Magyar Nemzeti Bank with the Hungarian Financial Supervisory Authority. In such a case the Governor of the Magyar Nemzeti Bank would become Vice-President under the authority of an appointed President of the new institution. Article 30 of the Transitional Provisions to the Fundamental Law therefore is not compatible with Article 14.2 of the Statute with regard to the possible reasons for dismissing the current Governor and, if applied, it would amount in practice to a dismissal of the Governor. It is also not compatible with Article 130 of the Treaty and Article 7 of the Statute to the extent the Governor would be subordinated or might be influenced by the President of the new institution in the performance of ESCB-related tasks.

Pursuant to Article 46 (12) and (13) of the Law, an appeal may be brought in the Labour Court against a motion for dismissal of a member of the Monetary Council, in accordance with the Labour Code. As regards the Governor of the Magyar Nemzeti Bank, similar provisions apply in Article 47(5) and (6), and in Article 48(2) of the Law as regards the Deputy Governors. Articles 46(12) and 47(5) of the Law specifically refer to Article 14.2 of the Statute and the right to seek remedy against a motion for dismissal of the Governor to the Court of Justice of the European Union. However, Article 77 of the Law, to enter into force on 1 January 2013, replaces Articles 46(12) and 47(5) of the Law. From 1 January 2013, Articles 46(12) and 47(5) of the Law will no longer refer to Article 14.2 of the Statute and the right to seek a remedy before the Court of Justice of the European Union. The ECB understands that although pursuant to Article 77 the Law will be silent on the jurisdiction of the Court of Justice of the European

29 See Section 6.5.1. Also since 2008 and thus before the ECB Convergence Report of May 2010 there have been several changes in the institutional framework for the Magyar Nemzeti Bank. The amendment,introduced by Law CVI of 2007 was technical. Law CIX of 2008 modified the provisions on the central bank information system and inspection, issuing operations, conflict of interest and authorisations. Law LVI of 2009 concerned the common provisions relating to the administrative proceedings, actions and sanctions of the Magyar Nemzeti Bank. Law LXXXV of 2009 introduced minor amendments to the Magyar Nemzeti Bank's rights regarding payment transactions and oversight powers and accounting services. Law CXLVIII of 2009 introduced the right of the Governor of the Magyar Nemzeti Bank to recommend to the Government the adoption of a legal act in the interests of the stability of the financial intermediary system. Law XI of 2010 established the Magyar Nemzeti Bank's rights and obligations stemming from Hungary's membership in the International Monetary Fund. Law CLV of 2009 introduced minor amendments to the rules on the conflict of interest and professional secrecy.

30 See Article 49(11) of Law LVIII of 2001.

Union to hear cases with regard to decisions to dismiss the Governor, Article 14.2 of the Statute is directly applicable and continues to apply.

The provisions concerning the remuneration of the Governor, Deputy Governors and the other members of the Monetary Council and Supervisory Board have been amended three times since September 2010.[31] All recently adopted amendments applied from the moment of their adoption to all concerned subjects. The remuneration of the current Governor and of the Deputy Governors has been significantly decreased compared to the remuneration paid at the beginning of their term of office. The manner and frequency of these changes in the remuneration of the members of the central bank decision-making bodies represent signs of pressure on them from the national authorities. Article 51 of the Law should only apply to future appointments and after taking due account of the Magyar Nemzeti Bank's views. To this extent, Article 66(1) which provides that the Law enters into force on 1 January 2012, is not compatible with the personal independence of the Governor and of the Deputy Governors.

The 2010 Convergence Report noted that Article 1 of Law XXVII of 2008 specifies the wording of the oath that the members of the Monetary Council – including the Governor – are required to use. In 2010 all members of the Monetary Council were appointed by the Parliament. Pursuant to Article 46(7), in conjunction with Articles 47(3) and 48(2) of the Law which entered into force on 1 January 2012, 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.[32] Therefore, it is not clear if the same oath is taken by the Governor and the Deputy Governors as the other members of the Monetary Council. The Magyar Nemzeti Bank's Governor acts in a dual capacity as a member of the Magyar Nemzeti Bank's Monetary Council and of the ECB decision-making bodies. The wording of the oath should take into account and reflect the status and the obligations and duties of the Magyar Nemzeti Bank's 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, the Deputy Governors and the other members of the Monetary Council from performing ESCB-related tasks. Articles 46(7) of the Law and Law XXVII of 2008 need to be adapted in this regard.

6.5.3 MONETARY FINANCING AND PRIVILEGED ACCESS

Article 12(4) of the Law 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 15 of the Law. The Magyar Nemzeti Bank may make the extension of such a loan subject to the performance of actions by the Hungarian Financial Supervisory Authority or by the credit institution, on the Financial Supervisory Authority's proposal. The extension of any emergency loan under Article 12(4) is granted independently and at the Magyar Nemzeti Bank's full discretion,

31 Law XC of 2010 reduced and capped the salary of the Magyar Nemzeti Bank's Governor at around HUF 2 000 000. Law CLIII of 2010 fixed the salaries of the Chair (HUF 1 200 000) and other members (HUF 800 000) of the Supervisory Board. Law CCVIII of 2011 maintained the salary cap for the Magyar Nemzeti Bank's Governor at ten times the national gross monthly average earnings, and also that of the Deputy Governors, the Chair of the Supervisory Board and other members of the Supervisory Board.

32 Law XXVII of 2008 on the oath of certain public officials specified the following wording of the oath "*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*!".

which may make such extensions conditional if necessary. However, it would 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.

Article 13 of the Law 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 15 of the Law, 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. This provision is compatible with the monetary financing prohibition. As already clarified in its opinion,[33] 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.

6.5.4 SINGLE SPELLING OF THE EURO

In several Hungarian legal acts[34] the name of the single currency is spelled in a way 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.

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.

6.5.5 LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

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

6.5.5.1 ECONOMIC POLICY OBJECTIVES

Article 3(2) of the Law provides that the Magyar Nemzeti Bank supports without prejudice to the primary objective of price stability the Government's general economic policies. This provision is incompatible with Article 127(1) of the Treaty and Article 2 of the Statute, as it does not reflect the secondary objective of supporting the general economic policies of the EU.

6.5.5.2 TASKS

Monetary policy

Article 41 of the Fundamental Law of Hungary and Articles 4 to 9, 11, 46, 59 and 65 of the Law 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

Article 4(6), Article 21 and Article 65(1) of the Law establishing the Magyar Nemzeti Bank's powers relating to the collection of statistics do not recognise the ECB's powers in this field.

33 See Opinion CON/2011/104 paragraph 9.3.
34 For example, the Laws on the 2012, 2011 and 2005 general budget in Hungary.

Official foreign reserve management

Article 4(3) and (4) and Article 59(2) of the Law, 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 4(5), Articles 19 and 20 , Article 23(b), and Article 65(2) and (3) of the Law 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 4(2), Articles 27 to 30 and Article 65(1) of the Law establishing the Magyar Nemzeti Bank's exclusive right to issue banknotes and coins do not recognise the Council's and the ECB's powers in this field.

6.5.5.3 FINANCIAL PROVISIONS

Appointment of independent auditors

Article 41 of the Law 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, and Article 43(b) of the Law, which provides for the shareholder's power to appoint and dismiss the auditor, do not recognise the Council's and the ECB's powers under Article 27.1 of the Statute.

Financial reporting

Article 49(4)(b) of the Law and Law C of 2000,[35] in conjunction with Government Decree 221/2000 (XII.19),[36] 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.

6.5.5.4 EXCHANGE RATE POLICY

Article 4(4), Articles 10 and 16 of the Law 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.

6.5.5.5 INTERNATIONAL COOPERATION

Article 36(4) of the Law 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.

6.5.5.6 MISCELLANEOUS

Articles 25 and 26 of the Law do not recognise the ECB's powers to impose sanctions.

With regard to Article 32 of the Law, which entitles the Magyar Nemzeti Bank to be consulted on draft national legislation related to its tasks, it is noted that consulting the Magyar Nemzeti Bank does not obviate the need to consult the ECB under Articles 127(4) and 282(5) of the Treaty.

35 *A számvitelről szóló törvény*, *Magyar Közlöny* 2000/95 (IX. 21.).

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

Article 46(7) of the Law 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 49(7) of the Law needs to be adapted to comply with Article 14.3 of the Statute.[37]

6.5.6 CONCLUSIONS

The Fundamental Law of Hungary, the Transitional Provisions to the Fundamental Law of Hungary and the Law do not comply with all the requirements for central bank independence, 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.

6.6 POLAND

6.6.1 COMPATIBILITY OF NATIONAL LEGISLATION

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

– the Polish Constitution,[38]

– the Law on Narodowy Bank Polski (hereinafter the "Law"),[39]

– the Law on the Bank Guarantee Fund ,[40]

– the Law on banking (hereinafter the "Law on banking"),[41]

– the Law on settlement finality in the payment and settlement systems and on the supervision of such systems.[42]

No major new legislation has been enacted in relation to the points identified in the ECB's Convergence Report of May 2010, and those comments are therefore largely repeated in this year's assessment.

6.6.2 INDEPENDENCE OF THE NCB

With regard to Narodowy Bank Polski's independence, the Polish Constitution, the Law and the Law on the State Tribunal[43] need to be adapted in the respects set out below.

37 See paragraph 3.7 of Opinion CON/2008/83.
38 *Konstytucja Rzeczypospolitej Polskiej* of 2 April 1997, *Dziennik Ustaw* of 1997, No 78, item 483.
39 *Ustawa o Narodowym Banku Polskim* of 29 August 1997. Consolidated version published in *Dziennik Ustaw* of 2005, No 1, item 2, with further amendments.
40 *Ustawa o Bankowym Funduszu Gwarancyjnym* of 14 December 1994. Consolidated version published in *Dziennik Ustaw* of 2009, No 84, item 711, with further amendments.
41 *Ustawa Prawo bankowe* of 29 August 1997. Consolidated version published in *Dziennik Ustaw* of 2002, No 72, item 665, with further amendments.
42 *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 2010 No 112, item 743, with further amendments.
43 *Ustawa o Trybunale Stanu* of 26 March 1982; consolidated version published in *Dziennik Ustaw* of 2002, No 101, item 925, with further amendments.

6.6.2.1 INSTITUTIONAL INDEPENDENCE

The Law 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 needs to be adapted to comply with Article 130 of the Treaty and Article 7 of the Statute.

Article 11(3) of the Law, 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, 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,[44] should comply with the prohibition on giving instructions to an NCB and its decision-making bodies and should not interfere with the NCB's ESCB-related tasks. In particular, it should be ensured that when auditing Narodowy Bank Polski, the application by the NIK of the "efficacy criterion" does not extend to an evaluation of Narodowy Bank Polski's activities related to its primary objective of price stability.[45] Article 203(1) of the Constitution needs to be adapted to comply with Article 130 of the Treaty and Article 7 of the Statute.

6.6.2.2 PERSONAL INDEPENDENCE

Article 9(5) of the Law 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,[46]
- been prohibited by the State Tribunal from occupying executive positions or holding posts of particular responsibility in state bodies.[47]

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

45 See paragraph 3.6 of Opinion CON/2011/9.

46 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).

47 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).

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.[48]

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 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 provide the following grounds for dismissal:

– an illness which permanently prevents them from performing their responsibilities,

– a conviction for a criminal offence under a final court sentence,

– submission of an untruthful disclosure declaration as confirmed by a final court judgment,[49]

– 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 therefore needs to be adapted to comply with Article 14.2 of the Statute. Article 14(3) of the Law, which reaffirms the possibility of dismissal of a member of the Monetary 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, 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 is silent on the right of national courts to review a decision to dismiss any member, other than the President, of the NCB's decision-making bodies who is involved in the performance of ESCB-related tasks. Even though this right may be available under general Polish law, providing specifically for such a right of review could increase legal certainty.

6.6.3 CONFIDENTIALITY

Article 23(7) of the Law 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

48 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 footnote 50 above.
49 See footnote 56 above.

instance covers disclosure to unspecified recipients, under "separate applicable provisions".[50] Such disclosure may potentially affect data protected under the ESCB's confidentiality regime and therefore the Law should be adapted to fully comply with Article 37 of the Statute.[51]

6.6.4 MONETARY FINANCING AND PRIVILEGED ACCESS

Article 42(1) in conjunction with Article 3(2)(5) of the Law provides for Narodowy Bank Polski's powers to grant refinancing credit to banks satisfying specified conditions.[52] In addition, Article 42(3) of the Law allows Narodowy Bank Polski to grant refinancing credit for the purpose of implementing bank rehabilitation proceedings, which are initiated in the event of a bank suffering a net loss, being threatened with such a loss or insolvency.[53] 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.[54] Safeguards currently contained in such rules aiming at ensuring timely repayment of the credit do not fully exclude an interpretation that would allow an extension of refinancing credit to a bank undergoing rehabilitation proceedings which then becomes insolvent.[55] More explicit safeguards are needed to avoid incompatibility with the monetary financing prohibition under Article 123 of the Treaty. Article 42 of the Law should be adapted accordingly.

Article 220(2) of the Polish Constitution provides that "the budget shall not provide for covering a budget deficit by way of contracting credit obligations to the State's central bank". While this provision prohibits the State from financing its budgetary deficit via Narodowy Bank Polski, the ECB understands that it does not constitute an implementation of Article 123 of the Treaty prohibiting monetary financing, and its aim and function are therefore not identical to those of the said Treaty prohibition. Article 123 of the Treaty, supplemented by Regulation (EC) No 3603/93, is directly applicable, so in general, it is unnecessary to transpose it into national legislation.

6.6.5 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 need to be adapted in the respects set out below.

6.6.5.1 ECONOMIC POLICY OBJECTIVES

Article 3(1) of the Law 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.

50 Article 23(7)(3) of the Law.
51 See Opinion CON/2008/53.
52 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).
53 Article 142(1) of the Law on banking.
54 Article 42(7) of the Law.
55 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).

6.6.5.2 TASKS

Monetary policy

Article 227(1) and (5) of the Constitution and Article 3(2)(5), Articles 12, 23 and 38 to 50a and 53 of the Law, 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, 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, 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, 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, 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.

6.6.5.3 FINANCIAL PROVISIONS

Appointment of independent auditors

Article 69(1) of the Law, 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.

6.6.5.4 EXCHANGE RATE POLICY

Articles 3(2)(3) and 17(4)(2) and Article 24 of the Law, 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.

6.6.5.5 INTERNATIONAL COOPERATION

Articles 5(1) and 11(3) of the Law, 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.

6.6.5.6 MISCELLANEOUS

Article 9(3) of the Law, 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, 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.

6.6.6 CONCLUSIONS

The Polish Constitution, the Law 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.[56]

6.7 ROMANIA

6.7.1 COMPATIBILITY OF NATIONAL LEGISLATION

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

– Law No 312 on the Statute of Banca Națională a României (hereinafter the "Law").[57]

There have been only limited changes in relation to the points identified in the ECB's Convergence Report of May 2010, and those comments are therefore largely repeated in this year's assessment.

6.7.2 INDEPENDENCE OF THE NCB

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

6.7.2.1 INSTITUTIONAL INDEPENDENCE

Article 3(1) of the Law 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 should bring this provision fully into line with Article 130 of the Treaty and Article 7 of the Statute.

Further, Article 3 of the Law 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 needs to be adapted to be fully consistent with Article 130 of the Treaty and Article 7 of the Statute.

6.7.2.2 PERSONAL INDEPENDENCE

Article 33(9) of the Law 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 is silent on the jurisdiction of the Court of Justice of the European Union to hear cases with regard to the

56 For a detailed review of necessary adaptations of the Constitution, the Law and other laws, see Opinion CON/2011/9.
57 *Monitorul Oficial al României*, Part One, No 582, 30.6.2004.

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 provides that no member of the Board of Banca Națională a României may be recalled from office for other reasons or following a procedure other than those provided for in Article 33(6) of the Law. 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[58], and Law 176/2010 on the integrity in the exercise of public functions and dignities[59], 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 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. For legal certainty reasons and in line with Article 33 of the Law, a clarification to this end in the abovementioned Laws would be welcome.

6.7.2.3 FINANCIAL INDEPENDENCE

Article 43 of the Law 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 any losses relating to previous financial years that remain uncovered. As noted in Chapter 6.7.4, 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 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 should therefore be adapted, in addition to taking into account the issues highlighted in Chapter 6.7.4, to ensure that such arrangement does 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 the Law concerning the organisation and functioning of the Court of Auditors[60], 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 should, for legal certainty reasons, be clearly defined by the legislation and should be without prejudice to the activities of Banca Națională a României's independent external auditors or interfere with the NCB's ESCB-related tasks.[61]

58 Published in *Monitorul Oficial al României*, Part One, No 279, 21.4.2003.
59 Published in *Monitorul Oficial al României*, Part One, No 621, 2.9.2010.
60 Published in *Monitorul Oficial al României*, Part One, No 282, 29.4.2009.
61 For the activities of the NCB's independent external auditors see, as an example, Article 27.1 of the Statute.

6.7.3 CONFIDENTIALITY

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

6.7.4 MONETARY FINANCING AND PRIVILEGED ACCESS

Articles 6(1) and 29(1) of the Law 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, 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.

Pursuant to Article 7(3) of the Law, 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 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 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 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.

Government Emergency Ordinance 90/2008 on the statutory audit of the annual financial statements and consolidated annual financial statements[62] (hereinafter the "2008 Ordinance") establishes rules on statutory auditors and audit entities and organises a system of public supervision of statutory audits. With this aim, it establishes the Council for the Public Supervision of Statutory Audits (Consiliul pentru Supravegherea Publică a Activității de Audit Statutar, hereinafter the "Council"), which is a public autonomous institution, with legal personality and designed to carry out the public supervision of statutory audits, according to the principles specified in Directive 2006/43/EC[63,64]. Banca Națională a României contributes funds and human resources to the functioning of the Council as follows: (i) the Governor or a person representing Banca Națională a României appointed by the Governor is a member of its decision-making body[65], and rotates as its chair on an annual basis;[66] (ii) Banca Națională a României contributes staff to the functioning of the Council;[67] and (iii) Banca Națională a României contributes a fixed percentage to the Council's total budget.[68] The provision of resources by an NCB to a supervisory authority does not give rise to monetary financing concerns insofar as the NCB will be financing the performance of a legitimate financial supervisory task under national law as part of its mandate, or as long as the NCB can contribute to and have influence on the decision-making of the supervisory authorities. However, in the case at hand, the involvement of Banca Națională a României in the supervision of the statutory audit of consolidated and annual financial statements does not seem linked to the financial stability of the financial sector. For this reason, the 2008 Ordinance should be made compliant with Article 123 of the Treaty by (i) restricting Banca Națională a României's involvement and financial contributions to the supervision of the statutory audit of the annual accounts of credit and financial institutions only; (ii) ensuring that the Romanian state reimburses Banca Națională a României fully for any expenses it incurs due to its role under the 2008 Ordinance; or (iii) that any contributions to the Council's total budget beyond the financial sector are made by the State.

6.7.5 LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

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

6.7.5.1 ECONOMIC POLICY OBJECTIVES

Article 2(3) of the Law 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.

62 Published in *Monitorul Oficial al României* No 481 of 30 June 2008.
63 Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC (OJ L 157, 9.6.2006, p. 87).
64 From 2009 the Council has been under the responsibility of the Ministry of Public Finance.
65 The term of office is three years and can be renewed twice.
66 Article 68 of the 2008 Ordinance.
67 Article 71 of the 2008 Ordinance.
68 Article 78(2) of the 2008 Ordinance.

6.7.5.2 TASKS

Monetary policy

Article 2(2)(a), Article 5, Articles 6(3) and 7(1), Articles 8, 19 and 20 and Article 33(1)(a) of the Law, 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, 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, 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, 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, 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.

6.7.5.3 FINANCIAL PROVISIONS

Appointment of independent auditors

Article 36(1) of the Law, 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, 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, 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.

6.7.5.4 EXCHANGE RATE POLICY

Article 2(2)(a) and (d), Article 9 and Article 33(1)(a) of the Law, 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, 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.

6.7.6 MISCELLANEOUS

With regard to Article 3(2) of the Law, 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 does not recognise the ECB's powers to impose sanctions.

Article 4(5) of the Law 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.

6.7.7 CONCLUSIONS

The Law does not comply with all the requirements for central bank independence, the monetary financing prohibition and legal integration into the Eurosystem. Also Ordinance 2008 does not comply with the monetary financing prohibition requirements. Romania is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.

6.8 SWEDEN

6.8.1 COMPATIBILITY OF NATIONAL LEGISLATION

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

– the Instrument of Government,[69] which forms part of the Swedish Constitution,

– the Law on Sveriges Riksbank (hereinafter the "Law"),[70]

– the Law on exchange rate policy.[71]

There have been no major changes to the Law in relation to the points identified in the ECB's Convergence Report of May 2010, and those comments are therefore largely repeated in this year's assessment.

6.8.2 INDEPENDENCE OF THE NCB

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

69 SFS 1974:152.
70 SFS 1988:1385.
71 SFS 1998:1404.

6.8.2.1 INSTITUTIONAL INDEPENDENCE

Article 13 of Chapter 9 of the Instrument of Government states that Sveriges Riksbank is an authority under the Riksdag. Article 2 of Chapter 3 of the Law, 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 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 secure and efficient payment systems. 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, 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 is therefore incompatible with central bank independence and should be adapted accordingly.

6.8.2.2 FINANCIAL INDEPENDENCE

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

The present arrangements on profit distribution are under review. However, as they currently stand, they are 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.

6.8.3 MONETARY FINANCING PROHIBITION

Article 1(3) of Chapter 8 of the Law 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, 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 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 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 should be aligned with the wording of Article 123(2) of the Treaty, which only exempts publicly owned credit institutions from the prohibition on monetary financing in respect of the supply of reserves by central banks; the central bank may not supply reserves to other public financial institutions. In the same vein, the range of public sector entities would need to be made consistent with Article 123(2) of the Treaty, and the ECB suggests, for reasons of legal certainty, inserting a reference to Article 123 of the Treaty in Article 1 of Chapter 8 of the Law.

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.

6.8.4 LEGAL INTEGRATION OF THE NCB INTO THE EUROSYSTEM

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

6.8.4.1 ECONOMIC POLICY OBJECTIVES

Article 2 of Chapter 1 of the Law provides that Sveriges Riksbank's objective is to maintain price stability. It also provides that Sveriges Riksbank promotes 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. In any case, 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.

6.8.4.2 TASKS

Article 1 of Chapter 1 of the Law, 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, 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, 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, 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 Article 9 of Chapter 6 of the Law, 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, 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

Article 14(2) of Chapter 9 of the Instrument of Government and Article 2 of Chapter 1 and Article 7 of Chapter 6 of the Law, 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, 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.

6.8.4.3 FINANCIAL PROVISIONS

Appointment of independent auditors

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

6.8.4.4 EXCHANGE RATE POLICY

Article 12 of Chapter 9 of the Instrument of Government and Chapter 7 of the Law, 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.

6.8.4.5 INTERNATIONAL COOPERATION

Pursuant to Article 6 of Chapter 7 in the Law, 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.

6.8.4.6 MISCELLANEOUS

With regard to Article 4 of Chapter 2 of the Law, which provides for the General Council's right to submit consultation opinions on behalf of Sveriges Riksbank within its area of competence, it is noted that consulting Sveriges Riksbank does not obviate the need to consult the ECB under Articles 127(4) and 282(5) of the Treaty.

As specified in Chapter 2.2.4, the primacy of Union law and rules adopted thereunder also means that national laws on access by third parties to documents may not lead to infringements of the ESCB's confidentiality regime. The ECB understands that the Public Access to Information and Secrecy Act[72] 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.

6.8.5 CONCLUSIONS

The Law, the Constitution and the Law on exchange rate policy do not comply with all the requirements for central bank independence, the monetary financing prohibition and legal integration into the Eurosystem. Sweden is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty. The ECB notes that the Treaty has obliged Sweden to adopt national legislation for integration into the Eurosystem since 1 June 1998. Over the years no legislative action has been taken by the Swedish authorities to remedy the incompatibilities described in this and previous reports.

72 SFS 2009:400.

GLOSSARY

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

Alert Mechanism Report: the first step of the EU's new surveillance procedure for preventing and correcting macroeconomic imbalances. In the report, the **European Commission** identifies EU Member States that will be subject to further in-depth analysis under the **macroeconomic imbalance procedure**.

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

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

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

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

Convergence criteria: the criteria set out in Article 140(1) of the **Treaty** (and developed further in the Protocol (No 13) on the convergence criteria referred to in Article 140) that must be fulfilled by each EU Member State before it can adopt the euro. They relate to performance in respect of price stability, government financial positions, exchange rates and long-term interest rates. The reports produced under Article 140(1) by the **European Commission** and the **European Central Bank** examine whether a high degree of sustainable convergence has been achieved by each EU Member State on the basis of its fulfilment of these criteria, in addition to examining the compatibility of their national legislation, including the statute of their respective **national central bank**, with the **Treaties**.

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

Council of the European Union (EU Council): an institution of the EU made up of representatives of the governments of the EU Member States, normally the ministers responsible for the matters under consideration.

Current transfers: transfers of the **general government** (e.g. relating to international cooperation), payments of current taxes on income and wealth and other transfers, such as workers' remittances, which are not related to capital expenditure; they also include production and import subsidies, social benefits and transfers to EU institutions.

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

Debt ratio (general government): general government debt is defined as total gross debt at nominal value outstanding at the end of the year and consolidated between and within the sectors of general government. The government debt-to-GDP ratio is defined as the ratio of general government debt to GDP at current market prices. It is the subject of one of the fiscal criteria used to define the existence of an excessive deficit, as laid down in Article 126(2) of the **Treaty**.

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

Deficit ratio (general government): the **general government** deficit is defined as net borrowing and corresponds to the difference between general government revenue and general government expenditure. The deficit ratio is defined as the ratio of the general government deficit to GDP at current market prices. It is the subject of one of the fiscal criteria used to define the existence of an excessive deficit, as laid down in Article 126(2) of the **Treaty**.

ECOFIN Council: the **EU Council** meeting in the composition of the ministers of economics and finance (see also **Council of the European Union)**.

Economic and Financial Committee: a consultative EU body which carries out preparatory work for the **ECOFIN Council** and the **European Commission** on topics related to the economic and financial situation of the EU Member States. Its composition and tasks are set out in Article 134 of the **Treaty**.

Economic and Monetary Union (EMU): the outcome of the process for the harmonisation of the economic policies of the EU Member States that led to the single currency, the euro, and the single monetary policy of the **euro area**. The process for achieving EMU, as laid down in the **Treaty**, involves three stages. Stage Three, the final stage, began on 1 January 1999 with the irrevocable fixing of exchange rates, the transfer of monetary competence to the **European Central Bank** and the introduction of the euro. The cash changeover on 1 January 2002 completed the process of setting up EMU.

Effective exchange rate (EER) (nominal/real): a weighted average of the bilateral exchange rates of a country's currency against the currencies of major trading partners. The weights used reflect the share of each partner country in the trade of the country under consideration and account for

competition in third markets. The real EER is the nominal EER deflated by a weighted average of foreign prices relative to domestic prices.

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

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

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

Excessive imbalance procedure: refers to the corrective arm of the **macroeconomic imbalance procedure**, which is initiated when excessive macroeconomic imbalances are identified in an EU Member State, including imbalances that jeopardise the proper functioning of **Economic and Monetary Union**. The procedure includes issuing policy recommendations, the preparation of a corrective action plan by the Member State concerned, enhanced surveillance and monitoring requirements and, in respect of EU Member States whose currency is the euro, the possibility of financial sanctions in the event of a failure to take corrective action.

Euro area: the area formed by the EU Member States whose currency is the euro and in which a single monetary policy is conducted under the responsibility of the **Governing Council** of the **European Central Bank**. The euro area currently comprises Belgium, Germany, Estonia, Ireland, Greece, Spain, France, Italy, Cyprus, Luxembourg, Malta, the Netherlands, Austria, Portugal, Slovenia, Slovakia and Finland.

Eurogroup: an informal gathering of the ministers of economy and finance of the EU Member States whose currency is the euro. Its status is recognised under Article 137 of the **Treaty** and in Protocol No 14. The Eurogroup meets on a regular basis (usually prior to meetings of the **ECOFIN Council**) to discuss issues connected with the euro area countries' shared responsibilities for the single currency. The **European Commission** and the **European Central Bank** are regularly invited to take part in these meetings.

European Central Bank (ECB): the EU institution which, together with the **national central banks (NCBs)** of the EU Member States whose currency is the euro, defines and implements the monetary policy for the euro area. The ECB lies at the centre of the **Eurosystem** and the **European System of Central Banks (ESCB)**, which are governed by the decision-making bodies of the ECB, the **Governing Council** and the **Executive Board,** and, as a third decision-making body, the **General Council**. The ECB has its own legal personality under Article 282(3) of the **Treaty**. It ensures that the tasks conferred upon the Eurosystem and the ESCB are implemented either through its own activities or through those of the NCBs, pursuant to the **Statute** of the ESCB.

European Commission: the EU institution which ensures the application of the provisions of the **Treaty**. The Commission develops EU policies, drafts proposals for new EU laws and makes sure that EU decisions are properly implemented. In the area of economic policy, the Commission proposes Integrated Guidelines for Growth and Jobs, containing the Broad Economic Policy Guidelines and the Employment Guidelines, and reports to the **Council of the European Union (EU Council)** on economic developments and policies. It also monitors public finances within the framework of multilateral surveillance and submits reports on this to the EU Council.

European Council: the EU institution which brings together the Heads of State or Government of the EU Member States, the President of the **European Commission** and the European Council's own President (see also **Council of the European Union**) to provide the EU with the necessary impetus for its development and to define the general political directions and priorities thereof. It does not have a legislative function.

European Monetary Institute (EMI): a temporary institution established on 1 January 1994 at the start of Stage Two of **Economic and Monetary Union**. It went into liquidation following the establishment of the **European Central Bank** on 1 June 1998.

European Parliament: an institution of the EU comprising 754 (as of March 2012) directly elected representatives of the citizens of the EU Member States. Parliament plays a role in the EU's legislative process, although with differing prerogatives depending on the various procedures used for enacting different EU laws. In matters related to monetary policy and the **European System of Central Banks**, Parliament has mainly consultative powers. However, the **Treaty** establishes certain procedures with respect to the democratic accountability of the **European Central Bank (ECB)** to Parliament (e.g. presentation of the ECB's Annual Report, including a general debate on monetary policy, and regular testimonies before Parliament's Committee on Economic and Monetary Affairs).

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

European System of Central Banks (ESCB): composed of the **European Central Bank (ECB)** and the **national central banks (NCBs)** of all 27 EU Member States, i.e. it includes, in addition to the members of the **Eurosystem**, the NCBs of those EU Member States whose currency is not the euro. The ESCB is governed by the **Governing Council** and the **Executive Board** of the ECB, and, as a third decision-making body of the ECB, by the **General Council**.

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

Eurosystem: the central banking system of the **euro area**. It comprises the **European Central Bank** and the **national central banks** of the EU Member States whose currency is the euro.

Excessive deficit procedure: the provisions set out in Article 126 of the **Treaty** and specified in the Protocol (No 12) on the excessive deficit procedure require EU Member States to maintain budgetary discipline, define the criteria for a budgetary position to be considered an excessive deficit

and regulate steps to be taken following the observation that the requirements for the budgetary balance or government debt have not been fulfilled. Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure is also an element of the **Stability and Growth Pact**.

Executive Board of the ECB: one of the decision-making bodies of the **European Central Bank (ECB)**. It comprises the President and the Vice-President of the ECB and four other members appointed by the **European Council**, acting by a qualified majority among the Heads of State or Government of the euro area member countries, on a recommendation from the **Council of the European Union**, after it has consulted the European Parliament and the ECB.

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

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

General Council of the ECB: one of the decision-making bodies of the **European Central Bank (ECB)**. It comprises the President and the Vice-President of the ECB and the governors of all the **national central banks** of the **European System of Central Banks**.

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

Governing Council of the ECB: the supreme decision-making body of the **European Central Bank (ECB)**. It comprises all the members of the **Executive Board** of the ECB and the governors of the **national central banks** of the EU Member States whose currency is the euro.

Gross external debt: the outstanding amount of an economy's financial liabilities that require payments of principal and/or interest at some point in the future to the rest of the world.

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

Harmonised Index of Consumer Prices (HICP): a measure of the development of consumer prices that is compiled by **Eurostat** and harmonised for all EU Member States.

Harmonised long-term interest rates: Article 4 of the Protocol (No 13) on the convergence criteria, referred to in Article 140 of the **Treaty**, requires interest rate convergence to be measured by means of interest rates on long-term government bonds or comparable securities, taking into account differences in national definitions. In order to fulfil the Treaty requirement, the **European Central Bank** has carried out conceptual work on the harmonisation of long-term interest rate statistics and regularly collects data from the **national central banks**, in cooperation with and on behalf of the **Eurostat**. Harmonised data are used for the convergence examination in this report.

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

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

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

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

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

Macroeconomic imbalance procedure (MIP): a procedure aimed at broadening the surveillance of economic policies of the EU Member States to include a detailed and formal framework to prevent and correct excessive imbalances and to help the EU Member States affected to establish corrective action plans before divergences become entrenched. The first step of this new surveillance procedure of the EU is the **Alert Mechanism Report**.

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

National central bank (NCB): a central bank of an EU Member State.

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

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

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

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

Private sector debt: outstanding amounts at the end of the year of securities issued and loans taken out by non-financial corporations and households (including non-profit institutions serving households). The private sector debt-to-GDP ratio is defined as the ratio of private sector debt to GDP at current market prices.

Private sector credit flow: annual transactions on debt securities issued and loans taken out by non-financial corporations and households (including non-profit institutions serving households). The private sector credit flow-to-GDP ratio is defined as the ratio of private sector credit flow to GDP at current market prices.

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

Reference period: the time interval specified in Article 140 of the **Treaty** and in the Protocol (No 13) on the convergence criteria for examining progress towards convergence.

Reference value: the Protocol (No 12) on the excessive deficit procedure sets explicit reference values for the **deficit ratio** (3% of GDP) and the **debt ratio** (60% of GDP), while the Protocol (No 13) on the convergence criteria, referred to in Article 140 of the **Treaty**, specifies the methodology for calculating the reference values for the examination of price and long-term interest rate convergence.

Stability and Growth Pact: intended to serve as a means of safeguarding sound government finances in the EU Member States in order to strengthen the conditions for price stability and for strong, sustainable growth conducive to employment creation. To this end, the Pact prescribes that EU Member States specify medium-term budgetary objectives. It also contains concrete specifications on the **excessive deficit procedure**. The Pact consists of the Resolution of the Amsterdam European Council of 17 June 1997 on the Stability and Growth Pact and three Council Regulations, namely: i) 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, ii) Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure, and iii) Regulation (EU) No 1173/2011 of 16 November 2011 on the effective enforcement of budgetary surveillance in the euro area. The Stability and Growth Pact is complemented by the **ECOFIN Council**'s report entitled "Improving the implementation of the Stability and Growth Pact", which was endorsed by the Brussels European Council of 22 and 23 March 2005. It is also complemented by a Code of Conduct entitled "Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of stability and convergence programmes", which was endorsed by the ECOFIN Council on 11 October 2005.

Statute: refers to the Protocol (No 4) on the Statute of the **European System of Central Banks** and of the **European Central Bank**, annexed to the **Treaties**.

Treaties: 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.

Treaty: 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.

Treaty of Lisbon (Lisbon Treaty): amended the EU's two core treaties, the Treaty on European Union and the Treaty establishing the European Community, and renamed the latter as Treaty on the Functioning of the European Union. The Treaty of Lisbon was signed in Lisbon on 13 December 2007 and entered into force on 1 December 2009.

Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG): a Treaty signed by 25 EU Member States (all EU Member States except the Czech Republic and the United Kingdom) on 2 March 2012 that builds on the provisions of the enhanced **Stability and Growth Pact** and includes binding national rules which ensure close-to-balance budget positions in structural terms. All euro area member countries and most other EU Member States that are parties to the TSCG will introduce into their constitution – or equivalent law of a higher level than the annual budget law – the balanced budget rule, accompanied by an automatic correction mechanism in case of deviation from the fiscal objective. The TSCG will enter into force once it has been ratified by 12 euro area member countries.

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