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Convergence Report

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EUROPEAN ECONOMY

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Convergence Report
2016

EUROPEAN ECONOMY
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ABBREVIATIONS

Member States

BG	Bulgaria
CZ	Czech Republic
HR	Croatia
HU	Hungary
PL	Poland
RO	Romania
SE	Sweden
EA	Euro area
EA-19	Euro area, 19 Member States
EA-18	Euro area, 18 Member States before 2015
EA-17	Euro area, 17 Member States before 2014
EU-28	European Union, 28 Member States
EU-27	European Union, 27 Member States before July 2013 (i.e. EU-28 excl. HR)
EU-25	European Union, 25 Member States before 2007 (i.e. EU-27 excl. BG and RO)
EU-15	European Union, 15 Member States before 2004

Currencies

EUR	Euro
BGN	Bulgarian lev
CHF	Swiss franc
CZK	Czech koruna
HRK	Croatian kuna
HUF	Hungarian forint
PLN	Polish zloty
RON	Romanian leu (ROL until 30 June 2005)
SEK	Swedish krona

Central Banks

BNB	Bulgarska narodna banka (Bulgarian National Bank – central bank of Bulgaria)
ČNB	Česká národní banka (Czech National Bank – central bank of the Czech Republic)
HNB	Hrvatska narodna banka (Croatian National Bank – central bank of Croatia)
MNB	Magyar Nemzeti Bank (Hungarian National Bank – central bank of Hungary)
NBP	Narodowy Bank Polski (National Bank of Poland – central bank of Poland)
BNR	Banca Naţională a României (National Bank of Romania – central bank of Romania)

Other abbreviations

AMR	Alert Mechanism Report
BoP	Balance of Payments
CAR	Capital adequacy ratio
CBA	Currency board arrangement
CDS	Credit Default Swaps
CEE	Central and Eastern Europe
CIS	Commonwealth of Independent States
CIT	Corporate Income Tax
CPI	Consumer price index
CR5	Concentration ratio (aggregated market share of five banks with the largest market share)
EC	European Community
ECB	European Central Bank
EDP	Excessive Deficit Procedure

EMU	Economic and monetary union
ERM II	Exchange rate mechanism II
ESA	European System of Accounts
ESCB	European System of Central Banks
EU	European Union
Eurostat	Statistical Office of the European Union
FDI	Foreign direct investment
FGS	Funding for Growth Scheme
FSA	Financial Supervisory Authority
FSAP	Financial Sector Action Plan
GDP	Gross domestic product
HICP	Harmonised index of consumer prices
HFSA	Hungarian Financial Supervisory Authority
MFI	Monetary Financial Institution
MIP	Macroeconomic Imbalance Procedure
MTO	Medium-term objective
NCBs	National central banks
NEER	Nominal effective exchange rate
NIK	Najwyższa Izba Kontroli (Poland's Supreme Chamber of Control)
NPL	Non-performing loans
OJ	Official Journal
OJL	Official Journal Lex
PIT	Personal Income Tax
PPS	Purchasing Power Standard
PPP	Purchasing Power Percentage
REER	Real effective exchange rate
SNB	Swiss National Bank
TFEU	Treaty on the Functioning of the European Union
ULC	Unit labour costs
VAT	Value added tax
WSE	Warsaw Stock Exchange

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Convergence Report 2016

(prepared in accordance with Article 140(1) of the Treaty)

EUROPEAN
COMMISSION

Brussels, XXX
[…](2016) XXX draft

REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

CONVERGENCE REPORT 2016

(prepared in accordance with Article 140(1) of the Treaty on the Functioning of the European Union)

1. PURPOSE OF THE REPORT

Article 140(1) of the Treaty on the Functioning of the European Union (hereafter TFEU) requires the Commission and the European Central Bank (ECB) to report to the Council, at least once every two years, or at the request of a Member State with a derogation[1], on the progress made by the Member States in fulfilling their obligations regarding the achievement of economic and monetary union. The latest Commission and ECB Convergence Reports were adopted in June 2014.

The 2016 Convergence Report covers the following seven Member States with a derogation: Bulgaria, the Czech Republic, Croatia, Hungary, Poland, Romania and Sweden[2]. A more detailed assessment of the state of convergence in those Member States is provided in a Technical Annex to this Report.

The content of the reports prepared by the Commission and the ECB is governed by Article 140(1) TFEU. This Article requires the reports to include an examination of the compatibility of national legislation, including the statutes of the national central bank, with Articles 130 and 131 TFEU and the Statute of the European System of Central Banks and of the European Central Bank (hereafter ESCB/ECB Statute). The reports must also examine whether a high degree of sustainable convergence has been achieved in the Member State concerned by reference to the fulfilment of the convergence criteria (price stability, public finances, exchange rate stability, long-term interest rates), and by taking account of other factors mentioned in the final sub-paragraph of Article 140(1) TFEU. The four convergence criteria are developed in a Protocol annexed to the Treaties (Protocol No 13 on the convergence criteria).

The financial and economic crisis, along with the euro-area sovereign debt crisis, has exposed gaps in the economic governance system of the Economic and Monetary Union (EMU) and showed that its instruments need to be used more comprehensively. With the aim of ensuring a sustainable functioning of EMU, an overall strengthening of economic governance in the Union has been undertaken. The assessment of convergence is thus aligned with the broader European Semester approach which takes an integrated look at the economic policy challenges facing the EMU in ensuring fiscal sustainability, competitiveness, financial market stability and economic growth. The key innovations in the area of governance reform, reinforcing the assessment of each Member State's convergence process and its sustainability, include *inter alia* the strengthening of the excessive deficit procedure by the 2011 reform of the Stability and Growth Pact and new instruments in the area of surveillance of macroeconomic imbalances. In particular, this report takes into account the assessment of the 2016 Convergence Programmes and the findings under the Macroeconomic Imbalances Procedure[3].

[1] The Member States that have not yet fulfilled the necessary conditions for the adoption of the euro are referred to as "Member States with a derogation". Denmark and the United Kingdom negotiated opt-out arrangements before the adoption of the Maastricht Treaty and do not participate in the third stage of EMU.

[2] Denmark and the United Kingdom have not expressed an intention to adopt the euro and are therefore not covered in the assessment.

[3] The Commission published its fifth Alert Mechanism Report (AMR) in November 2015 and the conclusions of the corresponding in-depth reviews in March 2016.

Convergence criteria

The examination of the **compatibility of national legislation**, including the statutes of the national central bank, with Article 130 and with the compliance duty under Article 131 TFEU encompasses an assessment of observance of the prohibition of monetary financing (Article 123) and the prohibition of privileged access (Article 124); consistency with the ESCB's objectives (Article 127(1)) and tasks (Article 127(2)) and other aspects relating to the integration of the national central bank into the ESCB.

The **price stability criterion** is defined in the first indent of Article 140(1) TFEU: *"the achievement of a high degree of price stability […] 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 the Protocol on the convergence criteria further provides that *"the criterion on price stability […] 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 1.5 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"*[4]. The requirement of sustainability implies that the satisfactory inflation performance must essentially be attributable to the behaviour of input costs and other factors influencing price developments in a structural manner, rather than the influence of temporary factors. Therefore, the convergence examination includes an assessment of the factors that have an impact on the inflation outlook and is complemented by a reference to the most recent Commission services' forecast of inflation[5]. Related to this, the report also assesses whether the country is likely to meet the reference value in the months ahead.

The inflation reference value was calculated to be 0.7% in April 2016[6], with Bulgaria, Slovenia and Spain as the three 'best-performing Member States'[7].

It is warranted to exclude from the 'best performers' countries whose inflation rates could not be seen as a meaningful benchmark for other Member States[8]. Such outliers were in the past identified in the 2004, 2010, 2013 and 2014 Convergence Reports[9]. At the current juncture, it is warranted to identify Cyprus and Romania as outliers, as their inflation rates deviated by a wide margin from the euro area average and including them would unduly affect the reference value and thus the fairness of the criterion[10]. In case of Cyprus, deeply negative inflation mainly reflected the adjustment needs and exceptional situation of the economy. In case of Romania, it

[4] For the purpose of the criterion on price stability, inflation is measured by the Harmonised Index of Consumer Prices (HICP) defined in Council Regulation (EC) No 2494/95.

[5] All forecasts for inflation and other variables in the current report are from the Commission services' Spring 2016 Forecast. The Commission services' forecasts are based on a set of common assumptions for external variables and on a no-policy change assumption while taking into consideration measures that are known in sufficient detail.

[6] The cut-off date for the data used in this report is 18 May 2016.

[7] The respective 12-month average inflation rates were -1.0%, -0.8% and -0.6%.

[8] The use of the term 'best performer in terms of price stability' should be understood in the meaning of Article 140(1) TFEU and is not intended to represent a general qualitative judgement about the economic performance of a Member State.

[9] Lithuania, Ireland, Greece respectively, then in 2014, Greece, Bulgaria and Cyprus.

[10] In April 2016, the 12-month average inflation rate of Cyprus and Romania were respectively -1.8% and -1.3% and that of the euro area 0.1%.

was mainly due to large VAT rate reductions. Against that background, Bulgaria, Slovenia and Spain, the Member States with the next-lowest average inflation rates, are used for the calculation of the reference value.

The convergence **criterion dealing with public finances** is defined in the second indent of Article 140(1) TFEU as *"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)"*. Furthermore, Article 2 of the Protocol on the convergence criteria states that this criterion means 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"*. As part of an overall strengthening of economic governance in EMU, the secondary legislation related to public finances was enhanced in 2011, including the new regulations amending the Stability and Growth Pact[11].

The TFEU refers to the **exchange rate criterion** in the third indent of Article 140(1) as *"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 the Protocol on the convergence criteria provides: *"The criterion on participation in the exchange rate mechanism of the European Monetary System (…) shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of 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"*[12].

The relevant two-year period for assessing exchange rate stability in this report is 19 May 2014 to 18 May 2016. In its assessment of the exchange rate stability criterion, the Commission takes into account developments in auxiliary indicators such as foreign reserve developments and short-term interest rates, as well as the role of policy measures, including foreign exchange interventions, and international financial assistance wherever relevant, in maintaining exchange rate stability. Currently none of the Member States assessed in this Convergence Report participates in ERM II. Entry into ERM II is decided upon request of a Member State by consensus of all ERM II participants.

The fourth indent of Article 140(1) TFEU requires *"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 the Protocol on the convergence criteria further lays down that *"the criterion on the convergence of interest rates (…) shall mean that, observed over a period of one year before the examination, a Member State has had an average*

[11] A directive on minimum requirements for national budgetary frameworks, two new regulations on macroeconomic surveillance and three regulations amending the Stability and Growth Pact (SGP) entered into force on 13 December 2011 (one out of two new regulations on macroeconomic surveillance and one out of three regulations amending the SGP include new enforcement mechanisms for euro-area Member States). Besides the operationalisation of the debt criterion in the Excessive Deficit Procedure, the amendments introduced a number of important novelties in the Stability and Growth Pact, in particular an expenditure benchmark to complement the assessment of progress towards the country-specific medium-term budgetary objective.

[12] In assessing compliance with the exchange rate criterion, the Commission examines whether the exchange rate has remained close to the ERM II central rate, while reasons for an appreciation may be taken into account, in accordance with the Common Statement on Acceding Countries and ERM2 by the Informal ECOFIN Council, Athens, 5 April 2003.

nominal long-term interest rate that does not exceed by more than 2 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".

The interest rate reference value was calculated to be 4.0% in April 2016[13].

Article 140(1) TFEU also requires an examination of **other factors** relevant to economic integration and convergence. Those additional factors include the integration of markets, the development of the balance of payments on current account and the development of unit labour costs and other price indices. The latter are covered within the assessment of price stability. The additional factors are important indicators that the integration of a Member State into the euro area would proceed without difficulties and broadens the view on sustainability of convergence.

2. BULGARIA

In the light of its assessment on legal compatibility and on the fulfilment of the convergence criteria, and taking into account the additional relevant factors, the Commission considers that Bulgaria does not fulfil the conditions for the adoption of the euro.

Legislation in Bulgaria – in particular the Law on the Bulgarian National Bank – **is not fully compatible** with the compliance duty under Article 131 TFEU. Incompatibilities and imperfections exist in the fields of central bank independence, the prohibition of monetary financing and central bank integration into the ESCB at the time of euro adoption with regard to the tasks laid down in Article 127(2) TFEU and Article 3 of the ESCB/ECB Statute.

Bulgaria fulfils the criterion on price stability. The average inflation rate in Bulgaria during the 12 months to April 2016 was -1.0%, well below the reference value of 0.7%. It is projected to remain well below the reference value in the months ahead.

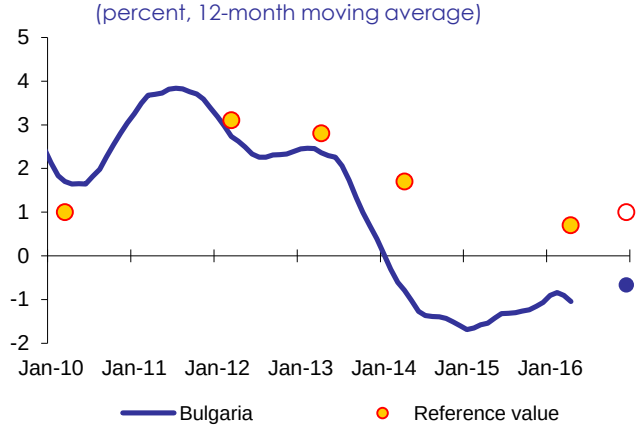
The annual HICP inflation rate in Bulgaria has been negative since summer 2013, with the downturn triggered by an unusually strong combination of disinflationary factors. Inflation reached a trough of -2.4% in January 2015 and then increased to -0.3% in May 2015, before falling back again. Core inflation was negative over most of the past two years, including in early 2016. Negative inflation has been sustained i.a. by weak domestic demand and falling import prices. In April 2016, annual HICP inflation stood at -2.5%.

Inflation is expected to rise gradually as the effect from the decline in commodity prices slowly tapers off, although it is set to remain negative throughout most of 2016. Accordingly, the Commission services' Spring 2016 Forecast projects annual average inflation at -0.7% in 2016 and 0.9% in 2017. The low price level in Bulgaria

[13] The reference value for April 2016 is calculated as the simple average of the average long-term interest rates of Bulgaria (2.5%), Slovenia (1.8%) and Spain (1.8%), plus two percentage points.

(47% of the euro-area average in 2014) suggests significant potential for further price level convergence in the long term.

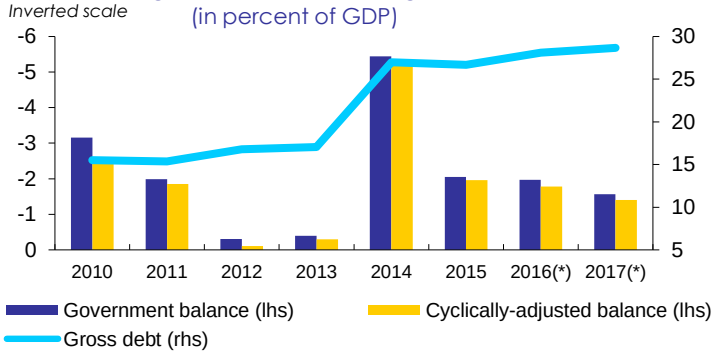
Graph 2a: **Bulgaria - Inflation criterion since 2010**
(percent, 12-month moving average)



Note: The dots in December 2016 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2016 Forecast.

Bulgaria fulfils the criterion on public finances. Bulgaria is not the subject of a Council Decision on the existence of an excessive deficit. The general government deficit increased from 0.8% of GDP in 2013 to 5.4% in 2014, due mainly to financial sector support measures. The deficit-to-GDP ratio was 2.1% in 2015 and according to the Commission services' Spring 2016 Forecast, it is projected to decrease to 2.0% in 2016 and to 1.6% in 2017, under a no-policy-change assumption, supported by the economic recovery. The gross public debt ratio decreased to 26.7% of GDP in 2015 and it is projected to increase to 28.1% of GDP in 2016 and to 28.7% of GDP in 2017. Based on the Commission's assessment of the 2016 Convergence Programme, Bulgaria is expected to broadly comply with the provisions of the Stability and Growth Pact. Nevertheless, further measures will be needed to ensure compliance in both 2016 and 2017. The Bulgarian fiscal framework has recently been strengthened by successive legislative steps, and the focus is now shifting towards implementation.

Graph 2b: **Bulgaria - Government budget balance and debt**
Inverted scale
(in percent of GDP)



(*) Commission services' Spring 2016 Forecast.
Source: Eurostat, Commission services.

Bulgaria does not fulfil the exchange rate criterion. The Bulgarian lev is not participating in ERM II. The Bulgarian National Bank pursues its primary objective

of price stability through an exchange rate anchor in the context of a Currency Board Arrangement (CBA). Bulgaria introduced its CBA in 1997, pegging the Bulgarian lev to the German mark and later the euro. Additional indicators, such as developments in foreign exchange reserves and short-term interest rates, suggest that investors' risk perception towards Bulgaria has remained favourable. A sizeable official reserves buffer continues to underpin the resilience of the CBA. During the two-year assessment period, the Bulgarian lev remained fully stable vis-à-vis the euro, in line with the operation of the CBA.

Bulgaria fulfils the criterion on the convergence of long-term interest rates. The average long-term interest rate in Bulgaria in the year to April 2016 was 2.5%, below the reference value of 4.0%. Long-term interest rates in Bulgaria declined from around 3.5% in early 2014 to around 2.5% by early 2015. Yield spreads vis-à-vis euro-area long-term benchmark bonds[14] increased significantly in the second half of 2014 partly linked to Bulgaria's banking problems, but then declined in 2015. The spread against the German benchmark bond widened again to some 230 basis points in early 2016.

Additional factors have also been examined, including balance of payments developments and integration of markets. Bulgaria's external balance recorded a significant surplus in 2015. The improvements in the trade and capital account balances from 2013 to 2015 more than counterbalanced the deterioration in the secondary income account. The Bulgarian economy is well integrated with the euro area through trade and investment linkages. On the basis of selected indicators relating to the business environment, Bulgaria performs worse than most euro-area Member States. Bulgaria's financial sector is well integrated with the EU financial sector, in particular through a high level of foreign ownership in its banking system. In the context of the Macroeconomic Imbalance Procedure, Bulgaria was subject to an in-depth review in 2016, which found that Bulgaria continues to experience excessive macroeconomic imbalances. The economy is characterised by remaining fragilities in the financial sector and high corporate indebtedness in a context of limited labour market adjustment.

3. THE CZECH REPUBLIC

In the light of its assessment on legal compatibility and on the fulfilment of the convergence criteria, and taking into account the additional relevant factors, the Commission considers that the Czech Republic does not fulfil the conditions for the adoption of the euro.

Legislation in the Czech Republic – in particular the Czech National Council Act No. 6/1993 Coll. on the Česká národní banka (the ČNB Law) – **is not fully compatible** with the compliance duty under Article 131 TFEU. Incompatibilities concern the independence of the central bank and central bank integration in the ESCB at the time of euro adoption with regard to the ČNB's objectives and the ESCB tasks laid down in Article 127(2) TFEU and Article 3 of the ESCB/ECB Statute. In

[14] Countries' long-term interest spreads vis-à-vis the euro-area long-term benchmark bonds (n.b. the German benchmark bond is used as a proxy for the euro area) are computed using the monthly series "EMU convergence criterion bond yields" published by Eurostat. The series is also published by the ECB under the name "Harmonised long-term interest rate for convergence assessment purposes".

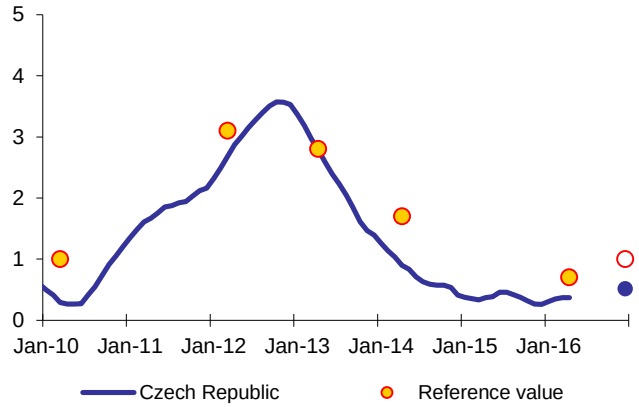
addition, the ČNB Law also contains imperfections relating to the prohibition of monetary financing and the ESCB tasks.

The Czech Republic fulfils the criterion on price stability. The average inflation rate in the Czech Republic during the 12 months to April 2016 was 0.4%, below the reference value of 0.7%. It is projected to remain below the reference value in the months ahead.

Price growth moderated significantly in 2014, with the annual HICP inflation rate slowing to 0.4% on average. This was mainly due to a large negative contribution from energy prices, reflecting the pass-through of a sharp decline in oil prices to domestic fuel prices, while the inflation contributions of food and services also declined. Inflation accelerated somewhat during the first half of 2015 but then slowed down again in the second half of the year amid renewed declines in food and energy prices. The annual HICP inflation rate thus averaged 0.3% in 2015. It picked up somewhat in early 2016 and stood at 0.5% in April 2016.

Inflation is projected to remain subdued in 2016 as the decline in oil and food prices during the second half of 2015 will continue to exert a dampening impact on the year-on-year rate. At the same time, domestic price pressures are expected to become stronger over the forecast horizon, particularly with regard to services prices. As a result, the Commission services' Spring 2016 Forecast projects annual HICP inflation to average 0.5% in 2016 and 1.4% in 2017. The price level in the Czech Republic (about 63% of the euro-area average in 2014) suggests potential for price level convergence in the long term.

Graph 3a: **Czech Republic - Inflation criterion since 2010**
(percent, 12-month moving average)

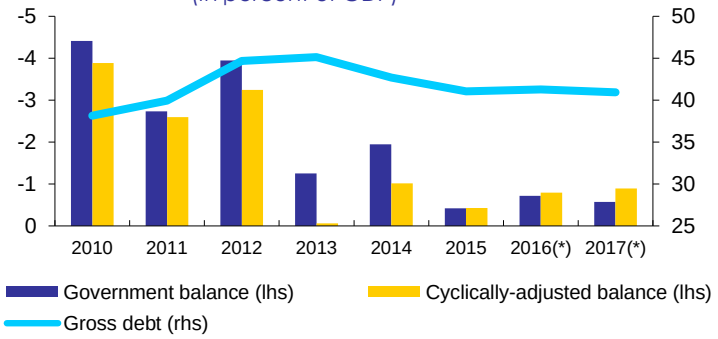


Note: The dots in December 2016 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2016 Forecast.

The Czech Republic fulfils the criterion on public finances. The Czech Republic is not the subject of a Council Decision on the existence of an excessive deficit. The general government deficit declined substantially from 1.9 % of GDP in 2014 to 0.4% of GDP in 2015. According to the Commission services' Spring 2016 Forecast, the general government deficit is projected at 0.7% of GDP in 2016 and to 0.6% in 2017, under a no-policy-change assumption. The gross public debt ratio declined from its peak of 45.1% of GDP in 2013 to 41.1% of GDP in 2015. It is projected to fall to 40.9% of GDP in 2017. Based on the Commission's assessment of the 2016

Convergence Programme, the Czech Republic is expected to comply with the provisions of the Stability and Growth Pact. The Czech Republic's fiscal framework is one of the weakest in the EU. Adoption of the reform package aimed at strengthening it has been repeatedly delayed, putting on hold the completion of transposition of the Directive on national budgetary frameworks into the Czech legal order, which was due by the end of 2013.

Graph 3b: **Czech Rep. - Government budget balance and debt**
Inverted scale (in percent of GDP)



(*) Commission services' Spring 2016 Forecast.
Source: Eurostat, Commission services.

The Czech Republic does not fulfil the exchange rate criterion. The Czech koruna is not participating in ERM II. The Czech Republic operates a floating exchange rate regime, allowing for foreign exchange market interventions by the central bank. On 7 November 2013, the ČNB announced that it would intervene on the foreign exchange market to weaken the koruna, so that its exchange rate against the euro was above 27 CZK/EUR. As a result, the koruna swiftly weakened from below 26 CZK/EUR to above 27 CZK/EUR. The koruna traded on average at around 27.5 CZK/EUR throughout 2014 and the first half of 2015, amid low volatility. It strengthened close to 27 CZK/EUR in mid-2015 and then remained near that lower bound set be the ČNB during the second half of 2015 and in early 2016. During the two years before this assessment, the koruna appreciated against the euro by some 1.6%.

The Czech Republic fulfils the criterion on the convergence of long-term interest rates. The average long-term interest rate in the Czech Republic in the year to April 2016 was 0.6%, well below the reference value of 4%. Long-term interest rates in the Czech Republic followed a downward trend from early 2014 up to April 2015, declining from above 2.4% to below 0.3%. Long-term interest rates jumped to above 1% in June 2015 but then declined again gradually throughout the second half of 2015. The spread against the German benchmark bond oscillated at around 25 basis points in early 2016.

Additional factors have also been examined, including balance of payments developments and integration of markets. The external balance of the Czech Republic remained in surplus over the last two years, increasing from below 1% of GDP in 2014 to above 3% of GDP in 2015. The Czech economy is highly integrated with the euro area through trade and investment linkages. On the basis of selected indicators relating to the business environment, the scores received by the Czech Republic in international rankings have improved in recent years, converging close to the euro-area average. The Czech financial sector is highly integrated into the EU

financial sector, in particular through a high degree of foreign ownership of financial intermediaries.

4. CROATIA

In the light of its assessment on legal compatibility and on the fulfilment of the convergence criteria, and taking into account the additional relevant factors, the Commission considers that Croatia does not fulfil the conditions for the adoption of the euro.

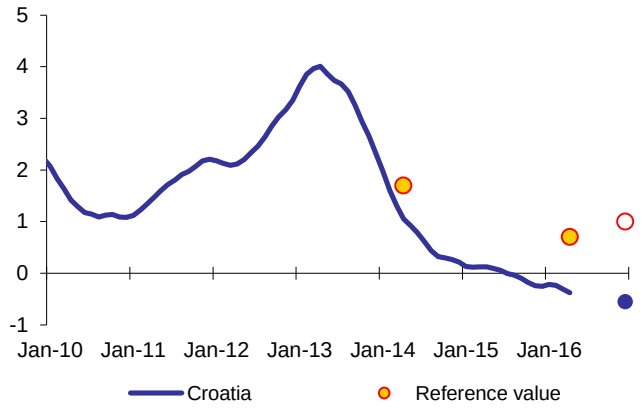
Legislation in Croatia is fully compatible with the compliance duty under Article 131 TFEU.

Croatia fulfils the criterion on price stability. The average inflation rate in Croatia during the 12 months to April 2016 was -0.4%, below the reference value of 0.7%. It is expected to fall well below the reference value in the months ahead.

Annual HICP inflation in Croatia averaged 0.2% in 2014 as declining prices of non-energy industrial goods and unprocessed food dampened growth of the headline rate. The inflation rate dropped into negative territory in December 2014 and then remained negative throughout most of 2015 due to rapidly falling energy prices. HICP inflation thus averaged -0.3% in 2015. It declined further in early 2016 and stood at -0.9% in April 2016.

According to the Commission services' Spring 2016 Forecast, annual HICP inflation is projected to remain negative throughout 2016 mainly as a result of falling energy prices. It is expected to turn positive in 2017 as the negative impact of lower energy prices fades out while continued economic expansion should support consumer price growth. Annual HICP inflation is thus forecasted to average -0.6% in 2016 and 0.7% in 2017. The price level in Croatia (about 65% of the euro-area average in 2014) suggests potential for further price level convergence in the long term.

Graph 4a: **Croatia - Inflation criterion since 2010**
(percent, 12-month moving average)

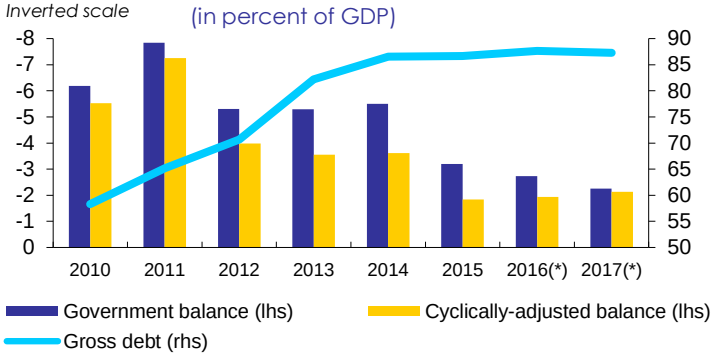


Note: The dots in December 2016 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2016 Forecast.

Croatia does not fulfil the criterion on public finances. Croatia is at present the subject of a Council Decision on the existence of an excessive deficit (Council

Decision of 28 January 2014), which the Council recommended to correct by 2016. After having increased to 5.5% of GDP in 2014, the general government deficit declined to 3.2% of GDP in 2015. The Commission services' Spring 2016 Forecast projects the deficit to decline to 2.7% of GDP in 2016 and 2.3% of GDP in 2017. The general government debt-to-GDP ratio is projected to peak at 87.6% of GDP in 2016 and then to decline slightly in 2017. Based on the Commission's assessment of the 2016 Convergence Programme, there is a risk that Croatia will not comply with the provisions of the Stability and Growth Pact. Therefore, further measures will be needed to ensure compliance in 2017. Despite some recent improvements, the Croatian fiscal framework remains relatively weak in terms of design and execution, mostly due to the magnitude and frequency of budget plan revisions, the extent of off-budget transactions and the insufficient safeguards regarding the independence of the national monitoring body.

Graph 4b: **Croatia - Government budget balance and debt**



(*) Commission services' Spring 2016 Forecast.
Source: Eurostat, Commission services.

Croatia does not fulfil the exchange rate criterion. The Croatian kuna is not participating in ERM II. The HNB operates a tightly managed floating exchange rate regime, using the exchange rate as the main nominal anchor to achieve its primary objective of price stability. International reserves held by the HNB hovered above EUR 12 billion throughout 2014. They increased to above EUR 14 billion in the first quarter of 2015 but then declined again and stood at some EUR 13.7 billion (31% of GDP) by end-2015. The kuna's exchange against the euro has remained broadly stable over the past two years, oscillating around 7.6 HRK/EUR. It continued to follow an intra-year pattern of temporarily appreciating in spring as a result of foreign exchange inflows generated by the tourism sector.

Croatia fulfils the criterion on the convergence of long-term interest rates. The average long-term interest rate in Croatia in the year to April 2016 was 3.7%, below the reference value of 4%. Long-term interest rates in Croatia declined from above 5% in early 2014 to about 3% in the second quarter of 2015 but then increased again to around 3.9% in the second half of 2015. The spread against the German benchmark bond stood at some 350 basis points in early 2016.

Additional factors have also been examined, including balance of payments developments and integration of markets. Croatia's external surplus (i.e. the combined current and capital account) increased significantly from 1% of GDP in 2014 to some 5.6% of GDP in 2015, partly as a result of losses incurred by foreign-owned banks due the legislated conversion of CHF loans. The Croatian economy is

well integrated with the euro area through trade and investment linkages. On the basis of selected indicators relating to the business environment, Croatia performs worse than most euro-area Member States. The financial sector is highly integrated into the EU financial system through foreign ownership of domestic banks. In the context of the Macroeconomic Imbalance Procedure, Croatia was subject to an in-depth review in 2016, which found that Croatia continues to experience excessive macroeconomic imbalances. Vulnerabilities were linked to high levels of public, corporate and external debt in a context of high unemployment.

5. HUNGARY

In the light of its assessment on legal compatibility and on the fulfilment of the convergence criteria, and taking into account the additional relevant factors, the Commission considers that Hungary does not fulfil the conditions for the adoption of the euro.

Legislation in Hungary - in particular the Law on the Magyar Nemzeti Bank (MNB) - **is not fully compatible** with the compliance duty under Article 131 TFEU. Incompatibilities notably concern the independence of the MNB, the prohibition of monetary financing and central bank integration into the ESCB at the time of euro adoption with regard to the ESCB tasks laid down in Article 127(2) TFEU and Article 3 of the ESCB/ECB Statute. In addition, the Law on the MNB also contains further imperfections relating to MNB integration into the ESCB.

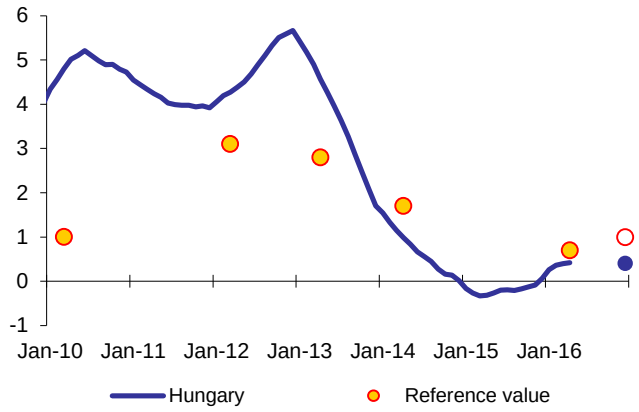
Hungary fulfils the criterion on price stability. The average inflation rate in Hungary during the 12 months to April 2016 was 0.4%, below the reference value of 0.7%. It is projected to remain below the reference value in the months ahead.

Annual HICP inflation in Hungary over the last two years reflected mainly global trends and was mostly driven by the fall in oil prices. It hovered around zero in 2014 and reached a trough of -1.4% at the beginning of 2015, as domestic demand generated no inflationary pressure, in the context of historically low inflation expectations. HICP inflation rose to 1% by end-2015, partly due to unprocessed food prices. In early 2016 inflation fell again, mainly thanks to a VAT cut on some meat products and another drop in the oil price. In April 2016, annual HICP inflation stood at 0.3%.

Inflation is projected to increase to 0.4% in 2016 and to 2.3% in 2017 according to the Commission services' Spring 2016 Forecast, mainly due to less favourable commodity price developments and strengthening domestic demand. The relatively low price level in Hungary (about 57% of the euro-area average in 2014) suggests potential for further price level convergence in the long term.

Graph 5a: **Hungary - Inflation criterion since 2010**

(percent, 12-month moving average)

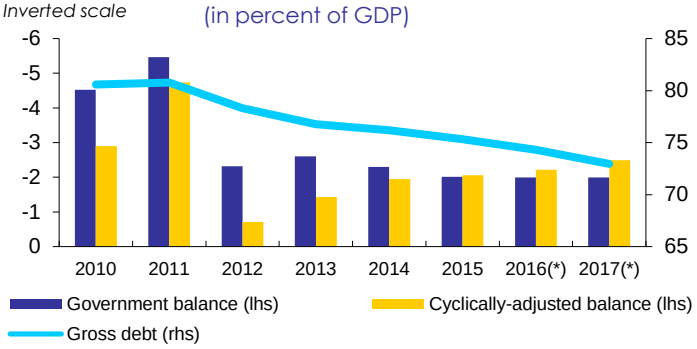


Note: The dots in December 2016 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2016 Forecast.

Hungary fulfils the criterion on public finances. Hungary is not the subject of a Council Decision on the existence of an excessive deficit. The general government deficit decreased from 2.6% of GDP in 2013 to 2.3% in 2014, due mainly to the increase in revenues. The deficit-to-GDP ratio decreased further to 2.0% in 2015 and according to the Commission services' Spring 2016 Forecast, it is projected to remain at that level in both 2016 and 2017, under a no-policy-change assumption. The gross public debt ratio decreased to 75.3% of GDP in 2015 and it is projected to decrease further to 74.3% of GDP in 2016 and to 73% of GDP in 2017[15]. Based on the Commission's assessment of the 2016 Convergence Programme, there is a high risk that Hungary will not comply with the provisions of the Stability and Growth Pact, as there is a high risk of a significant deviation from the required adjustment in 2016 as well as, under unchanged policies, in 2016 and 2017 taken together. Therefore further measures will be needed in both years to ensure compliance. The wide-ranging revamp of the Hungarian fiscal framework launched in 2011 is near to completion, but its effectiveness is yet to be established.

Graph 5b: **Hungary - Government budget balance and debt**

Inverted scale (in percent of GDP)



(*) Commission services' Spring 2016 Forecast, see also footnote 15.
Source: Eurostat, Commission services.

Hungary does not fulfil the exchange rate criterion. The Hungarian forint is not participating in ERM II. Hungary operates a floating exchange rate regime, allowing

[15] Eurostat has expressed a reservation on the quality of government finance data reported by Hungary in the April 2016 notification. This relates to the sector classification of Eximbank and would result in an increase of the government debt level for all years.

for foreign exchange market interventions by the central bank. The forint depreciated in summer 2014 to around 314 HUF/EUR, but regained those losses in the autumn, as the rate-cutting cycle was suspended in Hungary and the MNB provided foreign-currency liquidity for housing mortgage loan-related currency conversions. The forint weakened again in January 2015 (to 316.5 HUF/EUR), following the SNB's decision to let the Swiss franc appreciate. It then strengthened to around 299 in April in the wake of further monetary easing in the euro area, until the MNB responded with policy rate reduction in June 2015. From then on, the forint was broadly stable against the euro trading mostly in the range of 310 to 315. During the two years before this assessment, the forint depreciated against the euro by about 1%.

Hungary fulfils the criterion on the convergence of long-term interest rates. The average long-term interest rate in the year to April 2016 was 3.4%, below the reference value of 4.0%. The monthly average long-term interest rate declined from around 6% in early 2014 to close to 3% by early 2015, due to improving market confidence against the background of a global search for yields. Long-term interest rates temporarily rose to near 3.9% in mid-2015, together with rising US and euro-area yields, and were then fluctuating around 3.3% from autumn 2015. Long-term spreads vis-à-vis the German benchmark bond stood at some 290 basis points in April 2016.

Additional factors have also been examined, including balance of payments developments and integration of markets. The external balance recorded large surpluses over the past two years, increasing from around 6% of GDP in 2014 to almost 9% of GDP in 2015, reflecting mainly high absorption of EU funds. The balance-of-payments assistance granted to Hungary by the EU and the IMF in autumn 2008 was fully repaid by April 2016. The Hungarian economy is highly integrated with the euro area through trade and investment linkages. On the basis of selected indicators relating to the business environment, Hungary performs worse than most euro-area Member States. Hungary's financial sector is well integrated into the EU financial system.

6. POLAND

In the light of its assessment on legal compatibility and on the fulfilment of the convergence criteria, and taking into account the additional relevant factors, the Commission considers that Poland does not fulfil the conditions for the adoption of the euro.

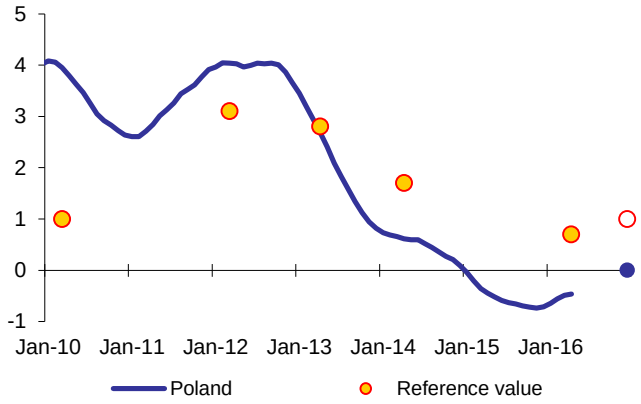
Legislation in Poland - in particular the Act on the Narodowy Bank Polski (NBP) and the Constitution of the Republic of Poland - **is not fully compatible** with the compliance duty under Article 131 TFEU. Incompatibilities concern the independence of the central bank, the prohibition of monetary financing and central bank integration into the ESCB at the time of euro adoption. In addition, the Act on the NBP also contains some imperfections relating to central bank independence and the NBP integration into the ESCB at the time of euro adoption.

Poland fulfils the criterion on price stability. The average inflation rate in Poland during the 12 months to April 2016 was -0.5%, below the reference value of 0.7%. It is expected to remain below the reference value in the months ahead.

Annual HICP inflation turned negative in August 2014 and decelerated to a minimum of -1.3% in February 2015, recovering gradually in early 2016. These developments were mainly driven by falling global oil and food prices. In April 2016, annual HICP inflation stood at -0.5%.

Inflation is expected to increase only gradually to 0.0% in 2016 and 1.6% in 2017 according to the Commission services' Spring 2016 Forecast. The low global inflation environment and subdued commodity prices should counteract positive impulses from the expected acceleration of wages. The relatively low price level in Poland (close to 55% of the euro-area average in 2014) suggests potential for further price level convergence in the long term.

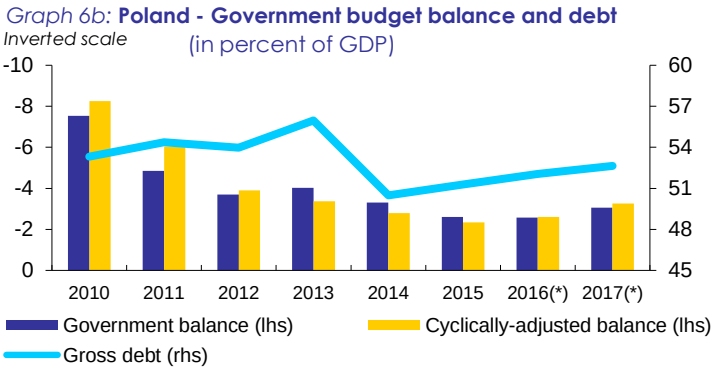
Graph 6a: **Poland - Inflation criterion since 2010**
(percent, 12-month moving average)



Note: The dots in December 2016 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2016 Forecast.

Poland fulfils the criterion on public finances. Poland is not the subject of a Council Decision on the existence of an excessive deficit. The general government deficit declined from 4.0% of GDP in 2013 to 3.3% in 2014, due to fiscal consolidation measures. The deficit-to-GDP ratio improved to 2.6% in 2015 and according to the Commission services' Spring 2016 Forecast it is projected to remain at 2.6% of GDP in 2016 and to widen to 3.1% in 2017, under a no-policy-change assumption. The general government debt-to-GDP ratio is forecast to increase from 51.3% in 2015 to 52.7% in 2017. Based on the Commission's assessment of the 2016 Convergence Programme, there is a risk that Poland will not comply with the provisions of the Stability and Growth Pact, as there is a risk of a significant deviation from the recommended adjustment both in 2016 and, under unchanged policies, in 2017. Therefore further measures will be needed to ensure compliance in 2016 and 2017. Poland remains the only EU country that does not have and does not plan to establish an independent fiscal council.

Graph 6b: **Poland - Government budget balance and debt**



(*) Commission services' Spring 2016 Forecast.
Source: Eurostat, Commission services.

Poland does not fulfil the exchange rate criterion. The Polish zloty is not participating in ERM II. Poland operates a floating exchange rates regime, allowing for foreign exchange market interventions by the central bank. After broadly stabilising until end-2014 in the range of 4.1-4.3 PLN/EUR, the zloty appreciated steeply until April 2015 to 4.0 PLN/EUR, supported by accelerating economic growth, ECB easing and end of the monetary easing cycle in Poland. It reversed the trend thereafter, affected by domestic political uncertainties. Exchange rate volatility in early 2016 was driven by factors such as a credit rating downgrade, global risks and compression of risk premia. Poland has benefited from a Flexible Credit Line arrangement with the IMF since 2009. Compared to April 2014, the exchange rate of the zloty against the euro was around 2.9% weaker in April 2016.

Poland fulfils the criterion on the convergence of long-term interest rates. The average long-term interest rate in the year to April 2016 was 2.9%, below the reference value of 4.0%. It declined from above 4% at the beginning of 2014 to around 3% in early 2015. It then went down to 2.7% during 2015 as market confidence improved and increased slightly at the beginning of 2016. As a result, long-term interest rate spreads vis-à-vis the German benchmark bond stood at around 280 basis points in early 2016.

Additional factors have also been examined, including balance of payments developments and integration of markets. Poland's external balance improved considerably in recent years and has been in surplus since 2013, driven by a strengthening trade balance. The Polish economy is well integrated with the euro area through trade and investment linkages. On the basis of selected indicators relating to the business environment, Poland performs worse than most euro-area Member States. Poland's financial sector is well integrated into the EU financial sector as confirmed by the substantial share of foreign-owned banks.

7. ROMANIA

In the light of its assessment on legal compatibility and on the fulfilment of the convergence criteria, and taking into account the additional relevant factors, the Commission considers that Romania does not fulfil the conditions for the adoption of the euro.

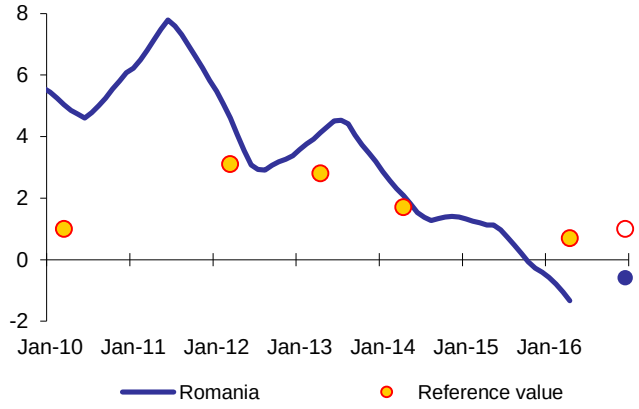
Legislation in Romania – in particular Law No. 312 on the Statute of the Bank of Romania (the BNR Law) – **is not fully compatible** with the compliance duty under Article 131 TFEU. Incompatibilities concern the independence of the central bank, the prohibition of monetary financing and central bank integration into the ESCB at the time of euro adoption. In addition, the BNR Law contains imperfections relating to central bank independence and to central bank integration in the ESCB at the time of euro adoption with regard to the BNR's objectives and the ESCB tasks laid down in Article 127(2) TFEU and Article 3 of the ESCB/ECB.

Romania fulfils the criterion on price stability. The average inflation rate in Romania during the 12 months to April 2016 was -1.3%, well below the reference value of 0.7%. It is projected to remain well below the reference value in the months ahead.

Annual HICP inflation has been on a downward path over the past two years, mainly driven by successive VAT cuts and low global oil prices, though underlying price pressures have been building amid strong domestic demand supported by fiscal stimulus and high wage growth. Inflation fluctuated between 1% and 2% for most of 2014, and moved into negative territory in June 2015 (-0.9%) following the cut of the VAT rate for some food products from 24% to 9%. The annual HICP inflation rate has been negative since then. HICP inflation was pushed down again by a reduction of the standard VAT rate by 4 pp. from January 2016 and stood at -2.6% in April 2016.

The Commission services' Spring 2016 Forecast projects annual HICP inflation to average -0.6% in 2016 and to rebound to 2.5% in 2017, once the transitory impact of the VAT rate cut for food products fades out, as the output gap closes and domestic pressures are mounting. Upside risks relate mainly to a stronger-than-expected build-up of domestic price pressures and acceleration of wage growth. The relatively low price level in Romania (around 52% of the euro-area average in 2014) suggests significant potential for further price level convergence in the long term.

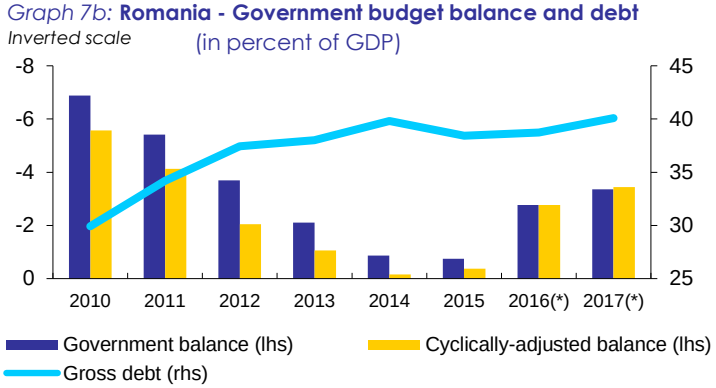
Graph 7a: **Romania - Inflation criterion since 2010**
(percent, 12-month moving average)



Note: The dots in December 2016 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2016 Forecast.

Romania fulfils the criterion on public finances. Romania is not the subject of a Council Decision on the existence of an excessive deficit. The general government deficit declined from 2.1% of GDP in 2013 to 0.9% in 2014, mainly due to expenditure restraint and better tax collection. The deficit-to-GDP ratio turned out at 0.7% in 2015 and according to the Commission services' Spring 2016 Forecast, it is projected to deteriorate to 2.8% of GDP in 2016 and to 3.4% in 2017, under a no-policy-change assumption. The general government debt ratio is expected to increase from 38.4% of GDP in 2015 to 40.1% of GDP in 2017. Based on the Commission's assessment of the 2016 Convergence Programme, there is a risk that Romania will not comply with the provisions of the Stability and Growth Pact, as there is a risk of a significant deviation both in 2016 and, under unchanged policies, 2017. Therefore further measures will be needed to ensure compliance in 2016 and 2017. Romania has adopted a comprehensive set of fiscal framework related provisions, but their disciplining effect is diminished by ineffective implementation.

Graph 7b: **Romania - Government budget balance and debt**



(*) Commission services' Spring 2016 Forecast.
Source: Eurostat, Commission services.

Romania does not fulfil the exchange rate criterion. The Romanian leu is not participating in ERM II. Romania operates a floating exchange rate regime, allowing for foreign exchange market interventions by the central bank. The leu's exchange rate against the euro showed relatively limited fluctuation between spring 2014 and early 2016, supported by the EU-IMF financial assistance programme until end-2015. The leu predominantly traded in the range of 4.4-4.5 RON/EUR during the assessment period. It weakened somewhat in late 2014, mainly due to an increase in global risk aversion, and firmed moderately at the beginning of 2015, supported by additional monetary easing in the euro area. It weakened again at the end of 2015 due to domestic political uncertainties but recovered in early 2016. Compared to April 2014, the exchange rate of the leu against the euro was basically unchanged in April 2016.

Romania fulfils the criterion on the convergence of long-term interest rates. The average long-term interest rate in Romania in the year to April 2016 was 3.6%, below the reference value of 4.0%. Long-term interest rates declined gradually from above 5% in spring 2014 to below 4% at the end of 2014 and were temporarily moving to below 3% in February 2015. They went up again in mid-2015 touching 4% and fluctuated around 3.5% thereafter. As a result, long-term interest rate spreads vis-à-vis the German benchmark bond declined from above 500 basis points in late 2012 to about 330 basis points in April 2016.

Additional factors have also been examined, including balance of payments developments and the integration of markets. Romania's external balance has been in surplus since 2013, reflecting, in particular, a lower merchandise trade deficit. Romania was a beneficiary of international financial assistance programmes during 2009-2015. The first two-year EU-IMF financial assistance programme in 2009 was followed by two successor programmes, granted in 2011 and 2013. Unlike the first programme, these were treated as precautionary, and no funding was requested. The Romanian economy is well integrated with the euro area through trade and investment linkages. On the basis of selected indicators relating to the business environment, Romania performs worse than most euro-area Member States. Romania's financial sector is well integrated into the EU financial system as confirmed by the substantial share of foreign-owned banks.

8. SWEDEN

In the light of its assessment on legal compatibility and on the fulfilment of the convergence criteria, and taking into account the additional relevant factors, the Commission considers that Sweden does not fulfil the conditions for the adoption of the euro.

Legislation in Sweden - in particular the Sveriges Riksbank Act, the Instrument of Government and the Law on the Exchange Rate Policy - **is not fully compatible** with the compliance duty under Article 131 TFEU. Incompatibilities and imperfections exist in the fields of independence of the central bank, prohibition of monetary financing and central bank integration into the ESCB at the time of euro adoption.

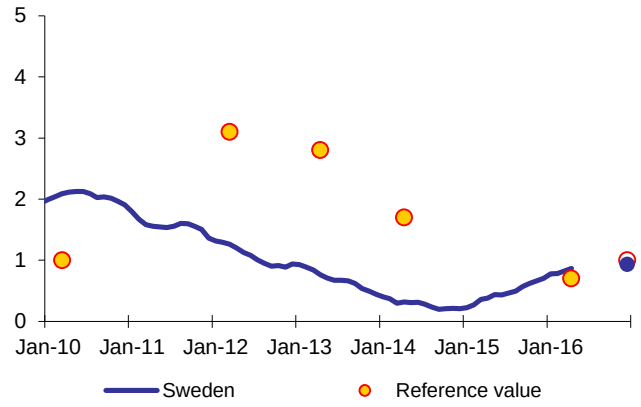
Sweden does not fulfil the criterion on price stability. The average inflation rate in Sweden during the 12 months to April 2016 was 0.9%, above the reference value of 0.7%. It is projected to return below the reference value in the months ahead.

Sweden's average inflation rate reached 0.7% in 2015, up from 0.2% in 2014, mainly due to krona depreciation, tax hikes as well as expanding domestic demand supported by an accommodative monetary policy. In April 2016, annual HICP inflation stood at 1.0%.

HICP inflation is likely to increase moderately in the course of 2016 on the back of currently strong growth, whereas low oil and commodity prices have a dampening effect. No particular upward pressure is foreseen from any HICP component and wage developments are projected to remain moderate. Accordingly, the Commission services' Spring 2016 Forecast projects annual average inflation at 0.9% in 2016 and 1.2% in 2017. The level of consumer prices in Sweden relative to the euro area gradually increased since Sweden's EU accession in 1995, reaching 124% in 2014.

Graph 8a: **Sweden - Inflation criterion since 2010**

(percent, 12-month moving average)



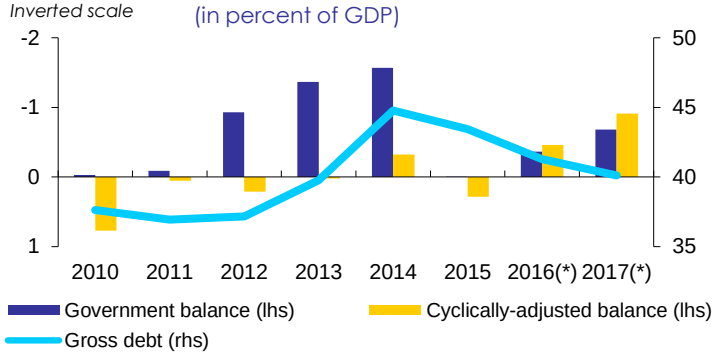
Note: The dots in December 2016 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2016 Forecast.

Sweden fulfils the criterion on public finances. Sweden is not the subject of a Council Decision on the existence of an excessive deficit. The general government balance improved from 1.6% of GDP in 2014 to 0.0% of GDP in 2015, reflecting mainly a strong rise in tax revenues, supported by buoyant private consumption and tax increases. According to the Commission services' Spring 2016 Forecast, the general government deficit is expected to reach 0.4% of GDP in 2016 and 0.7% in 2017. The gross general government debt ratio reached 43.4% of GDP in 2015 and is expected to gradually decline in the coming years to 41.3% of GDP in 2016 and 40.1% of GDP in 2017. Based on the Commission's assessment of the 2016 Convergence Programme, Sweden is expected to comply with the provisions of the Stability and Growth Pact. Sweden has a strong national fiscal framework, which is also reflected in its extensive track record of budgetary soundness.

Graph 8b: **Sweden - Government budget balance and debt**

Inverted scale

(in percent of GDP)



(*) Commission services' Spring 2016 Forecast.
Source: Eurostat, Commission services.

Sweden does not fulfil the exchange rate criterion. The Swedish krona is not participating in ERM II. Sweden operates a floating exchange rate regime, allowing for foreign exchange market interventions by the central bank. Between early-2013 and the beginning of 2015, the krona was on a depreciation trend, falling overall by almost 14% against the euro amid decisive monetary easing in Sweden. During the two years before this assessment, the krona depreciated against the euro by some 1.6%, fluctuating around on average 9.30 SEK/EUR.

Sweden fulfils the criterion on the convergence of long-term interest rates. The average long-term interest rate in Sweden in the year to April 2016 was 0.8%, well below the reference value of 4.0%. Swedish long-term interest rates continued declining in 2014, reaching an all-time low of 0.3% in April 2015, before recovering somewhat by early-2016. The spread vis-à-vis the German benchmark bond narrowed since early 2014 owing to a partial reversal of safe-haven flows from the euro area at the height of the crisis. The spread stood at some 68 basis points at the end of April 2016.

Additional factors have also been examined, including balance of payments developments and integration of markets. The surplus on Sweden's external balance has been relatively stable at around 6% since 2010. Sweden's economy is integrated with the euro area through trade and investment linkages. On the basis of selected indicators relating to the business environment, Sweden performs better than most euro-area Member States. Sweden's financial sector is well integrated into the EU financial sector, especially through inter-linkages in the Nordic-Baltic financial cluster. In the context of the Macroeconomic Imbalance Procedure, Sweden was subject to an in-depth review in 2016, which found that Sweden continues to experience macroeconomic imbalances.

Convergence Report 2016

Technical annex

1. INTRODUCTION

1.1. ROLE OF THE REPORT

The euro was introduced on 1 January 1999 by eleven Member States. Since then, Greece (2001), Slovenia (2007), Cyprus and Malta (2008), Slovakia (2009), Estonia (2011), Latvia (2014) and Lithuania (2015) have adopted the euro.

Those Member States which are assessed as not fulfilling the necessary conditions for the adoption of the euro are referred to as "Member States with a derogation". Article 140 of the Treaty lays down provisions and procedures for examining the situation of Member States with a derogation (Box 1.1). At least once every two years, or at the request of a Member State with a derogation, the Commission and the European Central Bank (ECB) prepare Convergence Reports for such Member States. Denmark and the United Kingdom negotiated opt-out arrangements before the adoption of the Maastricht Treaty ([16]) and do not participate in the third stage of EMU. Until these Member States indicate that they wish to participate in the third stage and adopt the euro, they are not the subject of an assessment as to whether they fulfil the necessary conditions.

In 2014, the Commission and the ECB adopted their latest regular Convergence Reports ([17]). Following the Convergence Reports and on the basis of a proposal by the Commission, the Council decided in July 2014 that Lithuania fulfilled the necessary conditions for adopting the euro as of 1 January 2015 ([18]). None of the other Member States assessed was deemed to meet the necessary conditions for adopting the euro.

In 2016, two years will have elapsed since the last regular reports were prepared. Denmark and the United Kingdom have not expressed a wish to enter the third stage of EMU. Therefore, this convergence assessment covers Bulgaria, the Czech Republic, Croatia, Hungary, Poland, Romania and Sweden. This Commission Staff Working Document is a Technical Annex to the Convergence Report 2016 and includes a detailed assessment of the progress with convergence.

The financial and economic crisis, along with the euro-area sovereign debt crisis, has exposed gaps in the economic governance system of the Economic and Monetary Union (EMU) and showed that its instruments need to be used more comprehensively. With the aim of ensuring a sustainable functioning of EMU, an overall strengthening of economic governance in the Union has been undertaken. Accordingly, this Commission Staff Working Document makes references where appropriate to procedures that help to strengthen the assessment of each Member States' convergence process and its sustainability. In particular, it incorporates references to the strengthened surveillance of macroeconomic imbalances (see sub-section 1.2.6.).

The remainder of the first chapter presents the methodology used for the application of the assessment criteria. Chapters 2 to 8 examine, on a country-by-country basis, fulfilment of the convergence criteria and other requirements in the order in which they appear in Article 140(1) (see Box 1.1). The cut-off date for the statistical data included in this Convergence Report was 18 May 2016.

1.2. APPLICATION OF THE CRITERIA

In accordance with Article 140(1) of the Treaty, the Convergence Reports shall examine the compatibility of national legislation with Articles 130 and 131 of the Treaty and the Statute of the European System of Central Banks (ESCB) and of the European Central Bank. The reports shall also examine the achievement of a high degree of sustainable convergence by reference to the fulfilment of the four convergence criteria dealing with price stability, public finances, exchange rate stability and long term interest rates as well as some additional factors. The four convergence criteria are developed further in a Protocol annexed to the Treaty (Protocol No 13 on the convergence criteria).

([16]) Protocol (No 16) on certain provisions relating to Denmark, Protocol (No 15) on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland.

([17]) European Commission, Convergence Report 2014, COM(2014) 326 final, 4 June 2014; European Central Bank, Convergence Report 2014, June 2014.

([18]) Council Decision of 23 July 2014 (OJ L 228, 31.7.2014, p. 29–32).

Box 1.1: **Article 140 of the Treaty**

"1. At least once every two years, or at the request of a Member State with a derogation, the Commission and the European Central Bank shall report 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 shall include an examination of the compatibility between the national legislation of each of these Member States, including the statutes of its national central bank, and Articles 130 and 131 and the Statute of the ESCB and of the ECB. The reports shall also examine the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of the following criteria:

— 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,

— 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),

— 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,

— 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.

The four criteria mentioned in this paragraph and the relevant periods over which they are to be respected are developed further in a Protocol annexed to the Treaties. 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.

2. After consulting the European Parliament and after discussion in the European Council, the Council shall, on a proposal from the Commission, decide which Member States with a derogation fulfil the necessary conditions on the basis of the criteria set out in paragraph 1, and abrogate the derogations of the Member States concerned.

The Council shall act having received a recommendation of a qualified majority of those among its members representing Member States whose currency is the euro. These members shall act within six months of the Council receiving the Commission's proposal.

The qualified majority of the said members, as referred to in the second subparagraph, shall be defined in accordance with Article 238(3)(a).

3. If it is decided, in accordance with the procedure set out in paragraph 2, to abrogate a derogation, the Council shall, acting with the unanimity of the Member States whose currency is the euro and the Member State concerned, on a proposal from the Commission and after consulting the European Central Bank, irrevocably fix the rate at which the euro shall be substituted for the currency of the Member State concerned, and take the other measures necessary for the introduction of the euro as the single currency in the Member State concerned."

1.2.1. Compatibility of legislation

In accordance with Article 140(1) of the Treaty, the legal examination includes an assessment of compatibility between a Member State's legislation, including the statute of its national central bank, and Article 130 and 131 of the Treaty. This assessment mainly covers three areas.

- First, the independence of the national central bank and of the members of its decision-making bodies, as laid down in Article 130, must be assessed. This assessment covers all issues linked to a national central bank's institutional financial independence and to the personal independence of the members of its decision-making bodies.

- Second, in accordance with Articles 123 and 124 of the Treaty, the compliance of the national legislation is verified against the prohibition of monetary financing and privileged access. The prohibition of monetary financing 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 central banks of Member States in favour of 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; and the purchase directly from these public sector entities by the ECB or central banks of debt instruments. As regards the prohibition on privileged access, the central banks, as public authorities, may not take measures granting privileged access by the public sector to financial institutions if such measures are not based on prudential considerations.

- Third, the integration of the national central bank into the ESCB has to be examined, in order to ensure that at the latest by the moment of euro adoption, the objectives of the national central bank are compatible with the objectives of the ESCB as formulated in Article 127 of the Treaty. The national provisions on the tasks of the national central bank are assessed against the relevant rules of the Treaty and the ESCB/ECB Statute.

1.2.2. Price stability

The price stability criterion is defined in the first indent of Article 140(1) of the Treaty: "the achievement of a high degree of price stability […] 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 the Protocol on the convergence criteria further stipulates that "the criterion on price stability […] 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 1.5 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".

Since national consumer price indices (CPIs) diverge substantially in terms of concepts, methods and practices, they do not constitute the appropriate means to meet the Treaty requirement that inflation must be measured on a comparable basis. To this end, the Council adopted on 23 October 1995 a framework regulation ([19]) setting the legal basis for the establishment of a harmonised methodology for compiling consumer price indices in the Member States. This process resulted in the production of the Harmonised Indices of Consumer Prices (HICPs), which are used for assessing the fulfilment of the price stability criterion.

As has been the case in past convergence reports, a Member State's average rate of inflation is measured by the percentage change in the arithmetic average of the last 12 monthly indices relative to the arithmetic average of the 12 monthly indices of the previous period. The reference value is calculated as the arithmetic average of the average rate of inflation of the three 'best-performing Member States in terms of price stability' plus 1.5 percentage points. Accordingly, the reference value is currently 0.7%, based on the data of Bulgaria (-1.0%), Slovenia (-0.8%) and Spain (-0.6%) over the 12-month period covering May 2015-April 2016. Cyprus and Romania were identified as outliers, as their inflation rates deviated by a wide margin from the euro area average reflecting country-specific economic circumstances (see Box 1.2).

The Protocol on the convergence criteria not only requires Member States to have achieved a high degree of price stability but also calls for a price performance that is sustainable. The requirement of sustainability aims at ensuring that the degree of price stability and inflation convergence achieved in previous years will be maintained after adoption of the euro. This deserves particular attention as the financial crisis exposed unsustainable price developments in many EU Member States, including euro area countries, in the pre-crisis period.

Inflation sustainability implies that the satisfactory inflation performance must essentially be due to the adequate behaviour of input costs and other factors influencing price developments in a structural manner, rather than reflecting the influence of cyclical or temporary factors. Therefore, this Technical Annex also takes account of the role of the macroeconomic situation and cyclical position in inflation performance,

([19]) Council Regulation (EC) No 2494/95 of 23 October 1995 concerning harmonised indices of consumer prices (OJ L 257, 27.10.1995, pp. 1-4), amended by Regulations (EC) No 1882/2003 and No 596/2009 of the European Parliament and of the Council.

Box 1.2: Assessment of price stability and the reference value

The numerical part of the price stability criterion implies a comparison between a Member State's average price performance and a reference value.

A Member State's **average rate of inflation** is measured by the percentage change in the unweighted average of the last 12 monthly indices relative to the unweighted average of the 12 monthly indices of the previous period, rounded to one decimal. This measure captures inflation trends over a period of one year as requested by the provisions of the Treaty. Using the commonly used inflation rate – calculated as the percentage change in the consumer price index of the latest month over the index for the equivalent month of the previous year – would not meet the one year requirement. The latter measure may also vary importantly from month to month because of exceptional factors.

The **reference value** is calculated as the unweighted average of the average rates of inflation of, at most, the three best-performing Member States in terms of price stability plus 1.5 percentage points. The outcome is rounded to one decimal. While in principle the reference value could also be calculated on the basis of the price performance of only one or two best performing Member States in terms of price stability, it has been existing practice to select the three best performers. Defining the reference value in a relative way (as opposed to a fixed reference value) allows to take into account the effects of a common shock that affects inflation rates across all Member States.

As Article 140(1) of the Treaty refers to 'Member States' and does not make a distinction between euro area and other Member States, the Convergence Reports select the three best performers from all Member States – EU-15 for the Convergence Reports before 2004, EU-25 for the reports between 2004 and 2006, EU-27 for reports between 2007 and 2013 and EU-28 for reports since 2014.

The notion of '**best performer in terms of price stability**' is not defined explicitly in the Treaty. It is appropriate to interpret this notion in a non-mechanical manner, taking into account the state of the economic environment at the time of the assessment. In previous Convergence Reports, when all Member States had a positive rate of inflation, the group of best performers in terms of price stability naturally consisted of those Member States which had the lowest positive average rate of inflation. In the 2004 report, Lithuania was not taken into account in the calculation of the reference value because its negative rate of inflation, which was due to country-specific economic circumstances, was significantly diverging from that of the other Member States, making Lithuania a de facto outlier that could not be considered as 'best performer' in terms of price stability. In 2010, in an environment characterised by exceptionally large common shocks (the global economic and financial crisis and the associated sharp fall in commodity prices), a significant number of countries faced episodes of negative inflation rates (the euro area average inflation rate in March 2010 was only slightly positive, at 0.3%). In this context, Ireland was excluded from the best performers, i.e. the only Member State whose average inflation rate deviated by a wide margin from that of the euro area and other Member States, mainly due to the severe economic downturn in that country. Outliers were also identified in 2013 (Greece) and 2014 (Greece, Bulgaria and Cyprus). At the current juncture, it is warranted to identify Cyprus and Romania as outliers, as their inflation rates deviated by a wide margin from the euro area average, driven by country-specific factors that limit their scope to act as meaningful benchmarks for other Member States. In case of Cyprus, deeply negative inflation mainly reflected the adjustment needs and exceptional situation of the economy. In case of Romania, it was mainly due to large VAT reductions. In April 2016, the 12-month average inflation rate of Cyprus and Romania were respectively -1.8% and -1.3% and that of the euro area 0.1%.

(Continued on the next page)

Box (continued)

Table 1:

Inflation reference value in previous and current Convergence Reports

Convergence Report adoption date	Cut-off month	Three best performers [1) 2)]	Reference value [3)]	Euro area average inflation rate [4)]
1998	January 1998	Austria, France, Ireland	2.7	1.5
2000	March 2000	Sweden, France, Austria	2.4	1.4
2002	April 2002	United Kingdom, France, Luxembourg [5)]	3.3	2.4
2004	August 2004	Finland, Denmark, Sweden	2.4	2.1
2006 May	March 2006	Sweden, Finland, Poland	2.6	2.3
2006 December	October 2006	Poland, Finland, Sweden	2.8	2.2
2007	March 2007	Finland, Poland, Sweden	3.0	2.1
2008	March 2008	Malta, Netherlands, Denmark	3.2	2.5
2010	March 2010	Portugal, Estonia, Belgium	1.0	0.3
2012	March 2012	Sweden, Ireland, Slovenia	3.1	2.8
2013	April 2013	Sweden, Latvia, Ireland	2.7	2.2
2014	April 2014	Latvia, Portugal, Ireland	1.7	1.0
2016	April 2016	Bulgaria, Slovenia, Spain	0.7	0.1

1) EU15 until April 2004; EU25 between May 2004 and December 2006; EU27 between January 2007 and June 2013; EU28 from July 2013 onwards.
2) In case of equal rounded average inflation for several potential best performers, the ranking is determined on the basis of unrounded data.
3) Reference values are only computed at the time of Convergence Reports. All calculations of the reference value between the Convergence Reports are purely illustrative.
4) Measured by the percentage change in the arithmetic average of the latest 12 monthly indices relative to the arithmetic average of the 12 monthly indices of the previous period.
5) Based on revised data, Germany would replace Luxembourg as one of the three Member States with the lowest 12-month average inflation in April 2002. This change would not affect the price and long-term interest rate reference values in April 2002.

Sources: Eurostat and Commission services.

developments in unit labour costs as a result of trends in labour productivity and nominal compensation per head, developments in import prices to assess how external price developments have impacted on domestic inflation. Similarly, the impact of administered prices and indirect taxes on headline inflation is also considered.

From a forward-looking inflation perspective, the report includes an assessment of medium-term prospects for price developments. The analysis of factors that have an impact on the inflation outlook – cyclical conditions, labour market developments and credit growth – is complemented by a reference to the most recent Commission services' forecast of inflation. That forecast can subsequently be used to assess whether the Member State is likely to meet the reference value also in the months ahead ([20]). Medium-term inflation prospects are also assessed by reference to the economies' key structural characteristics, including the functioning of the labour and product markets.

([20]) Based on the Commission services' Spring 2016 Forecast, the inflation reference value is forecast to stand at 1.0% in December 2016.

1.2.3. Public finances

The convergence criterion dealing with the government budgetary position is defined in the second indent of Article 140(1) of the Treaty as "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)". Furthermore, Article 2 of the Protocol on the convergence criteria states that this criterion means 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".

The convergence assessment in the budgetary area is thus directly linked to the excessive deficit procedure which is specified in Article 126 of the Treaty and further clarified in the Stability and Growth Pact (see Box 1.3 for further information on the excessive deficit procedure as strengthened by the 2011 reform of the Stability and Growth Pact). The details of the excessive deficit procedure are defined in Regulation 1467/97 as amended in 2005 and 2011 (under the "Six-Pack") which sets out the way in which government deficit and debt levels are assessed to determine

Box 1.3: **Excessive deficit procedure**

The excessive deficit procedure is specified in Article 126 of the Treaty, the associated Protocol on the excessive deficit procedure and Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure ([1]), which is the "corrective arm" of the Stability and Growth Pact. Together, they determine the steps to be followed to reach a Council decision on the existence and correction of an excessive deficit, which forms the basis for the assessment of compliance with the convergence criterion on the government budgetary position. As part of an overall strengthening of economic governance in the Union, Council Regulation (EC) No 1467/97 was amended in 2011. In particular, a numerical benchmark was introduced for operationalising the debt criterion in Article 126(2) of the Treaty.

Article 126(1) states that Member States shall avoid excessive government deficits. The Commission is required to monitor the development of the budgetary situation and of the stock of government debt in the Member States with a view to identifying gross errors (Article 126(2)). In particular, compliance with budgetary discipline is to be examined by the Commission on the basis of the following two criteria:

- whether the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value, specified in the Protocol on the EDP as 3 percent 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;
- whether the ratio of government debt to gross domestic product exceeds a reference value, specified in the Protocol on the EDP as 60 percent of GDP, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

According to the Protocol on the excessive deficit procedure, the Commission provides the statistical data for the implementation of the procedure. As part of the application of this Protocol, Member States have to notify data on government deficits, government debt, nominal GDP and other associated variables twice a year, before 1 April and before 1 October ([2]). After each reporting date, Eurostat examines whether the data are in conformity with ESA2010 ([3]) rules and related Eurostat decisions and, if they are, validates them.

The Commission is required to prepare a report if a Member State does not fulfil the requirements under one or both of the criteria given above (Article 126(3)). The report also has to take into account whether the government deficit exceeds government investment expenditure and all other relevant factors. These include developments in the medium-term economic position ([4]) the medium-term budgetary position of the Member State ([5]), in the medium-term government debt position ([6]), as well as any other factors which, in the opinion of the Member State concerned, are relevant and which the Member State has put forward.

The Council and the Commission shall make a balanced overall assessment of all the relevant factors. Those factors shall be taken into account in the steps leading to the decision on the existence of an excessive deficit

([1]) OJ L 209, 2.8.1997, p. 6. Regulation as amended by Regulation (EC) No 1056/2005 (OJ L 174, 7.7.2005, p. 5).
([2]) Council Regulation (EC) No 479/2009 on the application of the Protocol on the excessive deficit procedure (OJ L 145, 10.06.2009, p1), as amended.
([3]) Regulation (EU) No 549/2013 of the European Parliament and of the Council of 21 May 2013 on the European system of national and regional accounts in the European Union, OJ L 174, 26.6.2013, p 1–727).
([4]) In particular, potential growth, including the various contributions, cyclical developments, and the private sector net savings position.
([5]) In particular, the record of adjustment towards the medium-term budgetary objective, the level of the primary balance and developments in primary expenditure, the implementation of policies in the context of the prevention and correction of excessive macroeconomic imbalances and in the context of the common growth strategy of the Union, as well as the overall quality of public finances, in particular the effectiveness of national budgetary frameworks.
([6]) In particular, its dynamics and sustainability, including, risk factors including the maturity structure and currency denomination of the debt, stock-flow adjustment and its composition, accumulated reserves and other financial assets, guarantees, in particular those linked to the financial sector, and any implicit liabilities related to ageing and private debt, to the extent that it may represent a contingent implicit liability for the government.

(Continued on the next page)

Box (continued)

when assessing compliance on the basis of the debt criterion. When assessing compliance on the basis of the deficit criterion in a country with a debt ratio exceeding the reference value, those factors shall be taken into account in the steps leading to the decision on the existence of an excessive deficit subject to the double condition that the deficit is close to the reference value and its excess over it is temporary. Due consideration is foreseen for pension reforms introducing a multi-pillar system including a mandatory, fully-funded pillar and the net cost of the publicly managed pillar.

In the next step of the procedure, the Economic and Financial Committee (EFC) formulates an opinion on the Commission report, within at most two weeks after its publication (Article 126(4), Article 3.1 of Regulation 1467/97). If it considers that an excessive deficit exists or may occur, the Commission addresses an opinion to the Council (Article 126(5)). Then, on the basis of a Commission proposal and after an overall assessment, which includes any observation that the concerned Member State may have, the Council decides, whether an excessive deficit exists (Article 126(6)).

If the Council decides that an excessive deficit exists, it has to issue without delay a recommendation to the Member State concerned with a view to correcting the deficit within a given period (Article 126(7)). According to Regulation 1467/97, the Council recommendation has to specify when the correction of the excessive deficit should be completed, the annual budgetary targets that the Member State concerned has to achieve, and has to include a maximum deadline of six months for effective action to be taken by the Member State concerned. Within this deadline, the Member State concerned shall report to the Council on action taken. The report shall include targets for government expenditure and revenue and for the discretionary measures consistent with the Council's recommendation, as well as information on the measures taken and the nature of those envisaged to achieve the targets.

If effective action has been taken in compliance with a recommendation under Article 126(7) and, compared with the economic forecasts underlying the recommendation, unexpected adverse economic events with major unfavourable consequences for government finances occur subsequent to its adoption, the Council may decide, on a recommendation from the Commission, to adopt a revised recommendation under the same article, which may notably extend the deadline for the correction of the excessive deficit. In the case of severe economic downturn for the euro area or the EU as a whole, the Council may also decide, on recommendation by the Commission, to adopt a revised recommendation under Article 126(7), provided that this does not endanger fiscal sustainability in the medium term.

Where it establishes that there has been no effective action in response to its recommendations, the Council adopts a decision under Article 126(8) on the basis of a Commission recommendation immediately after the expiry of the deadline for taking action (or at any time thereafter when monitoring of the action taken by the Member State indicates that action is not being implemented or is proving to be inadequate). The provisions of Article 126(9 and 11), on enhanced Council surveillance and ultimately sanctions in case of non-compliance, as well as the new enforcement mechanisms introduced in 2011, are not applicable to Member States with a derogation (that is, those that have not yet adopted the euro), which is the case of the Member State considered in this report. Following a Council decision establishing, under Article 126(8), that the Member State did not take effective action in response to a Council recommendation under Article 126(7), the Council, on recommendation by the Commission, addresses to Member States with a derogation a new recommendation under Article 126(7).

When, in the view of the Council, the excessive deficit in the Member State concerned has been corrected, the Council abrogates its decision on the existence of an excessive deficit, again on the basis of a Commission recommendation (Article 126(12)).

More information about the EU fiscal surveillance framework could be found in the *Vade Mecum on the Stability and Growth Pact*, European Economy Institutional Paper 021, March 2016: http://ec.europa.eu/economy_finance/publications/eeip/pdf/ip021_en.pdf

whether an excessive deficit exists, under article 126 of TFEU. The convergence assessment in the budgetary area is therefore judged by whether the Member State is subject to a Council decision under 126(6) on the existence of an excessive deficit ([21]).

([21]) The definitions of the government deficit and debt used in this report are in accordance with the excessive deficit

Long-term sustainability of public finances deserves particular attention at a time when the financial crisis has significantly impacted on the fiscal positions and debt levels in many Member States. In response to this, economic governance in the EMU was substantially strengthened in 2011, which included, *inter alia*, the operationalisation of the debt criterion in the Excessive Deficit Procedure ([22]).

1.2.4. Exchange rate stability

The Treaty refers to the exchange rate criterion in the third indent of Article 140(1) as "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 the Protocol on the convergence criteria stipulates: "The criterion on participation in the exchange rate mechanism of the European Monetary System (…) shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of 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" ([23]). Based on the Council Resolution on the establishment of the ERM II ([24]), the European Monetary System has been replaced by the Exchange Rate Mechanism II upon the introduction of the euro, and the euro has become the centre of the mechanism.

In its assessment of the exchange rate stability criterion, the Commission takes into account developments in auxiliary indicators such as foreign reserve developments and short-term interest rates, as well as the role of policy measures, including foreign exchange interventions, and international financial assistance wherever relevant, in maintaining exchange rate stability.

In principle, the assessment of this criterion verifies the participation in ERM II and examines exchange rate behaviour within the mechanism. As currently none of the Member States assessed in this Convergence Report participates in ERM II, de facto exchange rate stability is reviewed for analytical purposes. The relevant period for assessing exchange rate stability in this Technical Annex is 19 May 2014 to 18 May 2016.

1.2.5. Long-term interest rates

The fourth indent of Article 140(1) of the Treaty requires "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 the Protocol on the convergence criteria further stipulates that "the criterion on the convergence of interest rates (…) 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" (see Box 1.4).

For the assessment of the criterion on the convergence of interest rates, yields on benchmark long-term bonds have been taken, using an average rate over the latest 12 months.

procedure, as was the case in previous convergence reports. These definitions are laid out in the amended Council Regulation (EC) No 479/2009. In particular, government debt is general government consolidated gross debt at nominal value. Information regarding the excessive deficit procedure and its application to different Member States since 2002 can be found at: http://ec.europa.eu/economy_finance/economic_governance/sgp/deficit/index_en.htm.

([22]) A directive on minimum requirements for national budgetary frameworks, two new regulations on macroeconomic surveillance and three regulations amending the Stability and Growth Pact and complementing it with new enforcement mechanisms for euro area Member States entered into force on 13 December 2011. Besides the operationalisation of the debt criterion in the Excessive Deficit Procedure mentioned in Box 1.3, the amendments introduced a number of important novelties in the Stability and Growth Pact, in particular an expenditure benchmark to complement the assessment of progress towards the country-specific medium-term budgetary objective.

([23]) In assessing compliance with the exchange rate criterion, the Commission examines whether the exchange rate has remained close to the ERM II central rate, while reasons for an appreciation may be taken into account, in accordance with the Common Statement on Acceding Countries and ERM2 by the Informal ECOFIN Council, Athens, 5 April 2003.

([24]) 97/C 236/03 of 16 June 1997, OJ C 236, 2.8.1997, p.5.

Box 1.4: **Data for the interest rate convergence**

The fourth indent of Article 140(l) of the Treaty requires that the durability of nominal convergence and exchange rate stability in Member States should be assessed by reference to long-term interest rates. Article 4 of the Protocol on the convergence criteria adds that these "Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions".

Article 5 of the Protocol requires that the Commission should provide the statistical data used for the application of the convergence criteria. However, in the context of the interest rate criterion, the ECB has developed the criteria for harmonising the series of yields on benchmark 10 year bonds on behalf of Eurostat and collects the data from the central banks. The selection of bonds for inclusion in this series is based on the following criteria:

- issued by central government;
- a residual maturity as close as possible to 10 years;
- adequate liquidity, which is the main selection criterion; the choice between a single benchmark or the simple average of a sample is based on this requirement;
- fixed coupon;
- yield gross of tax.

For sixteen Member States, the residual maturity of the benchmark bond is above 9.5 years. For eleven Member States, the residual maturity of the benchmark bond is below 9.5 years, in particular for Luxembourg with a residual maturity below 8 years. All yields are calculated on the basis of secondary market rates. For the Czech Republic and Germany a basket of bonds is used, while a single benchmark bond is used in twenty-five Member States. For Estonia, no appropriate harmonised series or proxy could be identified, primarily reflecting the very low level of Estonian government debt.

Data used in this Report can be found on Eurostat ("Maastricht criterion bond yields (mcby): EMU convergence criterion bond yields", code: tec00097). The same series is also published by the ECB's Statistical Data Warehouse (code IRS.M.*Country Code*.L.L40.CI.0000.*Currency Code*.N.Z).

The reference value for April 2016 is calculated as the simple average of the average long-term interest rates in Bulgaria (2.5%), Slovenia (1.8%) and Spain (1.8%), plus 2 percentage points, yielding a reference value of 4.0%.

1.2.6. Additional factors

The Treaty in Article 140 also calls for an examination of other factors relevant to economic integration and convergence. These additional factors include financial, product and labour market integration and the development of the balance of payments. The examination of the development of unit labour costs and other price indices, which is also prescribed by Article 140 of the Treaty, is covered in the section on price stability.

The assessment of additional factors gives an important indication of a Member State's ability to integrate into the euro area without difficulties. As regards the balance of payments, the focus is on the situation and development of the external balance ([25]). Market integration is assessed through trade, foreign direct investment and a smooth functioning of the internal market. Finally, progress in financial integration is examined, together with the main characteristics, structures and trends of the financial sector.

Starting with the 2012 Convergence Report, the convergence assessment is aligned with the broader European Semester approach which takes an integrated look at the economic policy challenges facing EMU in ensuring fiscal sustainability, competitiveness, financial market stability and economic growth.

([25]) The external balance is defined as the combined current and capital account (net lending/borrowing vis-à-vis the rest of the world). This concept permits in particular to take full account of external transfers (including EU transfers), which are partly recorded in the capital account. It is the concept closest to the current account as defined when the Maastricht Treaty was drafted.

Box 1.5: The Macroeconomic Imbalance Procedure (MIP)

The Macroeconomic Imbalance Procedure (MIP): key elements

A key lesson from the economic and financial crisis has been that the economic governance framework underpinning EMU needed to be further strengthened to address the issue of unsustainable macroeconomic trends. The procedure on prevention and correction of macroeconomic imbalances – the Macroeconomic Imbalance Procedure (MIP) – responds to this need and was one of the key elements of the legislative package (the "Six-Pack") to enhance the governance structures in EMU.

The overall design of the MIP provides for preventive action and corrective action for more serious cases. The procedure relies on a two-step approach where the first step consists of an alert mechanism that aims to identify Member States with potentially emerging macroeconomic imbalances and which require more in-depth investigation. If, on the basis of such an in-depth analysis (second step), the situation is considered unproblematic no further steps are taken. If the Commission however considers that macroeconomic imbalances exist, it may come forward with proposals for policy recommendations for the Member State concerned (which will be – in the preventive arm – part of the integrated package of recommendations under the European Semester). In case the in-depth review points to excessive imbalances in a Member State, the Council could declare the existence of an excessive imbalance and adopt a recommendation asking the Member State to present a Corrective Action Plan (CAP). Although the Commission had identified cases of excessive imbalances, the Excessive Imbalances Procedure has never been launched, as specific monitoring and decisive policy action has been deemed as sufficient response to these situations.

The alert mechanism scoreboard: design and rationale

The scoreboard is an element of the alert mechanism and is intended to facilitate the identification of potential imbalances that are under the scope of the MIP and require closer examination. In line with the different challenges facing the Member States, it comprises indicators of the external position (current account and net international investment position), competitiveness developments (real effective exchange rates, unit labour cost, export market shares) and indicators of internal imbalances (private sector and general government debt, private sector credit flow, change in total financial sector liabilities, house prices and four employment indicators). The scoreboard thus encompasses variables where both the economic literature and recent experiences suggest associations with economic crises, while indicative alert thresholds were identified for each indicator.

The 2016 Alert Mechanism Report (AMR) and In-Depth Reviews (IDR)

As the first step of the MIP process of 2016, the Commission published its fifth Alert Mechanism Report in November 2015. The AMR made an economic reading of the scoreboard, based on which 18 Member States were identified for the conduct of IDR. Five of them are Member States covered in this report (Bulgaria, Croatia, Hungary, Romania and Sweden). The Commission concluded that Hungary and Romania do not experience macroeconomic imbalances in the MIP sense. Sweden was found to be experiencing imbalances, while Bulgaria and Croatia are continuing to experience excessive imbalances.

The section on additional factors makes reference to the surveillance of macroeconomic imbalances under the Macroeconomic Imbalance Procedure, which was adopted in December 2011 as one of the key elements of the legislative package (the "Six-Pack") to enhance the governance structures in EMU, and integrates its results into the assessment (see Box 1.5).

2. BULGARIA

2.1. LEGAL COMPATIBILITY

2.1.1. Introduction

The legal basis for the Bulgarska narodna banka (BNB – central bank of Bulgaria), the Law on the Bulgarian National Bank (the BNB Law) of 1997, has been amended to some degree since the 2014 Convergence Report by repealing Article 14(2) of the BNB Law. The 2014 Convergence Report indicated that as regards the Governor such provision stipulating that "where the duties of a Governing Council member cease before the term of office has expired, another person shall be elected/appointed for the outstanding period of the term of office" was not in line with Article 14.2 of the ESCB/ECB Statute pursuant to which the term of office of a Governor shall be no less than five years. Further comments provided in the 2014 Convergence Report are largely repeated in this year's assessment.

2.1.2. Central Bank independence

Article 14(1) of the BNB Law does not accurately mirror the grounds for dismissal of the Governor set out exhaustively in Article 14.2 of the ESCB/ECB Statute.

Pursuant to Article 14(1) of the BNB Law, a member of the BNB Governing Council, including the Governor, may be relieved from office (1) "if he no longer fulfils the conditions required for the performance of his duties under Article 11(4)", (2) "if he is in practical inability to perform his duties for more than six months" or (3) "if he has been guilty of serious professional misconduct".

Whereas the second ground for dismissal is not provided in Article 14.2 of the ESCB/ECB Statute, the third dismissal ground provided in Article 14(1) of the BNB Law narrows down the concept of "serious misconduct" of Article 14.2 of the ESCB/ECB Statute to "serious professional misconduct". In order to remove these imperfections and limit interpretation problems, Article 14(1) of the BNB Law should be amended.

Furthermore, the ground for dismissal provided in the Conflict of Interest Prevention and Ascertainment Act of 2008 which has been applicable to the BNB Governor, Deputy Governors and the members of the BNB Managing Board since December 2010 has to be brought in line with Article 14.2 of the ESCB/ECB Statute. Article 33(1) in conjunction with Article 3(13) of the Conflict of Interest Prevention and Ascertainment Act provides that the breach of its provisions and the existence of a conflict of interest are grounds for dismissal. This incompatibility should be removed by specifying that a dismissal of the Governor is only admissible if, as set out in Article 14.2 of the ESCB/ECB Statute, the breach of the duty is a lack of fulfilment of the conditions required for the performance of the Governor's duties or is a serious misconduct of which the Governor has been guilty.

Pursuant to Article 12(1) of the BNB Law, the Governor shall be elected by the National Assembly. The National Assembly has taken the view that it has the power to annul or amend its decisions, including decisions under Article 12(1) of the BNB Law. The National Assembly has substantiated this assertion by stating that pursuant to a Constitutional Court decision of 26 February 1993, the Bulgarian Constitution does not explicitly prohibit the National Assembly from amending or annulling its decisions. Such understanding would allow the dismissal of the Governor under conditions other than those mentioned in Article 14.2 of the ESCB/ECB Statute. It should be ensured that the Governor, when properly elected or appointed, may not be dismissed under conditions other than those mentioned in Article 14.2 of the ESCB/ECB Statute.

Article 44 of the BNB Law should be amended with a view to achieving compatibility with Article 130 of the TFEU and Article 7 of the ESCB/ECB Statute. Pursuant to Article 44 of the BNB Law, the members of the Governing Council, in the performance of their tasks, shall be independent and shall not seek or take any instructions from the Council of Ministers or from any other body or institution. It should be clarified that this encompasses national, foreign and EU institutions or bodies. In this context, it is also noted that Article 3 of the BNB Law provides that "in the formulation of the general outlines of the monetary policy, the BNB and the Council of Ministers shall

inform each other". This procedure provides for the opportunity for the government to exert ex ante influence on the monetary policy of the BNB. As from the date of the formal adoption of the euro in Bulgaria or after the currency board agreement has been suspended this might constitute an incompatibility in the area of independence, with Article 130 of the TFEU and Article 7 of the ESCB/ECB.

2.1.3. Prohibition of monetary financing and privileged access

Article 45(1) and (2) of the BNB Law are not fully consistent with Article 123 of the TFEU and Article 21.1 of the ESCB/ECB Statute and thus should be amended.

Article 45(1) of the BNB Law provides that the BNB shall not extend credits and guarantees, including through purchase of debt instruments, to the Council of Ministers, municipalities, as well as to other governmental and municipal institutions, organizations and enterprises. Article 45(1) of the BNB Law should be amended with a view to including all entities mentioned in Article 123(1) of the TFEU and Article 21.1 of the ESCB/ECB Statute. Furthermore, while the prohibition of monetary financing does not allow the direct purchase of public sector debt, purchases on the secondary market are not prohibited unless they qualify as a circumvention of the objective of Article 123 of the TFEU. For this reason, the word 'direct' should be inserted in Article 45(1) of the BNB Law.

Pursuant to Article 45(2) in conjunction with Article 33(2) of the BNB Law, Article 45(1) of the BNB Law 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. The scope of this exemption should be amended to be fully consistent with the wording of Article 123(2) of the TFEU and Article 21.3 of the ESCB/ECB Statute.

2.1.4. Integration in the ESCB

Objectives

The objectives of the BNB are compatible with the Treaty on the Functioning of the European Union.

Tasks

The incompatibilities in the BNB Law are linked to the following ESCB/ECB tasks:

• definition of monetary policy and monetary functions, operations and instruments of the ESCB (Articles 2(1) and (3), 16(4) and (5), 28, 30, 31, 32, 33, 35, 38, 41 and 61 of the BNB Law);

• conduct of foreign exchange operations and the definition of foreign exchange rate policy (Articles 20(1), 28, 31, 32 of the BNB Law);

• right to authorise the issue of banknotes and the volume of coins (Articles 2(5), 16(9), 24 to 27 of the BNB Law);

• non-recognition of the role of the ECB in the field of international cooperation (Articles 5, 16(12) and 37(4) of the BNB Law);

• ECB's right to impose sanctions (Article 61, 62 of the BNB Law).

There are also numerous imperfections regarding:

• non-recognition of the role of the ECB in the functioning of the payment systems (Articles 2(4) and 40(1) of the BNB Law);

• non-recognition of the role of the ECB and the EU in the collection of statistics (Article 4(1) and 42 of the BNB Law);

• non-recognition of the role of the ECB and of the Council in the appointment of the external auditor (Articles 49(4) of the BNB Law);

• absence of an obligation to comply with the Eurosystem's regime for the financial reporting of NCB operations (Article 16(11), 46 and 49 of the BNB Law).

2.1.5. Assessment of compatibility

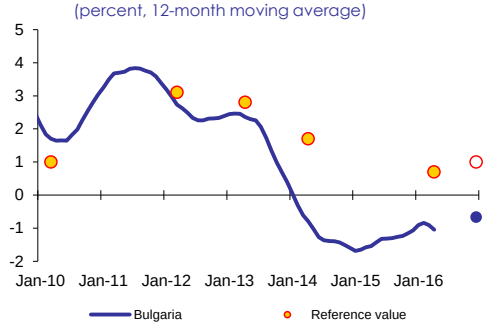
The BNB Law and the Conflict of Interest Prevention and Ascertainment Act are not fully compatible with Article 131 of the TFEU as regards central bank independence, the prohibition of monetary financing and the integration in the ESCB at the time of euro adoption.

2.2. PRICE STABILITY

2.2.1. Respect of the reference value

The 12-month average inflation rate, which is used for the convergence assessment, was well below the reference value at the time of the last convergence assessment of Bulgaria in 2014. Average annual inflation fell to -1.7% by January 2015, before starting to slowly rise again. In April 2016, the reference value was 0.7%, calculated as the average of the 12-month average inflation rates in Bulgaria, Slovenia and Spain plus 1.5 percentage points. The average inflation rate in Bulgaria during the 12 months to April 2016 was -1.0%, i.e. 1.7 percentage points below the reference value. The 12-month average inflation rate is projected to remain well below the reference value in the months ahead.

Graph 2.1: **Bulgaria - Inflation criterion since 2010**
(percent, 12-month moving average)

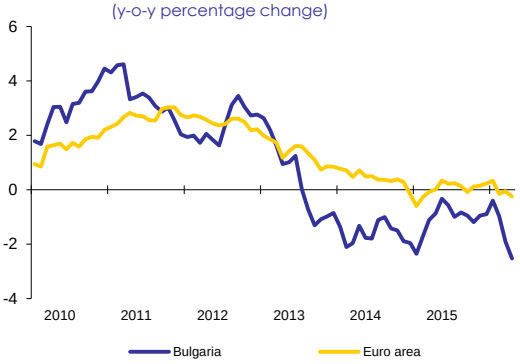


Note: The dots in December 2016 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2016 Forecast.

2.2.2. Recent inflation developments

The annual HICP inflation rate in Bulgaria has been negative since summer 2013. This was initially due to an unusually strong combination of disinflationary factors, i.a. a good harvest, administrative energy price reductions and declining import prices. Weak domestic demand and low inflation in the euro area sustained the disinflationary environment and falling oil commodity prices represented a new downward price shock in 2014 and 2015. The inflation rate reached its trough of -2.4% at the beginning of 2015 and then increased somewhat with the passing or even partial reversal of the above mentioned shocks. Headline inflation was approaching positive territory by early 2016, but it fell back sharply again in March and April, due mainly to unprocessed food and fuel prices. The inflation rate in Bulgaria has remained below that of the euro area throughout the past two years.

Graph 2.2: **Bulgaria - HICP inflation**
(y-o-y percentage change)



Source: Eurostat.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) stayed above headline inflation during most of 2014 and 2015, highlighting the effect of plunging energy prices on inflation. Core inflation bottomed out at -1.9% in late 2014 and increased to 0.4% by October 2015. It then reversed and turned negative again in early 2016, reaching -0.6% in April 2016. The components of core inflation had trended downwards over the past few years, reaching their lows at different points in 2014 and they demonstrated no clear trend since then. Processed food prices were the first to turn around, partly due to rising unprocessed food prices. After becoming positive again in April 2015, they reached 1.0% at end-2015. Non-energy industrial goods inflation reflected both lower import prices and weak domestic demand, as consumers have remained cautious in spending, despite the strong growth in real wages over the past years. It bottomed in autumn 2014 at -2.4%, but remained deeply negative even in early 2016. Services inflation was the lowest in November 2014 at -2.7%, and after increasing to 1.2% by October 2015, it fell back to -0.5% by April 2016. Negative producer price inflation confirmed the lack of cost pressures in 2014-2015 and reached about -4% in early 2016.

2.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and cyclical stance

The economic recovery has accelerated in Bulgaria with GDP growth of 1.5% in 2014 and 3% in 2015. Domestic demand had a good year in 2014, but its growth slowed somewhat in 2015, while net exports picked up. According to the Commission services' Spring 2016 Forecast, the main driver of Bulgaria's GDP growth is expected to shift

Table 2.1:
Bulgaria - Components of inflation (percentage change)[1] weights in total

	2010	2011	2012	2013	2014	2015	Apr-16	2016
HICP	3.0	3.4	2.4	0.4	-1.6	-1.1	-1.0	1000
Non-energy industrial goods	0.3	-0.4	-0.8	-1.5	-2.2	-1.6	-1.5	276
Energy	9.2	8.9	7.9	-1.7	-3.8	-6.7	-6.7	107
Unprocessed food	-1.6	1.6	4.4	4.4	-0.8	0.6	-1.0	75
Processed food	7.5	7.7	1.5	1.3	-0.4	0.6	1.1	214
Services	1.5	1.9	2.4	1.1	-1.3	0.1	0.2	328
HICP excl. energy and unproc. food	2.5	2.6	1.2	0.3	-1.3	-0.3	-0.1	818
HICP at constant taxes	2.1	3.2	2.4	0.4	-1.6	-1.1	-1.1	1000
Administered prices HICP	3.6	2.5	4.9	-1.1	-1.0	1.6	0.5	161

1) Measured by the arithmetic average of the latest 12 monthly indices relative to the arithmetic average of the 12 monthly indices in the previous period.

Sources: Eurostat, Commission services.

gradually back to domestic demand by 2017. The purchasing power of households has been buoyed by growth in real wages in a low-inflation environment and economic sentiment remains relatively high. Public investment is however expected to decrease in 2016, with the slowdown of the implementation of projects co-financed by the EU. GDP growth is forecast to moderate to 2% in 2016, before picking up to 2.4% in 2017. This relatively modest growth momentum would imply a persistent negative output gap.

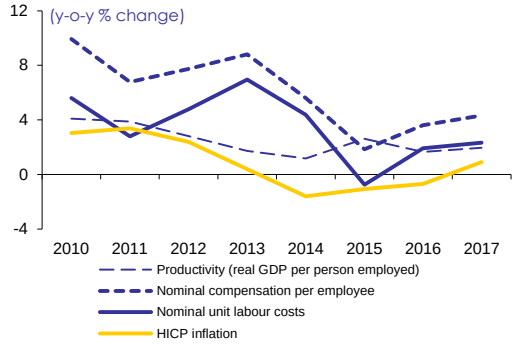
The fiscal stance, as measured by the change in the structural balance, has shifted over recent years. Following years of consolidation, the fiscal stance was expansionary in 2014 and broadly neutral in 2015. According to the Commission services' Spring 2016 Forecast, the structural balance is projected to remain broadly unchanged in 2016, but to tighten in 2017.

In the context of its currency board arrangement to the euro, most standard monetary policy instruments are not available to Bulgaria. In response to these limitations, the BNB has set relatively conservative liquidity and capital requirements on the banking sector. Bank interest rates decreased over the past two years, reflecting monetary easing in the euro area. However, private sector lending continued to stagnate, with new loans merely replacing maturing ones. The domestic banking crisis in 2014 caused disruption in financial intermediation. Overall, weak lending still contributes to the current low-inflation environment.

Wages and labour costs

The labour market has started to improve gradually over 2014-15. Employment increased by a moderate 0.4% in 2014 and 2015. This together with a decrease in the labour force, partly due to emigration, helped to reduce the unemployment rate from 13% in 2013 to about 9% in 2015. Nominal wage growth was dampened by negative inflation over the past few years, in particular in 2015, despite continuing wage convergence pressures and skills shortages in some sectors.

Graph 2.3: **Bulgaria - Inflation, productivity and wage trends**



Source: Eurostat, Commission services' Spring 2016 Forecast.

Labour productivity growth was weak in 2013-2014, as the decline in employment ended, but it picked up in 2015 with higher output growth. Nominal unit labour cost growth slowed down over the past two years, which mainly reflected the rapidly declining growth of nominal compensation per employee. Labour productivity growth is expected to remain moderate over 2016-17, given the gradual stabilisation of the labour market and the lack of sufficient new investment. According to the Commission services' Spring 2016 Forecast, ULC growth is projected to pick up again in 2016 and 2017, in line with the evolution of nominal compensation per employee.

Table 2.2:

Bulgaria - Other inflation and cost indicators **(annual percentage change)**

	2010	2011	2012	2013	2014	2015	2016[1)]	2017[1)]
HICP inflation								
Bulgaria	3.0	3.4	2.4	0.4	-1.6	-1.1	-0.7	0.9
Euro area	1.6	2.7	2.5	1.3	0.4	0.0	0.2	1.4
Private consumption deflator								
Bulgaria	2.4	4.5	3.6	-2.5	-0.1	-0.8	-0.7	0.9
Euro area	1.6	2.3	1.9	1.1	0.5	0.2	0.4	1.3
Nominal compensation per employee								
Bulgaria	9.9	6.8	7.7	8.8	5.6	1.8	3.6	4.3
Euro area	2.2	2.2	1.8	1.7	1.3	1.2	1.5	1.9
Labour productivity								
Bulgaria	4.1	3.9	2.8	1.7	1.2	2.6	1.7	2.0
Euro area	2.8	1.5	-0.1	0.6	0.3	0.6	0.5	0.8
Nominal unit labour costs								
Bulgaria	5.6	2.8	4.8	7.0	4.4	-0.7	1.9	2.3
Euro area	-0.6	0.6	1.9	1.1	1.0	0.7	0.9	1.1
Imports of goods deflator								
Bulgaria	8.5	9.0	3.8	-2.8	-2.9	-3.7	-3.0	1.6
Euro area	6.0	7.0	2.6	-2.0	-2.6	-3.6	-2.7	1.1

1) Commission services' Spring 2016 Forecast.

Source: Eurostat, Commission services.

External factors

Given the high openness of the Bulgarian economy, developments in import prices play an important role in domestic price formation. Global energy and food prices are particularly relevant for inflation, given their relatively large share in the consumer basket and the high energy intensity of the Bulgarian economy. Import prices (measured by the imports of goods deflator) had a strong disinflationary effect over the past three years, falling by nearly -3% per year. This reflects mainly the lower international oil price and the stronger nominal effective exchange rate of the lev. Import prices are expected to continue declining also in 2016. In particular, the fall in the oil price is expected to pass through to lower energy-related inflation. It should be noted that Bulgaria depends on a single source of gas supply and negotiates gas prices bilaterally, occasionally diverging from global price trends.

The nominal effective exchange rate of the lev (measured against a group of 36 trading partners) appreciated by about 4% from mid-2013 until early 2014, as some currencies of major trading partners depreciated against the euro (Turkish Lira, Russian Rouble, Romanian Leu). About half of this appreciation had been unwound by early 2016, but the stronger nominal effective exchange rate contributed to lower import prices over the assessment period. On the other hand, the depreciation of the euro (and hence of the lev) against the US dollar in 2014-2015 cushioned somewhat the disinflationary impact of lower oil prices.

Administered prices and taxes

The growth rate of administered prices ([26]) was above headline consumer price inflation in Bulgaria over the past two years, but indirect tax changes played overall a negligible role. The share of administered prices in the HICP basket is relatively high in Bulgaria at around 16% compared to 13% in the euro area. The annual change of administered prices turned from a 1% decline in 2014 to an increase of 1.5% in 2015. In particular, household electricity prices were increased in mid-2014 and in late 2014. Overall, administered prices raised headline inflation in 2014 by about 0.1 percentage points (by decreasing less than the headline) and in 2015 by about 0.5 percentage points.

([26]) According to the Eurostat definition, administered prices in Bulgaria include inter alia electricity and other regulated utility prices, pharmaceutical products, hospital services, part of public transport and education. For details, see http://ec.europa.eu/eurostat/documents/272892/272989/HICP-AP+classification+2015-02/023e5b4d-6300-47dc-b7aa-27d1e5013f3b

Indirect tax changes had on aggregate an insignificant effect on inflation over 2014-15. During this period, annual constant-tax HICP was on average at the same level as headline inflation. In early 2016, a tobacco excise tax increase took place, but annual constant-tax HICP was on average broadly at the same level as headline inflation during the assessment period.

Medium-term prospects

Annual HICP inflation is expected to rise gradually as the effect from the decline in commodity prices slowly tapers off; however it is to remain negative throughout the first three quarters of 2016. In the meantime, the weaker euro and the tightening domestic labour market conditions are expected to exert some upward price pressure. Accordingly, the Commission services' Spring 2016 Forecast projects HICP inflation to average -0.7% in 2016 and 0.9% in 2017.

Risks to the inflation outlook appear broadly balanced, with the most significant risks related to global energy and food price developments, given their relatively large share in the Bulgarian consumer basket. Additional inflation risk factors are core inflation movements elsewhere in the EU and administered prices changes.

The level of consumer prices in Bulgaria was at 47% of the euro area average in 2014. Over the long run, there is significant potential for further price level convergence, in line with the expected catching-up of the Bulgarian economy (Bulgaria's income level was at about 44% of the euro area average in PPS terms in 2014).

Medium-term inflation prospects will depend on wage and productivity developments, as well as on global commodity price trends. Tax policy is expected to have only a limited impact on inflation.

2.3. PUBLIC FINANCES

2.3.1. Recent fiscal developments

On 22 June 2012, the Council decided to abrogate the decision on the existence of an excessive deficit according to Article 126 (12) TFEU, thereby closing the excessive deficit procedure for Bulgaria ([27]). The general government deficit was kept well below the Treaty reference value of 3% of GDP in 2012 and in 2013. Although the general government deficit reached 5.4% of GDP in 2014, the Commission concluded in its November 2015 report in accordance with Art 126(3) of the TFEU that the excess over the reference value could be qualified as exceptional and temporary and also taking into account all relevant factors the opening of an EDP was not suggested ([28]). The expenditure-to-GDP ratio increased by 2.6 pp. between 2013 and 2015 to 40.2%, which was somewhat counterbalanced by an increase in the revenue ratio by 1.0 pp. of GDP to 38.2%. The increase in the expenditure ratio mainly reflects a higher investment ratio, partly stemming from increased absorption of EU funds. The higher revenue ratio reflects both more capital transfers from the EU and more tax revenue partly in light of enhanced tax collection.

The general government deficit in 2015 reached 2.1% of GDP, i.e. below the target of 2.8% of GDP in the 2015 Convergence Programme. The better outcome mainly reflects higher tax revenues, mostly attributable to improved tax administration. Those additional revenues more than offset various expenditure slippages, such as the incomplete implementation of the planned reduction of the public wage bill. In structural terms, the deficit improved by 0.1 pp. in 2015. As the output gap remained broadly unchanged (slight negative) in the period of 2013-2015, the actual growth performance had a neutral impact on the fiscal consolidation.

General government gross debt increased from 17.1% of GDP in 2013 to 27% of GDP in 2014. This reflected not only the underlying budget deficit in 2014 but also the pay-out of guaranteed deposits, support to the financial sector via a liquidity scheme and pre-financing for a roll-over of a large bond maturing in January 2015. The gross public debt ratio slightly decreased to 26.7% of GDP in 2015.

([27]) An overview of all excessive deficit procedures can be found at: http://ec.europa.eu/economy_finance/economic_governance/sgp/deficit/index_en.htm

([28]) The 2014 deficit was negatively affected by the statistical re-classification inside the general government of the Deposit Insurance Fund following the repayment of the guaranteed deposits in the Corporate Commercial Bank (KTB) amounting to around 3.0% of GDP.

Table 2.3:

Bulgaria - Budgetary developments and projections **(as % of GDP unless indicated otherwise)**

Outturn and forecast [1]	2010	2011	2012	2013	2014	2015	2016	2017
General government balance	-3.2	-2.0	-0.3	-0.4	-5.4	-2.1	-2.0	-1.6
- Total revenues	33.5	32.1	34.4	37.2	36.6	38.2	37.0	37.2
- Total expenditure	36.7	34.1	34.7	37.6	42.1	40.2	38.9	38.7
of which:								
- Interest expenditure	0.7	0.7	0.8	0.7	0.9	1.0	1.0	1.0
p.m.: Tax burden	26.4	25.5	26.7	28.0	28.1	29.8	30.1	30.3
Primary balance	-2.4	-1.3	0.5	0.3	-4.6	-1.1	-0.9	-0.5
Cyclically-adjusted balance	-2.6	-1.9	-0.1	-0.3	-5.2	-2.0	-1.8	-1.4
One-off and temporary measures	-0.1	0.0	0.0	0.0	-3.2	-0.1	0.0	0.0
Structural balance [2]	-2.5	-1.8	-0.1	-0.3	-2.0	-1.9	-1.8	-1.4
Government gross debt	15.5	15.3	16.8	17.1	27.0	26.7	28.1	28.7
p.m: Real GDP growth (%)	0.1	1.6	0.2	1.3	1.5	3.0	2.0	2.4
p.m: Output gap	-1.8	-0.4	-0.6	-0.3	-0.7	-0.3	-0.6	-0.5

Convergence programme	2016	2017	2018	2019
General government balance	-1.9	-0.8	-0.4	-0.2
Structural balance [2] [3]	-1.7	-0.5	-0.2	0.0
Government gross debt	31.7	31.2	31.8	30.8
p.m. Real GDP growth (%)	2.1	2.5	2.7	2.7

1) Commission services' Spring 2016 Forecast.

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

3) Commission services' calculations on the basis of the information in the programme. There are no one-off and other temporary measures in the programme.

Sources: Commission services, the 2016 Convergence Programme of Bulgaria

2.3.2. Medium-term prospects

The 2016 budget was adopted by Parliament on 2 December 2015. It aims at achieving a general government deficit of 1.9% of GDP based on a number of measures both on the revenue and on the expenditure side. First, strengthening of tax compliance in light of exercising fiscal control and forced collection of arrears is expected to increase tax revenues by ¼% of GDP. Increase in excise duty on fuel and cigarettes would imply higher revenues of 0.2% of GDP, which could be partly off-set by the fuel voucher system provided in the agriculture sector. Higher revenues from the hike of road tolls and the concession revenues related to the transport sector as well as the lower national co-financing related to the absorption of the EU-funds are partly counterbalanced by the budgeted higher public investments from own resources. According to the Commission services' Spring 2016 Forecast, the general government deficit is foreseen to be 2% of GDP.

In 2017, the Commission forecasts the general government balance to improve and achieve a deficit of 1.6% of GDP in light of some revenue increasing measures and of the economic growth. Taking into account the negative output gap estimated by 2017, the structural deficit is projected to be 1.4% of GDP. The public-debt-to-GDP ratio is forecast to increase from 27% in 2014 to around 29% by 2017.

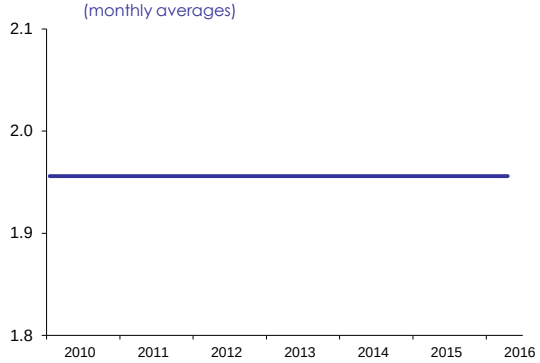
Bulgaria submitted the 2016 update of the Convergence Programme on 15 April 2016. The Programme aims at the gradual improvement of the general government balance from 1.9% of GDP in 2016 to 0.8% of GDP in 2017 and further to 0.2% of GDP in 2019. Also, the Programme targets the achievement of the medium-term objective of a structural deficit of 1% of GDP in 2017. In 2017, compared with the Commission forecast of 1.6% of GDP, the targeted improvement of the deficit is ambitious and specification of further deficit decreasing measures are likely to be needed to be achieved. Based on the assessment of the convergence programme and taking into account the Commission services' Spring 2016 Forecast, the Commission is of the opinion that Bulgaria is expected to broadly comply with the provisions of the Stability and Growth Pact. Further details can be found in the

Assessment of the 2016 Convergence Programme for Bulgaria ([29]).

As far as the national fiscal framework is concerned – which refers to numerical fiscal rules, medium-term budgetary frameworks, independent fiscal institutions, and budgetary procedures – the Bulgarian system has gradually been strengthened over the last few years, also driven by EU legal requirements. Bulgaria declared its intention to apply the provisions of the Fiscal Compact ([30]). The main milestones of the reform were the introduction of a wide set of numerical rules at the general government level, and an improved medium-term budgetary framework in 2014. Over the course of 2015, the reform process was continued by the stipulation of an automatic correction mechanism in case of a significant divergence from the targeted structural balance position as well as by the establishment of the Fiscal Council, entrusted with a broad mandate including monitoring compliance with national fiscal rules. The Fiscal Council members were appointed by Parliament at the end of 2015, however, the body is not yet fully operational.

2.4. EXCHANGE RATE STABILITY

Graph 2.4: **Bulgaria - BGN/EUR exchange rate**
(monthly averages)



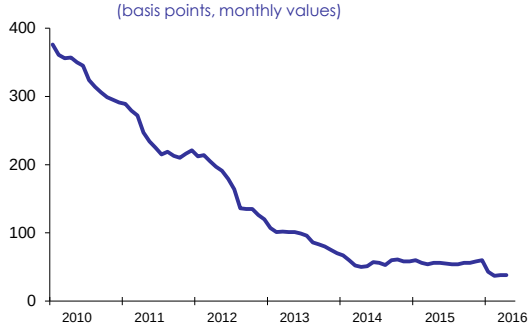
Source: ECB.

The Bulgarian lev does not participate in ERM II. The BNB pursues its primary objective of price stability through an exchange rate anchor in the context of a currency board arrangement (CBA). Bulgaria introduced its CBA on 1 July 1997, pegging the Bulgarian lev to the German mark and subsequently to the euro (at an exchange rate of 1.95583 BGN/EUR). Under the CBA, the BNB's monetary liabilities have to be fully covered by its foreign reserves. The BNB is obliged to exchange monetary liabilities and euro at the official exchange rate without any limit. The CBA serves as a key macroeconomic policy anchor.

Over the past two years, the CBA continued to operate in a challenging environment, with low nominal GDP growth, weak credit flows and contagion risks in the banking sector related both to the failing domestic banks and Greece. However, growing exports, a favourable external funding position of the banking sector and sizable reserve buffers have underpinned the resilience of the CBA.

Bulgaria's international reserves increased from around EUR 14 billion to over EUR 20 billion between mid-2014 and end-2015. International reserves were boosted by the issuance of EUR 3.1 billion in long-term, foreign-currency government debt in March 2015 and by BNB macroprudential action to reduce spill-over risks from Greece via the repatriation of banking sector foreign assets. International reserves covered around 144% of the monetary base, about 166% of short-term debt ([31]), 54% of broad money (M3) and about 46% of GDP as of end-2015. A high reserve coverage was deliberately built into the framework for Bulgaria's CBA, to cater for potential financial sector stress following the 1996-97 crisis.

Graph 2.5: **Bulgaria - 3-M Sofibor spread to 3-M Euribor**
(basis points, monthly values)



Source: Eurostat.

The BNB does not set monetary policy interest rates. The domestic interest rate environment is directly affected by the monetary policy of the euro area through the operation of Bulgaria's CBA. Short-term interest rate differentials vis-à-vis the

([29]) http://ec.europa.eu/economy_finance/economic_governance/sgp/convergence/index_en.htm

([30]) Title III of the intergovernmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union.

([31]) Based on estimated residual maturity

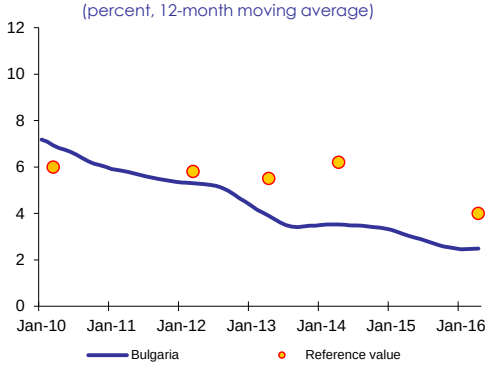
euro area were quite stable over the past two years. The 3-month spread hovered around 55 basis points till end 2015 and declined to around 40 basis points in early 2016.

2.5. LONG-TERM INTEREST RATES

For Bulgaria, the development of long-term interest rates over the current reference period is assessed on the basis of secondary market yields on a single benchmark government bond with a residual maturity of close to but below 10 years.

The Bulgarian 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion was below the reference value at the 2014 convergence assessment of Bulgaria. It declined from around 3.5% in mid-2014 to around 2.5% by end-2015. In April 2016, the latest month for which data are available, the reference value, given by the average of long-term interest rates in Bulgaria, Slovenia and Spain plus 2 percentage points, stood at 4.0%. In that month, the twelve-month moving average of the yield on the Bulgarian benchmark bond stood at 2.5%, i.e. about 1.5 percentage points below the reference value.

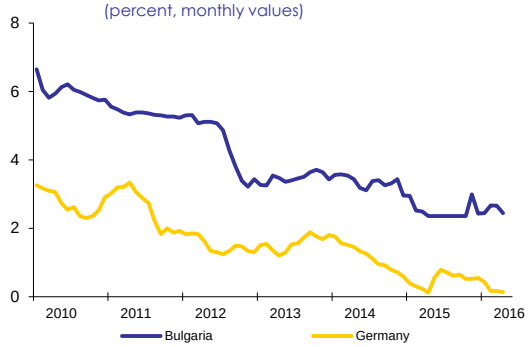
Graph 2.6: **Bulgaria - Long-term interest rate criterion**
(percent, 12-month moving average)



Source: Commission services.

The long-term interest rate of Bulgaria increased somewhat in mid-2014, partly reflecting its domestic banking sector problems. Bulgarian benchmark bond yields started to fall again at end-2014, as the political situation stabilised with the formation of a new government and depositors of KTB were finally able to access their frozen bank deposits. In early 2015, Bulgaria's long-term interest rate fell significantly, supported by strong demand for its government securities, partly due to the spill-over from the ECB's public sector asset purchase programme.

Graph 2.7: **Bulgaria - Long-term interest rates**
(percent, monthly values)



Source: Eurostat.

Spreads to the Bund increased by almost 100 basis points between mid-2014 and November 2014, partly reflecting Bulgaria's banking problems. Then they started to decline gradually, reaching post-2008 financial crisis lows in mid-2015, before rising again from late 2015, partly linked with the Fed's policy tightening. The spread to the German benchmark bond was at around 230 basis points in April 2016 ([32]).

2.6. ADDITIONAL FACTORS

The Treaty (Article 140 TFEU) calls for an examination of other factors relevant to economic integration and convergence to be taken into account in the assessment. The assessment of the additional factors – including balance of payments developments, product, labour and financial market integration – gives an important indication of a Member State's ability to integrate into the euro area without difficulties.

In November 2015, the Commission published its fifth Alert Mechanism Report (AMR 2016) ([33]) under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.5). The AMR 2016 scoreboard showed that Bulgaria exceeded the indicative threshold in four out of fourteen indicators, two in the area of external imbalances (i.e. the net international investment position and nominal unit labour cost) and two in the area of internal imbalances (i.e. unemployment and long-term unemployment rate). In line with the conclusion of the AMR 2016 (i.e. that imbalances had been identified for Bulgaria in the previous

([32]) The reference to the German benchmark bond is included for illustrative purposes, as a proxy of the euro area long-term AAA yield.

([33]) http://ec.europa.eu/europe2020/pdf/2016/ags2016_alert_mechanism_report.pdf

Table 2.4:

Bulgaria - Balance of payments **(percentage of GDP)**

	2010	2011	2012	2013	2014	2015
Current account	-1.7	0.3	-0.9	1.3	0.9	1.4
of which: Balance of trade in goods	-9.5	-6.6	-9.6	-7.0	-6.5	-4.3
Balance of trade in services	6.4	6.7	6.2	6.3	5.9	6.1
Primary income balance	-2.7	-3.9	-2.5	-3.8	-2.3	-4.1
Secondary income balance	4.0	4.1	5.0	5.7	3.8	3.7
Capital account	0.8	1.2	1.3	1.1	2.2	3.2
External balance [1)]	-1.0	1.6	0.5	2.4	3.1	4.6
Financial account [2)]	1.8	3.3	2.3	2.1	-0.7	6.3
of which: Direct investment	-2.5	-2.9	-2.6	-3.0	-2.1	-3.4
Portfolio investment	1.8	0.9	2.1	0.3	-2.8	-1.3
Other investment [3)]	3.2	4.9	-2.4	6.0	0.0	2.6
Change in reserves	-0.6	0.4	5.1	-1.3	4.2	8.4
Financial account without reserves	2.5	2.9	-2.8	3.4	-4.9	-2.1
Errors and omissions	2.8	1.7	1.8	-0.3	-3.8	1.7
Gross capital formation	22.9	21.6	22.1	21.4	21.4	21.3
Gross saving	20.9	22.0	20.8	22.9	24.2	23.2
Gross external debt	100.3	91.6	93.2	91.1	97.4	82.9
International investment position	-93.2	-83.4	-78.4	-73.5	-74.8	-60.7

1) The combined current and capital account.

2) The data is presented under BPM6 methodology, where the signs of financial account items are the opposite as under BPM5 (that was used in earlier Convergence Reports).

3) Including financial derivatives.

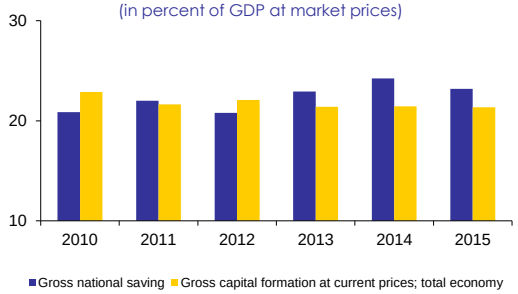
Sources: Eurostat, Commission services, Bulgarian National Bank.

MIP round), Bulgaria was subject to an in-depth review, which found that Bulgaria continued to experience excessive macroeconomic imbalances. The economy is characterised by remaining fragilities in the financial sector and high corporate indebtedness in a context of limited labour market adjustment.

2.6.1. Developments of the balance of payments

Bulgaria's external balance (i.e. the combined current and capital account) has been in surplus since 2011, following a rapid adjustment from deficits above 20% of GDP in 2007-08. The surplus of the external balance reached 3.1% of GDP in 2014 and rose to 4.6% of GDP in 2015, partly due to strong export growth. The latter was also reflected in the trade balance of goods, which although still negative has improved strongly in 2015, by more than two percentage points of GDP. The trade balance in services has remained positive owing to stable growth in the tourism, transportation and business process outsourcing sectors and reached about 6% of GDP both in 2014 and 2015. The capital account surplus also increased in the last couple of years, from 1.1% of GDP in 2013 to over 3% of GDP in 2015, mainly due to an increase in the absorption of EU funds. The primary income balance stayed negative, reflecting the negative net international investment position, but it was counterbalanced by a surplus of secondary income.

Graph 2.8: **Bulgaria - Saving and investment**
(in percent of GDP at market prices)



Source: Eurostat, Commission services.

The large saving-investment gap of the Bulgarian economy observed in 2007-08 closed by 2013. Gross national saving was supported by households and companies, and reached around 23% of GDP both in 2013 and 2015. On the other

Table 2.5:

Bulgaria - Market integration

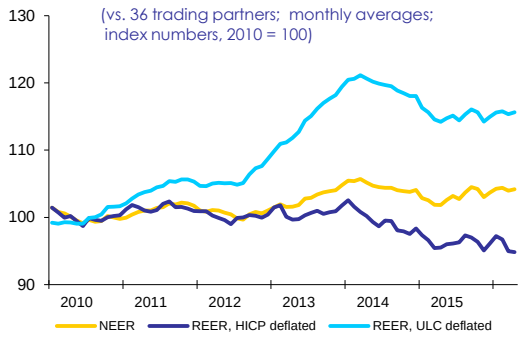
	2010	2011	2012	2013	2014	2015
Trade openness [1] (%)	56.2	62.9	66.3	68.3	69.1	69.3
Trade with EA in goods & services [2)+3)] (%)	24.6	28.0	28.8	29.7	30.7	31.5
Export performance (% change) [4]	7.1	5.6	0.8	7.5	-3.4	5.8
World Bank's Ease of Doing Business Index rankings [5]	57	59	66	58	36	38
WEF's Global Competitiveness Index rankings [6]	71	74	62	57	54	54
Internal Market Transposition Deficit [7] (%)	0.4	0.9	0.6	0.3	0.9	0.7
Real house price index [8]	100.0	90.4	85.6	85.9	87.2	90.3
Residential investment [9] (%)	2.7	2.3	1.7	1.7	1.6	1.6

1) (Imports + Exports of goods and services / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics, Balance of Payments).
2) (Imports + Exports of goods with EA-19 / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).
3) Trade in services with EA-19 (average credit and debit in % of GDP at current prices) (Balance of Payments).
4) Index for exports of goods and services divided by an index for growth of markets (percentage change on preceding year).
5) New methodology as of 2014 (World Bank).
6) (World Economic Forum)
7) Percentage of internal market directives not yet communicated as having been transposed, relative to the total. (Nov. data, May in 2013 and 2015).
8) Deflated house price index (2010=100), Eurostat.
9) Gross capital formation in residential buildings (in % of GDP), Eurostat.

Sources: Eurostat, World Bank, World Economic Forum, Commission services.

hand, private investment remained low, as negative inflation, which started in mid-2013, increased the burden of debt-servicing. In addition, the still unsupportive business environment and increased perceived risks from the financial sector turmoil in 2014 influenced the investment climate negatively. Meanwhile, the public sector increased its investment in 2014-2015, thanks mainly to EU funds.

Graph 2.9: **Bulgaria - Effective exchange rates**



Source: Commission services.

Competitiveness seems to have been preserved in the past two years, although relevant indicators show a somewhat mixed picture. The real effective exchange rate, deflated by ULC, appreciated significantly between mid-2012 and early 2014. It then depreciated for about a year and has stabilised since early 2015. After a long period of improvement, Bulgaria's export performance deteriorated in 2014, before it picked up again in 2015.

The financial account without official reserves recorded significant net inflows in 2014 and 2015. Net FDI inflows have remained at low levels by pre-crisis standards, reaching around 2% of GDP in 2014 and 3% of GDP in 2015. The net inflow of portfolio investment in 2014 and 2015, reflected i.a. increased government borrowing. The positive balance of net other inflows in 2015 represented mainly the build-up of foreign assets of the banking sector. Although still high, gross external debt has improved further in the past two years, from about 91% of GDP in 2013 to around 83% of GDP in 2015, due to reduced foreign liabilities of the banking sector and some corporate deleveraging. The net international investment position has also improved, from around 73% of GDP in 2013 to around 61% of GDP in 2015.

According to the Commission services' Spring 2016 Forecast, the external surplus is projected at 3.5% of GDP 2016 and at 3.8% of GDP in 2017.

2.6.2. Market integration

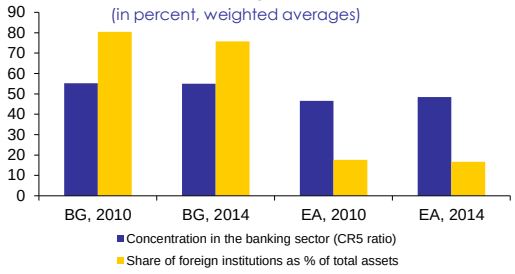
The Bulgarian economy is well integrated with the euro area through trade and investment linkages. As a small open economy, Bulgaria is characterised by a high ratio of trade openness, which increased from a low post-crisis level of 56% in 2010 to around 69% in 2015. Trade with the euro area expressed in percentage of GDP reached about 31% in 2015. Beyond the euro-area, the main trading partners are Romania, Russia and Turkey.

The stock of FDI in Bulgaria amounted to some 80% of GDP in 2014, with FDI mainly originating in the Netherlands, Austria, the UK and Greece. The main recipient sectors of FDI were services (chiefly real estate, renting and business activities, financial intermediation and trade) and to a lesser extent manufacturing (17% of the total) and construction.

Concerning the business environment, Bulgaria performs in general worse than most euro-area Member States in international rankings. The difference to the euro-area average is more pronounced based on the WEF's Global Competitiveness Index than on the World Bank's Ease of Doing Business indicator, but Bulgaria's position deteriorated with the latter in 2015. Public administration as a whole scores relatively poorly according to the World Bank's Worldwide Governance Indicators. According to the May 2015 Internal Market Scoreboard, Bulgaria's transposition deficit of EU Directives was at 0.7% which is above the target (0.5%) proposed by the European Commission in the Single Market Act (2011).

The Bulgarian labour market adjusted to the economic shock of 2008-2013 by shedding labour rather than by lowering wages, in a context of generally flexible wage-setting conditions. Following the initial labour shedding, the economy has not been able to absorb the available supply of labour because of structural issues, including the employability effects of long-term unemployment and skills mismatches. The Bulgarian labour market was characterised by persistent emigration, which is fundamentally driven by the large income gap with other EU Member States.

Graph 2.10: **Bulgaria - Foreign ownership and concentration in the banking sector**

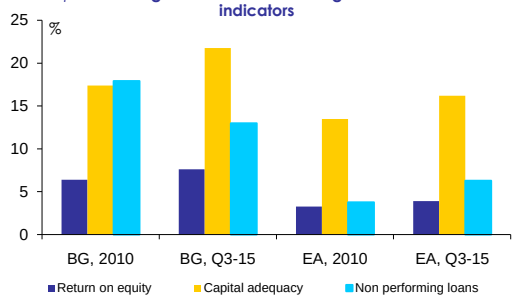


Source: ECB, Structural financial indicators.

Bulgaria's financial sector is well integrated with the EU financial sector, in particular through a high level of foreign ownership in its banking system. The share of foreign-owned institutions in total bank assets reached 76% in 2014. Bank concentration, as measured by the market share of the five largest credit institutions in total assets, remained somewhat above the euro area average in 2014.

The banking system came under strong liquidity pressure in June 2014 due to deposit withdrawals by individuals and firms. This led to placing the fourth-largest bank, Corporate Commercial Bank (KTB), and its subsidiary in a regime of special supervision. In addition, the third-biggest bank, First Investment Bank, required state liquidity aid. Guaranteed deposits of KTB became available only in December 2014, more than five months after its banking activities were suspended. Nevertheless, public confidence in banks appears to have recovered and deposit flows have normalised since the summer 2014 liquidity crisis. The deposit-guarantee and bank-resolution frameworks were strengthened with the transposition of the relevant EU directives into national law.

Graph 2.11: **Bulgaria - Selected banking sector soundness indicators**

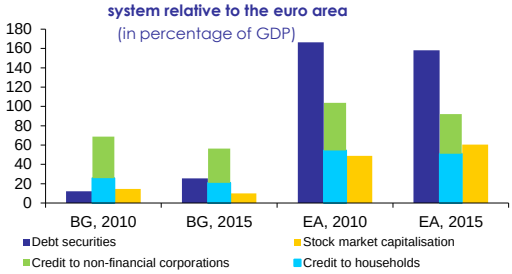


Source: ECB, EC calculations.

Based on the available data, the capital adequacy of the banking sector measured by standard regulatory ratios is somewhat higher than in the euro area. The average capital adequacy ratio stood close to 22% in September 2015. The deterioration of the loan portfolio that started in 2008 has halted, but the share of non-performing loans still reached 13% at end-September 2015, well above the euro-area average. Profitability of the domestic banking sector remained above the euro-area level, with average return on equity (RoE) above 4% in 2014. However, a robust assessment of the soundness of the banking sector can only be made based on the results of the ongoing asset quality review and stress test, which are expected to end in August. Similar reviews are currently being conducted in the insurance and pension fund sectors.

After the pre-2009 boom, real house prices in Bulgaria fell till 2012. There has been a slow recovery since then, but the real house price index reached still only 90.3% of its 2010 level in 2015. Residential investment hovered below 2% of GDP in recent years as the stock of loans for house purchases decreased in 2014-2015.

Graph 2.12: **Bulgaria - Recent development of the financial system relative to the euro area**
(in percentage of GDP)



Note: Debt Securities other than shares, excluding financial derivatives.
Source: ECB, Commission services.

The financial system in Bulgaria is smaller relative to GDP than that of the euro area. Domestic bank credit stood at around 56% of GDP in 2015, with the majority of it denominated in foreign-currencies. The capitalization of the stock market reached less than 10% of GDP in 2015, well below the euro-area average of 60%. The debt securities market remains small in comparison with the euro area average (25% vs. 158% of GDP) and is mainly used for financing a part of Bulgaria's relatively low public debt. The consolidated stock of private sector debt at 124% of GDP in 2014 was somewhat below the euro-area average of 138%.

3. CZECH REPUBLIC

3.1. LEGAL COMPATIBILITY

3.1.1. Introduction

Česká národní banka (ČNB – Czech national bank) was established on January 1, 1993. Its main legal basis is the Czech National Council Act No. 6/1993 Coll. on the Czech National Bank, adopted on 17 December 1992 (the ČNB Law).

Following the Convergence Report 2014, the ČNB Law was amended by several laws. ([34]) However, since there have been no amendments as regards the incompatibilities highlighted in the Commission's 2014 Convergence Report, the comments made in the latter are largely repeated in this year's assessment.

3.1.2. Central Bank independence

Article 9(1) of the ČNB Law prohibits the ČNB and its Board from taking instructions from the President of the Czech Republic, Parliament, the Government, administrative authorities, European Union institutions, any government of a Member State of the European Union or any other body.

Further, Article 9(1) of the ČNB Law needs to be adapted to fully reflect the provisions of Article 130 of the TFEU and Article 7 of the Statute and consequently expressly prohibit third parties from giving instructions to the ČNB and its Board members who are involved in the performance of ESCB-related tasks.

The power for the Chamber of Deputies of the Parliament to impose modifications to the annual financial report which was previously submitted and rejected (Article 47(5) of the ČNB Law) could hamper the ČNB's institutional independence. Moreover, it is formulated in a very general manner which could create situations where the Parliament requests changes affecting the financial independence of the ČNB. Thus, the current wording of Article 47(5) of the ČNB Law constitutes an incompatibility which should be removed from the Act.

Article 6(10) of the ČNB Law provides that members of the Bank Board, which also includes the Governor, may be relieved from office only if they no longer fulfil the conditions required for the performance of their duties or if they have been guilty of serious misconduct. Although article 6(10) of the ČNB Law extends the protection offered by article 14.2 of the ESCB/ECB Statute to Governors against arbitrary dismissal to all Bank Board members of the ČNB, it remains silent on the Governor's right in case of dismissal to seek a remedy before the Court of Justice of the European Union. However, pursuant to footnote 22, the Commission understands that the possibility to seek legal redress by the Governor before the ECJ, as enshrined in article 14.2 of the ESCB/ECB Statute, would apply. However, the ČNB Law would benefit from a more explicit clarification. .

Pursuant to Article 11(1) of the ČNB Law, the Minister of Finance or another nominated member of the Government may attend the meetings of the Bank Board in an advisory capacity and may submit motions for discussion. Article 11(2) entitles the Governor of the ČNB, or a Vice-Governor nominated by him, to attend the meetings of the Government in an advisory capacity. With regard to Article 11(1) of the ČNB Law, although a dialogue between a central bank and third parties is not prohibited as such, it should be ensured that this dialogue is constructed in such a way that the Government should not be in a position to influence the central bank when the latter is adopting decisions for which its independence is protected by the TFEU. The active participation of the Minister, even without voting right, to discussions where monetary policy is set would structurally give to the Government the opportunity to influence the central bank when taking its key decisions. Therefore, Article 11(1) of the ČNB Law is incompatible with Article 130 of the TFEU, as Member States have to undertake not to seek to influence the members of the decision-making bodies of the national central bank.

([34]) Act 135/2014 Coll., Act 204/2015 Coll, Act 375/2015 Act and 377/2015 Coll. In particular, Act 375/2015 Coll. amending relevant legislation in relation to the enactment of the Financial Crisis Prevention and Resolution Act and to the changes in the deposit insurance system adds provisions in the field of resolution and the possibility for the ČNB to provide at its discretion emergency liquidity assistance to the Financial Market Guarantee System.

3.1.3. Prohibition of monetary financing and privileged access

Article 34a(1) first half-sentence of the ČNB Law prohibits the ČNB from providing overdraft facilities or any other type of credit facility to the bodies, institutions or other entities of the European Union, central governments, regional or local authorities or other bodies governed by public law, other entities governed by public law or public undertakings of the Member States of the European Union. The list of entities does not fully mirror the one in Article 123(1) of the TFEU and, therefore, has to be amended.

Moreover, the footnote in Article 34a(1) of the ČNB Law should refer to Article 123(2) of the TFEU instead of globally to Article 123 of the TFEU.

3.1.4. Integration in the ESCB

Objectives

Pursuant to Article 2(1) of the ČNB Law, "in addition" to the ČNB's primary objective of maintaining price stability, the ČNB shall work to ensure financial stability and the safety and sound operation of the financial system and – without prejudice to its primary objective – support the general economic policies of the Government and the European Union. Article 2(1) of the ČNB Law needs to be amended with a view to achieving compatibility with Article 127 TFEU and Article 2 of the ESCB/ECB Statute. Compatibility with the ESCB's objectives requires a clear supremacy of the primary objective over any other objective.

Tasks

The incompatibilities in this area, following the TFEU provisions and ESCB/ECB Statute, include:

definition of monetary policy and monetary functions, operations and instruments of the ECB/ESCB (Articles 2(2)(a), 5(1) and 23 to 26, 28, 29, 32, 33 of the ČNB Law);

conduct of exchange rate operations and the definition of exchange rate policy (Articles 35 and 36 of the ČNB Law);

holding and management of foreign reserves (Articles 35(c), 36 and 47a of the ČNB Law);

non-recognition of the competences of the ECB and of the Council on the banknotes and coins (Article 2(2)(b), Articles 12 to 22 of the ČNB Law);

ECB's right to impose sanctions (Article 46a of the ČNB Law).

- the possibility for Parliament to demand amendments to the report of the ČNB on monetary policy developments and to determine the content/scope of the extraordinary report in view of the absence of a specification regarding the non-forward looking nature of the reports (Article 3 of the ČNB Law)

There are also some imperfections regarding:

the absence of reference of the role of the ECB and of the EU in the collection of statistics (Article 41);

non-recognition of the role of the ECB in the functioning of the payment systems (Articles 2.2 c), 38 and 38a of the ČNB Law);

non-recognition of the role of the ECB and of the Council in the appointment of the external audit of the ČNB (Article 48(2) of the ČNB Law);

absence of an obligation to comply with the Eurosystem's regime for the financial reporting of NCB operations (Article 48 of the ČNB Law);

non-recognition of the role of the ECB in the field of international cooperation (Article 2(3) of the ČNB Law).

3.1.5. Assessment of compatibility

As regards the independence of the central bank, the prohibition of monetary financing and the integration of the central bank in the ESCB at the time of euro adoption, the ČNB Law is not fully compatible with the compliance duty under Article 131 of the TFEU.

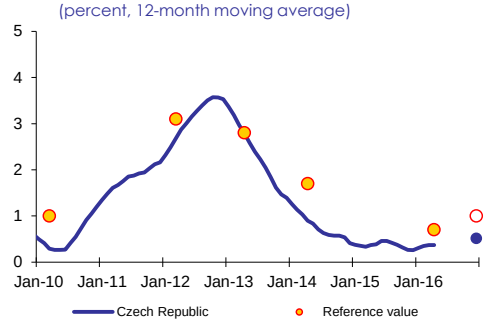
3.2. PRICE STABILITY

3.2.1. Respect of the reference value

The 12-month average inflation rate, which is used for the convergence assessment, was below the

reference value at the time of the last convergence assessment of the Czech Republic in 2014. It declined gradually to below 0.4% in early 2015 and then remained broadly stable up to late 2015 when it fell below 0.3%. In April 2016, the reference value was 0.7%, calculated as the average of the 12-month average inflation rates in Bulgaria, Slovenia and Spain plus 1.5 percentage points. The corresponding inflation rate in the Czech Republic was 0.4%, i.e. 0.3 percentage points below the reference value. The 12-month average inflation rate is projected to remain below the reference value in the months ahead.

Graph 3.1: **Czech Republic - Inflation criterion since 2010**
(percent, 12-month moving average)



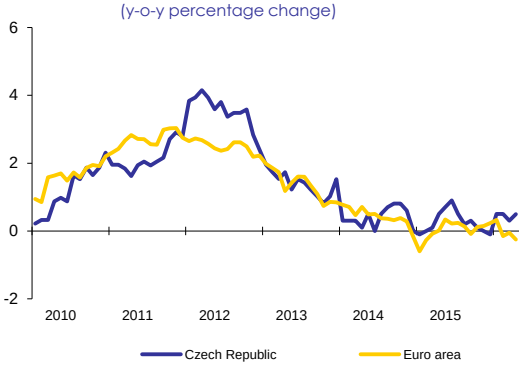
Note: The dots in December 2016 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2016 Forecast.

3.2.2. Recent inflation developments

Price growth moderated significantly in 2014, with the HICP inflation rate slowing to 0.4% from 1.4% in the previous year. This was largely due to a large negative contribution from energy prices, reflecting the pass-through of a sharp decline in oil prices to domestic fuel prices. Falling food prices also contributed to weak price growth in the second half of 2014. Inflation accelerated somewhat during the first half of 2015, as the negative contribution of energy prices moderated while food and administered prices recorded some modest increases. There was a sharp slowdown in the second half of the year, however, amid renewed declines in food and energy prices. The annual HICP inflation rate averaged 0.3% in 2015. It picked up somewhat in early 2016 and stood at 0.5% in April 2016.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) averaged about 1% in 2014-2015, reflecting weak underlying price pressures in the economy. Prices of non-energy industrial goods, which had declined every year since 2002, rose moderately in 2014 and 2015, reflecting the koruna's weaker nominal effective exchange rate and strengthening domestic demand. Prices of processed food continued to increase but at a slower rate than in 2011-2013, due to lower contributions from input prices and changes in indirect taxes. These factors also led to slower growth in the price of services in 2014, although growth accelerated in 2015 amid strengthening domestic demand. Core inflation exceeded headline inflation in 2014 and 2015 as a result of the negative contribution of energy prices to the headline rate in these years. Producer price inflation for total industry was negative in both years, falling to -3.2% in 2015, highlighting weak supply-side cost pressures.

Graph 3.2: **Czech Republic - HICP inflation**
(y-o-y percentage change)



Source: Eurostat.

3.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and cyclical stance

The Czech Republic emerged from a 2-year recession in 2014, with domestic demand acting as the main driver of growth. The growth rate of private consumption accelerated in 2014 and 2015, amid falling unemployment and higher real disposable income. Gross fixed capital formation has contributed positively to real GDP growth in the last two years, particularly in 2015, also reflecting a significant increase in public investment co-financed by EU funds. The level of such investment is expected to fall in 2016, however, contributing to slower real GDP growth. According to the Commission services' Spring 2016 Forecast, real GDP growth is expected to slow to 2.1% in 2016, compared to 4.2% in 2015. Growth is then expected to accelerate to 2.6% in 2017 amid renewed growth in investment. While the Czech economy is estimated to have operated below its potential in the period 2009-2014, the

Table 3.1:
Czech Republic - Components of inflation (percentage change)[1)] weights in total

	2010	2011	2012	2013	2014	2015	Apr-16	2016
HICP	1.2	2.2	3.5	1.4	0.4	0.3	0.4	1000
Non-energy industrial goods	-2.4	-1.7	-0.5	-0.5	0.4	0.5	0.6	242
Energy	4.3	7.2	7.7	0.6	-3.8	-3.0	-3.0	137
Unprocessed food	3.5	0.7	7.6	7.2	1.2	0.7	2.4	77
Processed food	2.1	5.9	5.0	3.0	2.7	1.1	0.5	209
Services	1.9	1.1	3.1	1.0	0.6	0.9	1.1	335
HICP excl. energy and unproc. food	0.4	1.4	2.5	1.0	1.1	0.8	0.8	786
HICP at constant taxes	-0.1	2.2	2.2	0.4	0.3	0.1	0.2	1000
Administered prices HICP	5.1	2.8	8.3	3.5	0.4	0.5	0.8	102

1) Measured by the arithmetic average of the latest 12 monthly indices relative to the arithmetic average of the 12 monthly indices in the previous period.

Sources: Eurostat, Commission services.

output gap is estimated to have closed in 2015 and is projected to be positive in 2016 and 2017.

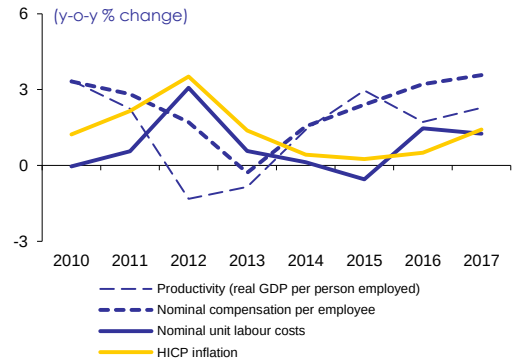
The fiscal stance, as measured by the change in the structural balance, was accommodative in 2014. The structural balance deteriorated from a minor surplus in 2013 to a deficit of about 0.8% of GDP in 2014 before improving again to -0.4% of GDP in 2015. Its evolution largely reflected developments in the headline deficit and fading one-off factors. The structural balance is expected to deteriorate somewhat in 2016 and 2017.

Monetary policy, conducted within an inflation targeting framework ([35]), has remained highly accommodative. The ČNB's main policy rate (the 2-week repo rate) has been set at 0.05% since November 2012. Moreover, in view of projected undershooting of the inflation target for a protracted period of time, the ČNB decided in November 2013 to start using the exchange rate as an additional instrument for easing monetary conditions by allowing the koruna exchange rate against the euro to float freely only on the weaker side of the 27 CZK/EUR level. Following its meeting on 5 May 2016, the Bank Board of the ČNB reiterated that it would not discontinue the use of the exchange rate as a monetary policy instrument before 2017.

Wages and labour costs

The labour market has performed strongly since the economy emerged from recession at the end of 2013. The unemployment rate, which had peaked at 7% in 2012 and 2013, fell to 6.1% in 2014 and to 5.1% in 2015, one of the lowest in the EU. At the same time, the number of employed persons increased by 0.6% in 2014 and 1.2% in 2015. This occurred despite falls in the population of working age and was made possible by an increase in the participation rate, as more workers were drawn into the labour market. Nominal wage growth has accelerated, reaching 2.4% in 2015, while real wage growth has also turned positive in an environment of low inflation.

Graph 3.3: **Czech Rep. - Inflation, productivity and wage trends**



Source: Eurostat, Commission services' Spring 2016 Forecast.

Labour productivity sharply accelerated in 2014 and 2015 as the number of persons employed grew more moderately than real GDP. With labour productivity growing faster than compensation per employee, nominal unit labour costs fell in 2015, after having remained broadly stable in 2014. As a consequence of lower GDP growth, labour productivity is also expected to increase at a slower rate in 2016 and 2017. At the same time, increasingly tight labour market conditions should give rise to faster growth of compensation per employee. As a result, nominal unit labour costs are expected to increase in 2016 and 2017.

([35]) As from January 2010, the inflation target of the ČNB is set as annual consumer price index growth of 2% (with a tolerance band of ± 1 percentage point).

Table 3.2:
Czech Republic - Other inflation and cost indicators **(annual percentage change)**

	2010	2011	2012	2013	2014	2015	2016[1)]	2017[1)]
HICP inflation								
Czech Republic	1.2	2.2	3.5	1.4	0.4	0.3	0.5	1.4
Euro area	1.6	2.7	2.5	1.3	0.4	0.0	0.2	1.4
Private consumption deflator								
Czech Republic	0.5	1.6	2.2	0.9	0.5	0.1	0.5	1.4
Euro area	1.6	2.3	1.9	1.1	0.5	0.2	0.4	1.3
Nominal compensation per employee								
Czech Republic	3.3	2.8	1.7	-0.3	1.5	2.4	3.2	3.6
Euro area	2.2	2.2	1.8	1.7	1.3	1.2	1.5	1.9
Labour productivity								
Czech Republic	3.4	2.2	-1.3	-0.8	1.4	3.0	1.7	2.3
Euro area	2.8	1.5	-0.1	0.6	0.3	0.6	0.5	0.8
Nominal unit labour costs								
Czech Republic	0.0	0.6	3.1	0.6	0.1	-0.5	1.5	1.3
Euro area	-0.6	0.6	1.9	1.1	1.0	0.7	0.9	1.1
Imports of goods deflator								
Czech Republic	1.4	2.9	3.8	0.0	1.9	-1.9	-2.4	1.3
Euro area	6.0	7.0	2.6	-2.0	-2.6	-3.6	-2.7	1.1

1) Commission services' Spring 2016 Forecast.

Source: Eurostat, Commission services.

External factors

Given the size and openness of the Czech economy, import prices have a sizeable effect on domestic price formation. This has particularly been the case in recent years, when there have been significant negative price shocks in global commodity markets. Developments were, however, quite mixed across categories of imported goods with the price of oil falling in koruna terms and contributing to falling energy prices in the domestic economy while prices of other energy goods increased.

The exchange rate provided an inflationary impulse to domestic price developments in 2014, with the nominal effective exchange rate (measured against a group of 36 trading partners) weaker by more than 5%. As a result, Czech import prices increased by 1.9% compared to a fall of 2.6% in the euro area. Developments in the exchange rate had only a moderate impact on inflation in 2015 as the koruna's nominal effective exchange rate remained on average close to its 2014 level.

Administered prices and taxes

The share of administered prices in the HICP basket has been on a generally declining trend in recent years, although there was a slight increase in 2015. It stood at 11% in 2015 ([36]), compared to 13% in the euro area. Changes in administered prices were not a significant driver of inflation in 2014 and 2015, with growth rates broadly in line with those of headline HICP inflation. Falling retail energy prices and the abolition of regulatory fees in the healthcare sector contributed to weak growth in administered prices in these years. Tax changes had a marginally positive impact on HICP inflation in 2014 and 2015.

Medium-term prospects

Annual HICP inflation is expected to remain subdued in 2016 as the decline in oil and food prices during the second half of 2015 will continue to exert a dampening impact on the year-on-year rate. At the same time, domestic price pressures are expected to become stronger, particularly with regards to services prices. According to the Commission services' Spring 2016 Forecast, annual HICP inflation is expected to average 0.5% in 2016, accelerating in the second half of the year. This acceleration is expected to continue in 2017, with HICP inflation forecasted to average 1.4%.

([36]) According to the Eurostat definition, administered prices in the Czech Republic include *inter alia* heat energy, public transport, pharmaceuticals, medical and social services. For details, see: http://ec.europa.eu/eurostat/documents/272892/272989/HICP-AP+classification+2015-02/023e5b4d-6300-47dc-b7aa-27d1e5013f3b

Risks to the inflation outlook are broadly balanced. The main downside risks relate to weaker-than-expected economic activity which could stem from a slowdown in external demand. On the upside, faster-than-expected growth in domestic wages could give rise to inflationary demand pressures.

The level of consumer prices in the Czech Republic dropped to below 63% of the euro-area average in 2014, with the relative price gap widest for services. This suggests there is potential for further price level convergence in the long term. After having basically stagnated between 2007 until 2013, Czech GDP per capital in purchasing power standards increased by almost 2 percentage points to above 79% of the euro-area average in 2014.

Medium-term inflation prospects will be affected by productivity and wage developments as well as the functioning of product markets. Given the openness of the Czech economy and its limited resource base, commodity prices and other external price shocks will continue to exercise significant influence on domestic inflation.

3.3. PUBLIC FINANCES

3.3.1. Recent fiscal developments

On 17 June 2014, the Council decided to abrogate the decision on the existence of an excessive deficit according to Article 126 (12) TFEU, thereby closing the excessive deficit procedure for the Czech Republic ([37]). The general government deficit declined substantially from 1.9 % of GDP in 2014 to 0.4% of GDP in 2015. Total revenue-to-GDP ratio increased to 42.2% of GDP in 2015, up from 40.8% in 2014, while total expenditure-to-GDP remained broadly stable at 42.6% of GDP in 2015, compared to 42.8 % in 2014.

The 2015 headline deficit outcome is well below the target of 1.9 % of GDP in the 2015 Convergence Programme. This significantly better-than-expected outcome was due to several temporary factors including an exceptionally high absorption rate of EU funds, which boosted GDP growth. The structural balance improved in 2015 on the back of a rapidly closing negative output gap.

The debt-to-GDP ratio declined from its peak of 45.1% of GDP in 2013 to 41.1% of GDP in 2015, remaining well below the 60% threshold. The fall was mainly induced by a favourable stock-flow adjustment, reflecting better liquidity management.

3.3.2. Medium-term prospects

According to the Commission services' Spring 2016 Forecast, the headline deficit is projected to increase to 0.7% of GDP in 2016, largely as a result of fading one-off factors and stabilisation of tax revenues in line with lower economic growth. The revenue-to-GDP ratio is expected to drop to 40.7% while the expenditure-to-GDP ratio is set to fall to 41.4%, as co-financing of EU-funded investment should decline due to lower expected drawdown of EU funds in the new programming period. The structural balance is set to deteriorate somewhat in 2016.

The headline deficit is expected to decline marginally to 0.6% of GDP in 2017 due to the continued improvement in economic performance. The structural deficit should, however, further worsen to almost 1% of GDP. The debt-to-GDP ratio is projected to fall to 40.9% of GDP in 2017.

The 2016 Convergence Programme was submitted by the Czech authorities on 11 May 2016. The authorities expect the headline deficit to decline to 0.6% of GDP in 2016 and then to stabilise at 0.5% of GDP beyond. The Czech Republic over-achieved its medium-term budgetary objective, set as a structural deficit of 1 % of GDP, which continues to be met over the programme horizon. According to the convergence programme, the government debt-to-GDP ratio is expected to remain at 41.1% in 2016 and to fall to 39.3% in 2019. Based on its assessment of the convergence programme and taking into account the Commission services' Spring 2016 Forecast, the Commission is of the opinion that the Czech Republic is expected to comply with the provisions of the Stability and Growth Pact. Further details can be found in the Assessment of the 2016 Convergence Programme for the Czech Republic ([38]).

([37]) An overview of all excessive deficit procedures can be found at: http://ec.europa.eu/economy_finance/economic_governance/sgp/deficit/index_en.htm

([38]) http://ec.europa.eu/economy_finance/economic_governance/sgp/convergence/index_en.htm

Table 3.3:

Czech Republic - Budgetary developments and projections **(as % of GDP unless indicated otherwise)**

Outturn and forecast [1]	2010	2011	2012	2013	2014	2015	2016	2017
General government balance	-4.4	-2.7	-3.9	-1.3	-1.9	-0.4	-0.7	-0.6
- Total revenues	38.6	40.4	40.7	41.6	40.8	42.2	40.7	40.7
- Total expenditure	43.0	43.2	44.7	42.8	42.8	42.6	41.4	41.3
of which:								
- Interest expenditure	1.3	1.3	1.4	1.3	1.3	1.1	1.0	1.0
p.m.: Tax burden	32.6	33.9	34.4	35.1	34.4	35.0	35.1	35.2
Primary balance	-3.1	-1.4	-2.5	0.1	-0.6	0.7	0.3	0.4
Cyclically-adjusted balance	-3.9	-2.6	-3.2	-0.1	-1.0	-0.4	-0.8	-0.9
One-off and temporary measures	0.2	0.0	-1.8	-0.1	-0.2	0.0	0.0	0.0
Structural balance [2]	-4.0	-2.6	-1.5	0.0	-0.8	-0.4	-0.7	-0.9
Government gross debt	38.2	39.9	44.7	45.1	42.7	41.1	41.3	40.9
p.m: Real GDP growth (%)	2.3	2.0	-0.9	-0.5	2.0	4.2	2.1	2.6
p.m: Output gap	-1.2	-0.3	-1.6	-2.8	-2.2	0.0	0.2	0.7

Convergence programme	2016	2017	2018	2019
General government balance	-0.6	-0.5	-0.5	-0.5
Structural balance [2] [3]	-0.5	-0.7	-0.6	-0.2
Government gross debt	41.1	40.7	40.2	39.3
p.m. Real GDP (% change)	2.5	2.6	2.4	2.4

1) Commission services' Spring 2016 Forecast.

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

3) Commission services' recalculated structural balance on the basis of the information in the programme. One-off and other temporary measures in the convergence programme of April 2016 are -0.2% of GDP in 2015, deficit-increasing; and 0.0% of GDP in both 2016 and 2017.

Sources: Commission services, the 2016 Convergence Programme of Czech Republic.

As far as the national fiscal framework is concerned – which refers to numerical fiscal rules, medium-term budgetary frameworks, independent fiscal institutions, and budgetary procedures – the Czech Republic scores low compared to other EU Member States. Medium-term budgetary framework and expenditure ceilings exist but enforcement and monitoring is weak. The draft reform package aimed at strengthening the framework was revamped several times. This package is also meant to complete the transposition of the Directive on national budgetary frameworks ([39]) into Czech legislation, which Member States were obliged to carry out by the end of 2013. Its latest version was approved by the government in February 2015 but still awaits adoption by the parliament.

3.4. EXCHANGE RATE STABILITY

The Czech koruna does not participate in ERM II. Since the late 1990s, the ČNB has been operating an explicit inflation targeting framework combined with a floating exchange rate regime, allowing for foreign exchange market interventions by the central bank. The exchange rate of the koruna against the euro remained broadly stable between early 2010 until late 2013, oscillating between 24 and 26 CZK/EUR.

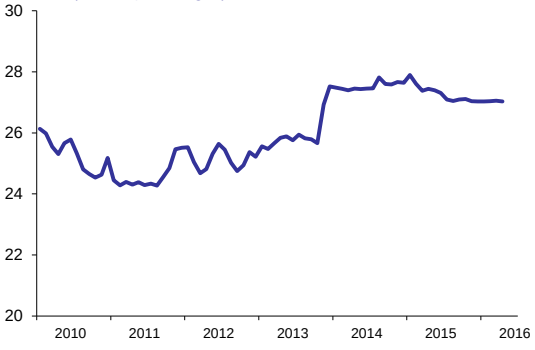
On 7 November 2013, the ČNB began using the exchange rate as an additional instrument for easing monetary conditions in view of projected price developments indicating an undershooting of the inflation target for a protracted period of time. The ČNB announced that it would intervene on the foreign exchange market to weaken the koruna, so that its exchange rate against the euro was close to 27, and clarified that it regarded this commitment as one-sided, allowing the exchange rate to float freely on the weaker side of this level. The announcement and initial market interventions proved to be effective as the koruna swiftly weakened from below 26 CZK/EUR to above 27 CZK/EUR.

The koruna traded on average at around 27.5 CZK/EUR throughout 2014 and the first half of 2015, amid low volatility. It strengthened close to 27 CZK/EUR in mid-2015 and then remained near

([39]) Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary framework of the Member States

its lower bound set be the ČNB during the second half of 2015 and in early 2016. During the two years before this assessment, the koruna appreciated against the euro by some 1.6%.

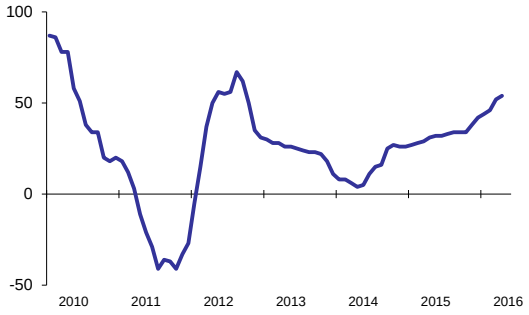
Graph 3.4: **Czech Republic - CZK/EUR exchange rate**
(monthly averages)



Source: ECB.

International reserves held by the ČNB increased by more than EUR 8 billion to above EUR 40 billion (27% of GDP) in late 2013, largely as a result of its foreign exchange market interventions. They continued to increase gradually over the next two years, with the pace of reserve accumulation accelerating considerably in the second half of 2015. As a result, they reached almost EUR 60 billion by end-2015 (36% of GDP).

Graph 3.5: **Czech Republic - 3-M Pribor spread to 3-M Euribor**
(basis points, monthly values)



Source: Eurostat.

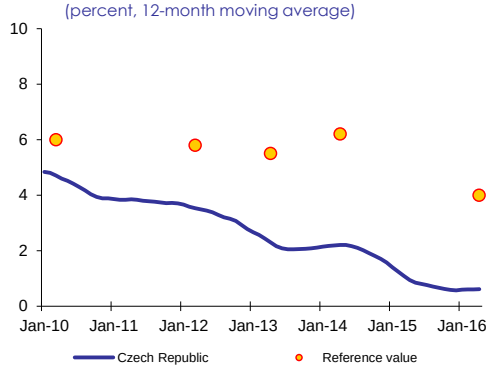
The 3-month interest rate differential vis-à-vis the euro area tightened to below 10 basis points in early 2014 as a result of koruna liquidity injections related to the ČNB's foreign exchange market interventions combined with declining excess liquidity in the euro area. It widened again to above 10 basis points in June 2014 and above 20 basis points in September 2014 following the ECB deposit facility rate cuts. It then continued to widen gradually throughout late 2014 and 2015 as excess liquidity in the euro area increased through ECB asset purchase programmes. The widening trend accelerated in late 2015 and early 2016, following further ECB deposit facility rate cuts. At the cut-off date of this report, the 3-month spread vis-à-vis the euro area was some 54 basis points.

3.5. LONG-TERM INTEREST RATES

Long-term interest rates in the Czech Republic used for the convergence examination reflect secondary market yields on a basket of government bonds with a residual maturity of about 10 years.

The Czech 12-month average long-term interest rate relevant for the assessment of the Treaty criterion was well below the reference value at the time of the last convergence assessment of the Czech Republic in 2014. It remained broadly stable at just above 2% in the first half of 2014 and then declined gradually to below 0.6% by end-2015. In April 2016, the latest month for which data are available, the reference value, given by the average of long-term interest rates in Bulgaria, Slovenia and Spain plus 2 percentage points, stood at 4%. In that month, the 12-month moving average of the yield on the Czech benchmark bond stood at 0.6%, i.e. 3.4 percentage points below the reference value.

Graph 3.6: **Czech Republic - Long-term interest rate criterion**
(percent, 12-month moving average)

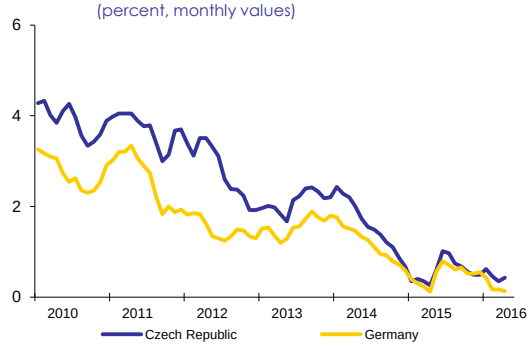


Source: Commission services.

Long-term interest rates in the Czech Republic followed a downward trend from early 2014 up to April 2015, declining from above 2.4% to below 0.3%, mainly thanks to strong investment demand. As a result, the spread against the German long-term benchmark bond narrowed from some 70 basis points to about 10 basis points over this time period. Long-term interest rates jumped to above 1% in June 2015, largely mirroring the bond market correction in the euro area, but then

declined again gradually throughout the second half of 2015. The spread against the German benchmark bond oscillated at around 25 basis points in early 2016 ([40]).

Graph 3.7: **Czech Republic - Long-term interest rates**
(percent, monthly values)



Source: Eurostat.

3.6. ADDITIONAL FACTORS

The Treaty (Article 140 TFEU) calls for an examination of other factors relevant to economic integration and convergence to be taken into account in the assessment. The assessment of the additional factors – including balance of payments developments, product and financial market integration – gives an important indication of a Member State's ability to integrate into the euro area without difficulties.

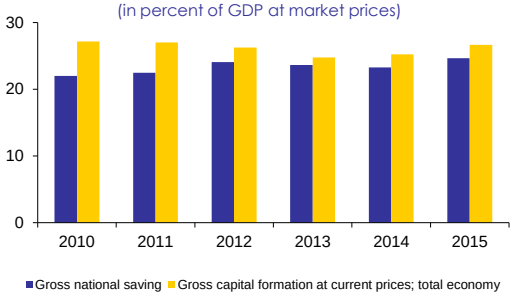
In November 2015, the Commission published its fifth Alert Mechanism Report (AMR 2016) ([41]) under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.5). The AMR 2016 scoreboard showed that that the Czech Republic exceeded the indicative threshold in one out of fourteen indicators, i.e. the net international investment position. In line with the conclusions of the AMRs 2012-16, the Czech Republic has not been subject to in-depth reviews in the context of the MIP.

3.6.1. Developments of the balance of payments

According to the balance of payments data, the Czech Republic's external balance (i.e. the combined current and capital account) remained in surplus over the last two years, increasing from below 1% of GDP in 2014 to above 3% of GDP in 2015. The improvement reflected higher surpluses in both the current and capital accounts. The current account surplus increased from 0.2% of GDP in 2014 to 0.9% of GDP in 2015, due to an increase in the income balance. The higher capital account surplus largely reflected a substantial drawdown of funds from the EU budget.

However, according to the national accounts data, gross capital formation has actually increased at a faster pace than savings since 2013, giving rise to a more negative savings-investment balance. This increase was largely driven by the general government sector as public investment increased significantly in 2014 and 2015. In contrast, gross capital formation by the household and corporate sectors fell over this period and the savings-investment gap of the private sector as a whole improved.

Graph 3.8: **Czech Republic - Saving and investment**
(in percent of GDP at market prices)



Source: Eurostat, Commission services.

Export performance improved significantly in 2014, reflecting a sharp depreciation of the nominal effective exchange rate in late 2013 and stronger external demand as the euro area emerged from recession. Export growth remained buoyant in 2015 but slowed down somewhat compared to the previous year. External price and cost competitiveness, as measured by ULC- and HICP-deflated real effective exchange rates, improved considerably in late 2013 and, to a lesser degree, throughout 2014. The real effective exchange rate then increased somewhat in the course of 2015 as a result of the nominal effective exchange rate appreciation.

The financial account balance remained positive in 2014 and 2015, increasing quite sharply in 2015. This increase was largely driven by rising official reserves, as the pace of external asset accumulation by the ČNB accelerated in the second half of 2015. The contribution of net FDI flows also increased while net portfolio investment flows contributed

([40]) The reference to the German benchmark bond is included for illustrative purposes, as a proxy of the euro area long-term AAA yield.
([41]) http://ec.europa.eu/europe2020/pdf/2016/ags2016_alert_mechanism_report.pdf

Table 3.4:

Czech Republic - Balance of payments **(percentage of GDP)**

	2010	2011	2012	2013	2014	2015
Current account	-3.7	-2.1	-1.6	-0.5	0.2	0.9
of which: Balance of trade in goods	1.0	1.9	3.1	4.1	5.2	4.7
Balance of trade in services	2.0	2.0	1.9	1.7	1.3	1.7
Primary income balance	-6.4	-5.6	-5.9	-6.1	-6.1	-5.5
Secondary income balance	-0.3	-0.5	-0.7	-0.3	-0.2	0.0
Capital account	1.0	0.3	1.3	2.0	0.8	2.4
External balance [1)]	-2.7	-1.8	-0.3	1.5	0.9	3.3
Financial account [2)]	-3.2	-1.9	0.3	1.7	1.5	4.3
of which: Direct investment	-2.4	-1.1	-3.0	0.2	-1.9	0.6
Portfolio investment	-3.8	-0.1	-1.4	-2.3	2.1	-3.7
Other investment [3)]	2.0	-0.2	2.7	-0.7	-0.5	-0.5
Change in reserves	1.1	-0.4	2.0	4.5	1.7	7.9
Financial account without reserves	-4.2	-1.4	-1.7	-2.8	-0.2	-3.6
Errors and omissions	-0.5	-0.1	0.5	0.2	0.5	1.0
Gross capital formation	27.2	27.0	26.3	24.8	25.3	26.7
Gross saving	22.0	22.5	24.1	23.6	23.3	24.6
Gross external debt	55.2	54.8	60.2	63.5	68.6	70.7
International investment position	-46.1	-45.3	-46.1	-41.6	-37.0	-31.2

1) The combined current and capital account.

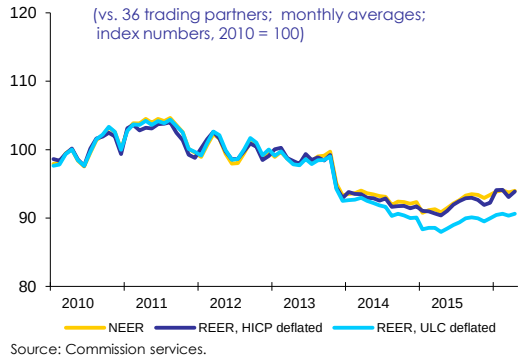
2) The data is presented under BPM6 methodology, where the signs of financial account items are the opposite as under BPM5 (that was used in earlier Convergence Reports).

3) Including financial derivatives.

Sources: Eurostat, Commission services, Czech National Bank.

negatively in 2015. Although gross external debt increased gradually to almost 71% of GDP in 2015, the net international investment position continued to improve.

Graph 3.9: **Czech Republic - Effective exchange rates**



Source: Commission services.

According to the Commission services' Spring 2016 Forecast, the trade balance is expected to improve in 2016 and 2017, contributing to further improvement in the current account balance. The risks to this outlook are, however, tilted to the downside, as lower than expected world demand could give rise to a weaker trade performance.

3.6.2. Market integration

The Czech economy is highly integrated with the euro area through trade and investment linkages. Trade openness of the Czech Republic remains very high. It has continued to increase in recent years, reaching almost 94% of GDP in 2015. The share of trade with the euro area expressed in percentage of GDP is high and has also been further increasing in recent years, exceeding 57% in 2015 as neighbouring euro-area countries belong to the Czech Republic's largest trade partners.

The Czech Republic has attracted a high share of FDI in the tradable sector thanks to its geographical proximity to EU core markets, relatively good infrastructure and highly educated labour force. FDI inflows mainly originate in the euro area, with the Netherlands, Germany, and Austria accounting for more than half of the total stock.

Table 3.5:
Czech Republic - Market integration

	2010	2011	2012	2013	2014	2015
Trade openness [1] (%)	72,2	79,1	83,1	84,2	91,7	93,9
Trade with EA in goods & services [2)+3)] (%)	45,2	49,2	50,8	51,5	56,3	57,7
Export performance (% change) [4]	3,3	3,2	2,9	-1,4	5,2	3,1
World Bank's Ease of Doing Business Index rankings [5]	70	64	65	75	33	36
WEF's Global Competitiveness Index rankings [6]	36	38	39	46	37	31
Internal Market Transposition Deficit [7] (%)	1.2	1,9	0,2	0,4	0,3	0,5
Real house price index [8]	100,0	98,4	94,9	94,1	95,9	99,6
Residential investment [9] (%)	4,1	3,7	3,7	3,3	3,2	3,2

1) (Imports + Exports of goods and services / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics, Balance of Payments).
2) (Imports + Exports of goods with EA-19 / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).
3) Trade in services with EA-19 (average credit and debit in % of GDP at current prices) (Balance of Payments).
4) Index for exports of goods and services divided by an index for growth of markets (percentage change on preceding year).
5) New methodology as of 2014 (World Bank).
6) (World Economic Forum)
7) Percentage of internal market directives not yet communicated as having been transposed, relative to the total. (Nov. data, May in 2013 and 2015).
8) Deflated house price index (2010=100), Eurostat.
9) Gross capital formation in residential buildings (in % of GDP), Eurostat.

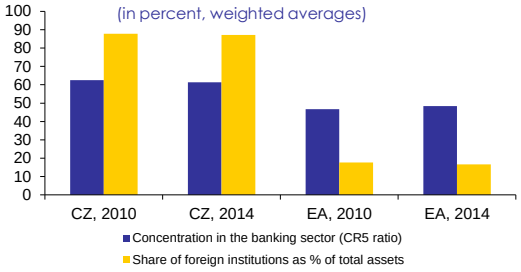
Sources: Eurostat, World Bank, World Economic Forum, Commission services.

As far as the business environment is concerned, the scores received by the Czech Republic in international rankings have improved in recent years, converging close to the euro-area average. At the same time, the Czech Republic's deficit in the transposition of EU directives was just 0,5% in 2015.

Protection of permanent employees against collective and individual dismissals is relatively strict (as measured by the 2013 OECD employment protection indicator). Cross-border migration flows have remained relatively subdued although net immigration into the Czech Republic seems to have picked up somewhat recently.

The Czech financial sector remains highly integrated into the EU financial sector. The main channel of integration is through a high degree of foreign ownership of financial intermediaries as about 87% of banking sector's assets was in 2014 held by foreign institutions via local branches and subsidiaries. Bank concentration, as measured by the market share of the largest five credit institutions in total assets, has remained above the euro-area average over the past years at just above 60%.

Graph 3.10: **Czech Republic - Foreign ownership and concentration in the banking sector**

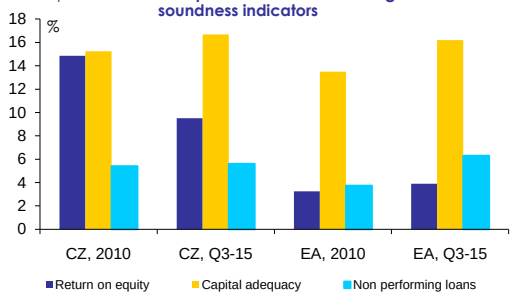


Source: ECB, Structural financial indicators.

The Czech banking sector is well capitalised with the average capital adequacy ratio of 16.7% in the third quarter of 2015, similar to 16.2% in the euro area. Moreover, its profitability has held up remarkably well in recent years, with the average return on equity (RoE) reaching almost 10% in Q3-2015, compared to about 4% in the euro area. At the same time, the share of non-performing loans has remained broadly stable at around 5½% while it exceeded 6% in the euro area.

After having followed a declining trend between end-2008 and end-2013, the real house price index started recovering again in 2014 and it exceeded its 2010 level by end-2015. However, the GDP share of residential investment remained quite stable in recent years even though bank lending to households for house purchase expanded by some 14% between end-2013 and end-2015.

Graph 3.11: **Czech Republic - Selected banking sector soundness indicators**

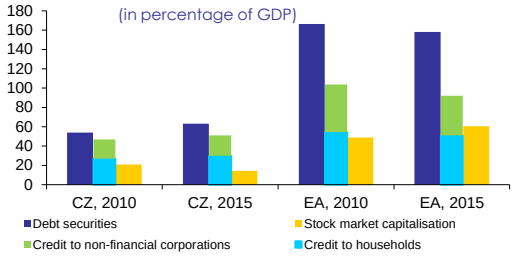


Source: ECB, IMF, EC calculations.

The financial system in the Czech Republic is smaller relative to GDP than that of the euro area. Outstanding bank credit to non-financial companies and households reached 51% of Czech GDP in 2015, compared to 92% in the euro area. The stock of quoted shares issued by Czech enterprises declined to below 15% of GDP in 2015 from above 20% of GDP in 2010. It was thus far below the euro-area level of 60% of GDP. The total amount of outstanding debt securities increased from 54% of GDP in 2010 to 63% of GDP in 2015, while it exceeded 150% of GDP in the euro area. The consolidated stock of private sector debt increased from 68% of GDP in 2010 to almost 73% of GDP in 2014, remaining significantly below the euro-area average of 138%.

Graph 3.12: **Czech Republic - Recent development of the financial system relative to the euro area**

(in percentage of GDP)



Note: Debt Securities other than shares, excluding financial derivatives.
Source: ECB, Commission services.

4. CROATIA

4.1. LEGAL COMPATIBILITY

4.1.1. Introduction

The main legal rules governing the Croatian National Bank (Hrvatska narodna banka – HNB) are laid down in Article 53 of the Constitution of the Republic of Croatia ([42]) and the Act on the Croatian National Bank (the HNB Act) ([43]). The HNB Act was amended in 2013 with a view to Croatia entering the European Union on 1 July 2013. The Act provides for specific rules applying to the HNB as of EU accession of Croatia and a specific chapter for rules applying to the HNB as of the moment the euro becomes the official currency of the Republic.

4.1.2. Central Bank independence

The principle of independence of the HNB is laid down in Article 53 of the Constitution and in Articles 2 (2) and 71 of the HNB Act. Article 71 of the HNB Act contains a specific reference to the principle of central bank independence as enshrined in the TFEU, stating that the HNB shall be independent in achieving its objective and carrying out its tasks under the Act in accordance with Article 130 of the TFEU. As regards the rules on a possible removal of the HNB Governor from office, Article 81 of the HNB Act makes a specific reference to the relevant wording of Article 14.2 of the ESCB/ECB Statute.

No incompatibilities and imperfections exist in this area.

4.1.3. Prohibition of monetary financing and privileged access

No incompatibilities and imperfections exist in this area. The rules on prohibition of lending to the public sector pursuant to Article 78 of the HNB Act include a specific reference to the prohibition of monetary financing as laid down in Article 123 of the TFEU.

4.1.4. Integration in the ESCB

Objectives

The objectives of the HNB are laid down in Articles 3 and 72 of the HNB Act and are fully compatible with the objectives applying to the European System of Central Banks pursuant to Article 127 of the TFEU.

Tasks

The provisions under chapter VIII of the HNB Act define the tasks the HNB has to carry out as integral part of the European System of Central Banks pursuant to the rules of the TFEU and the ESCB/ECB Statute. No incompatibilities exist with regard to these tasks. The Commission understands that the competence of the HNB Council to decide on the HNB's membership in international institutions pursuant to Article 104 (11) of the HNB Act is without prejudice to the ECB's powers in the field of international cooperation involving tasks entrusted to the ESCB under Article 6.1 of the ESCB/ECB Statute.

4.1.5. Assessment of compatibility

The Constitution and the Act on the Croatian National Bank are fully compatible with Articles 130 and 131 of the TFEU. This assessment is without prejudice to an analysis of the potential changes to the HNB Act on the basis of a draft law which is pending in the Croatian Parliament at the moment of writing the 2016 Convergence Report.

4.2. PRICE STABILITY

4.2.1. Respect of the reference value

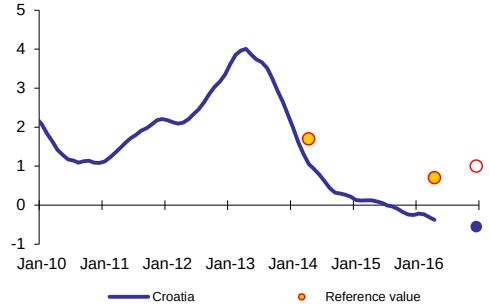
The 12-month average inflation rate, which is used for the convergence assessment, was below the reference value at the time of the 2014 convergence assessment of Croatia. It declined gradually throughout 2014 to around 0.1% in early 2015 and dropped into negative territory in the second half of 2015. In April 2016, the reference value was 0.7%, calculated as the average of the 12-month average inflation rates in Bulgaria, Slovenia and Spain plus 1.5 percentage points. The corresponding inflation rate in the Croatia

([42]) Constitution as amended and published in the Official Journal of the Republic of Croatia no. 56/90, 135/97, 113/2000, 123/2000, 124/2000, 28/2001, 55/2001 and 76/2010.

([43]) Official Journal of the Republic of Croatia no. 75/2008 and 54/2013.

was -0.4%, i.e. 1.1 percentage points below the reference value. The 12-month average inflation rate is projected to fall well below the reference value in the months ahead.

Graph 4.1: **Croatia - Inflation criterion since 2010**
(percent, 12-month moving average)

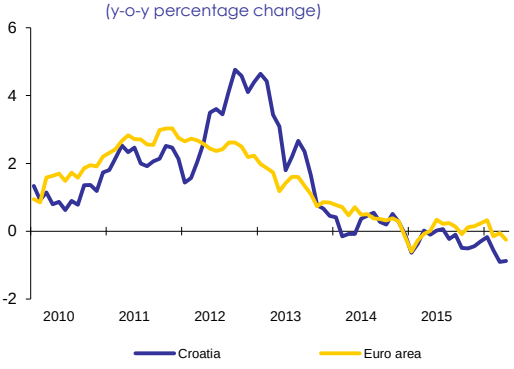


Note: The dots in December 2016 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2016 Forecast.

4.2.2. Recent inflation developments

After having temporarily exhibited negative growth rates in early 2014, annual HICP inflation in Croatia averaged 0.2% in 2014 as declining prices of non-energy industrial goods and unprocessed food dampened growth of the headline rate. The inflation rate dropped again into negative territory in December 2014 and then remained negative throughout most of 2015 due to rapidly falling energy prices. HICP inflation thus averaged -0.3% in 2015. It declined further in early 2016 and stood at -0.9% in April 2016.

Graph 4.2: **Croatia - HICP inflation**
(y-o-y percentage change)



Source: Eurostat.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) decelerated sharply from 2.1% in 2013 to 0.6 % in 2014. It then broadly stabilised at 0.8% in 2015 and at around 0.7% in early 2016. The decline reflected a contraction and subsequent stabilisation of non-energy industrial goods prices while processed food prices also increased at a slower pace than in preceding years. Prices of services, which account for about a third of the HICP basket, thus became the main driver of core inflation in 2014 and 2015. Industrial producer prices continued to decline throughout 2014 and 2015.

4.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and cyclical stance

The pace of economic contraction slowed in 2014 with real GDP declining by some 0.4%. After six years in recession, the Croatian economy finally expanded again in 2015 as real GDP increased by 1.6 %. The recovery was mainly driven by domestic demand which was supported by falling energy prices, a stabilising labour market and a reformed personal income tax regime. The related pick-up in import growth offset continued export acceleration and thus led to a reduction in the growth contribution of net exports. Real GDP growth is expected to accelerate to about 1.8% in 2016 and 2.1% in 2017, driven by domestic demand, with investment growth partly spurred by EU funds. As a result, the negative output gap is estimated to almost fully close by 2017.

The fiscal stance, as measured by the change in the structural balance, was loosened slightly in 2014. It was then tightened considerably in 2015, largely on the back of a sizeable drop in public investment. The structural deficit is thus estimated to have dropped to below 2% of GDP in 2015. In view of the gradually closing output gap, the fiscal stance is projected to be mildly expansionary in 2016 and 2017.

The HNB has continued to pursue an accommodative monetary policy by preserving high levels of liquidity in the monetary system in order to ease domestic financing conditions while simultaneously maintaining a broadly stable exchange rate of the kuna against the euro. However, the high degree of euroisation constrains the scope of domestic monetary policy, while its effectiveness is also limited by the shallow domestic money market and relatively high concentration in the banking sector.

Table 4.1:
Croatia - Components of inflation

	(percentage change)[1]							weights in total
	2010	2011	2012	2013	2014	2015	Apr-16	2016
HICP	1.1	2.2	3.4	2.3	0.2	-0.3	-0.4	1000
Non-energy industrial goods	-0.6	-0.2	1.2	-0.1	-1.1	0.1	0.3	267
Energy	9.9	7.0	10.8	1.8	0.7	-5.9	-6.3	108
Unprocessed food	-2.2	1.5	5.5	4.5	-3.6	0.8	-0.6	82
Processed food	0.1	5.6	2.7	5.3	0.9	0.6	0.6	201
Services	1.6	-0.1	0.7	1.6	1.7	1.4	1.2	343
HICP excl. energy and unproc. food	0.3	1.5	1.6	2.1	0.6	0.8	0.8	811
HICP at constant taxes	0.6	2.1	2.5	1.9	-0.6	-0.6	-0.7	1000
Administered prices HICP	4.3	1.4	7.6	3.4	1.7	0.4	0.2	151

1) Measured by the arithmetic average of the latest 12 monthly indices relative to the arithmetic average of the 12 monthly indices in the previous period.

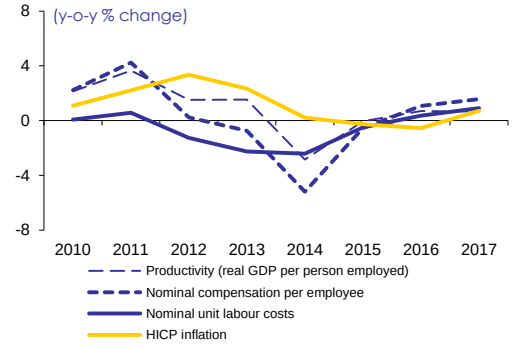
Sources: Eurostat, Commission services.

Wages and labour costs

The labour market situation started improving in 2015. After having stagnated in 2014, the unemployment rate declined close to 16% in 2015 while employment continued increasing. This was, however, not yet reflected in nominal wage developments as wages continued to decline in 2015.

Nominal compensation per employee contracted significantly in 2014. As a result, despite the parallel drop in labour productivity, nominal unit labour costs (ULC) declined. Nominal compensation per employee decreased also in 2015 while labour productivity stabilised, resulting in a further reduction in nominal ULC. As continued labour market recovery should result in positive wage growth, nominal ULC are expected to increase in 2016 and 2017.

Graph 4.3: **Croatia - Inflation, productivity and wage trends**



Source: Eurostat, Commission services' Spring 2016 Forecast.

External factors

External factors have a significant impact on domestic price dynamics. The ratio of imports to GDP has been constantly increasing since the collapse registered in the aftermath of the global financial crisis, reaching about 47% of GDP in 2015. Import prices (measured by the imports of goods deflator) declined by some 1% in 2014 and 1.4% in 2015, largely as a result of lower prices of imported commodities.

The nominal effective exchange rate (measured against a group of 36 trading partners) depreciated somewhat in the second half of 2014 and in early 2015. It subsequently recovered a part of its losses and then remained broadly stable up to early 2016. The exchange rate thus did not provide a substantial inflationary impulse to domestic price developments over the last two years.

Administered prices and taxes

Administered prices represent almost 20% of the HICP basket ([44]), compared to about 13% in the euro area. Increases of administered prices have contributed positively to inflation in recent years, despite having followed a downward trend. Their subdued growth in 2014 and 2015 mainly reflected significant increases in prices of water supply and sewerage collection as well as hospital and postal services, which were partly offset by falling electricity and later also gas prices.

Tax changes provided a significant positive contribution to HICP inflation in 2014. This was due to the increase in the lower VAT rate from 10% to 13%, higher excise taxes on tobacco and

([44]) According to the Eurostat definition, administered prices in Croatia include *inter alia* water supply, refuse and sewerage collection, electricity, gas and heat energy as well as dental, hospital and postal services. For details, see: http://ec.europa.eu/eurostat/documents/272892/272989/HICP-AP+classification+2015-02/023e5b4d-6300-47dc-b7aa-27d1e5013f3b

Table 4.2:
Croatia - Other inflation and cost indicators **(annual percentage change)**

	2010	2011	2012	2013	2014	2015	2016[1)]	2017[1)]
HICP inflation								
Croatia	1.1	2.2	3.4	2.3	0.2	-0.3	-0.6	0.7
Euro area	1.6	2.7	2.5	1.3	0.4	0.0	0.2	1.4
Private consumption deflator								
Croatia	1.5	2.4	3.2	1.9	-0.4	-0.5	-0.5	0.7
Euro area	1.6	2.3	1.9	1.1	0.5	0.2	0.4	1.3
Nominal compensation per employee								
Croatia	2.2	4.2	0.2	-0.7	-5.2	-0.5	1.1	1.6
Euro area	2.2	2.2	1.8	1.7	1.3	1.2	1.5	1.9
Labour productivity								
Croatia	2.1	3.7	1.5	1.5	-2.8	0.0	0.7	0.7
Euro area	2.8	1.5	-0.1	0.6	0.3	0.6	0.5	0.8
Nominal unit labour costs								
Croatia	0.1	0.6	-1.3	-2.2	-2.4	-0.5	0.4	0.9
Euro area	-0.6	0.6	1.9	1.1	1.0	0.7	0.9	1.1
Imports of goods deflator								
Croatia	1.4	6.3	2.9	-0.4	-1.0	-1.4	-0.8	0.4
Euro area	6.0	7.0	2.6	-2.0	-2.6	-3.6	-2.7	1.1

1) Commission services' Spring 2016 Forecast.

Source: Eurostat, Commission services.

refined petroleum products as well as the introduction of fiscal levies on mobile services. A more modest inflationary impact of tax changes in 2015 was largely related to further excise tax hikes.

Medium-term prospects

According to the Commission services' Spring 2016 Forecast, annual HICP inflation is projected to remain negative throughout 2016 mainly as a result of falling energy prices, including a sharp reduction of administered gas tariffs as of April 2016. Annual inflation is expected to turn positive in 2017 as the negative impact of lower energy prices fades out while continued economic expansion should support consumer price growth. Annual HICP inflation is thus forecasted to average -0.6% in 2016 and 0.7% in 2017.

Risks to the inflation outlook are broadly balanced. A slower-than-expected GDP expansion, possibly induced by a less favourable external environment, would further limit inflationary pressures. On the other hand, higher-than-expected increases in some administered prices could contribute positively to inflation developments.

The level of consumer prices in Croatia declined to close to 65% of the euro-area average in 2014. This suggests there is potential for further price level convergence in the long term. However, Croatian GDP per capita in purchasing power standards has stagnated at around 55% of the euro-area average in recent years.

Medium-term inflation prospects will be affected by productivity and wage developments as well as the extent of spare capacity in the economy. The rebalancing of the economy towards the external sector is expected to continue as Croatia deepens its integration in the EU value chains. With continued economic recovery, it will be crucial to ensure that wages increase in line with productivity growth.

4.3. PUBLIC FINANCES

4.3.1. The excessive deficit procedure for Croatia

On 28 January 2014, the European Council decided that an excessive deficit existed in Croatia in accordance with Article 126(6) of the Treaty on the Functioning of the European Union (TFEU). The Council issued a recommendation to Croatia in accordance with Article 126(7) TFEU with a view to bringing to an end the situation of an excessive deficit by 2016. In particular, the Council recommended to the Croatian authorities to gradually reduce the general government deficit

Table 4.3:

Croatia - Budgetary developments and projections **(as % of GDP unless indicated otherwise)**

Outturn and forecast [1]	2010	2011	2012	2013	2014	2015	2016	2017
General government balance	-6.2	-7.8	-5.3	-5.3	-5.5	-3.2	-2.7	-2.3
- Total revenues	41.3	41.0	41.7	42.5	42.6	43.7	44.1	44.4
- Total expenditure	47.5	48.8	47.0	47.8	48.1	46.9	46.8	46.6
of which:								
- Interest expenditure	2.6	3.0	3.4	3.5	3.5	3.6	3.6	3.6
p.m.: Tax burden	36.1	35.2	35.9	36.4	36.5	37.2	37.2	37.4
Primary balance	-3.6	-4.8	-1.9	-1.8	-2.0	0.4	0.9	1.3
Cyclically-adjusted balance	-5.5	-7.3	-4.0	-3.6	-3.6	-1.8	-1.9	-2.1
One-off and temporary measures	0.0	0.0	0.0	-0.2	-0.1	-0.1	0.0	0.0
Structural balance [2]	-5.5	-7.3	-4.0	-3.3	-3.5	-1.7	-1.9	-2.1
Government gross debt	58.3	65.2	70.7	82.2	86.5	86.7	87.6	87.3
p.m: Real GDP growth (%)	-1.7	-0.3	-2.2	-1.1	-0.4	1.6	1.8	2.1
p.m: Output gap	-1.4	-1.3	-2.8	-3.7	-4.0	-2.9	-1.7	-0.3

Convergence programme	2016	2017	2018	2019
General government balance	-2.6	-2.0	-1.6	-1.0
Structural balance [2] [3]	-1.7	-1.6	-1.7	-1.6
Government gross debt	85.9	84.7	82.8	80.0
p.m. Real GDP (% change)	2.0	2.1	2.3	2.5

1) Commission services' Spring 2016 Forecast.

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

3) Commission services' calculations on the basis of the information in the programme. There are no one-off and other temporary measures in the programme.

Sources: Commission services, the 2016 Convergence Programme of Croatia.

to 4.6%, 3.5% and 2.7% of GDP in 2014, 2015, and 2016, respectively, consistent with an annual improvement in the structural balance of 0.5%, 0.9% and 0.7% of GDP in the three respective years. The Commission considered in June 2014 that Croatia had taken effective action and that no further steps in the excessive deficit procedure were needed. Since then, the excessive deficit procedure for Croatia has been held in abeyance.

4.3.2. Recent fiscal developments

The general government deficit declined from 5.5% of GDP in 2014 to 3.2% of GDP in 2015. The main driver of the sizeable improvement was a 22% drop in public investment. This, together with a further reduction in public subsidies and the wage bill, resulted in a 0.8% decrease in general government expenditure in nominal terms, bringing the expenditure-to-GDP ratio down to 46.9%. At the same time, revenues grew by a solid 4.4%, mainly on account of strong growth in indirect taxes. The share of revenues in GDP increased to 43.7%. The primary balanced turned to a surplus of 0.4% of GDP in 2015, for the first time since more than a decade.

The 2015 deficit outcome was well below the 5.0% of GDP targeted in the 2015 Convergence Programme. The structural balance improved from some -3.5% of GDP in 2014 to about -1.7% in 2015, after having marginally deteriorated in 2014.

In 2014, general government debt increased by more than 4 percentage points to 86.5% of GDP, mostly due to the underlying deficit dynamics. In 2015, the debt-to-GDP ratio increased only slightly to 86.7% of GDP, reflecting the lower deficit and a draw-down of government deposits.

4.3.3. Medium-term prospects

Due to the parliamentary elections in November 2015, a temporary financing arrangement was in place in the first quarter of 2016. The 2016 Budget Act was adopted by Parliament on 21 March 2016. The budget does not present ESA-based targets for the developments in the general government sector in 2016. The budget does not outline sizeable measures on the revenue side, apart from an increase in the supplementary health insurance premium, but it envisages moderate restraints in most spending categories.

The Commission services' Spring 2016 Forecast, which takes into account the adopted budget, projects the general government deficit to decline to 2.7% of GDP in 2016 and further to 2.3% of GDP in 2017 on a no-policy-change basis. The structural balance is expected to deteriorate by about 0.2 pp. both in 2016 and 2017. On the back of strengthening primary surplus, public debt is expected to peak at 87.6% of GDP in 2016 and then to decline slightly in 2017.

The 2016 Convergence Programme was submitted on 28 April 2016. It confirms the government's commitment to reduce the general government deficit to below 3% of GDP by 2016, as recommended by the Council. In particular, the general government deficit is targeted to gradually decline from 3.2% of GDP in 2015 to 2.6% of GDP in 2016 and 2.0% of GDP in 2017. The deficit target for 2016 is broadly in line with the Commission services' Spring 2016 Forecast. The deficit target for 2017 is lower than the Commission projection, largely on account of the Commission services' more conservative assessment of the impact of measures presented in the programme. Based on its assessment of the convergence programme and taking into account the Commission services' Spring 2016 forecast, the Commission is of the opinion that there is a risk that Croatia will not comply with the provisions of the Stability and Growth Pact. Therefore, further measures will be needed to ensure compliance in 2017. Further details can be found in the Assessment of the 2016 Convergence Programme for Croatia ([45]).

As far as the fiscal framework is concerned – which refers to numerical fiscal rules, medium-term budgetary frameworks, independent fiscal institutions and budgetary procedures – the Croatian framework remains relatively weak, despite improvements in recent years, which notably materialised in the amendments to the Budget Act and the adoption of the Fiscal Responsibility Law. In particular, the multiannual expenditure framework is one of the least binding in the European Union: its consistency with annual budgets (whose allocations are also frequently revised) is limited, and its expenditure ceilings are revised without public explanation. In addition, the budgetary process gives little consideration to the sizeable off-budget transactions and accounting adjustments. Finally, the design of the numerical fiscal rules could be improved, and the independence of the monitoring body, the Fiscal Policy Commission, is not yet fully guaranteed.

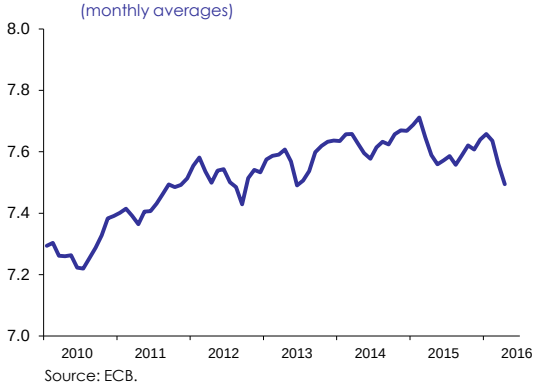
([45]) http://ec.europa.eu/economy_finance/economic_governance/sgp/convergence/index_en.htm

4.4. EXCHANGE RATE STABILITY

The Croatian kuna does not participate in ERM II. The HNB operates a tightly managed floating exchange rate regime, using the exchange rate as the main nominal anchor to achieve its primary objective of price stability. The HNB does not target a specific level or band for the kuna exchange rate against the euro but, through its foreign exchange transactions, it aims to prevent excessive exchange rate fluctuations.

The kuna's exchange against the euro has remained broadly stable over the past two years, oscillating around 7.6 HRK/EUR. It continued to follow an intra-year pattern of temporarily appreciating in spring as a result of foreign exchange inflows generated by the tourism sector.

Graph 4.4: **Croatia - HRK/EUR exchange rate**
(monthly averages)

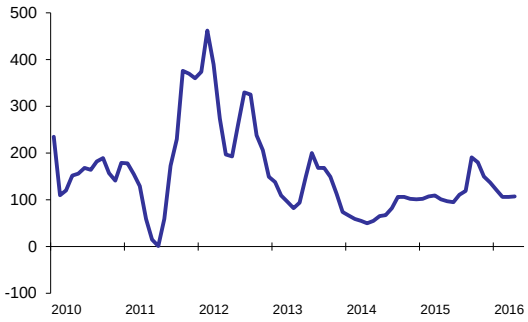


Source: ECB.

International reserves held by the HNB hovered above EUR 12 billion (29% of GDP) throughout 2014. They increased to above EUR 14 billion in the first quarter of 2015 but then declined again and stood at some EUR 13.7 billion (31% of GDP) by end-2015. They were negatively affected by losses related to the legislated conversion of CHF-denominated housing loans into euros which created a currency mismatch on the banking sector's balance sheet and thus necessitated an injection of foreign-exchange liquidity by the HNB with a negative impact of almost EUR 0.3 billion on its international reserve level. By end-2015, international reserves are estimated to have covered about 140% of Croatia's short-term external debt and some 36% of broad money (M4).

The HNB does not actively use changes in interest rates on its lending and deposit facilities as a monetary policy tool given their weak transmission in a shallow domestic money market. As a result, the evolution of short-term rates mainly reflects changes in kuna liquidity in the monetary system. The 3-month interest rate differential against the euro area widened from around 60 basis points in the first half of 2014 to above 100 basis points in September 2014 as money market rates declined in the euro area due to the ECB deposit facility rate cuts while the domestic benchmark rate Zibor increased somewhat. The short-term interest differential remained at around 100 basis points until September 2015 when the legislated conversion of CHF-denominated housing loans resulted in a considerable tightening of money market conditions in Croatia. Domestic money market conditions then eased again in late 2015 and early 2016. At the cut-off date of this report, the 3-months spread vis-à-vis the euro area stood at some 107 basis points.

Graph 4.5: **Croatia - 3-M Zibor spread to 3-M Euribor**
(basis points, monthly values)



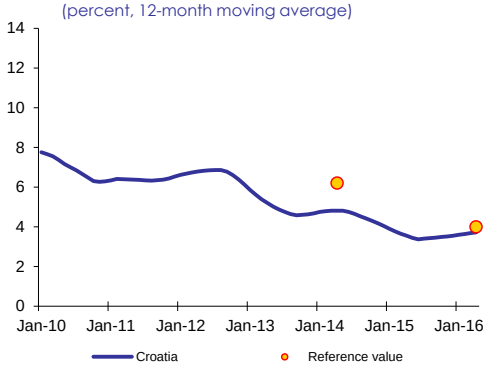
Source: Eurostat.

4.5. LONG-TERM INTEREST RATES

The long-term interest rate in Croatia used for the convergence examination reflects the secondary market yield on a single benchmark government bond with a residual maturity of close to, but below, 10 years.

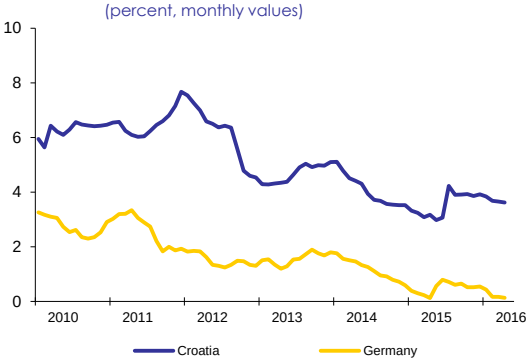
The Croatian 12-month average long-term interest rate relevant for the assessment of the Treaty criterion was below the reference value at the time of the 2014 convergence assessment of Croatia. It declined gradually from around 4.8% in the first half of 2014 to below 3.5% in mid-2015, before increasing slightly in late 2015. In April 2016, the last month for which data are available, the reference value, given by the average of long-term interest rates in Bulgaria, Slovenia and Spain plus 2 percentage points, stood at 4%. In that month, the 12-month moving average of the yield on the Croatian benchmark bond stood at 3.7%, i.e. 0.3 percentage points below the reference value.

Graph 4.6: **Croatia - Long-term interest rate criterion**
(percent, 12-month moving average)



Source: Commission services.

Graph 4.7: **Croatia - Long-term interest rates**
(percent, monthly values)



Source: Eurostat.

Long-term interest rates in Croatia declined from above 5% in early 2014 to about 3% in the second quarter of 2015. This was largely due to favourable financial market developments in the euro area as the spread vis-à-vis the German long-term benchmark bond narrowed to a more limited extent from above 330 to below 250 basis points over the same time period. Long-term interest rates then increased to around 3.9% in the second half of 2015, mainly due to the deterioration in domestic financial market sentiment, with the spread to the German benchmark bond widening back to some 340 basis points. In April 2016, the long-term interest rate stood at 3.6% and the spread vis-à-vis the German benchmark bond at about 350 basis points ([46]).

([46]) The reference to the German benchmark bond is included for illustrative purposes, as a proxy of the euro area long-term AAA yield.

4.6. ADDITIONAL FACTORS

The Treaty (Article 140 TFEU) calls for an examination of other factors relevant to economic integration and convergence to be taken into account in the assessment. The assessment of the additional factors – including balance of payments developments, product and financial market integration – gives an important indication of a Member State's ability to integrate into the euro area without difficulties.

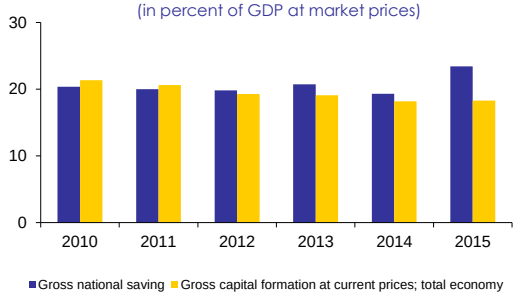
In November 2015, the Commission published its fifth Alert Mechanism Report (AMR 2016) ([47]) under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.5). The AMR 2016 scoreboard showed that Croatia exceeded the indicative threshold for six out of fourteen indicators, two in the area of external imbalances (i.e. the net international investment position and change in the export market share), two in the area of internal imbalances (i.e. general government gross debt and the unemployment rate) and two new employment indicators (long-term and youth unemployment). In line with the conclusion of the AMR 2016, Croatia was subject to an in-depth review, which found that Croatia continued to experience excessive macroeconomic imbalances. Vulnerabilities were linked to high levels of public, corporate and external debt in a context of high unemployment.

4.6.1. Developments of the balance of payments

The current account surplus remained broadly stable at below 1% of GDP in 2014. This masked an improvement in the balance of trade in goods and services which was offset by a worsening of both the primary and the secondary income balance. In 2015, the current account registered a record surplus of above 5% of GDP. This reflected a further improvement in the trade balance and a higher surplus on the secondary income balance as well as a large temporary fall in the primary income deficit, which was mainly related to losses incurred by the foreign-owned banking sector in the aftermath of the legislated conversion of CHF loans. The capital account balance remained close to zero in 2014 and then increased to 0.4% of GDP in 2015. Croatia's external surplus (i.e. the combined current and capital account) thus increased significantly from 1% of GDP in 2014 to some 5.6% of GDP in 2015.

The improvement in the external balance reflects the ongoing weakness of investment and residual deleveraging pressures in the household sector and among financial corporations which were only partly offset by the continued high borrowing needs of the general government. As a result, while gross capital formation remained below 19% of GDP in 2014 and 2015, gross national saving increased from below 20% of GDP in 2014 to above 23% of GDP in 2015.

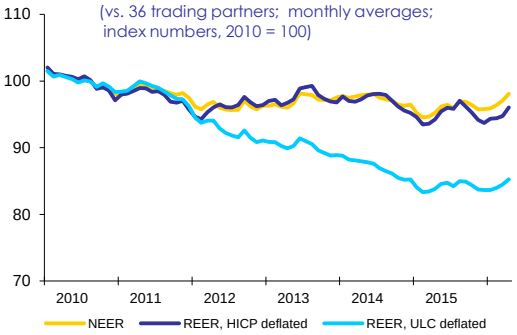
Graph 4.8: **Croatia - Saving and investment**
(in percent of GDP at market prices)



Source: Eurostat, Commission services.

In 2014 and 2015, export performance was very good as Croatia swiftly increased its export market share. Exports were supported by improved cost and price competitiveness as the ULC- and HICP-deflated real effective exchange rates depreciated throughout 2014 before broadly stabilising in 2015. The improvement in the ULC-based REER was more pronounced than in the case of the HICP-based REER which continued to move largely in sync with the NEER.

Graph 4.9: **Croatia - Effective exchange rates**



Source: Commission services.

([47]) http://ec.europa.eu/europe2020/pdf/2016/ags2016_alert_mechanism_report.pdf

Table 4.4:

Croatia - Balance of payments **(percentage of GDP)**

	2010	2011	2012	2013	2014	2015
Current account	-1.1	-0.8	-0.1	1.0	0.8	5.2
of which: Balance of trade in goods	-13.2	-14.3	-14.3	-15.1	-14.8	-15.1
Balance of trade in services	12.8	13.8	14.8	15.5	16.8	17.9
Primary income balance	-3.1	-3.0	-3.4	-2.0	-3.3	-0.7
Secondary income balance	2.4	2.7	2.8	2.6	2.1	3.1
Capital account	0.1	0.1	0.1	0.1	0.2	0.4
External balance [1)]	-1.0	-0.7	0.0	1.1	1.0	5.6
Financial account [2)]	-2.9	-3.2	-0.9	-0.9	-0.2	4.6
of which: Direct investment	-2.1	-2.5	-2.7	-1.9	-3.1	-0.3
Portfolio investment	-0.9	-1.5	-4.0	-4.4	1.7	-0.2
Other investment [3)]	-0.2	-0.1	5.7	1.2	2.4	3.4
Change in reserves	0.2	0.9	0.1	4.2	-1.2	1.7
Financial account without reserves	-3.1	-4.1	-1.0	-5.1	1.0	2.9
Errors and omissions	-2.0	-2.4	-0.9	-2.0	-1.3	-1.0
Gross capital formation	21.4	20.6	19.3	19.1	18.2	18.3
Gross saving	20.4	20.0	19.8	20.7	19.3	23.4
Gross external debt	n.a.	88.8	83.2	82.3	83.6	76.8
International investment position	-95.6	-91.8	-90.9	-89.3	-88.3	-79.0

1) The combined current and capital account.

2) The data is presented under BPM6 methodology, where the signs of financial account items are the opposite as under BPM5 (that was used in earlier Convergence Reports).

3) Including financial derivatives.

Sources: Eurostat, Commission services, Croatian National Bank.

The financial account posted a marginally negative balance in 2014 before displaying a substantial surplus in 2015. The turnaround mainly reflected the evolution of international reserves held by the HNB, which increased in 2015, after having declined in 2014. At the same time, net inflows of foreign direct investment declined from some 3% of GDP in 2014 to just 0.3% of GDP in 2015 while the positive contribution of other investment increased by about 1 pp. in 2015. On the other hand, the contribution of portfolio investment turned negative again in 2015. The net international investment position (NIIP), which remained broadly stable at around -88% of GDP in 2014, improved to -79% of GDP by the end of 2015 while gross external debt declined to below 77% of GDP.

According to the Commission services' Spring 2016 Forecast, the external surplus is expected to contract somewhat in 2016 and 2017.

4.6.2. Market integration

The Croatian economy is well integrated with the euro area through trade and investment linkages. The degree of trade openness increased considerably in recent years to above 50% of GDP in 2015 but remains relatively low given the small size of the Croatian economy. Trade with the euro area amounted to about 29% of GDP and thus constituted over half of total trade, with Italy, Germany and Slovenia as Croatia's largest trade partners. There, nevertheless, remains significant room for a deepening of trade integration with the euro area.

FDI has so far been mainly directed into the banking, real estate and retail sectors, with the largest inflows originating from the Netherlands, Austria and Germany. On the other hand, Croatia failed to attract significant FDI inflows into the tradable goods sector and it is thus weakly integrated into global supply chains. Relatively high costs and an unfavourable business environment appear to be the main obstacles to attracting FDI.

With regard to the business environment, Croatia performs worse than most euro-area Member States according to several commonly used indicators, including the World Bank's Ease of

Table 4.5:
Croatia - Market integration

	2010	2011	2012	2013	2014	2015
Trade openness [1] (%)	40.2	42.9	43.9	44.8	47.4	51.1
Trade with EA in goods & services [2)+3)] (%)	21.1	21.3	22.1	23.8	26.9	29.2
Export performance (% change) [4]	-3.8	-2.9	0.3	1.7	4.0	5.4
World Bank's Ease of Doing Business Index rankings [5]	79	80	84	89	39	40
WEF's Global Competitiveness Index rankings [6]	77	76	81	75	77	77
Internal Market Transposition Deficit [7] (%)	n.a.	n.a.	n.a.	0.6	0.1	0.1
Real house price index [8]	100.0	97.9	93.3	88.0	86.9	84.9
Residential investment [9] (%)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

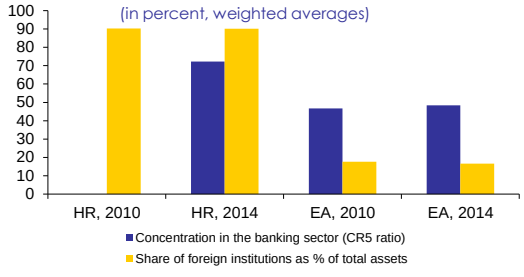
1) (Imports + Exports of goods and services / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics, Balance of Payments).
2) (Imports + Exports of goods with EA-19 / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).
3) Trade in services with EA-19 (average credit and debit in % of GDP at current prices) (Balance of Payments).
4) Index for exports of goods and services divided by an index for growth of markets (percentage change on preceding year).
5) New methodology as of 2014 (World Bank).
6) (World Economic Forum)
7) Percentage of internal market directives not yet communicated as having been transposed, relative to the total. (Nov. data, May in 2015).
8) Deflated house price index (2010=100), Eurostat.
9) Gross capital formation in residential buildings (in % of GDP), Eurostat.

Sources: Eurostat, World Bank, World Economic Forum, Commission services.

Doing Business Index and the World Economic Forum's Global Competitiveness Index. At the same time, Croatia's deficit in the transposition of EU directives was just 0.1% in 2015.

Activity and employment rates are low compared to the euro-area average, which is partly related to underlying institutions and policies such as early retirement schemes, pension eligibility criteria, and the tax-benefit system. The 2013 and 2014 labour market reforms have significantly reduced the gap with other EU economies in terms of employment protection legislation, with a positive impact on employment growth but also leading to a significant increase in the use of temporary contracts. Inefficient wage determination in the public sector still hampers government's control over the public wage bill and may hinder wage responsiveness.

Graph 4.10: **Croatia - Foreign ownership and concentration in the banking sector**
(in percent, weighted averages)

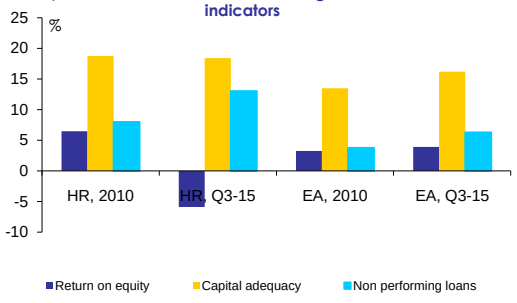


Source: ECB, Structural financial indicators and HNB Banks Bulletin.

The financial sector in Croatia is highly integrated into the EU financial sector, in particular through foreign ownership of the banking sector, as around 90% of its assets are held by subsidiaries of foreign banks. Market concentration is relatively high, with the largest five banking institutions accounting for more than 70% of banking sector assets.

The banking system in Croatia is well capitalized. In the third quarter of 2015, its capital adequacy ratio exceeded 18%, compared to 16% in the euro area. However, the quality of the loan portfolio deteriorated significantly between 2010 and 2015 as the share of non-performing loans (NPLs) reached 13% in Q3-2015 while it increased to 6% in the euro area. Profitability of the banking sector was negatively affected by the legislated conversion of CHF loans resulting in a negative return on equity in Q3-2015, compared to almost 4% return in the euro area.

Graph 4.11: **Croatia - Selected banking sector soundness indicators**



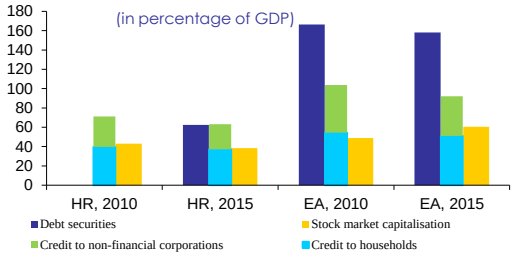
Source: ECB, HNB, EC calculations.

The real house price index has continued to decline in recent years, falling to below 85% of its 2010

level by the end of 2015. At the same time, bank lending to households for house purchase also declined while construction activity appears to have remained relatively subdued.

The financial system in Croatia is smaller relative to GDP than that of the euro area. Outstanding bank credit to Croatian non-financial corporations and households amounted to 63% of GDP in 2015, compared to 92% in the euro area, with the majority of loans denominated in euro. The stock of quoted shares issued by Croatian enterprises stood at below 40% of GDP in 2015 while it reached 60% of GDP in the euro area. The debt market, amounting to 62% of GDP in 2015 and largely dominated by government securities, is also not very developed relative to the euro area, where it exceeds 150% of GDP. After having declined between 2010 and 2013, the GDP share of consolidated private sector debt increased again to just above 120% in 2014, remaining below the euro-area average of 138%.

Graph 4.12: **Croatia - Recent development of the financial system relative to the euro area**



Note: Debt Securities other than shares, excluding financial derivatives.
Source: ECB, Commission services, HNB, Zagreb Stock Exchange.

5. HUNGARY

5.1. LEGAL COMPATIBILITY

5.1.1. Introduction

The main rules governing the National Bank of Hungary (Magyar Nemzeti Bank, hereafter: MNB) are laid down in Article 41 of the new Hungarian Fundamental Law and Act CXXXIX 2013 on the MNB (hereafter: MNB Act). The MNB Act has been subject to frequent changes including some recasts over recent years. The currently applicable MNB Act took effect on 1 October 2013, providing for the MNB to become responsible for macro-prudential policy and, further to the dissolution of the Hungarian Financial Supervisory Authority, micro-prudential supervision of the Hungarian financial sector. Since the most recent convergence exercise of 2014, the MNB Act was amended at several occasions ([48]).

5.1.2. Central Bank independence

Frequent amendments to the Central Bank Act of a Member State can create instability in the Central Bank's operations. Therefore, a stable legal framework that provides a solid basis for a Central Bank to function is essential for ensuring central bank independence.

Pursuant to Section 176 of the MNB Act, the MNB has become the legal successor of the liabilities of the former Hungarian Financial Supervisory Authority (HFSA), which ceased to exist on 1 October 2013. This legal succession also implies the transfer of all employees from the HFSA to the MNB pursuant to Section 183 of the MNB Act. The principle of central bank independence pursuant to Article 130 of the TFEU implies that the MNB must have sufficient financial resources to perform its ESCB and ECB-related tasks, in addition to its national tasks. The tasks transferred from the HFSA to the MNB must not affect its ability to carry out these tasks from an operational and financial point of view.

Further to this principle, the MNB should be fully insulated from all financial obligations resulting from any HFSA activities. Contractual relationships in the period prior to 1 October 2013 including, amongst others, all employment relations between any new MNB staff member and the former HFSA can be continued only with the proviso that the continuation does not impinge on the MNB's independence and its power to fully carry out its duties under the Treaties. Against this background, Section 176 and 183 of the MNB Act have to be aligned to the principle of central bank independence as enshrined in Article 130 of the TFEU.

According to Section 9 (7) of the MNB Act, the Governor and the Deputy Governors shall take an oath before the President of the Republic and other members of the Monetary Council before the Parliament upon taking office with the words required by Law XXVII of 2008 as amended on the oath and solemn promise of certain public officials. The Law requires making an oath with words "I, (name of the person taking the oath), hereby make an oath to be faithful to Hungary and to its Fundamental Law, to comply with its laws, and make sure others citizens comply with them too; I will fulfil the duties arising from my position as a (name of the position) for the benefit of the Hungarian nation […]". The oath does not contain a reference to the principle of central bank independence enshrined in Article 130 TFEU. What is more, the Fundamental Law contains only an indirect reference to EU law. Since the Governor and the Deputy-Governors as members of the Monetary Council are involved in the performance of ESCB related tasks, any oath should make a clear reference to the Central Bank independence under Article 130 of the TFEU. Therefore, the oath is an imperfection as regards the institutional independence of the MNB and the wording of the oath should be adapted to be fully in line with Article 130 of the TFEU.

In addition, Section 156(7) read in conjunction with Section 152(1) of the MNB Act, extends the application of conflict of interests provisions to Monetary Council members to six months following termination of their employment

([48]) The changes relate inter alia to the MNB's resolution powers, the legal framework regarding the Financial Stability Board and financial stability measures, rules regarding the distribution and reproduction of forint and euro coins and forint and euro medals, the possibility to provide emergency liquidity assistance to the Investor Protection Fund, payment transactions, the promotion of the development and security of the financial intermediary system, out-of-court dispute settlement for financial disputes.

relationship with the MNB. However, an exemption is granted as regards organisations covered by acts enumerated in Section 39 in which the Hungarian State or the MNB has a majority stake. Such an exemption could create situations where the privileged position of Monetary Council members could give them an unfair advantage in obtaining nominations or posts in other organisations, putting them in a position of conflict of interest while still in employment at the MNB.

Moreover, Section 157 of the MNB Act provides for an obligation for members of the Monetary Council, including the Governor and the Deputy Governor, to file declarations of wealth in the same manner as Members of Parliament, pursuant to the provisions of Section 90 of the Law XXXVI of 2012 on the Parliament. According to Section 157(1) of the MNB Act and Section 90(2) of the Law XXXVI of 2012, the obligation to submit a wealth declaration extends to close family members (spouse, domestic partner, and children). Pursuant to Section 90(3) of the Law XXXVI of 2012, members of the Monetary Council who fail to submit a wealth declaration will not be allowed to exercise their functions and will receive no remuneration until compliance with the obligation. This provision allows for the temporary removal from office of inter alia the Governor which seems to automatically fall into place once the failure to submit a wealth declaration as required by the above provisions is established by the Parliament. Such an automatism may lead to situations where the removal from office would result from an unintentional action that could not be qualified as a serious misconduct under Article 14.2 of the Statute of the ESCB. In order to preserve fully the principle of central bank independence, this incompatibility should be removed by an amendment of Section 157 of the MNB Act which would provide for an exception for such kind of unintentional omission.

5.1.3. Prohibition of monetary financing and privileged access

Pursuant to Section 36 of the MNB Act and subject to the prohibition of monetary financing set out under Section 146 of the MNB Act, the MNB can provide an emergency loan to credit institutions in the event of any circumstance arising in which the operation of a credit institution jeopardizes the stability of the financial system. In order to comply with the prohibition on monetary financing of Article 123 of the TFEU, it should be clearly specified that the loan is granted against adequate collateral to ensure that the MNB would not suffer any loss in case of debtor's default.

Pursuant to Section 37, as amended ([49]), the MNB may grant loans to the National Deposit Insurance Fund and Investor Protection Fund in emergency cases, subject to prohibition of monetary financing under Section 146 of the Act. Though the Act adequately reflects conditions for central bank financing provided to a deposit guarantee scheme a specific requirement should be included to ensure that the loans granted to the National Deposit Insurance Fund are provided against adequate collateral (e.g. a claim on future cash contributions, government securities, etc.) to secure the repayment of the loan. Therefore, Section 37 is incompatible with the prohibition on monetary financing as laid down in Article 123 of the TFEU.

Article 177(6) of the MNB Act provides for state compensation to the MNB of all expenses resulting from obligations which exceed the assets the MNB has taken over from the HFSA. The law does not contain any provisions on the procedure and deadlines on how the state shall reimburse the MNB of the expenses. Therefore, the reimbursement under Article 177(6) of the MNB Act is not accompanied by measures that would fully insulate the bank from all financial obligations resulting from any activities and contractual relationships of the HFSA originating from prior to the transfer of tasks. In case of a substantial time gap between the costs arising to the MNB and the reimbursement by the state pursuant to Article 177(6) of the MNB Act, the reimbursement would result in an ex-post financing scheme. Should the expenses incurred at the MNB exceed the value of assets taken over from the HFSA, such a scenario would constitute a breach of the prohibition of monetary financing laid down in Article 123 of the TFEU. In order to comply with the prohibition of monetary financing, Sections 176 and 183 of the MNB Act should be amended in order to insulate the MNB by appropriated means from all financial obligations resulting from the HFSA's prior activities or legal relationships and obligations including those deriving from the automatic further employment of HFSA staff by the MNB.

([49]) Article 37 was amended, as from July 2015, by Act LXXXV on Amendments of Acts to promote the Development of the Financial Intermediary System.

On 26 April 2016 the Hungarian legislator adopted an amendment to Section 162 of the MNB Act which remedied a law which was previously found unconstitutional by the Hungarian Constitutional Court ([50]). The new amendment to the MNB Act introduces provisions on the conditions of disclosure of data by a company related to the MNB ([51]). Furthermore, the amendment provides for supervision of the State Audit Office of the operations of foundations established by the MNB ([52]).

Notwithstanding the limitations regarding access to data of MNB companies, it is noted that pursuant to the principle of sincere cooperation (Article 4 TEU) a Member State is required, in full mutual respect, to assist the Commission and the European Central Bank in carrying out tasks which flow from the Treaties, such as providing the information necessary for monitoring the application of EU law.

5.1.4. Integration in the ESCB

Objectives

Article 3(2) of the MNB Act determines that, without prejudice to the primary objective of price stability, the MNB shall uphold to maintain the stability of the financial intermediary system, to increase its resilience, to ensure its sustainable contribution to economic growth and support the economic policy of the government. The objective laid down in Article 3(2) of the MNB Act is reduced to supporting the economic policy in Hungary. The Article has to be aligned to the secondary objective of the ESCB enshrined in Article 127 (1) of the TFEU and Article 2 the Statute of the ESCB in order to embrace the support of the general economic policies in the entire EU rather than in Hungary only.

Tasks

The MNB Act contains a series of incompatibilities with regard to the following ESCB/ECB tasks:

• definition of monetary policy and the monetary functions, operations and instruments of the ESCB (Sections 1 (2) and (3), 4, 16 – 21, 159 and 171 of the MNB Act);

• conduct of foreign exchange operations (Sections 1(2), 4(3), (4) and (12), 9 and 159(2) of the MNB Act) and the definition of foreign exchange policy (Sections 1(2), 4(4) and (12), 22 and 147 of the MNB Act);

• competences of the ECB and of the Council for banknotes and coins (Article K of the Fundamental Law and Sections 1(2), 4(2) and (12), 9, 23, 26 and 171(1) of the MNB Act);

There are also some imperfections in the MNB Act regarding the:

• non-accurate reflection of the principle of central bank independence in the MNB Act (section 1 (2) and (3) of the MNB Act)

• non-recognition of the role of the ECB in the functioning of the payment systems (Sections 1(2), 4(5) and (12), 9, 27-28, and 159(2), 171 (2) and (3) of the MNB Act);

• non-recognition of the role of the ECB and of the EU in the collection of statistics (Section 1(2), 30(1) and 171(1) of the MNB Act);

• non-recognition of the role of the ECB in the field of international cooperation (Section 135 (5) of the MNB Act));

• absence of an obligation to comply with the Eurosystem's regime for the financial reporting of NCB operations (Section 12(4)(b) and Law C of 2000/95 (IX.21.) in conjunction with Government Decree 221/2000 (XII.19.));

([50]) Decision Hungarian Constitutional Court – No 8/2016 of 31 March 2016.

([51]) Data relating to any task of the MNB and processed by company mostly or entirely owned by the MNB shall not be public until published by the company, but at most ten years from the time it was generated, if such disclosure would compromise the central economic or monetary policy. Furthermore, data relating to business activities and processed by companies mostly or entirely owned by the MNB or a company directly or indirectly managed by such a company shall not be disclosed if it would cause disproportionate harm to the company's business activity. Disproportionate harm is defined as providing an undue advantage to any competitor of such MNB company.

([52]) The original amendment to the MNB Act which was found unconstitutional *inter alia* provided that regarding foundations established by the MNB only data relating to the founder including the charter as well as information regarding the financial contribution required for the foundation's purpose as set out in the charter, should be public; any other data managed by the foundation should be accessible exclusively in accordance with the law on civil associations instead of laws on access to information of public interest. This provision was repealed.

• non-recognition of the role of the ECB and the Council in the appointment of external auditors (Sections 6 (1) (b), 15 and 144 of the MNB Act).

5.1.5. Assessment of compatibility

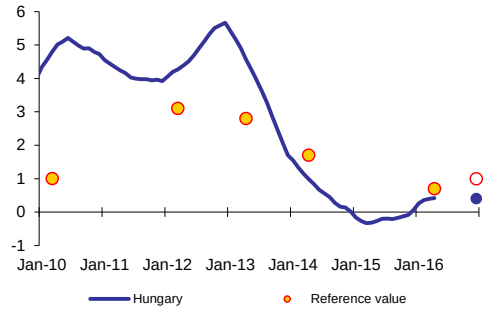
As regards central bank independence of the MNB, the prohibition on monetary financing and the integration of the MNB into the ESCB at the time of euro adoption, existing Hungarian legislation is not fully compatible with the Treaties and the Statute of the ESCB and the ECB pursuant to Article 131 of the TFEU.

5.2. PRICE STABILITY

5.2.1. Respect of the reference value

The 12-month average inflation rate, which is used for the convergence assessment, was below the reference value at the time of the last convergence assessment of Hungary in 2014. Average annual inflation fell to -0.3% by March 2015, before starting to gradually rise again. In April 2016, the reference value was 0.7%, calculated as the average of the 12-month average inflation rates in Bulgaria, Slovenia and Spain plus 1.5 percentage points. The average inflation rate in Hungary during the 12 months to April 2016 was 0.4%, i.e. 0.3 percentage points below the reference value. The 12-month average inflation rate is projected to remain below the reference value in the months ahead.

Graph 5.1: **Hungary - Inflation criterion since 2010**
(percent, 12-month moving average)

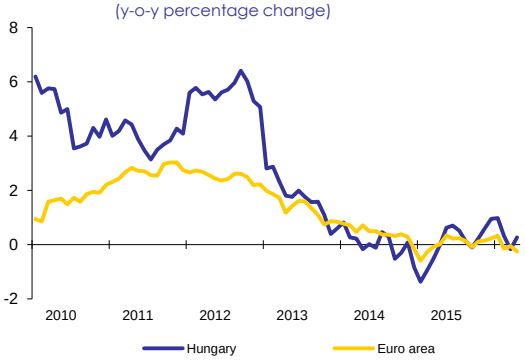


Note: The dots in December 2016 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2016 Forecast.

5.2.2. Recent inflation developments

Annual HICP inflation in Hungary over the last two years reflected mainly global trends and was mostly driven by the fall in oil prices. The annual changes of consumer prices were negative in several months, but there was no real threat of deflation, as core inflation remained around 1-2%. Headline inflation hovered around zero in 2014, amid deep price decreases of unprocessed food and energy. Although GDP growth was high, domestic demand generated no inflationary pressure yet, in the context of historically low inflation expectations. By January 2015, the decline in market energy and food prices pushed headline inflation to -1.4%. The oil price decrease continued in 2015, and although the forint depreciated and the output gap closed according to the Commission services' methodology, the pass-through to consumer prices was slow and limited. Nevertheless, HICP inflation rose to 1% by end-2015, partly due to unprocessed food prices. In early 2016 inflation fell again, mainly due to a VAT cut on some meat products and a further drop in the oil price.

Graph 5.2: **Hungary - HICP inflation**
(y-o-y percentage change)



Source: Eurostat.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) was less volatile than HICP inflation over the past two years. Core inflation declined from around 2% in mid-2014 to 0.8% by end-2014. It increased in early 2015 and remained around 1.5% from April 2015. Processed food inflation fell from above 3% in mid-2014 to zero by early 2015, supported by lower unprocessed food prices. It then gradually increased to around 1% by end-2015, before decreasing again in early 2016. Prices of non-energy industrial goods started rising in 2015, after having remained at an unchanged level in 2014, reflecting the impact of the weakening exchange rate and strengthening domestic demand. Services inflation was rather stable at around 2% over the past two years, with no significant wage pressure appearing, despite the tightening labour market. Industrial producer price inflation turned negative in early 2014 and was still negative in early 2016,

Table 5.1: **Hungary - Components of inflation**						(percentage change)[1]		weights in total
	2010	2011	2012	2013	2014	2015	Apr-16	2016
HICP	4.7	3.9	5.7	1.7	0.0	0.1	0.4	1000
Non-energy industrial goods	1.9	1.3	2.6	0.3	0.0	0.8	1.1	217
Energy	11.8	9.3	8.6	-6.1	-6.6	-7.4	-6.2	154
Unprocessed food	5.9	2.8	6.2	6.9	-1.9	3.6	4.3	80
Processed food	4.0	6.1	9.0	4.8	2.4	0.5	0.7	217
Services	3.9	2.1	4.1	3.6	2.3	2.2	2.1	332
HICP excl. energy and unproc. food	3.3	3.0	5.0	3.0	1.6	1.3	1.4	766
HICP at constant taxes	2.5	3.7	3.5	1.2	0.0	0.0	0.4	1000
Administered prices HICP	6.7	4.8	5.1	-4.8	-6.1	-0.7	0.1	151

1) Measured by the arithmetic average of the latest 12 monthly indices relative to the arithmetic average of the 12 monthly indices in the previous period.

Sources: Eurostat, Commission services.

suggesting that pipeline price pressures remain contained.

5.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and cyclical stance

After reaching the rate of 3.7% in 2014, real GDP growth in Hungary declined to 2.9% in 2015. Private consumption and the external sector both picked up and contributed to growth. The former grew by 3% in 2015, supported by household real disposable income, which was also growing strongly thanks to low inflation and high nominal wage growth. Households have also benefited from one-off measures including a reimbursement from banks for so-called illegitimate interest and exchange rate changes. The 1 pp. cut in the flat personal income tax rate introduced in January 2016 had a similar effect. The good performance of the labour market also supported consumption. Based on the Commission services' Spring 2016 Forecast, real GDP growth is expected to reach 2.5% in 2016 and 2.8% in 2017. The output gap is estimated to have closed in 2015.

The fiscal policy stance, as measured by the change in the structural balance, was significantly loosened in 2014 (by some 0.7 pp. of GDP) mostly on account of dynamic growth of cyclically-adjusted government expenditure in the election year. There was some tightening in 2015, but the Commission services' Spring 2016 Forecast projects a renewed loosening in 2016, followed by a partial reversal of this effect in 2017.

Monetary policy, conducted within an inflation targeting framework ([53]), has been further loosened since 2014, in view of below-target inflation. Starting from 7% in August 2012, the base rate was gradually reduced to 2.1% by July 2014. In March 2015, the MNB restarted the rate-cutting cycle, lowering the policy rate in five equal steps to 1.35% by July 2015. The MNB resumed policy rate reduction in March 2016 (by 15 basis points steps), with the policy rate reaching 1.05% by end-April. In addition to policy rate cuts, the MNB also loosened its policy via unconventional measures, in particular through the Funding for Growth Scheme (FGS) and from 2016 the Growth Supporting Programme (GFP) which aim to foster lending to SMEs. General credit conditions remained tight in the last two years, despite some gradual easing. Net lending to corporates turned positive in 2014 thanks to the FGS, but it was negative again in 2015, partly due to one-off factors.

Wages and labour costs

The improvement of the labour market continued in 2014-2015. Employment grew by around 5% in 2014 and 3% in 2015, not only due to the government's public works scheme, but also because of job creation in the private sector. The unemployment rate reached an all-time low, falling below 7% in 2015. Accordingly, nominal wage growth was around 4% in 2015, with no sign of moderation, despite the low-inflation environment.

([53]) Since August 2005, the MNB pursues a continuous medium-term inflation target of 3% with a permissible fluctuation band of +/- 1 percentage point (which was changed from 'ex post' to 'ex ante' in March 2015).

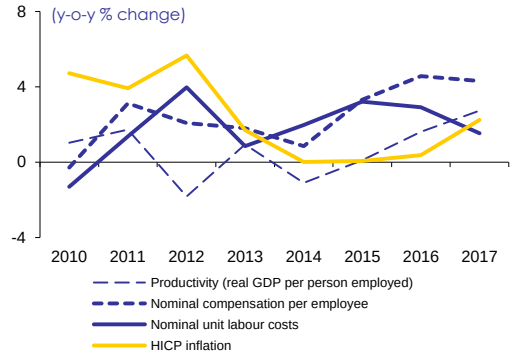
Table 5.2:
Hungary - Other inflation and cost indicators **(annual percentage change)**

	2010	2011	2012	2013	2014	2015	2016[1)]	2017[1)]
HICP inflation								
Hungary	4.7	3.9	5.7	1.7	0.0	0.1	0.4	2.3
Euro area	1.6	2.7	2.5	1.3	0.4	0.0	0.2	1.4
Private consumption deflator								
Hungary	3.7	3.7	6.3	2.1	1.0	0.1	0.8	2.3
Euro area	1.6	2.3	1.9	1.1	0.5	0.2	0.4	1.3
Nominal compensation per employee								
Hungary	-0.3	3.1	2.1	1.8	0.9	3.3	4.6	4.3
Euro area	2.2	2.2	1.8	1.7	1.3	1.2	1.5	1.9
Labour productivity								
Hungary	1.0	1.7	-1.8	0.9	-1.1	0.1	1.6	2.7
Euro area	2.8	1.5	-0.1	0.6	0.3	0.6	0.5	0.8
Nominal unit labour costs								
Hungary	-1.3	1.4	4.0	0.9	2.0	3.2	2.9	1.5
Euro area	-0.6	0.6	1.9	1.1	1.0	0.7	0.9	1.1
Imports of goods deflator								
Hungary	1.7	5.0	4.3	-0.6	0.1	-1.1	-0.5	0.3
Euro area	6.0	7.0	2.6	-2.0	-2.6	-3.6	-2.7	1.1

1) Commission services' Spring 2016 Forecast.

Source: Eurostat, Commission services.

Graph 5.3: **Hungary - Inflation, productivity and wage trends**



Source: Eurostat, Commission services' Spring 2016 Forecast.

Labour productivity growth was negative in 2014 and zero in 2015, but it is expected to gradually increase over the forecast horizon. Compensation per employee growth was also below 1% in 2014, but its pick-up in 2015 contributed to an increase in unit labour costs by around 2%. The ULC growth is to remain broadly stable in 2016 and it is projected to decrease in 2017 with the increase in labour productivity growth.

External factors

Given the high degree of openness of the Hungarian economy, developments in import prices play an important role in domestic price formation. The impact of lower energy and agricultural commodity prices on headline inflation is accentuated by their relatively high weight in the HICP basket. Growth of import prices (measured by the imports of goods deflator), had almost no inflationary effect in 2014, while the disinflationary impact started to dominate in 2015 (the deflator turned negative again) and this is expected to fade over the forecast horizon.

Import price dynamics have been significantly influenced by exchange rate fluctuations. The forint's nominal effective exchange rate (measured against a group of 36 trading partners) weakened on average by 3.2% in 2014 and by further 2.1% in 2015. The change of the nominal effective exchange rate would suggest inflationary pressure, but the pass-through of the exchange rate depreciation to consumer prices appears much smaller than in the past. Looking ahead, the change of import prices is expected to remain supportive of a low-inflation environment in 2016, pending only moderate weakening of the exchange rate.

Administered prices and taxes

The share of administered prices ([54]) in the HICP basket is relatively high in Hungary at around

([54]) According to the Eurostat definition, administered prices in Hungary include inter alia water supply, refuse and sewerage collection, electricity, gas, heat energy, pharmaceutical products, certain categories of passenger transport and postal services. For details, see http://ec.europa.eu/eurostat/documents/272892/272989/HI

16%, compared to the euro area average (13%). Administered prices declined by 4.8% in 2013, chiefly on account of three waves of cuts in regulated energy and other utility prices introduced as of January, July and November. These measures had an overall effect on the inflation rate of over -1 pp. for 2013 and entail − as a full-year effect − an additional reduction in the inflation rate of around 1 pp. for 2014. A further round of utility price cuts happened in April, September and October 2014 (with smaller items like the price of chimney sweeping and school textbooks), which decreased annual HICP by an additional 0.2 pp. in 2014 and 2015. Overall, administered prices lowered headline inflation by about 1.2 pp. in 2014 and 0.1 pp. in 2015

Changes in taxation had a very limited effect on inflation in 2014-2015. There were no major indirect tax changes in these two years, only some excise duty increases on alcoholic beverages and tobacco. The harmonised index of consumer prices at constant tax rates reflects the lack of significant changes in the tax system in 2014 and 2015. Starting from 2016, the VAT on some meat products was reduced to 5 percent, which would have a downward effect on headline inflation of about 0.2 pp., assuming full pass through.

Medium-term prospects

The historically low inflation figures over the past years have been driven to a large extent by the fall in oil prices. Core inflation stood at a moderate level, close to 1% in early 2016, although the output gap closed. Therefore once the effects of low oil prices fade, domestic demand is expected to push inflation to converge towards the central bank's 3% target. Accordingly, the Commission services' Spring 2016 Forecast projects HICP inflation to average 0.4% in 2016 and 2.3% in 2017.

Risks to the inflation outlook appear to be broadly balanced. Upside risks to the projection relate mainly to a stronger-than-expected recovery and a possible weakening of the exchange rate. At the same time, if the global inflation environment weakens further, this could translate into continuing low inflation.

The level of consumer prices in Hungary stood at about 57% of the euro area average in 2014, with the relative price gap larger for services than for goods. This suggests that there is scope for further price level convergence in the long term, as income levels (around 64% of the euro area average in PPS in 2014) rise towards the euro area average.

Medium-term inflation prospects will depend strongly on wage and productivity developments, notably on efforts to avoid excessive wage increases in the non-tradable sector and on the success with anchoring inflation expectations at the central bank's 3% target.

5.3. PUBLIC FINANCES

5.3.1. Recent fiscal developments

On 21 June 2013, the Council decided to abrogate the decision on the existence of an excessive deficit according to Article 126 (12) TFEU, thereby closing the excessive deficit procedure for Hungary ([55]). Since then, the general government deficit has been kept firmly below 3% of GDP. The deficit decreased to 2.3% of GDP in 2014 from 2.6% in the previous year, and then declined further reaching 2.0% GDP in 2015. Both government revenues and expenditure increased during this period relative to GDP, but the latter to a smaller extent, resulting in an improved fiscal balance. The revenue-to-GDP ratio went up from 47% in 2013 to 47.5% in 2014, and then further to 48.9% in 2015. This development reflected an elevated level of EU funds absorption by the general government and an upward trend in the tax burden, primarily due to improvements in tax administration and a tax-rich nature of the economic recovery. At the same time, the expenditure ratio went up by more than 1 pp. over the two years surpassing 50% of GDP.

The 2015 budgetary outturn overachieved the deficit target set in the 2015 Convergence Programme by 0.4 pp. of GDP. Tax and social security receipts significantly exceeded the budgeted numbers, while interest expenditure turned out to be lower. The resulting deficit-improving impact was partially absorbed by extra expenditure, most notably the higher-than-

CP-AP+classification+2015-02/023e5b4d-6300-47dc-b7aa-27d1e5013f3b

([55]) An overview of all excessive deficit procedures can be found at: http://ec.europa.eu/economy_finance/economic_governance/sgp/deficit/index_en.htm

Table 5.3:

Hungary - Budgetary developments and projections **(as % of GDP unless indicated otherwise)**

Outturn and forecast [1) 2)]	2010	2011	2012	2013	2014	2015	2016	2017
General government balance	-4.5	-5.5	-2.3	-2.6	-2.3	-2.0	-2.0	-2.0
- Total revenues	45.0	44.3	46.3	47.0	47.5	48.7	46.4	46.1
- Total expenditure	49.6	49.7	48.6	49.6	49.8	50.7	48.4	48.1
of which:								
- Interest expenditure	4.1	4.2	4.6	4.5	4.0	3.6	3.1	3.0
p.m.: Tax burden	37.5	36.9	38.6	38.2	38.6	39.2	38.7	38.3
Primary balance	-0.4	-1.3	2.3	1.9	1.7	1.6	1.1	1.0
Cyclically-adjusted balance	-2.9	-4.7	-0.7	-1.4	-1.9	-2.1	-2.2	-2.5
One-off and temporary measures	0.7	-0.2	0.7	0.1	0.3	0.0	0.7	0.0
Structural balance [3)]	-3.6	-4.5	-1.4	-1.5	-2.2	-2.0	-2.9	-2.5
Government gross debt	80.6	80.8	78.3	76.8	76.2	75.3	74.3	73.0
p.m: Real GDP growth (%)	0.7	1.8	-1.7	1.9	3.7	2.9	2.5	2.8
p.m: Output gap	-3.3	-1.5	-3.3	-2.4	-0.7	0.1	0.5	1.0

Convergence programme	2016	2017	2018	2019
General government balance	-1.9	-2.4	-1.8	-1.5
Structural balance [3) 4)]	-2.6	-2.5	-2.1	-2.0
Government gross debt	74.5	73.6	72.4	68.4
p.m. Real GDP (% change)	2.5	3.1	3.4	3.1

1) Commission services' Spring 2016 Forecast.

2) Excluding Eximbank.

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

4) Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures taken from the programme (0.7 % of GDP in 2016, deficit-reducing; zero afterwards).

Sources: Commission services, the 2016 Convergence Programme of Hungary.

expected spending from the domestic sources on EU co-financed projects. The cyclical upturn seen since 2013 has facilitated the containment of the general government deficit with strong revenue dynamics and a favourable denominator effect on the expenditure-to-GDP ratio. However, the structural balance deteriorated considerably, decreasing by 0.7 pp. to below -2% of GDP in 2014 and improving only slightly to -2% in 2015 despite the better-than-expected headline deficit.

Following the selling of the previously acquired second-pillar pension fund assets, the government debt-to-GDP ratio remained on a declining path, but the pace of debt-reduction slowed down somewhat. It decreased by around 1½ pp. over two years to close to 75% by the end of 2015, helped by a relatively low budget deficit and high nominal GDP growth ([56]). The reduction of the public debt was hampered by adverse stock-flow adjustment developments including the financial costs of state acquisitions of corporate assets, the revaluation effect of foreign-exchange-denominated debt, as well as delays in the reimbursement of EU funds.

5.3.2. Medium-term prospects

The 2016 budget was adopted by the Hungarian Parliament on 23 June 2015, well ahead of the standard mid-December date. It targets a deficit of 2% of GDP, while incorporating considerable tax cuts and some new spending commitments. Revenue-side measures, amounting to 0.7% of GDP, include the halving of the bank levy, a 1 pp. decrease of the flat rate personal income tax and an increase of the family tax allowance after two children as well as the cutting of the VAT rate on unprocessed pork meat. On the expenditure side, the budget extends career path schemes to civil servants in central government and entails extra appropriations for the public works scheme and capital expenditure from domestic sources. The deficit-increasing effect of these new measures is planned to be more than counterbalanced by declining interest outlays, savings in spending on social transfers and the domestic co-financing of EU funded projects as well as by contained expenditure on operating costs. In addition, the budget counts on substantial one-off revenues (around 0.4% of GDP) from agricultural land sales

([56]) Eurostat has expressed a reservation on the quality of government finance data reported by Hungary in the April 2016 notification. This relates to the sector classification of Eximbank and would result in an increase of the government debt level for all years.

to cover the costs of investment projects of the so-called Investment Fund. In late 2016, the Parliament enacted further measures with significant budgetary effects (estimated at some 0.3% of GDP) aimed at boosting the construction of residential houses, introducing a new generous housing grant scheme for families with children and cutting the VAT rate on newly built flats.

The Commission services' Spring 2016 Forecast projects the current year's deficit at 2% of GDP, i.e. identical with the official target. The forecast counts on a considerably increased budgetary breathing space even compared to the initial budgeted numbers. This is the result of favourable base effects, lower-than-expected interest outlays, higher-than-planned receipts from agricultural land sales and a sizeable windfall in corporate income tax expected to be paid under a corporate income tax credit arrangement in 2016 and 2017. Based on updated government plans, however, these deficit-improving effects are estimated to be absorbed by expenditure increasing measures. Based on a no-policy-change assumption, the deficit is projected to remain at 2% of GDP in 2017 ([57]). While the headline deficit is forecast to remain stable, the structural budget balance is expected to deteriorate sharply to around -3% of GDP in 2016 and then to reverse to around -2.5% in 2017. This reflects the cyclical upturn of the economy and a one-off effect in 2016. At the same time, the debt ratio is expected to decline further to 73% by the end of 2017, even though delays in the receipt of EU funds are assumed to have a debt-increasing effect throughout the forecast horizon.

The 2016 Convergence Programme, covering the period of 2016-2020, was submitted by the Hungarian authorities on 30 April 2016. It plans the headline deficit to increase to 2.4% of GDP by 2017 and then to decrease gradually to 1.2% of GDP by 2020. The government plans a gradual improvement of the structural balance in order to reach its medium-term objective, a deficit of 1.5% of GDP in structural terms as of 2017. However, using the commonly agreed methodology, the recalculated structural deficit would remain higher than the MTO throughout the programme period. Based on its assessment of the convergence programme and taking into account the Commission services' Spring 2016 Forecast, the Commission is of the opinion that there is a high risk that Hungary will not comply with the provisions of the Stability and Growth Pact, as it is expected to significantly deviate from the preventive arm requirements. Further details can be found in the Assessment of the 2016 Convergence Programme for Hungary ([58]).

As far as the fiscal framework is concerned – which refers to numerical fiscal rules, medium-term budgetary frameworks, independent fiscal institutions, and budgetary procedures – the process of re-regulation started with the adoption of the new Fundamental Law in 2011 has led to mixed results. The ongoing revamp has weakened some aspects of the efficiency of its operation (most notably by replacing the forward-looking real debt rule with a pro-cyclical debt ceiling), while strengthening others (inter alia, providing a constitutional basis for the new set-up). The progressively introduced set of national numerical rules has been all complied with over the last couple of years. Despite the recent gradual reinforcements, the Fiscal Council is not yet a body with a strong analytical basis, in contrast with its veto power over the annual budget bill. The medium-term budgetary framework was revamped in late 2013, but its implementation was repeatedly delayed and its effectiveness in genuinely lengthening the planning horizon is yet to be established.

5.4. EXCHANGE RATE STABILITY

The Hungarian forint does not participate in ERM II. Between mid-2001 and early 2008, the MNB operated a mixed framework that combined an inflation target with a unilateral peg of the forint to the euro, with a fluctuation band of +/-15%. On 26 February 2008, the exchange rate band was abolished and a free-floating exchange rate regime was adopted that however allows for foreign exchange interventions by MNB. In March 2015, a +/-1 percentage point ex ante tolerance band was designated around the continuous medium-term inflation target of 3 percent (that is in place since 2005), representing that inflation may fluctuate around the point target as an effect of shocks.

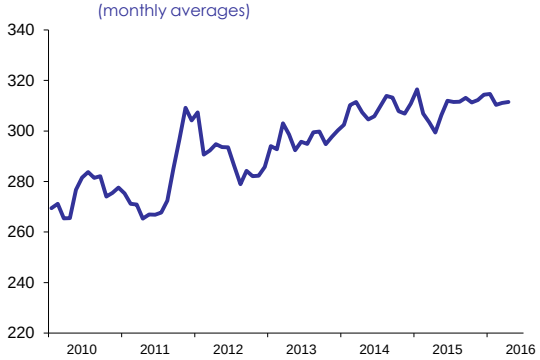
In the context of improving imbalances in Hungary being more than counterweighted by relatively

([57]) Following the cut-off date of the Spring Forecast, the government released the new 2017 draft budget increasing the deficit target to 2.4% of GDP. The new measures include VAT cuts for specific goods, which could not be incorporated yet in the Commission forecast.

([58]) http://ec.europa.eu/economy_finance/economic_governance/sgp/convergence/index_en.htm

looser monetary policy and rising geopolitical risks (mainly related to the conflict in Ukraine), the forint depreciated against the euro by about 4% between May 2012 and May 2014. The forint fell further in summer 2014, but regained those losses in the autumn, as the rate-cutting cycle ended in Hungary and the MNB provided FX liquidity for housing mortgage loan-related currency conversions to the banking sector. The forint was again weaker in January 2015 (HUF/EUR 316.5), following the SNB's decision to let the CHF appreciate, but then strenghtened in the wake of further monetary easing in the euro area. Since June 2015, the forint has been broadly stable against the euro, trading mostly between 310 and 315. Overall, during the two years before this assessment, the forint depreciated against the euro by about 1%. Inter-day exchange rate volatility during this period was highest in March 2015 and declined since then.

Graph 5.4: **Hungary - HUF/EUR exchange rate**
(monthly averages)



Source: ECB.

International reserves hovered generally around EUR 35bn between early 2012 and mid-2015, at a level two times higher than that of the 2006-2008 pre-crisis period. The level of international reserves was mainly influenced by sovereign debt management decisions (e.g. no international bond issuance in 2015), MNB measures (e.g. the Self-Financing Programme and its FX swaps with the banking sector for the conversion of household foreign exchange loans) and the uneven payment of EU funds. Accordingly, international reserves fell to around EUR 30bn by end-2015, which corresponded to about 28% of GDP. Hungary repaid the last tranches of its 2008 EU-IMF financial assistance in November 2014 (EUR 2bn) and April 2016 (EUR 1.5bn) to the EU.

Short-term interest rate differentials vis-à-vis the euro area decreased till August 2014 in parallel with the MNB's policy rate reductions and stayed around 200 basis points thereafter till March 2015. The MNB then restarted the rate-cutting cycle lowering the policy rate over five month by overall 75 basis points to 1.35%, which also mostly showed up in a narrowing interest rate differential. From September 2015, the MNB changed its key policy instrument from the two-week deposit to a three-month deposit instrument. However, short-term interest rate differentials widened again from late 2015, due to the impact of the ECB's asset purchase programmes on euro-area money market interest rates. The MNB resumed policy rate reduction in March 2016, cutting by 15 basis points in both March and April. At the cut-off date of this report, the 3-month spread vis-à-vis the euro area reached around 140 basis points.

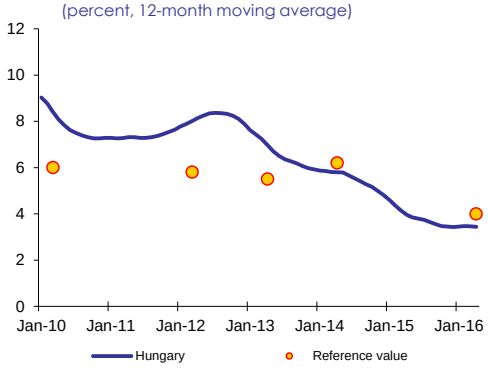
Graph 5.5: **Hungary - 3-M Bubor spread to 3-M Euribor**
(basis points, monthly values)

Source: National Bank of Hungary.

5.5. LONG-TERM INTEREST RATES

For Hungary, the development of long-term interest rates is assessed on the basis of secondary market yields on a single benchmark bond with a residual maturity of around 9 years.

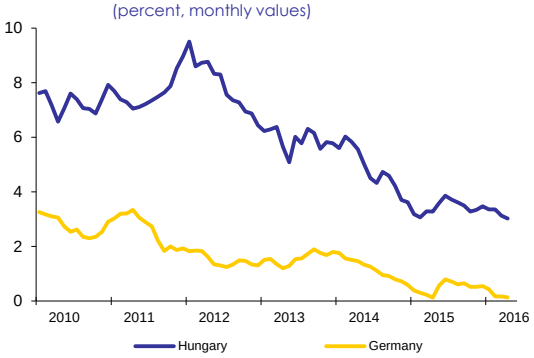
Graph 5.6: **Hungary - Long-term interest rate criterion**
(percent, 12-month moving average)



Source: Commission services.

The Hungarian 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion was below the reference value at the time of the 2014 convergence assessment of Hungary. It then fell from 5.8% to 3.4% by late 2015 and has remained broadly stable since then. In April 2016, the latest month for which data are available, the reference value, given by the average of long-term interest rates in Bulgaria, Slovenia and Spain plus 2 percentage points, stood at 4.0%. In that month, the 12-month moving average of the yield on the Hungarian benchmark bond stood at 3.4%, i.e. 0.6 percentage points below the reference value.

Graph 5.7: **Hungary - Long-term interest rates**
(percent, monthly values)



Source: Eurostat.

The long-term interest rate of Hungary decreased between early 2012 and early 2015 by about 650 basis points, approaching 3%. This reflected improving financial market confidence and falling domestic inflation, against the background of a global search for yields. Long-term interest rates increased with rising US and euro-area yields between February and June 2015. Afterwards, Hungarian long-term yields fell somewhat further in 2015, facilitated by low inflation until the Fed's rate hike and stayed broadly around 3.3% since then. Long-term spreads vis-à-vis the German benchmark bond stood at some 290 basis points in April 2016.

5.6. ADDITIONAL FACTORS

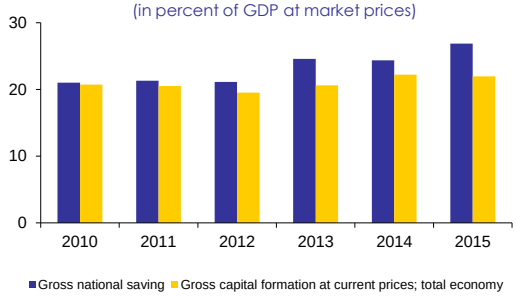
The Treaty (Article 140 TFEU) calls for an examination of other factors relevant to economic integration and convergence to be taken into account in the assessment. The assessment of the additional factors – including balance of payments developments, product, labour and financial market integration – gives an important indication of a Member State's ability to integrate into the euro area without difficulties.

In November 2015, the Commission published its fifth Alert Mechanism Report (AMR 2016) ([59]) under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.5). The AMR 2016 scoreboard showed that Hungary exceeded the indicative threshold in three out of fourteen indicators, two in the area of external imbalances (i.e. the net international investment position and export market share) and one in the area of internal imbalances (i.e. general government gross debt). In line with the conclusion of the AMR 2016 (i.e. that imbalances had been identified for Hungary in the previous MIP round), Hungary was subject to an in-depth review which found that Hungary is not experiencing macroeconomic imbalances.

5.6.1. Developments of the balance of payments

The external balance of Hungary (i.e. the combined current and capital account) gradually increased to 7.6% of GDP by 2013. The external surplus reached around 6% of GDP in 2014 and rose to nearly 9% of GDP in 2015. The improvement reflected higher surpluses in both the current and capital accounts. The current account surplus increased from 2% of GDP in 2014 to around 4% of GDP in 2015, mainly due to an increase in the trade in goods balance. The primary income balance also improved from 2014 to 2015. The growing capital account surplus reflected higher absorption of EU funds.

Graph 5.8: **Hungary - Saving and investment**
(in percent of GDP at market prices)



Source: Eurostat, Commission services.

Hungary's savings-investment surplus decreased in 2014 and increased in 2015. Accordingly, the high savings rate in the economy declined slightly from

([59]) http://ec.europa.eu/europe2020/pdf/2016/ags2016_alert_mechanism_report.pdf

Table 5.4:
Hungary - Balance of payments **(percentage of GDP)**

	2010	2011	2012	2013	2014	2015
Current account	0.3	0.8	1.8	3.9	2.0	4.2
of which: Balance of trade in goods	2.7	2.9	2.9	3.4	2.4	3.9
Balance of trade in services	2.7	3.3	3.8	3.9	4.7	4.7
Primary income balance	-4.7	-4.8	-4.2	-2.8	-4.5	-3.7
Secondary income balance	-0.4	-0.6	-0.8	-0.5	-0.7	-0.7
Capital account	1.8	2.3	2.6	3.6	3.7	4.5
External balance [1)]	2.1	3.1	4.3	7.6	5.7	8.7
Financial account [2)]	1.1	0.7	4.7	6.2	4.6	7.5
of which: Direct investment	-2.9	-1.4	-2.2	-0.1	-2.8	-1.0
Portfolio investment	0.3	-6.3	-1.5	-3.0	3.0	5.2
Other investment [3)]	0.7	4.5	11.8	8.1	3.6	7.8
Of which International financial assistance	0.0	-2.0	-3.9	-5.0	-1.9	0.0
Change in reserves	3.1	3.9	-3.3	1.1	0.7	-4.5
Financial account without reserves	-2.0	-3.2	8.1	5.1	3.9	12.0
Errors and omissions	-1.0	-2.5	0.4	-1.4	-1.1	-1.2
Gross capital formation	20.7	20.5	19.5	20.6	22.2	22.0
Gross saving	21.0	21.3	21.1	24.6	24.4	26.9
Gross external debt	160.5	161.5	158.3	145.5	145.0	133.7
International investment position	-108.9	-106.4	-94.2	-83.5	-75.5	-69.9

1) The combined current and capital account.
2) The data is presented under BPM6 methodology, where the signs of financial account items are the opposite as under BPM5 (that was used in earlier Convergence Reports).
3) Including financial derivatives.

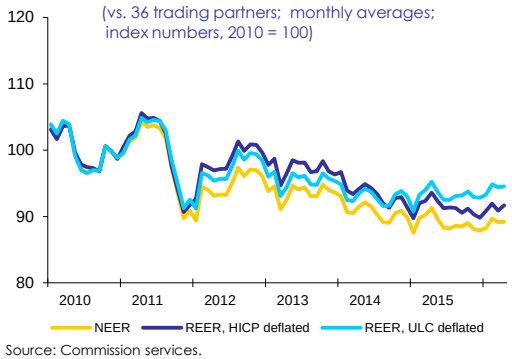
Sources: Eurostat, Commission services, Magyar Nemzeti Bank.

2013 to 2014 but increased further by 2.5 pp. in 2015. The savings rate of the household sector increased further, the enterprise sector's savings rate decreased while the government sector's corresponding indicator doubled (from 1.6% in 2014 to 3.4% in 2015). Overall investment as a share of GDP has increased between 2013 and 2015, reflecting positive real growth in gross fixed capital formation. However, it remained at relatively low levels compared to the pre-crisis years, despite the record high inflow of EU funds.

Despite some minor volatility, price and cost competitiveness indicators of Hungary have generally improved over the last two years. The weakening of the nominal effective exchange rate of the forint in 2014 and 2015 was reflected in the real-effective exchange rate deflated by HICP, while the ULC-based measure remained broadly stable. Hungary's export performance improved markedly both in 2014 and 2015.

Mirroring a continuous external surplus, the financial account has also been positive according to the new methodology. Direct investment registered a net inflow of 2.8% of GDP in 2014 and 1% of GDP in 2015. Portfolio investment net outflows reached 3.0% of GDP in 2014 and rose to 5.2% in 2015, partly reflecting the withdrawal of foreign investors from forint-denominated government securities. Other investment continued to register large outflows in 2014-15, while international reserves fell in 2015. The decrease of external debt, which is ongoing since 2011, proceeded slowly in 2014, but accelerated in 2015. The net international investment position improved from around -109% of GDP in 2010 to around -70% of GDP by end-2015.

Graph 5.9: **Hungary - Effective exchange rates**



Source: Commission services.

Table 5.5:

Hungary - Market integration

	2010	2011	2012	2013	2014	2015
Trade openness [1] (%)	84.1	90.9	92.5	92.0	93.3	94.9
Trade with EA in goods & services [2)+3)] (%)	45.5	49.2	50.7	51.0	53.4	54.7
Export performance (% change) [4]	0.3	0.4	-3.1	4.9	3.8	4.2
World Bank's Ease of Doing Business Index rankings [5]	46	51	54	54	40	42
WEF's Global Competitiveness Index rankings [6]	52	48	60	63	60	63
Internal Market Transposition Deficit [7] (%)	1.4	1.4	0.5	0.6	0.6	0.8
Real house price index [8]	100.0	93.1	84.4	80.5	83.0	92.7
Residential investment [9] (%)	3.1	2.2	2.0	1.4	1.6	n.a.

1) (Imports + Exports of goods and services / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics, Balance of Payments).

2) (Imports + Exports of goods with EA-19 / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).

3) Trade in services with EA-19 (average credit and debit in % of GDP at current prices) (Balance of Payments).

4) Index for exports of goods and services divided by an index for growth of markets (percentage change on preceding year).

5) New methodology as of 2014 (World Bank).

6) (World Economic Forum)

7) Percentage of internal market directives not yet communicated as having been transposed, relative to the total. (Nov. data, May in 2013 and 2015).

8) Deflated house price index (2010=100), Eurostat.

9) Gross capital formation in residential buildings (in % of GDP), Eurostat.

Sources: Eurostat, World Bank, World Economic Forum, Commission services.

The EU-IMF international financial assistance granted to Hungary in autumn 2008 expired in late 2010. The remaining programme-related IMF debt was repaid early in summer 2013. Of the EUR 5.5bn disbursed by the EU, EUR 2bn was repaid in November 2014 and EUR 1.5bn in April 2016. The EU's post-programme surveillance was discontinued in January 2015.

According to the Commission services' Spring 2016 Forecast, the external surplus is expected to remain at around 8% of GDP in both 2016 and 2017.

5.6.2. Market integration

The Hungarian economy is highly integrated with the euro area through trade and investment linkages. Trade openness increased from 84% in 2010 to 95% in 2015, reflecting the deeper integration of the Hungarian economy into continental and global supply chains. Flows with the euro area dominate trade, accounting for around 55% of the total trade in goods and services. Outside the euro area, the main goods trading partners in 2015 were Poland, the Czech Republic and Romania.

The stock of FDI in Hungary amounted to some 80% of GDP in 2014 (excluding SPEs), with FDI mainly originating from Germany, the Netherlands Luxembourg and Austria. The main recipient sectors of FDI were services (mostly 'professional, scientific and technical activities', financial intermediation and trade) and manufacturing (25% of the total), suggesting that FDI plays an important role in enhancing Hungary's export capacity and contributes significantly to economic integration with the euro area.

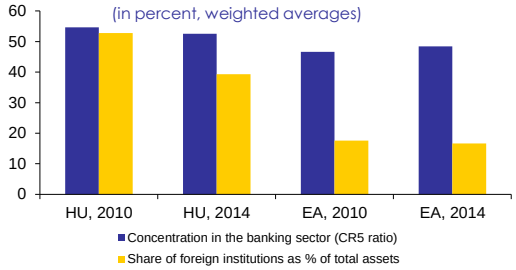
Concerning the business environment, Hungary performs in general worse than most euro area Member States in international rankings. According to the May 2015 Internal Market Scoreboard, Hungary's transposition deficit of EU Directives was at 0.8% which is above the target (0.5%) proposed by the European Commission in the Single Market Act (2011).

The Hungarian labour market can be considered as rather flexible in terms of employment protection (as measured by the 2013 OECD employment protection indicator for permanent workers). Policies on social transfers, early retirement and increasing statutory retirement age strengthened labour supply. Both domestic and international labour mobility is rather low in Hungary, although the latter has increased since the financial crisis.

Hungary's financial sector remains well integrated into the EU's financial system. This integration is noticeable in ownership and other cross-border linkages of the banking system. The share of bank assets owned by foreign lenders has declined (to 39.3% in 2014 from 52.8% in 2010) as foreign groups deleveraged and Hungarian investors, including the Hungarian State acquired several financial institutions in recent years. Bank

concentration, as measured by the market share of the largest five credit institutions in total assets, decreased to 52.5%, still above the euro-area average of 48.4%.

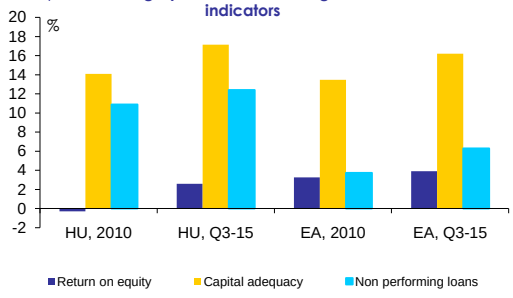
Graph 5.10: **Hungary - Foreign ownership and concentration in the banking sector**



Source: ECB, Structural financial indicators.

The Hungarian banking system remains well-capitalized, with a capital adequacy ratio above 17% at end-September 2015. Banks' profitability has been suppressed by the legacy of the pre-crisis credit boom, low economic growth and the heavy tax burden imposed on the financial sector. In 2014, the banking sector booked a large loss due to provisioning for the settlement of household foreign currency denominated (mainly in Swiss franc) mortgage loans, part of which was unwinded in 2015. The deterioration of the loan portfolio quality had finally ended in 2014 and the NPL ratio reached 12.4% in September 2015.

Graph 5.11: **Hungary - Selected banking sector soundness indicators**

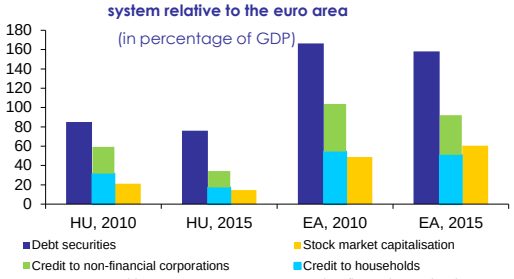


Source: ECB, EC calculations.

Real house prices bottomed in Hungary in 2013 following the 2008 financial crisis and the subsequent recession. The housing market recovery was initially slow, but it accelerated in 2015, with the real house price index reaching 93% of its 2010 level. Residential investment fell to an almost unprecendently low level of around 1.5% of GDP in 2013-2014, while the stock of housing loans declined in net terms.

The financial system in Hungary is smaller relative to GDP than that of the euro area. Domestic bank credit stood near 34% of GDP at end-2015, split evenly between households and non-financial corporations. Most household FX loans were redenominated to forint loans by law effective from early 2015. The total capitalization of the Budapest Stock Exchange amounted to less than 15% of GDP in 2015, well below the euro-area average of 60%. The debt securities market remains small in comparison with the euro area average (76% against 158% of GDP) and is mainly used for re-financing public debt. The consolidated stock of private sector debt at around 86% of GDP in 2015 was significantly below the euro-area average.

Graph 5.12: **Hungary - Recent development of the financial system relative to the euro area**



Note: Debt Securities other than shares, excluding financial derivatives.
Source: ECB, Commission services.

6. POLAND

6.1. LEGAL COMPATIBILITY

6.1.1. Introduction

The Act on the Narodowy Bank Polski (the NBP Act) was adopted on 29 August 1997. The consolidated version that includes all amendments to the NBP Act was published in Dziennik Ustaw of 2013, item 908. The NBP Act has not been amended since the 2014 Convergence Report. Therefore, the comments provided in the 2014 Convergence Report are largely repeated in this year's assessment.

6.1.2. Central Bank independence

The Polish Constitution and NBP Act do not explicitly prohibit the NBP and members of its decision-making bodies from seeking or taking outside instructions; they also do not expressly prohibit the Government from seeking to influence members of NBP decision-making bodies in situations where this may have an impact on NBP's fulfilment of its ESCB related tasks. The absence of such a reference to article 130 of the TFEU and article 7 of the ESCB/ECB Statute or its content constitutes an incompatibility. However, the Polish Constitutional Court has recognised that the central bank's independence is based on article 227 (1) of the Constitution. In this respect, it is noted that at the occasion of a future amendment to the Polish Constitution the Polish authorities should seize the opportunity to clarify in the Constitution that the principle of central bank independence as enshrined in article 130 of the TFEU and article 7 of the ESCB/ECB Statute applies. Alternatively, or in addition the NBP Act could also be amended to ensure full compatibility.

Article 23(1)(2) provides that the NBP's Governor has, inter alia, to provide draft monetary policy guidelines to the Council of Ministers and the Minister of Finance. This procedure provides for the opportunity for the Government to exert influence on the monetary and financial policy of the NBP and thus, constitutes an incompatibility in the area of independence, with Article 130 of the TFEU and Article 7 of the ESCB/ECB Statute.

Article 9(3) of the NBP Act foresees that the Governor of the NBP shall assume his/her duties after taking an oath before the Parliament. This oath refers to the observation of the provisions of the Polish Constitution and other laws, the economic development of Poland and the well-being of its citizens. The Governor of the NBP acts in dual capacity as a member of NBP's decision-making bodies and of the relevant decision-making bodies of the ECB. Article 9(3) of the NBP Act needs to be adapted to reflect the status and the obligations and duties of the Governor of the NBP as member of the relevant decision-making bodies of the ECB. Moreover, the oath does not contain a reference to central bank independence as enshrined in Article 130 of the TFEU. The oath as it stands now is an imperfection and should be adapted to be fully in line with the TFEU and the ESCB/ECB Statute.

The wording of the grounds for dismissal of the NBP's Governor as enumerated in Article 9(5) of the NBP Act could be interpreted as going slightly beyond those of Article 14.2 of the ESCB/ECB Statute. This imperfection should be removed to bring Article 9(5) of the Act fully in line with Article 130 of the TFEU.

The Law on the State Tribunal provides for suspension of the Governor from his duties following a procedure which is incompatible with the principle of central bank independence and Article 14.2 of the ESCB/ECB Statute. Pursuant to the second sentence of Article 11(1) of the Law on the State Tribunal read in conjunction with Article 3 and Article 1 (1)(3) of the very law, the Governor of the NBP can be suspended as a result of an indictment by the Parliament even before the State Tribunal has delivered its judgment on the removal from the office. The procedure violates the principle of central bank independence and Article 14.2 of the ESCB/ECB Statute given that the latter has to be understood as allowing for removal on grounds of serious misconduct only if the Governor has been guilty as established by a court decision ('guilty'). A suspension from office on grounds of serious misconduct and further to parliamentary indictment deprives the Governor of the possibility to continue exercising the duties until a court has found the Governor guilty of serious misconduct pursuant to Article 14.2 of the ESCB/ECB Statute. Therefore, this procedure breaches the Statute and Article 130 of the TFEU.

According to Article 203(1) of Poland's Constitution, the Supreme Audit Office (Najwyższa Izba Kontroli (NIK)) is entitled to examine the NBP's activities as regards its legality, economic prudence, efficiency and diligence. The NIK controls are not performed in the capacity of an independent external auditor, as laid down in Article 27.1 of the ESCB/ECB Statute and thus, should for legal certainty reasons be clearly defined so as to respect Article 130 of the TFEU and Article 7 of the ESCB/ECB Statute. Furthermore, the provision's relationship with article 69.1 of the NBP Act is also unclear. The relevant provision of the Constitution is therefore, incompatible and needs to be adapted in order to comply with Article 130 of the TFEU and Article 7 of the ESCB/ECB Statute.

6.1.3. Prohibition of monetary financing and privileged access

Article 42 in conjunction with Article 3(2)(5) of the NBP Act allow the NBP to extend refinancing loans to banks in order to replenish their funding and also extend refinancing to banks for the implementation of bank rehabilitation programmes, subject to conditionality under Article 42(4) of the same Act. Against this background, the current wording of Article 42(3) and (4) can be interpreted as allowing an extension of refinancing loans to banks experiencing rehabilitation proceedings which however could end in insolvency of the banks concerned. Effective preventive measures and more explicit safeguards should be provided in the NBP Act to clarify compatibility with Article 123 of the TFEU.

6.1.4. Integration in the ESCB

Objectives

Article 3(1) of the NBP Act sets the objectives of the NBP. It refers to the economic policies of the Government while it should make reference to the general economic policies in the Union, with the latter taking precedence over the former. This constitutes an imperfection with respect to Article 127(1) of the TFEU and Article 2 of the ESCB/ECB Statute.

Tasks

The incompatibilities in the NBP Act and in the Polish Constitution in this area are linked to the following ESCB/ECB/EU tasks:

- Limitation of the NPB's activities on the territory of the Republic of Poland (article 2.3 of the NBP Act);
- definition and implementation of monetary policy (Articles 227(1) and (5) of the Constitution, Articles, 3(2)(5), 12, 23, 38-50a, and 53 of the NBP Act);
- holding of foreign reserves; management of foreign exchange and the definition of foreign exchange policy (Articles 3(2)(2), 3(2)(3), 17(4)(2), 24 and 52 of the NBP Act);
- competences of the ECB and of the EU for banknotes and coins (Article 227(1) of the Constitution and Articles 4, 31 to 37 of the NBP Act). The NBP shall exercise its responsibility for issuing the national currency as part of the ESCB.
- appointment of independent auditors - Article 69(1) of the NBP Act foresees that NBP accounts are examined by external auditors. The NBP Act does not take into account that the auditing of a central bank has to be carried out by independent external auditors recommended by the Governing Council and approved by the Council. It is incompatible with Article 27.1 of the ESCB/ECB Statute.

There are also some imperfections regarding:

- non-recognition of the role of the ECB in the functioning of the payment systems (Articles 3(2)(1) of the NBP Act);
- non-recognition of the role of the ECB and of the EU in the collection of statistics (Article 3(2)(7) and 23 of the NBP Act);
- non-recognition of the role of the ECB in the field of international cooperation (Article 5(1) and 11(3) of the NBP Act);

6.1.5. Assessment of compatibility

As regards the independence of the central bank, the prohibition on monetary financing and the central bank integration into the ESCB at the time of euro adoption, the legislation in Poland, in particular the NBP Act and the Constitution of the Republic of Poland are not fully compatible with the compliance duty under Article 131 of the TFEU.

Table 6.1:
Poland - Components of inflation

	(percentage change)[1]							weights in total
	2010	2011	2012	2013	2014	2015	Apr-16	2016
HICP	2.6	3.9	3.7	0.8	0.1	-0.7	-0.5	1000
Non-energy industrial goods	0.0	1.0	0.9	-0.3	-0.9	-0.8	-1.0	300
Energy	6.3	9.2	8.0	-1.7	-1.2	-4.9	-4.8	135
Unprocessed food	3.1	2.7	4.2	3.3	-1.7	-1.7	0.9	74
Processed food	4.0	6.2	4.4	2.1	1.6	-0.3	-0.2	177
Services	2.5	3.0	3.5	1.6	1.3	1.7	1.7	315
HICP excl. energy and unproc. food	2.0	3.1	2.8	1.0	0.6	0.3	0.2	792
HICP at constant taxes	2.5	3.1	3.4	0.5	-0.3	-0.7	-0.5	1000
Administered prices HICP	3.9	5.3	5.3	1.7	1.2	0.9	1.1	150

1) Measured by the arithmetic average of the latest 12 monthly indices relative to the arithmetic average of the 12 monthly indices in the previous period.

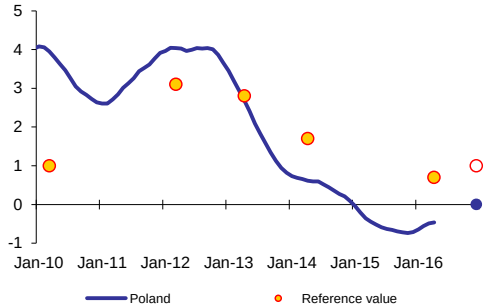
Sources: Eurostat, Commission services.

6.2. PRICE STABILITY

6.2.1. Respect of the reference value

The 12-month average inflation rate, which is used for the convergence assessment, was below the reference value at the time of the last convergence assessment of Poland in 2014. It subsequently followed a gradually declining path and fell below zero in early 2015 reaching -0.7% at the end of 2015. In April 2016, the reference value was 0.7%, calculated as the average of the 12-month average inflation rates in Bulgaria, Slovenia and Spain plus 1.5 percentage points. The corresponding inflation rate in Poland was -0.5%, i.e. 1.2 percentage points below the reference value. The 12-month average inflation rate is projected to remain below the reference value in the months ahead.

Graph 6.1: **Poland - Inflation criterion since 2010**
(percent, 12-month moving average)

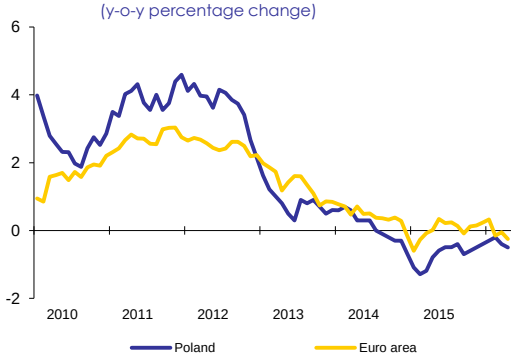


Note: The dots in December 2016 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2016 Forecast.

6.2.2. Recent inflation developments

Annual HICP inflation fell from a local high of 0.7% in February 2014 to zero in July 2014, before turning negative in the next month. It then fell to a minimum of -1.3% in February 2015, recovering gradually to around -0.4% in early 2016. Falling global oil prices were the main driver of these changes. Food price deflation was determined by declining global prices of agricultural products, a good harvest in autumn 2014 in Poland and the Russian embargo on imports of agri-food products introduced in August 2014. Relative stability of the zloty exchange rate in 2014 coupled with slow price growth in Poland's trade partners has dented import prices. Falling producer prices in industry reflected a lack of cost pressure.

Graph 6.2: **Poland - HICP inflation**
(y-o-y percentage change)



Source: Eurostat.

In early 2014, core inflation (measured as HICP inflation excluding energy and unprocessed food) stayed broadly at the same level as HICP inflation. It then fell slightly to 0.4% in July 2014 and since then has remained relatively low, fluctuating in the narrow corridor between 0.1% and 0.4%. Whereas non-energy industrial goods prices continued to

Table 6.2:
Poland - Other inflation and cost indicators **(annual percentage change)**

	2010	2011	2012	2013	2014	2015[1)]	2016[2)]	2017[2)]
HICP inflation								
Poland	2.6	3.9	3.7	0.8	0.1	-0.7	0.0	1.6
Euro area	1.6	2.7	2.5	1.3	0.4	0.0	0.2	1.4
Private consumption deflator								
Poland	3.2	4.9	3.4	0.4	-0.3	-1.2	0.0	1.6
Euro area	1.6	2.3	1.9	1.1	0.5	0.2	0.4	1.3
Nominal compensation per employee								
Poland	10.1	5.3	3.6	1.7	1.6	3.1	3.8	4.3
Euro area	2.2	2.2	1.8	1.7	1.3	1.2	1.5	1.9
Labour productivity								
Poland	6.6	4.4	1.4	1.3	1.5	2.2	3.0	3.0
Euro area	2.8	1.5	-0.1	0.6	0.3	0.6	0.5	0.8
Nominal unit labour costs								
Poland	3.3	0.9	2.1	0.3	0.1	0.9	0.8	1.3
Euro area	-0.6	0.6	1.9	1.1	1.0	0.7	0.9	1.1
Imports of goods deflator								
Poland	1.8	9.5	5.8	-1.2	-2.2	-1.3	0.0	2.0
Euro area	6.0	7.0	2.6	-2.0	-2.6	-3.6	-2.7	1.1

1) Nominal compensation per employee and nominal unit labour costs for 2015 are estimates.

2) Commission services' Spring 2016 Forecast.

Source: Eurostat, Commission services.

decline throughout 2014 and 2015, reflecting weak inflationary pressures at global markets, processed food prices only declined in 2015, in line with falling prices of unprocessed food. On the other hand, services price inflation remained positive, given strong domestic demand growth. In the absence of cost pressures, producer price inflation in industry has remained negative since late 2012, averaging -2.2% in 2015.

6.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and cyclical stance

Real GDP increased to 3.3% in 2014 and 3.6% in 2015, slightly above estimates of potential output growth of around 3% and well above the EU average. Growth was mainly driven by private consumption, benefiting from favourable labour market conditions and comparatively low lending rates, and to a lesser extent by investment. The negative output gap is thus estimated to have narrowed considerably. Real GDP growth is projected to stay robust at 3.7% in 2016 and 3.6% in 2017, supported by solid real wage growth, further employment gains and recently announced fiscal measures, with the output gap closing in 2016 and turning positive in 2017.

The fiscal stance, as measured by the change in the structural balance, was tightened in 2014 and slightly tightened in 2015. However, significant pro-cyclical expansion is expected in 2016 to be followed by a more limited fiscal expansion in 2017 as supplementary spending plans will not be fully compensated by additional revenue measures.

Monetary policy, conducted within an inflation targeting framework ([60]), was eased as the Monetary Policy Council (MPC) cut its main policy rate steadily from 4.75% in November 2012 to 2.5% in July 2013 in line with the subsequent disinflation trend. The MPC again lowered the key rate in October 2014 to 2.0% and further to 1.5% in March 2015 as inflation decelerated and moved into negative territory in 2015. The MPC then kept the policy rate unchanged during the second half of 2015 and in early 2016.

Wages and labour costs

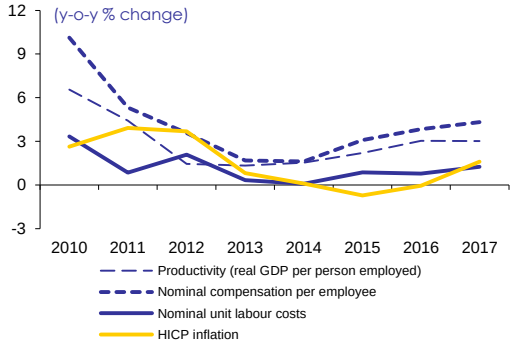
Employment has been consistently on the rise since mid-2013 reaching the highest values since comparable data are available at the end of 2015 (both in terms of absolute numbers as well as the employment rate). In line with this, the

([60]) Since the beginning of 2004, the NBP has pursued a continuous inflation target of 2.5% with a permissible fluctuation band of +/- 1 percentage point.

unemployment rate has declined steadily since 2013 returning to pre-crisis (2008) level of around 7% by the end of 2015.

Following a period of sluggish growth, labour productivity accelerated in 2014 and especially in 2015. Compensation per employee followed a similar trend, with somewhat stronger growth in 2015 translating into nominal ULC growing by 0.9%, up from zero in the previous year ([61]). With unemployment at record lows and expectations of a further reduction, wage pressures are expected to strengthen with ULC growth of over 1% in 2017.

Graph 6.3: **Poland - Inflation, productivity and wage trends**



Source: Eurostat, Commission services' Spring 2016 Forecast.

External factors

Although external trade represents a lower share of GDP in Poland than in regional peers, prices of imported goods and services play an important role in domestic price formation. Imported inflation (measured by the imports of goods deflator) has stayed slightly negative since 2013. This was driven by very low inflation globally, relative stability of the zloty exchange rate and since late 2014 also the fall in global oil prices. The import deflator is forecast to increase in 2016 compared to previous year and turn positive in 2017.

Administered prices and taxes

Increases in administered prices ([62]), with a weight of around 15% in the HICP basket (compared to 13% in the euro area), exceeded HICP inflation in recent years. The average annual increase in administered prices was 1.2% in 2014 and 1.1% in 2015. The positive annual rate of growth of administered prices was mainly related to hikes in electricity prices in January 2014 and January 2015. Administered prices are set to decrease in 2016 following decreases in natural gas and electricity prices.

The impact of tax measures on overall consumer price developments was marginal in 2014 and 2015 as constant tax inflation lingered only some 0.4 pp. below headline inflation in 2014 while both inflation measures were identical in 2015. In 2014 a marginally positive inflation contribution was provided by higher excise duties on alcohol and tobacco.

Medium-term prospects

Looking ahead, inflation is expected to increase only gradually. The low global inflation environment and subdued commodity prices should counteract positive impulses from the expected gradual acceleration of wages. The Commission services' Spring 2016 Forecast projects annual HICP inflation to average 0.0% in 2016 and 1.6% in 2017.

Risks to the inflation outlook appear to be broadly balanced. On the one hand, possible exchange rate depreciation, for instance due to increased capital outflows, could result in higher consumer price growth. On the other hand, the outlook for global growth, commodity prices and related price pressures remains fragile.

The level of consumer prices in Poland was at around 55% of the euro-area average in 2014. This suggests potential for further price level convergence in the long term, as income levels (about 64% of the euro-area average in PPS in 2014) increase towards the euro-area average. On the other hand, in the last decade the relatively fast convergence in income level was actually associated with divergence in comparative price levels.

Medium-term inflation prospects in Poland will hinge upon wage and productivity trends as well as on the functioning of product markets. Further structural measures to increase labour supply and to facilitate the effective allocation of labour market resources will play an important role in alleviating potential wage pressures, resulting inter alia from negative demographic developments. As

([61]) Please note that recent quarterly figures would suggest a different estimate for 2015.

([62]) According to the Eurostat definition, administered prices in Poland include *inter alia* water supply, refuse and sewerage collection, electricity, gas, heat energy and certain categories of passenger transport. For details, see http://ec.europa.eu/eurostat/documents/272892/272989/HICP-AP+classification+2015-02/023e5b4d-6300-47dc-b7aa-27d1e5013f3b

Table 6.3:

Poland - Budgetary developments and projections **(as % of GDP unless indicated otherwise)**

Outturn and forecast [1]	2010	2011	2012	2013	2014	2015	2016	2017
General government balance	-7.5	-4.9	-3.7	-4.0	-3.3	-2.6	-2.6	-3.1
- Total revenues	38.1	38.8	38.9	38.4	38.9	38.9	39.1	39.1
- Total expenditure	45.6	43.6	42.6	42.4	42.2	41.5	41.7	42.2
of which:								
- Interest expenditure	2.5	2.5	2.7	2.5	1.9	1.8	1.7	1.5
p.m.: Tax burden	32.0	32.5	32.8	32.8	33.0	33.3	33.7	33.5
Primary balance	-5.0	-2.3	-1.0	-1.5	-1.4	-0.8	-0.9	-1.5
Cyclically-adjusted balance	-8.2	-6.0	-3.9	-3.4	-2.8	-2.4	-2.6	-3.3
One-off and temporary measures	0.0	0.0	0.1	0.0	-0.2	0.0	0.4	0.0
Structural balance [2]	-8.2	-6.0	-4.0	-3.4	-2.6	-2.3	-3.0	-3.3
Government gross debt	53.3	54.4	54.0	56.0	50.5	51.3	52.0	52.7
p.m: Real GDP growth (%)	3.7	5.0	1.6	1.3	3.3	3.6	3.7	3.6
p.m: Output gap	1.4	2.3	0.4	-1.2	-1.0	-0.5	0.0	0.4

Convergence programme	2016	2017	2018	2019
General government balance	-2.6	-2.9	-2.0	-1.3
Structural balance [2] [3]	-2.9	-2.7	-2.1	-1.6
Government gross debt	52.0	52.5	52.0	50.4
p.m. Real GDP (% change)	3.8	3.9	4.0	4.1

1) Commission services' Spring 2016 Forecast.

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

3) Commission services' calculations on the basis of the information in the programme.

Sources: Commission services, the 2016 Convergence Programme of Poland.

to product markets, there is scope to enhance the competitive environment, especially in the services and energy sectors. At the macro level, a prudent fiscal stance will be essential to contain inflationary pressures.

6.3. PUBLIC FINANCES

6.3.1. Recent fiscal developments

In June 2015, the Council decided to abrogate the decision on the existence of an excessive deficit according to Article 126(12) TFEU, thereby closing the excessive deficit procedure for Poland ([63]). While the general government deficit was slightly above 3% of GDP in 2014, Poland was eligible for abrogation under the Stability and Growth Pact provisions concerning systemic pension reforms - Article 2(7) of Regulation (EC) 1467/97. In particular, the total net costs in 2014 of the 1999 systemic pension reform were estimated at 0.4% of GDP. The Council considered them to be sufficient to explain the excess of the deficit over the 3% of GDP reference value in 2014.

The general government deficit declined from 3.3% of GDP in 2014 to 2.6% in 2015. In structural terms, the deficit also improved by 0.3 pp. to 2.3% of GDP in 2015. The ratio of total government expenditure to GDP has followed a downward trend since 2010. The ratio fell from 42.2% of GDP in 2014 to 41.5% in 2015. Debt servicing costs decreased visibly, while investment expenditure was on the rise. Total government revenue remained at 38.9% of GDP in 2014 and in 2015.

In 2014, the deficit reduction was driven by both an improvement in revenues and a small fall in government expenditures. On the revenue side VAT collection improved after the particularly weak performance in the previous year, while a better labour market situation supported stronger personal income tax collection. Government revenues from social contributions also increased, due to re-direction from the second to the first pension pillar, in the context of the reversal of the 1999 pension system reform made in 2013. On the expenditure side, the improvement was mostly due to the substantial fall in the costs of public debt servicing. Moreover, the government maintained the freeze in the wage fund of public sector employees.

([63]) An overview of all excessive deficit procedures can be found at: http://ec.europa.eu/economy_finance/economic_governance/sgp/deficit/index_en.htm

In 2015, the further decrease in the budget deficit was driven by falling expenditures. In particular, expenditures on compensation of employees increased much below the rate suggested by private sector wage dynamics helped by a continued freeze of the wage bill for most central government institutions. In addition, public debt servicing costs continued to fall benefitting from low interest rates. On the revenue side, social contributions increased dynamically following acceleration of wage and employment growth, while both taxes on production and imports and current taxes on income and wealth stayed at the 2014 level in relation to nominal GDP.

The significant fall of the general government debt in 2014, down by more than 5 pp. to 50.4% of GDP, is mainly explained by a large one-off transfer of private pension fund assets. In 2015, government debt increased to 51.3% of GDP.

6.3.2. Medium-term prospects

The 2016 budget was adopted only on 3 March 2016, as following the elections the new government amended the draft budget submitted to the Parliament by the outgoing government. The key amendment on the expenditure side was an increase of around 0.9% of GDP to finance the new child benefit. Revenues were also adjusted upwards. One-off revenue (around 0.5% of GDP) from the sale of mobile internet frequencies was moved to the 2016 budget, from the 2015 budget (which was also amended in December 2015). In addition, revenues from two new taxes (on assets of financial institutions and the retail sector) amounting to around 0.4% of GDP were incorporated in the planned revenue. Only the tax on assets of financial institutions was implemented from February 2016, while the other remained in the stage of consultations as of April. The Commission services' Spring 2016 Forecast projects a general government deficit of 2.6% of GDP in 2016, broadly in line with the level specified in the budget law, while assuming no revenue from the planned retail sector tax.

The general government deficit is projected to widen to 3.1% of GDP in 2017 under the no-policy-change scenario. The increase of the projected deficit is mainly explained by additional costs of the child benefit (in 2016 it entered into force only in the second quarter), legislated decrease in VAT rates and lack of other one-off revenues in 2017. The structural deficit is expected to deteriorate from 2¼% of GDP in 2015 to 3¼% of GDP in 2017.

The general government debt-to-GDP ratio is forecast to increase to 52.7% in 2017. The projected debt figures are, however, subject to considerable uncertainty in view of possible valuation effects of the sovereign debt denominated in foreign currency due to exchange rate fluctuations.

The 2016 Convergence Programme was submitted on 28 April 2016. It foresees an increase in the structural budget balance to 3.1% of GDP in 2016 and its gradual decrease in subsequent years. The Medium Term Objective of a structural deficit of not more than 1% of GDP is not expected to be reached within the programme period (2019). The nominal balance is expected in the Programme to be in a deficit of 2.6% of GDP in 2016, widening to 2.9% of GDP in 2017 and gradually declining thereafter. These projections are in line with the Commission services' Spring 2016 Forecast as regards 2016 and more favourable thereafter, in particular due to a slightly more optimistic macroeconomic scenario underpinning these budgetary projections. Based on the Commission's assessment of the 2016 Convergence Programme, there is a risk that Poland will not comply with the provisions of the Stability and Growth Pact, as there is a risk of a significant deviation from the recommended adjustment both in 2016 and, under unchanged policies, in 2017. Therefore further measures will be needed to ensure compliance in 2016 and 2017. Further details can be found in the Assessment of the 2016 Convergence Programme for Poland ([64]).

As far as the national fiscal framework is concerned – which refers to numerical fiscal rules, medium-term budgetary frameworks, independent fiscal institutions, and budgetary procedures – Poland fares relatively well, but lacks an independent fiscal council. Medium-term budgetary planning is based on the Multiannual State Financial Plan which covers four years and constitutes a basis for the preparation of annual budgets. There is a constitutional debt threshold for the general government and a separate debt rule for local governments. A new stabilising expenditure rule covering almost the entire general government was introduced at the end of 2013. In

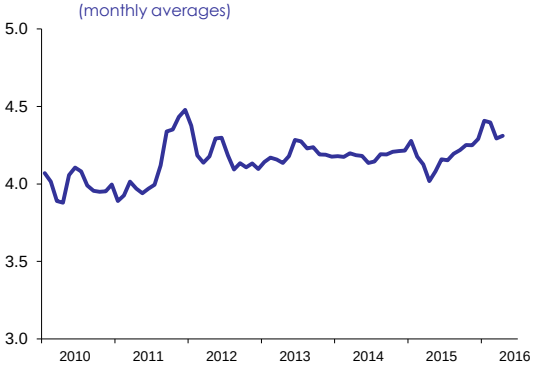
([64]) http://ec.europa.eu/economy_finance/economic_governance/sgp/convergence/index_en.htm

spite of the existence of these important elements of the framework, its credibility is compromised by frequent changes to the rules. Moreover, Poland is currently the only EU Member State without an independent fiscal council or plans to create one. Typically remits of such fiscal councils cover carrying out ex ante and ex post monitoring of compliance with fiscal rules, assessment of macroeconomic and budgetary forecasts as well as analysis of the long-term sustainability of public finances.

6.4. EXCHANGE RATE STABILITY

The Polish zloty does not participate in ERM II. Since April 2000, Poland operates a floating exchange rate regime, with the NBP preserving the right to intervene in the foreign exchange market, if it deems this necessary, in order to achieve the inflation target ([65]).

Graph 6.4: **Poland - PLN/EUR exchange rate**
(monthly averages)



Source: ECB.

The zloty broadly stabilised and predominantly traded in the range of 4.1-4.2 PLN/EUR during 2013 and until end of 2014. Zloty volatility increased thereafter. It weakened rather sharply in December 2014 along regional peers. It appreciated rather steeply in the beginning of 2015 following the Swiss National Bank's decision to let the CHF appreciate, touching below 4 PLN/EUR in April supported by accelerating economic growth, ECB easing and the end of the monetary easing cycle in Poland. The zloty then depreciated gradually in the second half of 2015, affected by domestic political uncertainty, and then rather sharply in January 2016 following the S&P credit rating downgrade, reaching 4.5 PLN/EUR. Exchange rate volatility in early 2016 was driven by factors such as a credit rating downgrade, benign global risks and compression of risk premia. Inter-day exchange rate volatility during this period was highest in February 2016 and declined since then. Poland has benefited from a Flexible Credit Line arrangement with the IMF since 2009. Compared to April 2014, the exchange rate of the zloty against the euro was around 2.9% weaker in April 2016.

Graph 6.5: **Poland - 3-M Wibor spread to 3-M Euribor**
(basis points, monthly values)

Source: Eurostat.

International reserves held by the NBP increased gradually from around EUR 77 billion by end-2013 to EUR 82 billion by end-2014 and fluctuated around EUR 90 billion during 2015 and at beginning of 2016. The reserve-to-GDP ratio was at around 20% by end-2015. The level of international reserves was mainly influenced by sovereign debt management decisions, inflows of EU funds and FX fluctuations.

Short-term interest rate differentials vis-à-vis the euro area remained in the range between 200 and 250 basis points during 2014. They started to decline at the end-2014 hitting a low of 165 basis points in early 2015, reflecting considerable monetary policy easing by the NBP, which gradually cut its key reference rate by 325 basis points between November 2012 and March 2015. Interest rate differentials have been widening gradually since then, reflecting mainly additional monetary policy easing by the ECB as well as domestic political uncertainties. At the cut-off date of this report, the 3-month spread vis-à-vis the euro area stood at around 190 basis points.

6.5. LONG-TERM INTEREST RATES

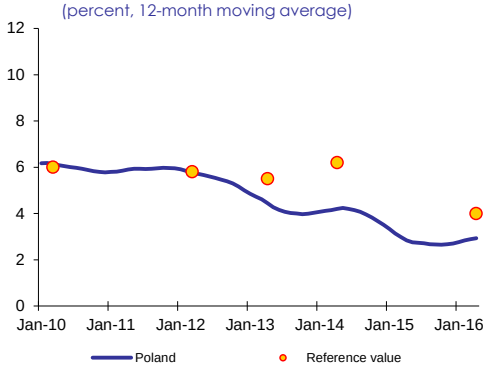
Long-term interest rates in Poland used for the convergence examination reflect secondary market yields on a single benchmark government bond

([65]) As from beginning of 2004, the inflation target of the NBP is set as annual consumer price index growth of 2.5% (with a permissible fluctuation band of ± 1 percentage point).

with a residual maturity of close to but below 10 years.

The Polish 12-month average long-term interest rate relevant for the assessment of the Treaty criterion was 2 percentage points below the reference value at the time of the last convergence assessment in 2014. It declined further from above 4% at the beginning of 2014 to below 4% at the end of 2014 due to improving market confidence.

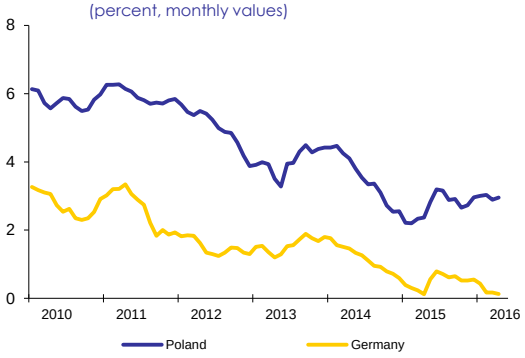
Graph 6.6: **Poland - Long-term interest rate criterion**
(percent, 12-month moving average)



Source: Commission services.

It went further down to around 3% in early 2015. It stayed around 2.7% during 2015 but increased slightly at the beginning of 2016 due to changing investors' risk perceptions, following S&P credit rating downgrade. In April 2016, the latest month for which data are available, the reference value, given by the average of long-term interest rates in Bulgaria, Slovenia and Spain plus 2 percentage points, stood at 4.0%. In that month, the 12-month moving average of the yield on the Polish benchmark bond stood at 2.9%, i.e. 1.1 percentage points below the reference value.

Graph 6.7: **Poland - Long-term interest rates**
(percent, monthly values)



Source: Eurostat.

Long-term interest rates declined from around 4.1% in early 2014 to just above 2% at the beginning of 2015, reflecting improved investor sentiment towards the country, strong economic growth as well as a substantial fall in domestic inflation. Long-term interest rates increased again during 2015 and fluctuated around 3% as risk appetite in global financial markets dwindled while perceptions of domestic political risks increased.

As a result, long-term interest rate spreads vis-à-vis the German benchmark bond increased to around 280 basis points in early 2016 ([66]).

6.6. ADDITIONAL FACTORS

The Treaty (Article 140 TFEU) calls for an examination of other factors relevant to economic integration and convergence to be taken into account in the assessment. The assessment of the additional factors – including balance of payments developments, product and financial market integration – gives an important indication of a Member State's ability to integrate into the euro area without difficulties.

In November 2015, the Commission published its third Alert Mechanism Report (AMR 2016) ([67]) under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.5). The AMR 2016 scoreboard showed that Poland exceeded the indicative threshold for one out of fourteen indicators, i.e. the international investment position. In line with the conclusions of the AMRs 2012-2016, Poland has not been subject to in-depth reviews in the context of the MIP.

6.6.1. Developments of the balance of payments

Poland's external balance (i.e. the combined current and capital account) has been positive since 2013, mainly reflecting a further improvement in the trade balance, which shifted into surplus. Although export growth remained solid, the trade in goods deficit widened somewhat in 2014 primarily due to strengthening imports reflecting a rebound in domestic demand. Lower prices of imported energy commodities helped the trade balance turn positive in 2015. The narrowing of the current account deficit was also supported

([66]) The reference to the German benchmark bond is included for illustrative purposes, as a proxy of the euro area long-term AAA yield.

([67]) http://ec.europa.eu/europe2020/pdf/2016/ags2016_alert_mechanism_report.pdf

Table 6.4:

Poland - Balance of payments **(percentage of GDP)**

	2010	2011	2012	2013	2014	2015
Current account	-5.4	-5.2	-3.7	-1.3	-2.0	-0.2
of which: Balance of trade in goods	-3.0	-3.5	-2.1	-0.1	-0.8	0.5
Balance of trade in services	0.9	1.4	1.5	1.9	2.1	2.3
Primary income balance	-3.3	-3.2	-3.1	-3.0	-3.2	-2.8
Secondary income balance	0.0	0.2	0.0	-0.1	-0.1	-0.2
Capital account	1.8	1.9	2.2	2.3	2.4	2.4
External balance [1)]	-3.6	-3.3	-1.5	1.0	0.4	2.1
Financial account [2)]	-6.4	-5.2	-2.3	-1.1	-0.8	1.8
of which: Direct investment	-1.8	-2.6	-1.2	-0.8	-2.0	-0.7
Portfolio investment	-6.1	-3.2	-3.9	0.0	0.4	0.7
Other investment [3)]	-1.8	-0.6	0.6	-0.5	0.7	1.6
Change in reserves	3.2	1.2	2.2	0.2	0.1	0.2
Financial account without reserves	-9.6	-6.4	-4.5	-1.3	-0.9	1.6
Errors and omissions	-2.8	-1.9	-0.8	-2.1	-1.2	-0.4
Gross capital formation	21.3	22.4	21.0	19.0	20.4	20.5
Gross saving	16.5	17.7	17.7	18.5	19.1	20.6
Gross external debt	65.8	65.4	72.1	70.6	71.0	70.3
International investment position	-65.1	-62.4	-65.4	-69.0	-68.5	-61.9

1) The combined current and capital account.

2) The data is presented under BPM6 methodology, where the signs of financial account items are the opposite as under BPM5 (that was used in earlier Convergence Reports).

3) Including financial derivatives.

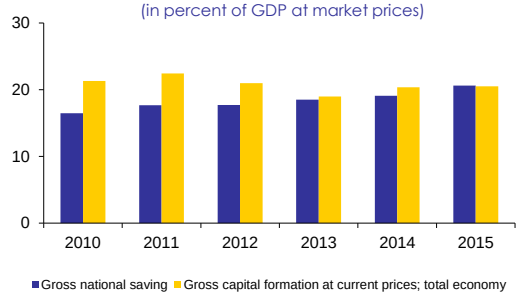
Sources: Eurostat, Commission services, National Bank of Poland.

by consistently strong performance of services exports. At the same time, the negative primary income balance remained broadly stable in 2013-2015 while the secondary income balance was close to zero.

As far as the saving-investment balance is concerned, gross national saving (as a percentage of GDP) kept increasing after 2013. In 2014, the increase was driven by rising gross saving of the corporate sector, which was partially offset by lower saving by households and the government. In 2015, gross national saving increased further as households started to increase their savings again. At the same time, gross fixed capital formation (as a percentage of GDP) increased in 2014 and remained relatively stable in 2015, after a fall in 2013. This was driven by both public and private sectors investment spending. However, the private sector investment-to-GDP ratio in Poland remains below the level observed among its regional peers.

Poland's external competitiveness appears to have remained solid. Poland's export performance was very strong over the past two years with gains in market shares. Strong cost-competitiveness has been an important factor. Since the second half of 2014, both the nominal and real effective exchange rate have followed a depreciation trend, with a temporary reversal in the first quarter of 2015 and then again in early 2016.

Graph 6.8: **Poland - Saving and investment**
(in percent of GDP at market prices)



Source: Eurostat, Commission services.

On the financing account of the balance of payments, direct investment recorded a net inflow of 2.0% of GDP in 2014 and 0.7% of GDP in 2015. The portfolio investment showed net outflows in 2014 and 2015, primarily due to increased residents' holdings of portfolio debt and equity abroad and marginal inflows of non-residents' financing at the sovereign debt market.

Table 6.5:
Poland - Market integration

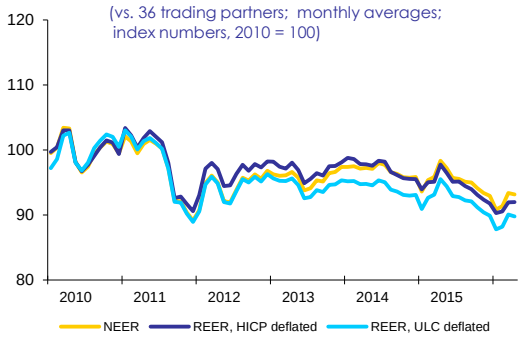
	2010	2011	2012	2013	2014	2015
Trade openness [1] (%)	42.2	44.8	45.9	46.9	48.4	49.4
Trade with EA in goods & services [2)+3)] (%)	24.1	25.2	25.1	25.6	27.0	27.8
Export performance (% change) [4]	1.3	1.6	2.9	4.6	3.3	3.5
World Bank's Ease of Doing Business Index rankings [5]	59	62	55	45	28	25
WEF's Global Competitiveness Index rankings [6]	39	41	41	42	43	41
Internal Market Transposition Deficit [7] (%)	1.7	2.1	1.8	1.2	0.7	1.5
Real house price index [8]	100.0	95.4	89.0	84.8	85.8	88.1
Residential investment [9] (%)	2.6	2.5	2.6	2.6	2.4	2.5

1) (Imports + Exports of goods and services / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics, Balance of Payments).
2) (Imports + Exports of goods with EA-19 / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).
3) Trade in services with EA-19 (average credit and debit in % of GDP at current prices) (Balance of Payments).
4) Index for exports of goods and services divided by an index for growth of markets (percentage change on preceding year).
5) New methodology as of 2014 (World Bank).
6) (World Economic Forum)
7) Percentage of internal market directives not yet communicated as having been transposed, relative to the total. (Nov. data, May in 2013 and 2015).
8) Deflated house price index (2010=100), Eurostat.
9) Gross capital formation in residential buildings (in % of GDP), Eurostat.

Sources: Eurostat, World Bank, World Economic Forum, Commission services.

The other investment also registered net outflows in 2014 and 2015.

Graph 6.9: **Poland - Effective exchange rates**



Source: Commission services.

Total gross external debt increased somewhat from 70.6% of GDP in 2013 to 71% of GDP in 2014 but decreased to 70.3% of GDP in 2015, while the negative net international investment position (NIIP) narrowed significantly from 69% of GDP in 2013 to 61.9% of GDP in 2015. Although this is well beyond the indicative threshold set in the MIP (-35% of GDP), a major part of the NIIP consists of the accumulated stock of foreign direct investments. Since May 2009, the stability of the balance of payments has been supported by precautionary access to the IMF's Flexible Credit Line (FCL) arrangement. As a step towards a gradual exit from the arrangement, in January 2015 and then again in January 2016 the size of the FCL was lowered due to strong fundamentals and abating external risks.

According to the Commission services' Spring 2016 Forecast, the external balance is expected to gradually deteriorate to 0.9% of GDP in 2016 and 0.4% of GDP 2017 as imports are foreseen to outpace exports.

6.6.2. Market integration

Poland's economy is well integrated with the euro area through both trade and investment linkages. Following a decrease in 2008-2009 as a result of the crisis, trade openness increased in the following years, reaching some 49% of GDP in 2015. The share of trade with euro-area partners expressed in percentage of GDP has been increasing in recent years, reaching 28% in 2015. Within the euro area, Poland mainly trades with Germany, the Netherlands, Italy and France, while outside the euro area its main trading partners are, the Czech Republic, Russia and the United Kingdom.

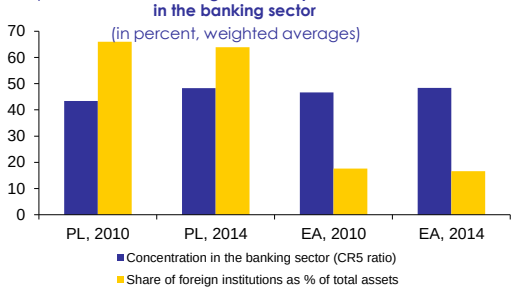
FDI inflows to Poland have mainly originated in Germany, the Netherlands, France and Luxembourg, which together provided over 50% of the FDI stock at the end of 2014. The significant size and growth of the domestic market as well as good access to large regional markets have supported the attractiveness of the country for FDI.

Concerning the business environment, Poland performs in general worse than most euro-area

Member States in international rankings. Moreover, according to the May 2015 Internal Market Scoreboard, Poland's transposition deficit of EU Directives was at 1.5% which is substantially above the target (0.5%) proposed by the European Commission in the Single Market Act (2011).

The current segmentation with a substantial share of temporary employment of the Polish labour market affects productivity and the accumulation of human capital in the longer term. Shortcomings in the education system and in the design of active labour market policies lead to mismatches between labour demand and supply. Poland has recently taken some measures to tackle labour market segmentation. The Polish labour market can be considered as rather flexible in terms of employment protection (as measured by the 2013 OECD employment protection indicator, while collective bargaining has a stronger impact on wage formation in sectors dominated by state enterprises, such as mining. Preferential sector-specific social security arrangements — in particular the highly subsidised pension systems for farmers and miners — also reduce labour mobility and have high budgetary costs. Outward migration flows, especially after EU accession in 2004, were substantial, while domestic labour mobility is hampered by factors such as housing policies, transport infrastructure, access to child care and skills mismatches.

Graph 6.10: **Poland - Foreign ownership and concentration in the banking sector**



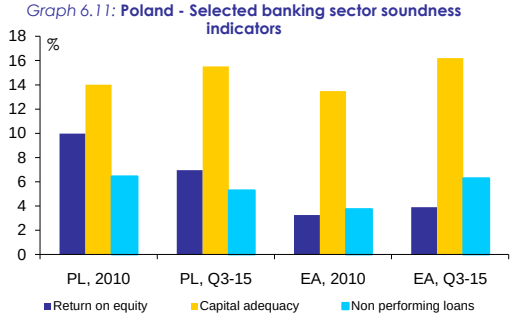
Source: ECB, Structural financial indicators.

Poland's financial sector is well integrated within the overall EU financial system. In 2015, around 64% of the Polish banking sector's assets were owned by foreign financial institutions, predominantly from EU Member States. Concentration in the Polish banking sector has remained close to the euro-area average. The share of total assets owned by the five largest lenders amounted to 48%.

The capitalisation of banks continued to improve reaching a capital adequacy ratio (CAR) of 14.9% in 2014. Profitability remained high in 2014, with return on equity (ROE) at around 10%, however, it decreased to 7% in Q3 2015, mainly due to record low interest rates and higher contributions to the Bank Guarantee Fund. The new tax on financial sector assets is expected to weigh on the profitability of the banking sector, which could also be negatively affected by pending proposals to convert foreign-currency denominated loans. The non-performing loans ratio broadly followed the euro-area trend and deteriorated during the crisis to about 6½% in 2009-2010, up from 3.9% in 2007, before dropping to 5.3% in Q3 2015.

According to Eurostat, real house prices in Poland declined by over 28% between 2008 and 2013. House prices started to recover in 2014 and increased by 2.3% in 2015. Investment in dwellings has remained relatively stable at around 2.5% of GDP.

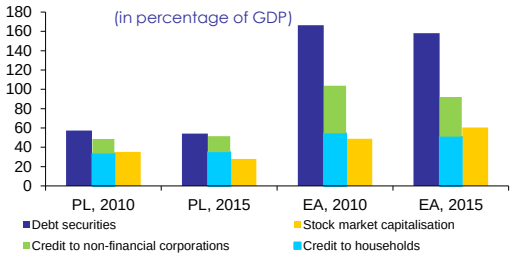
Graph 6.11: **Poland - Selected banking sector soundness indicators**



Source: ECB, EC calculations.

The financial system in Poland is smaller relative to GDP than that of the euro area. Credit to the private economy (households and non-financial corporations) has increased to 49% of GDP in 2014 from 39% in 2007. The share of foreign-currency denominated loans remains significant (around 30% of the total loan stock), particularly in the mortgage loan segment where around 40% of housing loans are denominated either in Swiss franc or euro. Nevertheless, the share of foreign-currency denominated loans has been gradually declining, as most banks do not offer them since 2009.

Graph 6.12: **Poland - Recent development of the financial system relative to the euro area**



Note: Debt Securities other than shares, excluding financial derivatives.
Source: ECB, Commission services.

The total capitalisation of the Warsaw Stock Exchange represented 28% of GDP in 2015, down from a pre-crisis record high of 45% of GDP in 2007, following the decrease in private pension funds involvement in the capital market. The debt securities market is one of most liquid in the region but remains small in comparison with the euro area (54% against 158% of GDP). The market is dominated by government bonds (over 90% share) while corporate bonds account for only about 7% of the outstanding amounts. Consolidated private sector debt went up from around 70% to close to 79% of GDP in 2015, significantly below the euro-area average.

7. ROMANIA

7.1. LEGAL COMPATIBILITY

7.1.1. Introduction

The Banca Naţională a României (BNR) is governed by Law No. 312 on the Statute of the Bank of Romania of 28 June 2004 (hereinafter 'the BNR Law') which entered into force on 30 July 2004.

The BNR law has not been amended since the Convergence Report 2014. Therefore, the comments provided in the Convergence Report 2014 are largely repeated in this year's assessment.

7.1.2. Central Bank independence

As regards central bank independence, a number of incompatibilities and imperfections have been identified with respect to the TFEU and the ESCB/ECB Statute.

According to Article 33(10) of the BNR Law, the Minister of Public Finances and one of the State Secretaries in the Ministry of Public Finances may participate, without voting rights, in the meetings of the BNR Board. Although a dialogue between a central bank and third parties is not prohibited as such, this dialogue should be constructed in such a way that the Government should not be in a position to influence the central bank's decision-making in areas for which its independence is protected by the Treaty. The active participation of the Minister and one of the State Secretaries, even without voting right, in discussions of the BNR Board where BNR policy is set could structurally offer to the Government the possibility to influence the central bank when taking its key decisions. Against this background, Article 33(10) of the BNR Law is incompatible with Article 130 of the TFEU.

Article 3(1) of the BNR Law needs to be amended with a view to ensuring full compatibility with Article 130 of the TFEU and Article 7 of the ESCB/ECB Statute. Pursuant to Article 3(1) of the BNR Law, the members of the BNR's decision-making bodies shall not seek or take instructions from public authorities or from any other institution or authority. First, for legal certainty reasons, it should be clarified that the BNR's institutional independence is also protected vis-à-vis national, foreign and EU institutions, bodies, offices or agencies. Moreover, Article 3 should expressly oblige the government not to seek to influence the members of the BNR's decision-making bodies in the performance of their tasks.

The BNR Law should be supplemented by rules and procedures ensuring a smooth and continuous functioning of the BNR in case of the Governor's termination of office (e.g. due to expiration of the term of office, resignation or dismissal). So far, Article 33(5) of the BNR Law provides that in case the Board of BNR becomes incomplete, the vacancies shall be filled following the procedure for the appointment of the members of the Board of BNR. Article 35(5) of the BNR Law stipulates that in case the Governor is absent or incapacitated to act, the Senior Deputy Governor shall replace the Governor.

Pursuant to Article 33(9) of the BNR Law, the decision to recall a member of the BNR Board (including the Governor) from office may be appealed to the Romanian High Court of Cassation and Justice. However, Article 33(9) of the BNR Law remains silent on the right of judicial review by the Court of Justice of the European Union in the event of the Governor's dismissal provided in Article 14.2 of the ESCB/ECB Statute. This imperfection should be corrected.

Article 33(7) of the Law provides that no member of the Board of BNR may be recalled from office for other reasons or following a procedure other than those provided in Article 33(6) of this 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 and the Law 176/2010 on the integrity in the exercise of public functions and dignities define the conflicts of interest incompatibilities applicable to the Governor and other members of the Board of the BNR and require them to report on their interests and wealth. For the sake of legal certainty, it is recommended to remove this imperfection and provide a clarification that the sanctions for the breach of obligations under those Laws do not constitute extra grounds for dismissal of the Governor of the Board of BNR, in addition to those contained in Article 33 of the BNR Law.

According to Articles 21 and 23 of the Law concerning the organisation and functioning of the Court of Auditors (No 94/1992), the Court of Auditors is empowered to control the establishment, management and use of the public sector's financial resources, including BNR's financial resources, and to audit the performance in the management of the funds of the BNR. Those provisions constitute an imperfection as regards article 27.1 of the ESCB/ECB Statutes and thus, for legal certainty reasons, it is recommended to define clearly in the Law that the scope of audit by the Court of Auditors, is without prejudice to the activities of the BNR's independent external auditors.

Article 43 of the BNR Law provides that the BNR 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. Such a procedure could, in certain circumstances, be seen as an intra-year credit, which negatively impacts on the financial independence of the BNR. A Member State may not put its central bank in a position where it has insufficient financial resources to carry out its ESCB tasks, and also its own national tasks, such as financing its administration and own operations. Article 43(3) of the BNR Law also provides that the BNR sets up provisions for credit risk in accordance with its rules, after having consulted the Ministry of Public Finance. The central bank must be free to independently create financial provisions to safeguard the real value of its capital and assets. Article 43 of the BNR Law is incompatible with Article 130 of the TFEU and Article 7 of the ECB/ESCB Statute and should, therefore, be adapted, to ensure that the above arrangements do not undermine the ability of the BNR to carry out its tasks in an independent manner.

7.1.3. Prohibition of monetary financing and privileged access

According to Article 26 of the BNR Law, the BNR under exceptional circumstances and only on a case-by-case basis may grant loans to credit institutions which are unsecured or secured with assets other than assets eligible to collateralise the monetary or foreign exchange policy operations of the BNR. It cannot be excluded that such lending results in the provision of solvency support to a credit institution that is facing financial difficulties and thereby would breach the prohibition of monetary financing and be incompatible with Article 123 of the TFEU. Article 26 of the BNR Law should be amended to avoid such a lending operation.

Articles 6(1) and 29(1) of the BNR Law prohibit the direct purchases by the BNR in the primary market of debt instruments issued by the State, national and local public authorities, autonomous public enterprises, national corporations, national companies and other majority state-owned companies. Article 6(2) of the BNR Law extends this prohibition to the debt instruments issued by other bodies governed by public law and public undertakings of other EU Member States. Article 7(2) of the BNR Law prohibits the BNR 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) of the BNR Law extends this prohibition to other bodies governed by public law and public undertakings of Member States. These provisions do not fully mirror the entities listed in Article 123 of the TFEU (amongst others, a reference to Union institutions is missing) and, therefore, have to be amended.

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

As noted above in point 8.1.2., Article 43 of the BNR Law provides that the BNR shall transfer to the State on a monthly basis 80% of its net revenues left after deduction of the expenses related to the financial year and the uncovered loss of the previous financial years. This provision does not rule out the possibility of an intra-year anticipated profit distribution under circumstances where the BNR would accumulate profit during the first half of a year, but suffer losses during the second half. The adjustment would be made by the State only after the closure of the financial year

and would thus imply an intra-year credit to the State, which would breach the prohibition on monetary financing. This provision is, therefore, also incompatible with the Article 123 of the TFEU and has to be amended.

7.1.4. Integration in the ESCB

Objectives

Pursuant to Article 2(3) of the BNR Law, the secondary objective of the BNR is to support the State's general economic policy. Article 2(3) of the BNR Law contains an imperfection as it should contain a reference to the general economic policies in the Union as per Article 127(1) of the TFEU and Article 2 of the ESCB/ECB Statute.

Tasks

The incompatibilities in the BNR Law are linked to the following ESCB/ECB tasks:

- definition of monetary policy and monetary functions, operations and instruments of the ESCB (Articles 2(2)(a), 5, 6(3), 7(1), 8, 19, 20 and 22(3) and 33(1)(a) of the BNR Law);
- conduct of foreign exchange operations and the definition of foreign exchange policy (Articles 2(2)(a) and (d), 9 and 33(1)(a) of the BNR Law);
- holding and management of foreign reserves (Articles 2(2)(e), 9(2)(c), 30 and 31 of the BNR Law);
- right to authorise the issue of banknotes and the volume of coins (Articles 2(2)(c), 12 to 18 of the BNR Law);
- non-recognition of the role of the ECB and of the Council in regulating, monitoring and controlling foreign currency transactions (Articles 10 and 11 of the BNR Law);
- lack of reference to the role of the ECB in payment systems (Articles 2(2)(b), 22 and 33(1)(b) of the BNR Law).

There are also imperfections regarding the:

- non-recognition of the role of the ECB and the EU in the collection of statistics (Article 49 of the BNR Law);
- non-recognition of the role of the ECB and of the Council in the appointment of an external auditor (Article 36(1) of the BNR Law);
- absence of an obligation to comply with the ESCB/ECB regime for the financial reporting of NCB operations (Articles 37(3) and 40 of the BNR Law);
- non-recognition of the ECB's right to impose sanctions (Article 57 of the BNR Law).

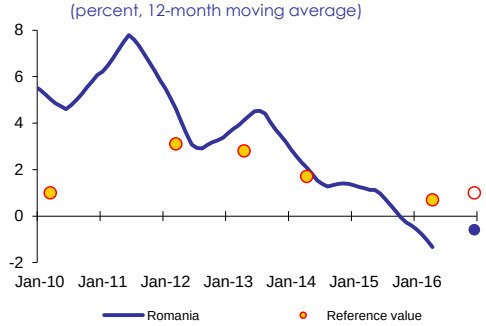
7.1.5. Assessment of compatibility

As regards the independence of the BNR, the prohibition on monetary financing and the BNR's integration into the ESCB at the time of euro adoption, the legislation in Romania, in particular the BNR Law, is not fully compatible with the compliance duty under Article 131 of the TFEU.

7.2. PRICE STABILITY

7.2.1. Respect of the reference value

Graph 7.1: **Romania - Inflation criterion since 2010**
(percent, 12-month moving average)



Note: The dots in December 2016 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2016 Forecast.

The 12-month average inflation rate, which is used for the convergence assessment, was above the reference value at the time of the last convergence assessment of Romania in 2014. Average annual inflation has declined steadily since then, moving into negative territory since October 2015 and gradually falling to -1% in early 2016. In April 2016, the reference value was 0.7%, calculated as the average of the 12-month average inflation rates in Bulgaria, Slovenia and Spain plus 1.5 percentage points. The average inflation rate in Romania during the 12 months to April 2016 was -1.3%, i.e. 2.0 percentage points below the reference value. It is projected to remain well below the reference value in the months ahead.

Table 7.1:
Romania - Components of inflation (percentage change)[1] weights in total

	2010	2011	2012	2013	2014	2015	Apr-16	2016
HICP	6.1	5.8	3.4	3.2	1.4	-0.4	-1.3	1000
Non-energy industrial goods	3.5	3.3	2.4	2.0	1.6	1.0	0.3	252
Energy	7.6	9.3	6.9	4.1	2.3	-2.7	-3.3	119
Unprocessed food	2.9	5.4	0.6	6.4	-0.7	-3.4	-5.2	154
Processed food	10.4	7.5	3.5	2.3	0.2	-1.6	-3.2	213
Services	4.1	3.5	4.2	2.6	3.1	2.2	2.0	262
HICP excl. energy and unproc. food	6.4	5.0	3.3	2.3	1.7	0.7	-0.1	727
HICP at constant taxes	1.8	3.8	3.2	3.0	1.1	1.2	2.0	1000
Administered prices HICP	5.4	7.6	5.3	6.0	2.0	1.6	0.7	138

1) Measured by the arithmetic average of the latest 12 monthly indices relative to the arithmetic average of the 12 monthly indices in the previous period.

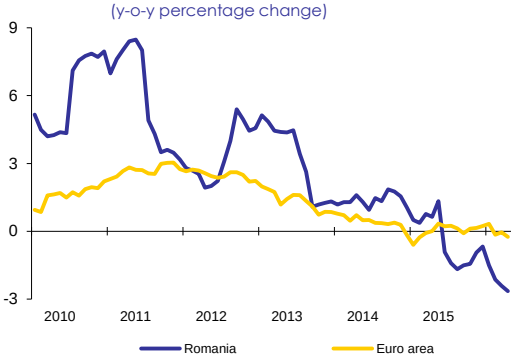
Sources: Eurostat, Commission services.

7.2.2. Recent inflation developments

Annual HICP inflation has been on a downward path over the past two years, mainly driven by successive VAT cuts and low global oil prices, though underlying price pressures have been building amid strong domestic demand supported by fiscal stimulus and high wage growth. It dropped rapidly from around 4.5% at the beginning of 2013 to just above 1% in September 2013 and fluctuated between 1% and 2% for most of 2014. The considerable decline in 2014 was attributable to several factors: (i) the 15 pp. reduction of the VAT rate for flour and bakery products from September 2013, (ii) the abundant harvest in 2014, (iii) falling global energy and oil prices and (iv) disinflationary pressures stemming from a persistently negative output gap. Inflation developments in 2015 and over the forecast horizon (2016-2017) are markedly influenced by fiscal policy, in particular by the successive reductions of the VAT rates for different categories of products. After falling to below 1% in the first months of 2015, inflation moved into negative territory in June 2015 (-0.9%) following the cut of the VAT rate for the remaining food products from 24% to 9%.

The annual HICP inflation rate has been negative since then, reaching a historical low of -2.6% in April 2016. The main reasons for the steep fall in early 2016 were the reduction of the standard VAT rate by 4 pp. from January 2016 and persistently low global oil prices.

Graph 7.2: **Romania - HICP inflation**
(y-o-y percentage change)



Source: Eurostat.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) declined sharply by almost 2 pp. in the second half of 2013 and stabilised around 1.6% in the first half of 2014. The main drivers were slowing inflation for services and processed food. Annual core inflation increased slightly to 2% in the last quarter of 2014 as the impact of the VAT cut for flour and bakery products wore out. In the second half of 2015, following the cut of the VAT rate for the remaining food products, core inflation dropped below zero, but started a modest recovery as of November 2015. It again turned negative in early 2016, following the cut in the standard VAT rate. Annual average producer price inflation for total industry has been negative since the last quarter of 2014.

Table 7.2:

Romania - Other inflation and cost indicators **(annual percentage change)**

	2010	2011	2012	2013	2014	2015	2016[1)]	2017[1)]
HICP inflation								
Romania	6.1	5.8	3.4	3.2	1.4	-0.4	-0.6	2.5
Euro area	1.6	2.7	2.5	1.3	0.4	0.0	0.2	1.4
Private consumption deflator								
Romania	7.2	4.2	4.5	2.6	1.2	1.2	0.2	1.8
Euro area	1.6	2.3	1.9	1.1	0.5	0.2	0.4	1.3
Nominal compensation per employee								
Romania	1.9	-4.1	9.4	3.8	5.3	3.2	6.9	6.2
Euro area	2.2	2.2	1.8	1.7	1.3	1.2	1.5	1.9
Labour productivity								
Romania	-0.5	1.9	5.7	4.4	2.1	4.7	4.2	3.8
Euro area	2.8	1.5	-0.1	0.6	0.3	0.6	0.5	0.8
Nominal unit labour costs								
Romania	2.4	-5.8	3.5	-0.6	3.1	-1.4	2.5	2.3
Euro area	-0.6	0.6	1.9	1.1	1.0	0.7	0.9	1.1
Imports of goods deflator								
Romania	5.7	6.0	7.5	-6.2	-1.8	-2.3	-3.4	1.2
Euro area	6.0	7.0	2.6	-2.0	-2.6	-3.6	-2.7	1.1

1) Commission services' Spring 2016 Forecast.

Source: Eurostat, Commission services.

7.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and cyclical stance

Economic growth has been strong over the past two years. Romania's economy expanded by 3.0% in 2014, the drivers of growth switching gradually from net exports to domestic demand. Real GDP growth accelerated further to 3.8% in 2015, on the back of surging domestic demand, while net exports contributed negatively to growth. Private consumption was strong, particularly supported by a cut of the VAT for food. Investment also bounced back and returned to almost pre-crisis growth rates in 2015. GDP growth is set to remain above potential at 4.2% in 2016 and 3.7% in 2017, supported by additional fiscal stimulus. The output gap is estimated to close in 2016 and to turn positive in 2017.

The fiscal stance, as measured by the change in the structural balance, tightened in 2014 compared with 2013, but loosened somewhat in 2015. The structural budget balance was estimated at around ¼% of GDP in 2014 and ½% in 2015. The fiscal stance is projected to become highly expansionary and pro-cyclical, with structural deficit deteriorating to 2¾% of GDP in 2016 and 3½% of GDP in 2017.

The BNR, operating within an inflation targeting framework ([68]), cut the key policy rate by a total of 350 basis points between July 2013 and May 2015 in order to stimulate lending and domestic demand, on the back of an improved inflation outlook. It also reduced minimum reserve requirements with the medium-term goal to align them gradually with ratios prevailing in the rest of the EU. Nevertheless, credit growth remained negative in 2014 but picked up in 2015 due to very strong lending in domestic currency.

Wages and labour costs

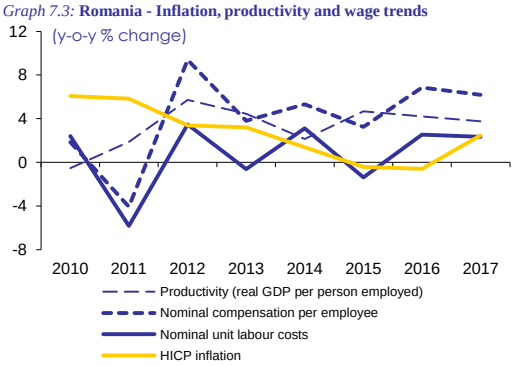
In 2014 employment registered a positive growth rate for the first time since the crisis, supported by strong economic growth. Despite a drop in total employment in 2015 on account of a significant reduction of the number of self-employed persons, employment is expected to remain broadly stable in 2016 and 2017. Employment levels in Romania remain, nonetheless, low compared to most other EU Member States. The unemployment rate has decreased to below 7% and is expected to remain at the same level.

Strong economic growth and successive increases of both public sector and minimum wages have been driving nominal wages upwards since 2013,

([68]) As from 2013, the BNR follows a flat multi-annual inflation target of 2.5% (± 1pp.).

and most notably in 2015. Labour productivity growth slowed somewhat in 2014 but picked up again in 2015 when it exceeded the increase in nominal compensation per employee. Compensation per employee is expected to increase further by around 7% in 2016 and slightly above 6% in 2017. Wage growth has been accelerating considerably (growing in double digits in early 2016) and is forecast to outpace productivity growth in 2016 and 2017, resulting in significant increases in nominal unit labour costs which are likely to weigh on competitiveness and job creation.

Graph 7.3: **Romania - Inflation, productivity and wage trends**



Source: Eurostat, Commission services' Spring 2016 Forecast.

External factors

Due to the openness of the Romanian economy and its deep integration into the world and the EU economy, developments in import prices play a significant role in domestic price formation. In particular, energy and food commodity prices have been a significant determinant of import price inflation in Romania, given the large weight of these categories in the Romanian HICP. Import price inflation (measured by the imports of goods deflator) was negative and significantly below consumer price inflation in both 2014 and 2015. Going forward, import price inflation is projected to remain negative in 2016 and to pick up and turn positive in 2017, remaining below consumer price inflation.

Fluctuations of the leu have only moderately influenced import price dynamics in recent years. The nominal effective exchange rate (measured against a group of 37 trading partners) appreciated somewhat in the first half of 2014, but depreciated slightly between mid-2014 and mid-2015, reflecting mainly monetary policy easing. It recovered again in the third quarter of 2015 and has been on a slight upward path since then.

Administered prices and taxes

Changes in administered prices and indirect taxes have considerably influenced inflation developments in recent years. Administered prices ([69]) have a slightly larger weight in the Romanian HICP basket than in the euro area (13.7% compared to 12.9%). The average annual increase in administered prices plunged from 6.0% in 2013 to 2.0% in 2014 and 1.6% in 2015 due to limited growth of electricity and gas prices, although remaining substantially above average headline inflation. The liberalisation of gas and electricity prices in Romania had a rather moderate impact on inflation, as the expected upward pressure on energy and therefore on administered prices was counterbalanced by low global commodity prices.

Increases in fuel excise duties contributed moderately to inflation in Romania in 2014 and 2015. HICP inflation measured at constant taxes was above HICP inflation in the first quarter of 2014 due to the effect of the VAT cut on bread and flour. Starting from the second quarter of 2014 this trend was reversed and constant-tax inflation remained below HICP inflation until the second quarter of 2015. With the cut of the VAT rate for food products, the two indicators diverged significantly from each other. The gap between the two increased to 3 pp. in June 2015 and has been around 3 pp. until the end of 2015. HICP inflation was pushed down further by a reduction of the standard VAT rate by 4 pp. from January 2016. These several VAT cuts decreased annual inflation by 5 pp. in January 2016, as measured by the constant-tax index (HICP-CT).

These measures had an overall effect on inflation rate of over [X%] for 2015 and entail an additional reduction in the inflation rate of around [X pp.] for 2016.

Medium-term prospects

According to the Commission services' Spring 2016 Forecast, annual HICP inflation is projected to remain slightly negative at -0.6% in 2016 mainly on account of the 4 pp. reduction of the

([69]) According to the Eurostat definition, administered prices in Romania include *inter alia* regulated electricity and gas prices, regulated utility prices, medical products, postal services and cultural services and part of public transport. For details, see: http://ec.europa.eu/eurostat/documents/272892/272989/HICP-AP+classification+2015-02/023e5b4d-6300-47dc-b7aa-27d1e5013f3b

standard VAT and continuously low global oil prices. However, as the transitory impact of the VAT rate cut for food products fades out, the output gap closes and domestic pressures are mounting (a further 19% increase in the minimum wage from May 2016 and strengthening domestic demand), inflation is set to return to positive territory in the second half of 2016. Despite the additional cut in the standard VAT rate by 1pp. VAT cut announced for January 2017, inflation is expected to re-enter the NBR's target band (2.5% ±1 pp.) and to reach an annual average of 2.5% in 2017.

Risks to the inflation outlook are broadly balanced. Downside risks are related to persistently low global commodity prices, with the overall impact amplified by the relatively large weight of commodities in the consumption basket. Inflationary pressures from the closing of the output gap in 2016 may be higher than currently expected. A gradual withdrawal of monetary stimulus in the US and associated capital outflows from emerging markets might exert some downward pressure on the exchange rate which would feed into higher inflation. Upside risks to the projection relate mainly to a stronger-than-expected build-up of domestic price pressures and acceleration of wage growth.

Over the long run, there is potential for further significant price level convergence in line with the expected catching-up of the Romanian economy (with income levels in purchasing power standard at about 51% of the euro-area average in 2014). The level of consumer prices in Romania was around 52% of the euro-area average in 2014, with the relative price gap widest for services.

Medium-term inflation prospects will depend strongly on productivity and wage developments, notably on efforts to avoid excessive wage increases and on the success of anchoring inflation expectations at the central bank's 2.5% target. A prudent fiscal policy and the continuation of structural reforms will be essential to contain inflationary pressures and support sustainable convergence going forward. Tax policy is expected to have some impact on inflation in 2017 due to a cut of the standard VAT rate by 1pp. from January 2017 and cuts in excise duties on fuel.

7.3. PUBLIC FINANCES

7.3.1. Recent fiscal developments

Romania benefited from three consecutive EU/IMF financial assistance programmes between 2009 and 2015. Fiscal policy targets of the 2013-2015 precautionary programme included reaching the medium-term budgetary objective by 2015, as recommended by the Council ([70]), improving fiscal governance and public debt management, and implementing additional structural reforms to improve public revenue and expenditure management. On 21 June 2013, the Council decided to abrogate the decision on the existence of an excessive deficit according to Article 126 (12) TFEU, thereby closing the excessive deficit procedure for Romania ([71]).

The headline general government deficit declined further from 2.1% of GDP in 2013 to 0.9% of GDP in 2014. In structural terms, the deficit improved by 0.8 pp. to ¼% of GDP. The 2015 general government deficit of 0.7% of GDP was better than the -1.2% of GDP targeted in the 2015 Convergence Programme. The structural balance deteriorated somewhat due to the enacted measures.

The adjustment over 2013-2015 was mainly driven by measures on the revenue side. The measures adopted in 2014 included an increase in excises on fuel, an introduction of inflation indexation of excise duties, broadening of the property tax base, and an increase in royalties on mineral resources other than oil and gas. In 2015, fiscal easing measures, namely a cut by 5 pp. in social security contributions, a cut of the VAT rate on food and the doubling of child benefits (from mid-2015) were compensated by higher tax revenues on the back of strong economic growth, better tax compliance and lower-than-budgeted expenditure on some public investment items (e.g. co-financing of EU-funded projects). The general government revenue-to-GDP ratio increased from 33.1% in 2013 to 34.8% in 2015, while total government expenditure increased from 35.2% to 35.5% of GDP over the same period.

([70]) For the Country-Specific Recommendations addressed to Romania in 2015, see: http://ec.europa.eu/europe2020/pdf/csr2015/csr2015_council_romania_en.pdf.

([71]) An overview of all excessive deficit procedures can be found at: http://ec.europa.eu/economy_finance/economic_governance/sgp/deficit/index_en.htm

Table 7.3:

Romania - Budgetary developments and projections **(as % of GDP unless indicated otherwise)**

Outturn and forecast [1]	2010	2011	2012	2013	2014	2015	2016	2017
General government balance	-6.9	-5.4	-3.7	-2.1	-0.9	-0.7	-2.8	-3.4
- Total revenues	32.7	33.7	33.4	33.1	33.5	34.8	31.8	31.5
- Total expenditure	39.6	39.1	37.1	35.2	34.3	35.5	34.6	34.9
of which:								
- Interest expenditure	1.5	1.6	1.8	1.7	1.7	1.6	1.7	1.7
p.m.: Tax burden	26.9	28.0	28.0	27.5	27.7	28.2	26.6	25.8
Primary balance	-5.4	-3.8	-1.9	-0.4	0.8	0.9	-1.1	-1.6
Cyclically-adjusted balance	-5.6	-4.1	-2.0	-1.1	-0.2	-0.4	-2.8	-3.4
One-off and temporary measures	0.0	-1.1	0.5	0.0	0.0	0.3	0.1	0.0
Structural balance [2]	-5.6	-3.0	-2.6	-1.1	-0.2	-0.6	-2.8	-3.4
Government gross debt	29.9	34.2	37.4	38.0	39.8	38.4	38.7	40.1
p.m: Real GDP growth (%)	-0.8	1.1	0.6	3.5	3.0	3.8	4.2	3.7
p.m: Output gap	-3.9	-3.8	-4.9	-3.1	-2.1	-1.1	0.0	0.3

Convergence programme	2016	2017	2018	2019
General government balance	-2.9	-2.9	-2.3	-1.6
Structural balance [2] [3]	-2.7	-2.9	-1.9	-1.3
Government gross debt	39.1	39.8	39.9	39.3
p.m. Real GDP (% change)	4.2	4.3	4.5	4.7

1) Commission services' Spring 2016 Forecast.

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

3) Commission services' calculations on the basis of the information in the programme. There are no one-off and other temporary measures in the programme.

Sources: Commission services, the 2016 Convergence Programme of Romania.

General government debt fell from 39.8% of GDP in 2014 to 38.4% of GDP in 2015, thanks to strong GDP growth and a relatively low general government deficit.

7.3.2. Medium-term prospects

The budget for 2016 was adopted by the Parliament on 16 December 2015 targeting a deficit of 2.95% of GDP. On the revenue side, the fiscal stance has been loosened by a new Fiscal Code, which reduced the standard VAT rate from 24% to 20% from January 2016 and further to 19% from January 2017. The dividend tax was also reduced from 16% to 5%. The new Fiscal Code also eliminates the special construction tax and the extra excise duty on fuel from 2017. On the expenditure side, public sector wages were increased in several steps in 2015, including specific increases in selected sectors and a general wage hike by 10% as of December 2015. The minimum wage, which also affected public sector workers, was raised by 12.5% in 2014 and 17% in 2015. An additional 19% increase of the minimum wage was enacted from May 2016.

Taking these measures into account, according to the Commission services' Spring 2016 Forecast, the 2016 general government balance will deteriorate from -0.7% of GDP in 2015 to -2.8% of GDP in 2016 and to -3.4% of GDP in 2017. The structural deficit is forecast to widen by nearly 3 pp. to 3.4% of GDP in 2017 as a consequence of the fiscal easing and closing of the output gap in 2016-2017, reflecting strongly expansionary fiscal stance. The general government debt-to-GDP ratio is projected to rise from 38.4% of GDP in 2015 to 40.1% of GDP in 2017.

Romania submitted the 2016 Convergence Programme on 28 April 2016. The Programme departs from the MTO, which has been achieved in 2014-2015, and does not aim to return to it within the programme period. The Convergence Programme targets a deficit of 2.9% of GDP both in 2016 and 2017, 2.3% in 2018 and 1.6% in 2019. The Commission services' Spring 2016 Forecast expects the deficit to amount to 2.8% of GDP in 2016 and to further increase to 3.4% of GDP in 2017 under a no-policy-change assumption. The Programme has a more favourable macroeconomic scenario in 2017 compared to the macro projections in the Commission services' Spring 2016 Forecast. Based on the Commission's assessment of the 2016 Convergence Programme, there is a risk that Romania will not comply with

the provisions of the Stability and Growth Pact, as there is a risk of a significant deviation both in 2016 and, under unchanged policies, 2017. Therefore further measures will be needed to ensure compliance in 2016 and 2017. Further details can be found in the Assessment of the 2016 Convergence Programme for Romania ([72]).

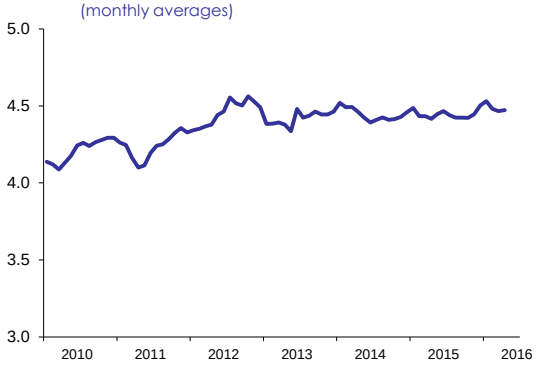
As far as the national fiscal framework is concerned – which refers to numerical fiscal rules, medium-term budgetary frameworks, independent fiscal institutions, and budgetary procedures – Romania has conducted a series of reforms since 2010, aiming to ensure fiscal discipline and prevent the budgetary slippages. Romania has declared its intention to apply the provisions of the Fiscal Compact. Overall, Romania has a sound fiscal framework in terms of principles and rules in legislation, but the framework is not effectively implemented in practice. Fiscal measures adopted are often not in full compliance with the Fiscal Responsibility Law and ad hoc government acts providing derogations from the law are weakening the fiscal rules. The medium-term fiscal plans are not adequately guiding budgetary process. The Fiscal Council is often given very little time to react to budgetary proposals and its opinions and recommendations are not sufficiently taken into account.

7.4. EXCHANGE RATE STABILITY

The Romanian leu does not participate in ERM II. Romania has been operating a *de jure* managed floating exchange rate regime since 1991 with no preannounced path for the exchange rate ([73]). *De facto*, the exchange rate regime moved gradually from a strongly managed float – including through the use of administrative measures until 1997 – to a more flexible one. In 2005, Romania shifted to a direct inflation targeting framework combined with a floating exchange rate regime. The BNR has, nonetheless, stressed that currency intervention remains available as a policy instrument.

The leu's exchange rate against the euro showed relatively limited fluctuation between spring 2014 and beginning of 2016 also in comparison with other regional peers operating under floating exchange rate regimes. The leu predominantly traded in the range of 4.4-4.5 RON/EUR since 2013. The leu fluctuated little during 2014, but weakened somewhat in December 2014 mainly due to an increase in risk aversion at the global level. The leu strengthened moderately at the beginning of 2015, supported by the additional monetary easing in the euro area. The leu weakened again at the end of 2015 due to domestic political uncertainties but recovered in early 2016. The lower short-term volatility of the leu reflected the positive effects associated with the EU-IMF international financial assistance to Romania until end-2015, favourable global market conditions and also operations by the BNR in the interbank and foreign exchange markets. Compared to April 2014, the exchange rate of the leu against the euro was basically unchanged in April 2016.

Graph 7.4: **Romania - RON/EUR exchange rate**
(monthly averages)



Source: ECB.

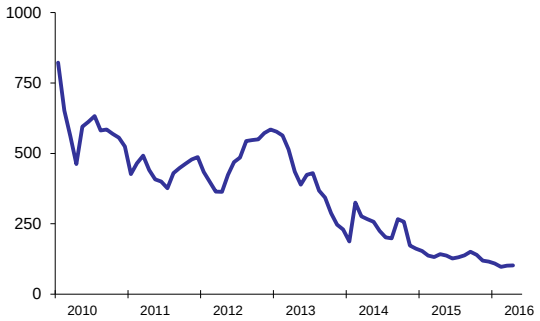
The NBR's gross international reserves declined from on average around EUR 35bn in 2012-2013 to around EUR 33.6bn in April 2016, mainly due to substantial repayments of international financial assistance to IMF and EU during 2014-2016. Short-term fluctuations in recent years have also reflected changes in the foreign exchange reserve requirements of credit institutions ([74]) as well as foreign exchange operations by the government. The reserve level was at around 22% of GDP by end-2015, covering above 100% of short-term debt and around 6 months of imports.

([72]) http://ec.europa.eu/economy_finance/economic_governance/sgp/convergence/index_en.htm

([73]) On 1 July 2005 the Romanian Leu (ROL) was replaced by the new leu (RON), with a conversion factor of 1 RON = 10,000 ROL. For convenience, however, the text of this report consistently refers to leu, meaning ROL before and RON after the conversion.

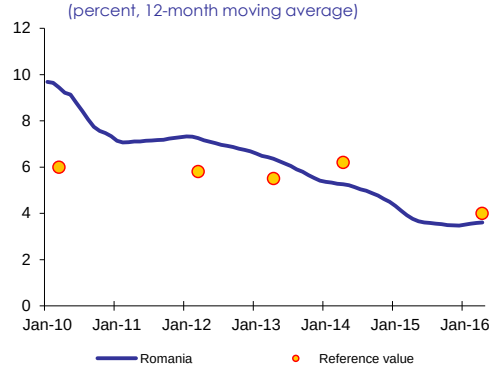
([74]) MRR ratio on foreign currency-denominated liabilities were cut from 20% to 18% in January, to 16% in July, and to 14% in November 2014, and further to 12% in January 2016.

Graph 7.5: **Romania - 3-M Robor spread to 3-M Euribor**
(basis points, monthly values)



Source: National Bank of Romania.

Graph 7.6: **Romania - Long-term interest rate criterion**
(percent, 12-month moving average)



Source: Commission services.

Short-term interest rate differentials vis-à-vis the euro area declined gradually from around 270 basis points at the beginning of 2014 to below 200 basis points by end-2014. They continued to decline substantially during 2015 and at the beginning of 2016. These developments reflect considerable monetary policy easing by the BNR from July 2013 to May 2015, when the key rate was by reducing the key policy rate from 5.25% to 1.75%. At the cut-off date of this report, the 3-month spread vis-à-vis the euro area stood at around 100 basis points.

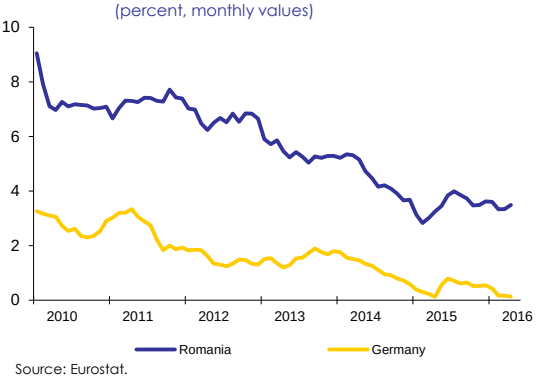
7.5. LONG-TERM INTEREST RATES

Long-term interest rates in Romania used for the convergence examination reflect secondary market yields on a single government benchmark bond with a residual maturity of around nine years.

The Romanian 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion was below the reference value at the time of the last convergence assessment of Romania in 2014. Since then, it declined further to below 5% mid-2014 and further to below 4% in early 2015 and floated around 3.5% over most of 2015. It went slightly up again in early 2016. In April 2016, the latest month for which data are available, the reference value, given by the average of long-term interest rates in Bulgaria, Slovenia and Spain plus 2 percentage points, stood at 4.0%. In that month, the 12-month moving average of the yield on the Romanian benchmark bond stood at 3.6%, i.e. 0.4 percentage points below the reference value.

Long-term interest rates declined gradually from above 5% in spring 2014 to below 4% at the end of 2014, reflecting a reduced country risk premium backed by a solid fiscal consolidation track record as well as a gradual downward adjustment of the expected path of interbank rates and the precautionary EU-IMF programme. They then gradually declined further, temporarily moving to below 3% in February 2015. It went up again in mid-2015 touching 4% and fluctuated around 3.5% thereafter. At the same time, the long-term spread vis-à-vis the German benchmark bond declined from above 500 basis points in late 2012 to around 250 basis points in January 2015 and stood at around 330 basis points in April 2016 ([75]).

Graph 7.7: **Romania - Long-term interest rates**
(percent, monthly values)



Source: Eurostat.

7.6. ADDITIONAL FACTORS

The Treaty (Article 140 TFEU) calls for an examination of other factors relevant to economic integration and convergence to be taken into account in the assessment. The assessment of the

([75]) The reference to the German benchmark bond is included for illustrative purposes, as a proxy of the euro area long-term AAA yield.

Table 7.4:

Romania - Balance of payments **(percentage of GDP)**

	2010	2011	2012	2013	2014	2015
Current account	-5.1	-4.9	-4.8	-1.1	-0.5	-1.1
of which: Balance of trade in goods	-7.6	-7.0	-6.9	-4.0	-4.2	-4.9
Balance of trade in services	1.2	1.2	1.9	3.3	3.9	4.3
Primary income balance	-1.2	-1.3	-1.7	-2.2	-1.3	-2.4
Secondary income balance	2.5	2.1	2.0	1.9	1.1	1.8
Capital account	0.2	0.5	1.4	2.1	2.6	2.4
External balance [1)]	-4.9	-4.4	-3.4	1.0	2.2	1.3
Financial account [2)]	-4.5	-3.5	-2.5	1.1	1.9	1.8
of which: Direct investment	-1.8	-1.3	-1.9	-2.0	-1.8	-1.7
Portfolio investment	-0.7	-1.3	-2.6	-3.8	-1.9	0.5
Other investment [3)]	-4.6	-1.7	3.1	5.5	6.6	3.4
Of which International financial assistance	6.3	1.8	-1.1	-3.3	-3.0	-0.9
Change in reserves	2.6	0.7	-1.1	1.4	-0.9	-0.4
Financial account without reserves	-7.1	-4.3	-1.4	-0.3	2.9	2.2
Errors and omissions	0.4	0.9	0.9	0.1	-0.2	0.5
Gross capital formation	26.8	27.9	26.8	25.6	25.2	25.6
Gross saving	22.3	23.5	22.6	24.9	25.4	24.7
Gross external debt	74.3	74.9	75.3	68.2	63.1	56.2
International investment position	-63.4	-65.4	-67.4	-62.6	-57.4	-51.1

1) The combined current and capital account.

2) The data is presented under BPM6 methodology, where the signs of financial account items are the opposite as under BPM5 (that was used in earlier Convergence Reports).

3) Including financial derivatives.

Sources: Eurostat, Commission services, National Bank of Romania.

additional factors – including balance of payments developments, product, labour and financial market integration – gives an important indication of a Member State's ability to integrate into the euro area without difficulties.

In November 2015, the Commission published its fifth Alert Mechanism Report (AMR 2016) ([76]) under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.5). The AMR 2016 scoreboard showed that Romania exceeded the indicative threshold in one out of fourteen indicators, i.e. the net international investment position. Romania benefited from a precautionary EU-IMF financial assistance programme totalling up to about EUR 5 billion which ended end September 2015. Close surveillance related to this arrangement implied that Romania was not subject to in-depth reviews in the context of the MIP in order to avoid the duplication of surveillance procedures until 2014 ([77]). In line with the conclusions of the AMR 2016 (i.e. that imbalances had been identified for Romania in the previous MIP round), Romania was subject to an in-depth review, which found that Romania is not experiencing macroeconomic imbalances.

7.6.1. Developments of the balance of payments

Romania's external balance (i.e. the combined current and capital account) has adjusted significantly in the wake of the global crisis. After having recorded a deficit of around 5% of GDP in 2010 it narrowed and then shifted into a surplus starting in 2013 which more than doubled in 2014. Although positive at around 1.3% of GDP, the external surplus modestly deteriorated in 2015. The overall improvement in the external balance in the last three years reflected a significant decline in the trade deficit, on the back of strong export performance resulting in a decrease in the balance of goods deficit and a rising surplus in the services balance. With the exception of 2013, the primary income balance deficit has widened while the secondary income balance surplus has decreased. Finally, the capital account recorded an increasing surplus in 2013-2015 due to, inter alia, improved absorption of EU funds.

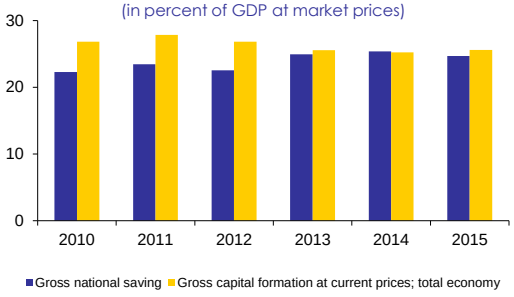
([76]) http://ec.europa.eu/europe2020/pdf/2016/ags2016_alert_mechanism_report.pdf

([77]) http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:140:0001:0010:EN:PDF

The current account adjustment was supported by corrections of the savings-investment balance. Romania's saving-investment balance narrowed from -4.5% in 2010 to close to balance in 2014 and widened slightly to around -0.9% in 2015 as both private and public sectors continued to adjust in parallel with improving financial conditions. The decline in investment up to 2014, contributed to the adjustment of the current account balance. In 2015, investment increased slightly, while saving decreased, resulting in a deterioration of the current account balance.

Improvements in cost competitiveness sustained export performance fuelled by a moderate depreciation in 2014-2015 of the nominal (NEER) and the real effective exchange rate (REER). Romania's improved competitiveness contributed to one of the highest growth rates in export market shares in the EU in 2010-2014. Romania was able to gain market shares in the EU market and also benefited from the dynamism of markets outside the EU.

Graph 7.8: **Romania - Saving and investment**
(in percent of GDP at market prices)



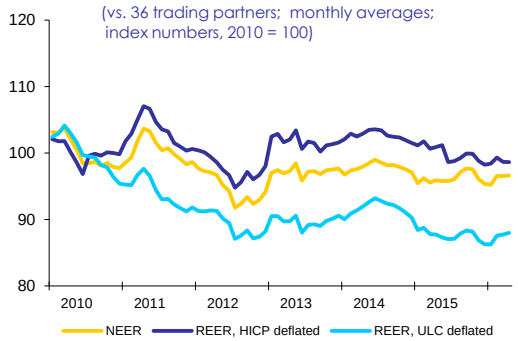
Source: Eurostat, Commission services.

Romania was a beneficiary of international financial assistance between 2009 and 2011, when it benefitted from EU balance-of-payments assistance programme and an IMF stand-by arrangement. The success of this EU-IMF programme and two successor programmes (2011-2013 and 2013-2015) enabled Romania to regain full market access since mid-2011. The latter two programmes were on a precautionary basis and no drawings were made. Romania has repaid all liabilities to the IMF and part of liabilities to the EU (EUR 1.6bn in 2015). Given the disbursements made under the first programme, Romania will be under post-programme surveillance until spring 2018, when 70 % of the financial assistance from the European Union has been repaid.

External financing pressures eased further in 2013-2015 amid the improvement in the external balance and a recovery in global risk appetite. After net FDI inflows had fallen sharply in 2009-2010, they stabilised broadly in 2013-2015, averaging around 2.0% of GDP. Net portfolio inflows increased gradually to reach nearly 4% of GDP in 2013, mainly reflecting significant portfolio investment into government securities following the inclusion of Romania in a number of international benchmark indices. However, portfolio inflows declined in 2014 and turned into outflows in 2015 in part due to the amortisation of government bonds. Gross external debt peaked at above 75% of GDP in 2012 reflecting the increase of public external debt. It declined to 56.2% of GDP in 2015, due to falling public and private sector debt. The net international investment position bottomed out at around -67% of GDP in 2012 and has improved since then to around -51% of GDP in 2015, on the back of narrowing current account deficits and strong nominal growth.

According to the Commission services' Spring 2016 Forecast, the external balance is expected to remain in balance in 2016 and to widen to -0.7% of GDP in 2017 as domestic demand accelerates, but to remain contained. Romania's external position benefited from higher absorption of EU funds up to 2015. It is expected to deteriorate in 2016 due to lower EU funds' absorption related to the end of the 2007-2013 programming period while the implementation of the 2014-2020 programmes has just started.

Graph 7.9: **Romania - Effective exchange rates**



Source: Commission services.

7.6.2. Market integration

Romania's economy is well integrated with the euro area through both trade and investment. The trade openness of Romania has increased significantly in the aftermath of the crisis, but is still relatively low. Trade openness in 2015 stood at around 45% of GDP. Romania's main trading

Table 7.5:
Romania - Market integration

	2010	2011	2012	2013	2014	2015
Trade openness [1] (%)	38.8	43.5	43.8	44.0	45.1	45.1
Trade with EA in goods & services [2)+3)] (%)	20.4	22.6	22.7	24.0	24.7	25.1
Export performance (% change) [4]	4.6	6.2	0.3	17.9	5.2	1.9
World Bank's Ease of Doing Business Index rankings [5]	65	72	72	73	37	37
WEF's Global Competitiveness Index rankings [6]	67	77	78	76	59	53
Internal Market Transposition Deficit [7] (%)	0.5	1.2	0.4	1.0	1.0	1.2
Real house price index [8]	100.0	84.2	76.5	74.3	72.0	73.2
Residential investment [9] (%)	2.9	2.7	3.1	2.4	n.a.	n.a.

1) (Imports + Exports of goods and services / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics, Balance of Payments).
2) (Imports + Exports of goods with EA-19 / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).
3) Trade in services with EA-19 (average credit and debit in % of GDP at current prices) (Balance of Payments).
4) Index for exports of goods and services divided by an index for growth of markets (percentage change on preceding year).
5) New methodology as of 2014 (World Bank).
6) (World Economic Forum)
7) Percentage of internal market directives not yet communicated as having been transposed, relative to the total. (Nov. data, May in 2013 and 2015).
8) Deflated house price index (2010=100), Eurostat.
9) Gross capital formation in residential buildings (in % of GDP), Eurostat.

Sources: Eurostat, World Bank, World Economic Forum, Commission services.

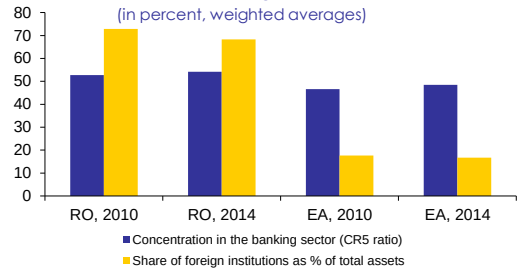
partners within the euro area are Germany, Italy and France, while outside the euro area it mainly trades with Hungary, Poland, Turkey and the United Kingdom. The share of trade with the euro area expressed in percentage of GDP has been increasing in recent years, reaching 25% in 2015.

Due to wage competitiveness, favourable corporate tax rates and a relatively large domestic market, Romania attracted substantial FDI inflows. The FDI stock reached 56% of GDP in 2014, with main FDI inflows originating from euro-area Member States, with the Netherlands, Austria and Germany accounting for more than half of the FDI stock at the end of 2014.

Concerning the business environment, Romania performs, in general, worse than most euro-area Member States in international rankings. In particular, Romania has low ranks in trading across borders and in registering property. According to the May 2015 Internal Market Scoreboard, Romania's transposition deficit of EU Directives was at 1.2% which is substantially above the target (0.5%) proposed by the European Commission in the Single Market Act (2011).

In terms of resilience during the crisis, the capacity of the Romanian labour market to adjust has been improved. The social dialogue law enacted in 2011 promoted a decentralisation of collective bargaining. However, a combination of factors, including representativeness criteria for trade unions and employers' associations, has hampered collective bargaining at sector and undertaking level. A recent revision of the social dialogue law aims at improving collective bargaining by establishing a representation cascade for trade unions at higher level when no representative trade union exists in the undertaking. Strong outward migration, including of the highly-skilled workers, presents a challenge to support a competitive economy.

Graph 7.10: **Romania - Foreign ownership and concentration in the banking sector**
(in percent, weighted averages)

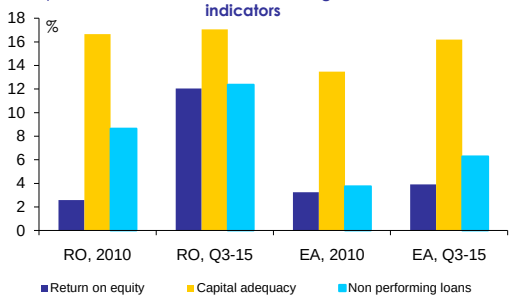


Source: ECB, Structural financial indicators

The Romanian financial sector is highly integrated into the EU financial sector, in particular through the strong presence of foreign banks in Romania. The share of foreign-owned banks, mainly euro area parent banks, in the total assets of the Romanian banking sector reached 68% in 2014. Concentration in the banking sector, as measured by the market share of the largest five credit institutions at 54%, remained above the euro area average.

The Romanian banking sector has remained resilient and well-capitalised as capital adequacy at system level stood at roughly 17.1% in Q3 2015, substantially above the euro area average. The deterioration in asset quality and the increase in loan-loss provisions necessary to support the cleaning up of bank balance sheets have put a strain on banking sector profitability until 2014, with return on equity declining from 22.5% in 2007 to -15.2% in 2014. The banking system returned to profit in 2015 (12% in Q3 2015). Non-performing loans (90 days overdue) have increased significantly in the post-crisis period (i.e. from below 2% in 2007) and peaked at nearly 20% in 2013. In 2014, measures were implemented to resolve non-performing loans which led to their decline to 12.4% in Q3 2015, although remaining considerably above the average of the euro area.

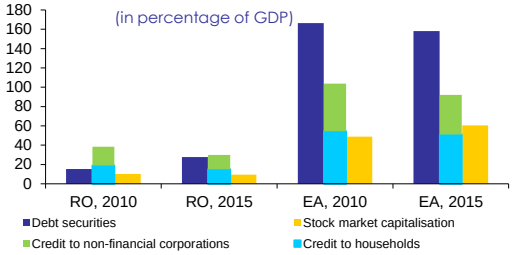
Graph 7.11: **Romania - Selected banking sector soundness indicators**



Source: ECB, EC calculations, NBR.

After the pre-crisis boom, house prices have followed a negative trend from 2008 (the first year with available data) to 2014. In 2015, real house prices went up slightly and reached 73% of their 2010 level. Investment in dwellings has been fluctuating at around 2.5-3% of GDP in the past five years.

Graph 7.12: **Romania - Recent development of the financial system relative to the euro area**



Note: Debt Securities other than shares, excluding financial derivatives.
Source: ECB, Commission services.

Romania still lags considerably behind the euro area as regards bank credit to the private non-financial sector (around 31% of GDP), around half of it in foreign currency (47% of total). The share of foreign-currency loans to the private sector decreased from a peak of around 67% of the total loans in 2012, inter alia due to the measures introduced by the National Bank of Romania to curb foreign-currency lending to unhedged households and corporates, in particular SMEs, and restricting the state guaranteed mortgage scheme to lending in domestic currency. However, recent legislative initiatives, including the recently enacted Law on debt discharge, raise concerns in terms of their potential impact on financial stability and the economy.

Equity and debt markets in Romania have remained comparatively underdeveloped. Stock market capitalisation (9.5% of GDP in 2015) has remained very low compared to the euro area average of 60%. The debt securities market remained small in comparison with the euro area average (28% vs. 158% of GDP) and has been dominated by issuances of government debt (T-bills and bonds denominated in both RON and foreign currency), whereas the issuance of corporate and municipal bonds has remained limited. Consolidated private sector debt declined from 74% of GDP in 2010 to below 60% in 2015 and was significantly below the euro-area average.

8. SWEDEN

8.1. LEGAL COMPATIBILITY

8.1.1. Introduction

The legal rules governing the Swedish Central Bank (Riksbank) are laid down in the Instrument of Government (as part of the Swedish Constitution) and the Riksbank Act from 1988, as amended. No amendments to these legal acts were passed with regard to the incompatibilities and the imperfections mentioned in the 2014 Convergence Report.

8.1.2. Central Bank independence

Article 3 of Chapter 6 of the Riksbank Act obliges the Riksbank to inform the minister appointed by the Swedish Government about a monetary policy decision of major importance prior to its approval by the Riksbank. A dialogue between a central bank and third parties is not prohibited as such, but regular upfront information of government representatives about monetary policy decisions, especially when the Riksbank would consider them as of major importance, could structurally offer to the government an incentive and the possibility to influence the Riksbank when taking key decisions. Therefore, the obligation to inform the minister about a monetary policy decision of major importance prior to its approval by the Riksbank limits the possibility for the Riksbank to independently take decisions and offers the possibility for the Government to seek to influence them. Such procedure is incompatible with the prohibition on giving instructions to the Central Bank, pursuant to Article 130 of the TFEU and Article 7 of the ESCB/ECB Statute. Article 3 of Chapter 6 should be revised in order to ensure that monetary policy decisions of major importance are communicated to the minister, if ever, only after its approval by the Riksbank and for information purposes only.

Pursuant to Article 2 of Chapter 3 of the Riksbank Act and Article 13 of Chapter 9 of the Instrument of Government, the prohibition on the members of the Executive Board to seek or take instructions only covers monetary policy issues. The provisions do not provide for their independence in the performance of ESCB-related tasks directly entrusted by the Treaties. By means of broad interpretation through reference to the explanatory memorandum to the Law (the memorandum extends the coverage to all ESCB tasks), one could consider these tasks as tacitly encompassed by the principle of central bank independence. However, the principle of the Riksbank's institutional independence cannot be considered as fully respected from a legal certainty perspective as long as the legal text itself does not contain a clear reference to them. Both provisions are therefore considered as incompatible with Article 130 of the TFEU and Article 7 of the ESCB/ECB Statute.

Pursuant to Article 4 of Chapter 10 of the Riksbank Act, the Swedish Parliament approves the Central Bank's profit and loss account and its balance sheet and determines the allocation of the Central Bank's profit. This practice impinges on the financial independence of the Riksbank and is incompatible with Article 130 of the TFEU. The Parliament must not be involved in the relevant decision-making process. Its right should be limited to approving the Central Bank's decision on the profit allocation. Legislative proposals to tackle the flaw have been submitted by the Swedish legislator but still provide for a decisive role of the Parliament in profit distribution and budget allocation, which are incompatible with the principle of financial independence as enshrined in Article 130 of the TFEU.

Article 4 of Chapter 1 of the Riksbank Act provides for the replacement of the Governor, in case of absence or incapacity, by the Vice-Governors nominated by the General Council. It is unclear whether the notion "absence" in Article 4 also refers to cases such as the expiry of the term of office, resignation, dismissal or other cause of termination of office. To ensure the smooth and continuous functioning of the Riksbank, the Riksbank Act would benefit from some improvement and should provide for clear procedures and rules regarding the succession of the Governor in case the notion "absence" also refers to instances of termination of office as well as in case the Governor is incapacitated.

8.1.3. Prohibition of monetary financing and privileged access

Under Article 8 of Chapter 6 of the Riksbank Act, the Riksbank may, in exceptional circumstances,

grant credits or provide guarantees on special terms to banking institutions and Swedish companies that are under the supervision of the Financial Services Authority. In order to comply with the prohibition on monetary financing of Article 123 of the TFEU it should be clearly specified that the loan is granted against adequate collateral to ensure that the Riksbank would not suffer any loss in case of the debtor's default. Although the Swedish Parliament inserted a new article 8a in Chapter 6 of the Riksbank Act obliging the Riksbank to provide information to the Government and a number of relevant public authorities on implemented liquidity support, the occasion was not seized to amend Article 8 as suggested above. Therefore, it continues to constitute an incompatibility with the prohibition on monetary financing under Article 123 of the TFEU.

Pursuant to Article 1(3) of Chapter 8 of the Riksbank Act, the Riksbank shall not extend credits or purchase debt instruments "directly from the State, another public body or institution of the European Union". The Article does not enumerate the entities covered by the prohibition of monetary financing correctly. Therefore, Article 1 is incompatible with the wording of Article 123(1) of the TFEU and 21(1) of the ESCB/ECB Statute.

According to the Article 1(4) of Chapter 8 of the Riksbank Act, the Riksbank may grant credit to and purchase debt instruments from financial institutions owned by the State or another public body. This provision of Article 1 does not fully comply with Article 123(2) of the TFEU and Article 21.3 of the ESCB/ECB Statute because the exemption only covers publicly owned institutions. For the sake of legal certainty it should be added that, in the context of the supply of reserves by central banks, these publicly owned credit institutions should be given the same treatment as private credit institutions.

The provisions of Article 4 of Chapter 10 on the allocation of the Riksbank's profit are supplemented by non-statutory guidelines on profit distribution, according to which the 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 contingency and balancing funds. Although these guidelines are not legally binding but accepted as a practice by Parliament for calculating profit allocation and there is no statutory provision limiting the amount of profit that may be paid out, such practice could constitute an incompatibility with the principle on the prohibition of monetary financing under Article 123 of the TFEU. For legal certainty reasons the law should ensure that the reserve capital of Riksbank is left unaffected in any case and that the actual contribution to the State budget does not exceed the amount of the net distributable profit.

8.1.4. Integration in the ESCB

Objectives

Chapter 1, Article 2 of the Riksbank Act should include a reference to the secondary objective of the ESCB, while the promotion of a safe and efficient payment system as a task should be subordinated to the primary and secondary objectives of the ESCB.

Tasks

The incompatibilities of the Riksbank Act with regard to the ESCB/ECB tasks are as follows:

- absence of a general reference to the Riksbank as an integral part of the ESCB and to its subordination to the ECB's legal acts (Chapter 1, Article 1);
- definition of monetary policy and monetary functions, operations and instruments of the ESCB (Chapter 1, Article 2 and Chapter 6, Articles 2, 3 and 5 and 6, Chapter 11, Article 1 and 2a of the Act; Chapter 9, Article 13 of the Instruments of Government);
- conduct of foreign exchange operations and the definition of foreign exchange policy (Chapter 7 of the Act; Chapter 8, Article13 and Chapter 9, Article 12 of the Instruments of Government); Articles 1 to 4 of the Law on Exchange Rate Policy;
- right to authorise the issue of banknotes and the volume of coins and definition of the monetary unit (Chapter 5 of the Act; Chapter 9, Article 14 of the Instruments of Government);
- ECB's right to impose sanctions (Chapter 11, Articles 2a, 3 and 5).

There are furthermore some imperfections regarding the:

- non-recognition of the role of the ECB and of the EU in the collection of statistics (Chapter 6, Articles 4(2) and Article 9, 10 and 11);
- non-recognition of the role of the ECB in the functioning of payment systems (Chapter 1, Article 2; Chapter 6, Article 7);
- non-recognition of the role of the ECB and of the Council in the appointment of an external auditor;
- non-recognition of the role of the ECB in the field of international cooperation (Chapter 7, Article 6).

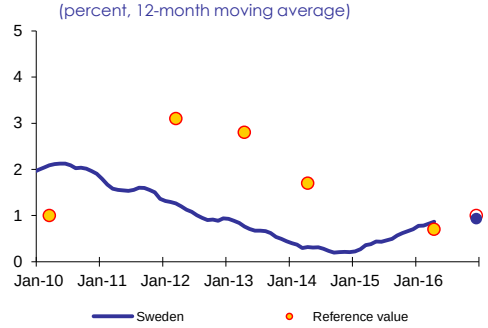
8.1.5. Assessment of compatibility

As regards the prohibition on monetary financing, the independence of the Riksbank as well as its integration into the ESCB at the time of euro adoption, the legislation in Sweden, in particular the Riksbank Act and the Instrument of Government as part of the Swedish Constitution, is not fully compatible with the compliance duty under Article 131 of the TFEU.

8.2. PRICE STABILITY

8.2.1. Respect of the reference value

Graph 8.1: **Sweden - Inflation criterion since 2010**
(percent, 12-month moving average)



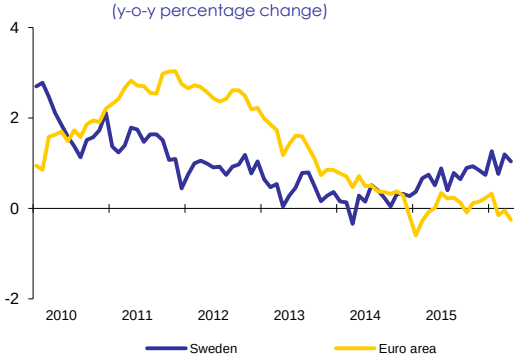
Note: The dots in December 2016 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2016 Forecast.

The 12-month average inflation rate, which is used for the convergence evaluation, was below the reference value at the time of the last convergence assessment of Sweden in 2014. In April 2016, the reference value was 0.7%, calculated as the average of the 12-month average inflation rates in Bulgaria, Slovenia and Spain, plus 1.5 percentage points. The corresponding inflation rate in Sweden was 0.9%, i.e. above the reference value. Sweden's 12-month average inflation rate is likely to return below the reference value in the months ahead.

8.2.2. Recent inflation developments

HICP inflation in Sweden bottomed out in late-2014. The depreciation of the krona, tax hikes as well as expanding domestic demand supported by an accommodative monetary policy resulted in an average inflation rate of 0.7% in 2015, compared with 0.2% the year before. On average, Swedish HICP inflation reached about 1% in the first quarter of 2016.

Graph 8.2: **Sweden - HICP inflation**
(y-o-y percentage change)



Source: Eurostat.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) followed a similar pattern as headline inflation, increasing from 0.5% in 2014 to 1.1% in 2015. The pick-up was induced by all of its three main components. Inflation in the service sector increased from 0.9% in 2014 to 1.3% in 2015 while processed food prices increased by 2.1% in 2015, after 1.0% in 2014, reflecting international price developments over that period. Non-energy industrial goods prices also started rising again in 2015, after having declined for four years. Producer price inflation was almost flat in 2014 before turning negative (averaging -1.9%) in 2015. Positive rates for the first half of the year were outweighed by negative ones during the second half due to falling energy and commodity prices.

Table 8.1: Sweden - Components of inflation	(percentage change)[1]							weights in total
	2010	2011	2012	2013	2014	2015	Apr-16	2016
HICP	1.9	1.4	0.9	0.4	0.2	0.7	0.9	1000
Non-energy industrial goods	0.9	-0.5	-1.0	-0.8	-0.4	0.3	0.9	286
Energy	5.5	4.8	0.5	-1.4	-2.0	-4.7	-4.2	87
Unprocessed food	0.9	-1.8	1.6	3.5	0.0	4.1	4.6	63
Processed food	1.8	2.7	2.4	1.3	1.0	2.1	1.6	141
Services	1.8	1.7	1.8	1.1	0.9	1.3	1.3	424
HICP excl. energy and unproc. food	1.5	1.1	1.0	0.5	0.5	1.1	1.2	851
HICP at constant taxes	1.9	1.4	1.3	0.4	0.2	0.5	0.7	1000
Administered prices HICP	1.7	1.9	3.1	1.9	1.7	1.2	1.1	141

1) Measured by the arithmetic average of the latest 12 monthly indices relative to the arithmetic average of the 12 monthly indices in the previous period.

Sources: Eurostat, Commission services.

8.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and cyclical stance

Sweden's economic growth has accelerated and is expected to remain robust in the coming years. Real GDP expanded by 2.3% in 2014 and 4.1% in 2015, making Sweden one of the currently fastest-growing economies in the EU. Steady growth in domestic demand, supported by expansionary monetary policy, helped to sustain economic growth against the impact of a weak external environment. In 2015, strong investment growth, rebounding exports and increasing government consumption also provided a significant impetus to growth. Annual real GDP growth rates are projected to slow down slightly to 3.4% in 2016 and 2.9% in 2017. The output gap has been negative over the past years, but is expected to turn positive in 2016 and to remain so in 2017.

The fiscal stance, as measured by changes in structural balance, was expansionary in 2014 and rather restrictive in 2015. It is expected to be slightly expansionary in 2016 and 2017.

Monetary policy, conducted within an inflation targeting framework ([78]), was loosened significantly since December 2011. In response to low inflationary pressures and sluggish economic growth, the Riksbank gradually cut its main policy rate from 2% in autumn 2011 to minus 0.5% in February 2016. Nevertheless, inflation has been below the target of 2% since 2011, due to the weak international economic activity and dampened export price growth abroad. In February 2015, the Riksbank also announced an asset purchase programme which – having been extended in several steps – aims at purchasing a total of SEK 245 billion in government bonds by the end of 2016 (SEK 200 billion until end-June and a further SEK 45billion during the second half of this year).

([78]) Since 1995, the Riksbank has targeted increases in the domestic CPI with the aim of keeping inflation at 2%.

Wages and labour costs

Employment recovered quickly following the financial crisis and has been expanding at a strong pace, growing by 1.4% in 2014 and 1.5% in 2015. This rise was driven primarily by services and the public sector, while the manufacturing and energy sectors saw a decrease in the number of employed persons. Continued building activity should also strengthen the contribution of the construction sector in creating jobs over the coming years.

In spite of steadily growing employment, the unemployment rate still hovers around roughly 7% due to increases in the labour force. Migrants enter the labour force only gradually. Also, employment is likely to be affected with a lag, as it could take several years for newly arrived migrants to find jobs.

The annual growth of nominal compensation per employee fell from above 3% in 2012 to 1.9% in 2013, but has subsequently increased again. In 2015, it stood at 3.6% according to the Commission services' Spring 2016 Forecast but is likely to fall back somewhat in 2016 (3.1%) and 2017 (3.2%).

Growth in labour productivity was moderate in 2013 and 2104, with 0.3% and 0.9%, respectively, but experienced a rebound last year at 2.6%. It is likely to become more subdued again in the next

Table 8.2:
Sweden - Other inflation and cost indicators **(annual percentage change)**

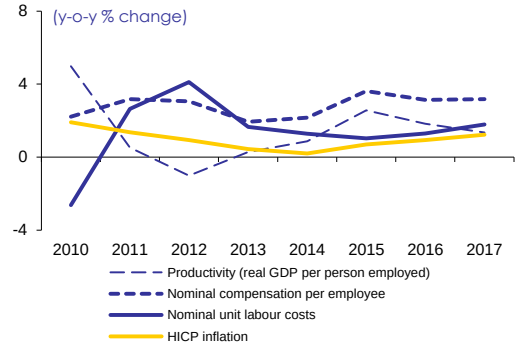
	2010	2011	2012	2013	2014	2015	2016[1)]	2017[1)]
HICP inflation								
Sweden	1.9	1.4	0.9	0.4	0.2	0.7	0.9	1.2
Euro area	1.6	2.7	2.5	1.3	0.4	0.0	0.2	1.4
Private consumption deflator								
Sweden	1.5	1.7	0.5	0.7	0.7	1.0	1.1	1.3
Euro area	1.6	2.3	1.9	1.1	0.5	0.2	0.4	1.3
Nominal compensation per employee								
Sweden	2.2	3.2	3.1	1.9	2.2	3.6	3.1	3.2
Euro area	2.2	2.2	1.8	1.7	1.3	1.2	1.5	1.9
Labour productivity								
Sweden	5.0	0.5	-1.0	0.3	0.9	2.6	1.8	1.4
Euro area	2.8	1.5	-0.1	0.6	0.3	0.6	0.5	0.8
Nominal unit labour costs								
Sweden	-2.6	2.6	4.1	1.7	1.3	1.0	1.3	1.8
Euro area	-0.6	0.6	1.9	1.1	1.0	0.7	0.9	1.1
Imports of goods deflator								
Sweden	0.3	-0.3	-1.9	-3.7	1.1	-0.7	-2.9	1.2
Euro area	6.0	7.0	2.6	-2.0	-2.6	-3.6	-2.7	1.1

1) Commission services' Spring 2016 Forecast.

Source: Eurostat, Commission services.

couple of years, while remaining above 1% both in 2016 and 2017. Accordingly, growth in nominal unit labour costs (ULC), which stood at 1.3% in 2014 and fell to 1.0% in 2015, is projected to increase to 1.3% and 1.8% in 2016 and 2017 respectively. These developments point to relatively limited price pressures from labour costs in the years ahead.

Graph 8.3: **Sweden - Inflation, productivity and wage trends**



Source: Eurostat, Commission services' Spring 2016 Forecast.

In fact, the current low inflation expectations can be said to have influenced wage negotiations this year. While some sectors have challenged the agreed benchmark, wage increases are likely to be relatively modest, overall in line with the 2.2% one-year agreement with industry.

External factors

Given the high openness of the Swedish economy, developments in import prices play an important role in domestic price formation. Import price growth (measured by the imports of goods deflator) has fluctuated significantly over the past years. Developments can be largely explained by, on the one hand, falling international commodity price inflation, and on the other hand the weakening krona. Looking ahead, the import deflator is expected to be negative this year, but is likely to return to a positive growth path as from 2017, thus dampening external disinflationary pressures.

The real effective exchange rate (measured against a group of 36 trading partners) has depreciated in 2014 and 2015 due to the weak krona, while domestic prices continue to grow more slowly than in the main trading partners. Overall, Swedish cost developments do not pose major challenges in terms of competitiveness.

Administered prices and taxes

The share of administered prices ([79]) in the Swedish HICP basket amounts to 14% and it is thus close to the euro-area average of 13%. Although not very large, it still contributed to driving inflation upwards over the last two years, as it stood at 1.7% in 2014 and 1.2% in 2015, largely explained by increases in rental prices, which rose by 1.3% over the period 2014/15 –the smallest increase since 2007.

Tax changes also added somewhat to higher headline inflation as emphasised by the slower pace with which HICP at constant taxes increased over the past two years.

Medium-term prospects

HICP inflation is likely to increase moderately in the course of 2016 on the back of currently strong growth and tax hikes. At the same time low oil prices have the opposite effect. No particular upward pressure is foreseen from any HICP component and wage developments are projected to remain moderate. Accordingly, the Commission services' Spring 2016 Forecast projects annual average inflation at 0.9% in 2016 and 1.2% in 2017.

Risks to the inflation outlook appear to be broadly balanced. An appreciating krona could dampen the currently projected rising inflation trajectory, even though the Riksbank has announced its intention to directly intervene on the foreign exchange market if necessary. At the same time, the Riksbank's loose monetary conditions could prevail, leading to faster inflation acceleration.

The level of consumer prices in Sweden relative to the euro area gradually increased since Sweden joined the EU in 1995. In 2014, the Swedish price level was at some 124% of the euro-area average, down from 129% in 2013. At the same time, the income level in Sweden remained rather stable over the past ten years, reaching 115% of the euro-area average in PPS in 2014.

In the medium term, inflation is likely to pick up given the projected closure of the output gap and further decreases in unemployment. With the expected robust domestic demand, companies are projected to raise prices and cautiously compensate for the subdued price levels over the past years. On the other hand, moderate wage developments, spare capacity still lingering in the Swedish economy and strong international competition will weigh on consumer price developments in the short run.

8.3. PUBLIC FINANCES

8.3.1. Recent fiscal developments

Sweden's general government deficit improved significantly last year from 1.6% of GDP in 2014 to 0.0% of GDP in 2015. This was mainly due to a strong rise in tax revenues, supported by strong private consumption and tax increases (principally increased social fees for young people, higher income taxes for high-income-earners, energy and fuel taxes and some excise duties) and a temporary high corporate tax payment in the fourth quarter of 2015.

The structural balance improved, from a deficit of 0.3% of GDP in 2014 to a surplus of 0.3% in 2015. The higher expenditure related to the large refugee and migrant inflows into Sweden over the last couple of years has been so far compensated with strong economic growth and tax hikes. The expenditure-to-GDP ratio decreased from 51.7% of GDP in 2014 to 50.4% in 2015, while the revenues-to-GDP ratio increased by 0.2 pp. to 50.4% of GDP.

Overall, Swedish public finances remain robust. The budgetary outcome in 2015 was substantially better than the deficit of 1.4% of GDP targeted in the 2015 Convergence Programme, generally on the back of stronger-than-expected growth in 2015.

The government debt-to-GDP ratio rose to 44.8% in 2014, i.e. up by 5 pp. compared to 2013. This was due largely to statistical factors linked to changing accounting standards. In 2015, the government gross debt came down to 43.4% of GDP.

([79]) According to the Eurostat definition, fully administered prices in Sweden *inter alia* include water supply, refuse and sewerage collection, hospital services and combined passenger transport. Mainly administered prices *inter alia* include actual rents for housing and medical services. For details, see http://ec.europa.eu/eurostat/web/hicp/methodology/hicp-administered-prices

Table 8.3:

Sweden - Budgetary developments and projections **(as % of GDP unless indicated otherwise)**

Outturn and forecast [1]	2010	2011	2012	2013	2014	2015	2016	2017
General government balance	0.0	-0.1	-0.9	-1.4	-1.6	0.0	-0.4	-0.7
- Total revenues	51.1	50.5	50.7	51.0	50.2	50.4	49.8	49.7
- Total expenditure	51.2	50.5	51.7	52.4	51.7	50.4	50.1	50.4
of which:								
- Interest expenditure	1.1	1.1	0.9	0.8	0.7	0.5	0.5	0.5
p.m.: Tax burden	44.1	43.5	43.5	43.8	43.8	44.1	43.8	43.9
Primary balance	1.0	1.0	0.0	-0.6	-0.9	0.5	0.1	-0.2
Cyclically-adjusted balance	0.8	0.1	0.2	0.0	-0.3	0.3	-0.5	-0.9
One-off and temporary measures	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Structural balance [2]	0.8	0.1	0.2	0.0	-0.3	0.3	-0.5	-0.9
Government gross debt	37.6	36.9	37.2	39.8	44.8	43.4	41.3	40.1
p.m: Real GDP growth (%)	6.0	2.7	-0.3	1.2	2.3	4.1	3.4	2.9
p.m: Output gap	-1.4	-0.2	-1.9	-2.4	-2.1	-0.5	0.2	0.4

Convergence programme	2016	2017	2018	2019
General government balance	-0.4	-0.7	-0.4	0.1
Structural balance [2] [3]	-0.8	-0.8	-0.4	-0.1
Government gross debt	42.5	41.1	40.3	39.1
p.m. Real GDP (% change)	3.8	2.2	1.8	2.1

1) Commission services' Spring 2016 Forecast.

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

3) Commission services' calculations on the basis of the information in the programme. There are no one-off and other temporary measures in the programme.

Sources: Commission services, the 2016 Convergence Programme of Sweden.

8.3.2. Medium-term prospects

Partly as a consequence of the migration and integration challenges, the 2016 Budget Bill, which was adopted on 17 December 2015, includes measures to promote labour market integration of vulnerable groups and education investments amounting to SEK 24 billion (EUR 2.55 billion).

By raising income tax rates for high-income earners and increased social fees for young employees and those older than 65, the budget also contributes to a limited tax shift back to labour. It also reduces deductions applicable to certain types of services, for instance for house repair and maintenance and for domestic services. Further tax increases in 2016 relate predominately to labour taxes (by 8.6% due to the combined effect of a sharp increase in the tax bases and rate hikes ([80])) and to local government taxes. In addition to the inherent uncertainty linked to expenditure on migration and integration, there is also a risk for the budget related to sickness leave benefits, where the expenditure has been on the rise over the past years. Since 1 February 2016, the 2.5-year-cap on the sickness insurance has been lifted, which will most likely have an increasing effect on expenditure.

The budget balance is foreseen to deteriorate in 2016 and 2017, as tax increases are likely to be outweighed by costs related to the recent large inflow of refugees and migrants and increasing sickness insurance expenses. The Spring Budget Bill includes measures involving expenditure amounting to SEK 31 billion to address the challenges linked to migration and integration.

According to the Commission services' Spring 2016 Forecast, the general government deficit will reach 0.4% of GDP in 2016 and 0.7% in 2017 and the structural deficit is also set to deteriorate to 0.9% until 2017. The revenue-to-GDP ratio is expected to remain rather stable at around 50% of GDP, while the expenditures are likely to remain at around 51% of GDP.

Gross government debt is well below the 60% of GDP Treaty reference value and is expected to

([80]) Mainly explained by legislated measures involving the gradual reduction of earned income tax credit, an unchanged lower threshold for central government income tax, abolished reduction of social security contributions for young people, lowered level of subsidy for home renovation services (ROT) and higher tax on petrol and diesel.

gradually decline in the coming years, reaching 41.3% of GDP in 2016 and 40.1% of GDP in 2017, mainly supported by strong economic growth and falling debt servicing costs due to low interest rates.

Sweden submitted the 2016 Convergence Programme on 28 April 2016. The main aim of the presented fiscal strategy is to remain at the medium-term budgetary objective (MTO), i.e. a structural balance of -1% of potential GDP. The Convergence Programme foresees a deficit of 0.4% of GDP in 2016 and 0.7% of GDP in 2017, which is fully in line with the Commission services' Spring 2016 Forecast. Based on the Commission's assessment of the Convergence Programme and taking into account the Commission services' Spring 2016 forecast, Sweden is expected to comply with the provisions of the Stability and Growth Pact. Further details can be found in the Assessment of the 2016 Convergence Programme for Sweden. ([81])

As far as the fiscal framework is concerned – which refers to numerical fiscal rules, medium-term budgetary frameworks, independent fiscal institutions, and budgetary procedures –Sweden has a strong domestic system since the 1990s, which is also reflected in its extensive track record of fiscal soundness. The main pillars of the framework are (i) the numerical target defined over the cycle for general government; (ii) a balanced-budget rule for local authorities; (iii) an effective medium-term budgetary framework leading to binding three-year expenditure ceilings; and (iv) the working of independent fiscal institutions, with a monitoring and analytical role for the Fiscal Policy Council. The authorities have recently started to re-examine the adequacy of the current 1% of GDP surplus target (in place since 2007). Irrespective of the stipulated level of the numerical rule, the method applied to monitor the fulfilment of the target is not clarified unambiguously (currently, multiple indicators are in use by the government to assess compliance). In its annual reports, the Fiscal Policy Council has signalled the issue of non-compliance for several years, including in 2016.

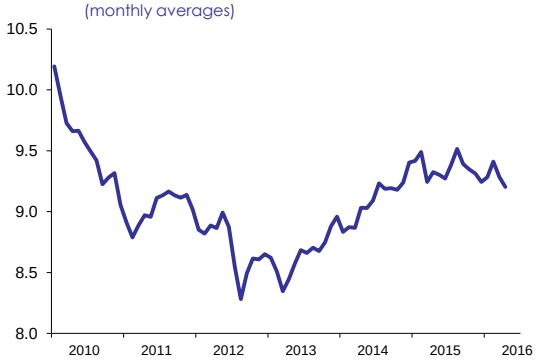
([81]) http://ec.europa.eu/economy_finance/economic_governance/sgp/convergence/index_en.htm

8.4. EXCHANGE RATE STABILITY

The Swedish krona does not participate in ERM II. The Riksbank pursues inflation targeting under a floating exchange rate regime.

Following the sharp depreciation of the krona against the euro in 2008, i.e. at the onset of the financial crisis, the krona recovered at a similarly rapid pace and by mid-2012 even reached a twelve-year high of 8.3 SEK/EUR. While this appreciation was arguably a correction of the krona's previous weakening, safe-haven flows, resulting from the intensification of the euro-area sovereign debt crisis, significantly contributed to it. Between early-2013 and the beginning of 2015, the krona was on a depreciation trend, falling overall by almost 14% against the euro. During the two years before this assessment, the krona depreciated against the euro by some 1.6%, fluctuating around on average 9.30 SEK/EUR.

Graph 8.4: **Sweden - SEK/EUR exchange rate**
(monthly averages)



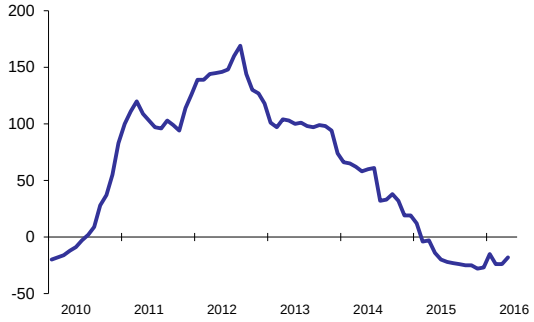
Source: ECB.

Since August 2012, i.e. when the Riksbank started cutting its repo rate, short-term interest rate spreads vis-à-vis the euro area have declined. The interest rate spread even turned negative (euro-area short-term interest rates being higher than Swedish ones) in February 2015, when the Riksbank was among the first European central banks to introduce a negative policy rate, cutting its repo rate to minus 0.1%. Three additional cuts to the repo rate, reaching minus 0.5% after the Riksbank's February 2016 Executive Board meeting, widened the 3-months STIBOR-EURIBOR spread further to about on average -20 basis points during the first four months of 2016.

In December 2012, the Riksbank decided to increase its foreign currency reserves by SEK 100 billion to reflect higher risks to the Swedish financial system from an uncertain economic

situation abroad and the increase in commitments to the IMF. Subsequently international reserves rose and peaked at about SEK 520 billion in May 2015, an increase by more than 20% since mid-2014. Early-2016 international reserves averaged slightly less than SEK 500 billion (a decline of 5% from the previous' year's peak), representing some 12% of GDP. In December 2015, the Riksbank introduced the operational framework to intervene on foreign exchange markets in a timely manner if needed in order to prevent a de-anchoring of inflation expectations due to a strengthening krona. Judging by international reserve statistics Riksbank interventions have not taken place thus far, though.

Graph 8.5: **Sweden - 3-M Stibor spread to 3-M Euribor**
(basis points, monthly values)



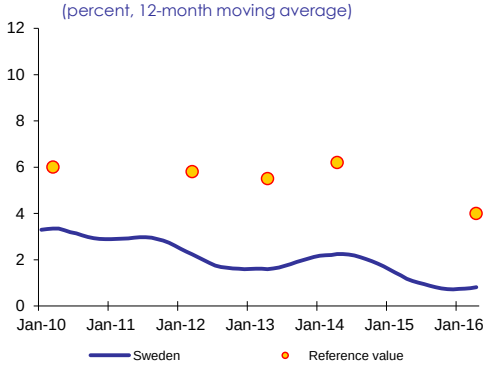
Source: Eurostat.

8.5. LONG-TERM INTEREST RATES

Long-term interest rates in Sweden used for the convergence examination reflect secondary market yields on a single benchmark government bond with a residual maturity of around nine years.

The Swedish 12-month average long-term interest rate, relevant for the assessment of the Treaty criterion was well below the reference value at the time of the 2014 convergence assessment of Sweden. Following a slight increase to 2.3% by May 2014, the relevant Swedish 12-month moving average long-term interest rate has declined again. In April 2016, the latest month for which data are available, the reference value, given by the average of long-term interest rates in Bulgaria, Slovenia and Spain plus 2 percentage points, stood at 4%. In that month, the 12-month average of the yield on the Swedish benchmark bond stood at 0.8%, i.e. 3.2 percentage points below the reference value.

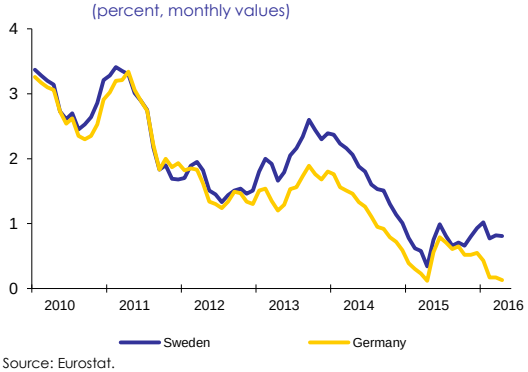
Graph 8.6: **Sweden - Long-term interest rate criterion**
(percent, 12-month moving average)



Source: Commission services.

Long-term interest rates declined more than 230 basis points between mid-2013 and April 2015, reaching an all-time low of 0.3%. In particular the loosening of monetary policy as a response to the low domestic inflation environment, the launch of the Riksbank's asset purchase programme, and safe-haven flows into Swedish government bonds, fuelled the compression of Swedish long-term interest rates, closely following the German benchmark bond. The announcement of the ECB's expanded asset purchase programme (EAPP) in January 2015 and its subsequent launch in March 2015 have led to a gradual re-pricing of investors' risks perceptions and triggered an abatement of flows into safe-haven assets, e.g. German or Swedish government bonds. Yields increased somewhat but with an average of 0.8% in early 2016 remain very low by historic standards.

Graph 8.7: **Sweden - Long-term interest rates**
(percent, monthly values)



Source: Eurostat.

Very low long-term interest spreads vis-à-vis the German benchmark bond widened between end-2012 and autumn 2013 before narrowing again

since early 2014. They stood at some 68 basis points at the end of April 2016 ([82]).

8.6. ADDITIONAL FACTORS

The Treaty (Article 140 TFEU) calls for an examination of other factors relevant to economic integration and convergence to be taken into account in the assessment. The assessment of the additional factors – including balance of payments developments, product and financial market integration – gives an important indication of a Member State's ability to integrate into the euro area without difficulties.

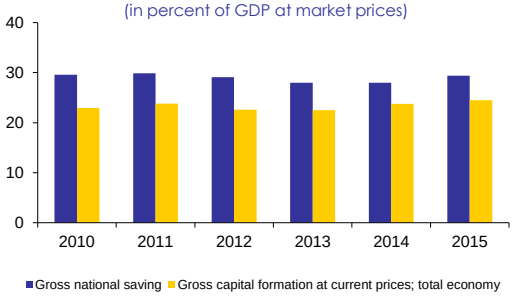
In November 2015, the Commission published its fifth Alert Mechanism Report (AMR 2016) ([83]) under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.5). The AMR 2016 scoreboard showed that Sweden exceeded the indicative threshold in four out of fourteen indicators, i.e. two in the area of external imbalances (the surplus on the current account, the change in the export market share) and two in the area of internal imbalances (the annual change in the house price index, the consolidated private sector debt in % of GDP). In line with the conclusions of the AMR 2016 (i.e. that imbalances had been identified for Sweden in the previous MIP round), Sweden was identified as warranting a further in-depth review, which found that Sweden continued to experience macroeconomic imbalances.

8.6.1. Developments of the balance of payments

Sweden's current account surplus gradually declined from its peak of 8.6% of GDP in 2008 to around 6% over the last years (5.9% in 2015). While the contribution of services and net primary income to the current account balance has been increasing, the trade surplus in goods diminished, resulting in a relatively stable current account surplus. The goods trade surplus has remained slightly above 3% of GDP since 2010 and Sweden's net international investment position has been improving successively and is expected to turn positive in the coming years. Current transfers have delivered a relatively steady negative impact, reflecting Sweden's foreign aid and positive net contributions to international organisations, as well as remittances transferred by foreign workers in Sweden to their home countries.

Sweden's large savings-investment surplus persisted in 2014 and 2015, reflecting high net savings by the private sector, a limited fiscal deficit and a low level of residential investment. As regards the latter, despite a recent rebound in housing investment, the number of new dwellings built still does not meet surging housing demand. Gross national savings reached almost 30% of GDP in 2014 and 2015, similar to previous years. While households have increased precautionary savings following the financial crisis, corporate and household saving had also risen as a result of reforms introduced in the 1990s, such as the introduction of a pension plan with defined contributions. Gross fixed capital formation cautiously took up again in 2014, but the uncertain economic environment is still affecting investment levels.

Graph 8.8: **Sweden - Saving and investment**
(in percent of GDP at market prices)



Source: Eurostat, Commission services.

A gradual recovery in Sweden's main trading partners and a relatively weak krona have been positively impacting Swedish export performance since 2015. This is projected to improve the outlook for export-oriented industrial production and manufacturing investment. Swedish cost developments do not point to major challenges in terms of competitiveness. Unit labour costs (ULC) have been growing in line with Sweden's main trading partners, while the accumulated ULC growth was broadly stable between the period of 2001 and 2014. The real effective exchange rate has depreciated in 2014 and 2015 due to the weak krona, while domestic prices continue growing more slowly than in the main trading partners. The decrease in Sweden's export market share continued in 2014 as goods exports lost further ground to international competitors. There has been a contraction of 9.8% in the previous five

([82]) The reference to the German benchmark bond is included for illustrative purposes, as a proxy of the euro area long-term AAA yield.
([83]) http://ec.europa.eu/europe2020/pdf/2016/ags2016_alert_mechanism_report.pdf

Table 8.4:

Sweden - Balance of payments **(percentage of GDP)**

	2010	2011	2012	2013	2014	2015
Current account	6.0	6.1	5.9	6.0	5.4	5.9
of which: Balance of trade in goods	3.9	3.6	3.7	3.6	3.3	2.9
Balance of trade in services	1.4	1.8	1.8	2.1	1.8	2.6
Primary income balance	2.0	2.0	2.2	1.9	1.9	2.1
Secondary income balance	-1.3	-1.3	-1.8	-1.7	-1.7	-1.6
Capital account	-0.1	-0.2	-0.2	-0.2	-0.1	-0.2
External balance [1)]	5.9	5.9	5.7	5.8	5.2	5.7
Financial account [2)]	7.5	8.0	1.5	3.3	3.2	3.2
of which: Direct investment	4.2	3.0	2.3	4.4	0.9	2.3
Portfolio investment	-3.9	-5.1	-3.1	-8.4	4.2	-2.1
Other investment [3)]	7.4	9.9	2.2	4.7	-1.8	2.8
Change in reserves	-0.1	0.1	0.1	2.6	0.0	0.3
Financial account without reserves	7.7	7.9	1.4	0.7	3.2	2.9
Errors and omissions	1.7	2.2	-4.2	-2.5	-2.0	-2.5
Gross capital formation	22.9	23.8	22.6	22.5	23.8	24.5
Gross saving	29.6	29.9	29.1	28.0	28.0	29.4
Gross external debt	198.1	192.9	187.0	184.6	190.6	181.5
International investment position	-8.4	-10.2	-16.6	-14.6	-2.5	-1.6

1) The combined current and capital account.

2) The data is presented under BPM6 methodology, where the signs of financial account items are the opposite as under BPM5 (that was used in earlier Convergence Reports).

3) Including financial derivatives.

Sources: Eurostat, Statistics Sweden, Commission services.

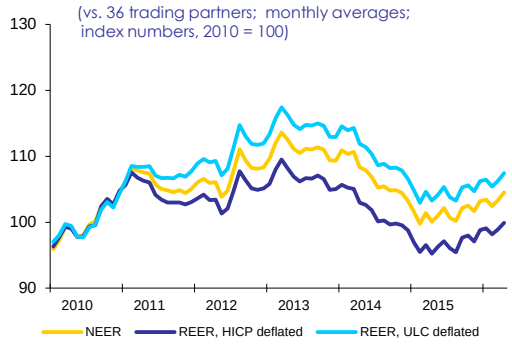
years, continuing a long-term trend that started already in the 1970s. However, a reversal was noted in 2015 when Sweden actually gained market shares.

Sweden's financial account shows relatively large fluctuations over time but seems to have stabilised around 3.2% in 2014 and 2015. However, the financial account balance consistently reflects Sweden's role as a net FDI investor abroad.

External reserves increased somewhat in 2014 and 2015, following the marked surge in 2013, when the Riksbank increased foreign currency reserves by SEK 100 billion to re-align them with the exposure of Swedish banks to foreign capital markets. External debt increased from 184.3% of GDP in 2013 to 190.3% of GDP in 2014, i.e. by 6 percentage points. Again, this development largely mirrors the increase in the gross government debt that was due largely to technical factors linked to changing accounting standards. Sweden's net international investment position improved significantly in 2014 and 2015.

According to the Commission services' Spring 2016 Forecast, net exports are expected to contribute somewhat positively to real GDP growth in 2016 and 2017, while the current account surplus is expected to remain stable during this period.

Graph 8.9: **Sweden - Effective exchange rates**



Source: Commission services.

8.6.2. Market integration

Sweden is integrated with the euro area through trade and investment linkages. Trade openness of the Swedish economy remained rather stable at

Table 8.5:
Sweden - Market integration

	2010	2011	2012	2013	2014	2015
Trade openness [1] (%)	41.8	42.9	42.0	39.9	41.0	41.5
Trade with EA in goods & services [2)+3)] (%)	17.8	18.6	17.9	17.4	17.6	17.7
Export performance (% change) [4]	2.0	1.0	-0.7	-2.7	0.3	3.3
World Bank's Ease of Doing Business Index rankings [5]	9	14	13	14	9	8
WEF's Global Competitiveness Index rankings [6]	2	3	4	6	10	9
Internal Market Transposition Deficit [7] (%)	0.9	0.6	0.1	0.1	0.2	0.4
Real house price index [8]	100.0	100.8	101.5	106.3	115.4	129.3
Residential investment [9] (%)	3.6	3.9	3.4	3.5	4.1	4.6

1) (Imports + Exports of goods and services / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics, Balance of Payments).
2) (Imports + Exports of goods with EA-19 / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).
3) Trade in services with EA-19 (average credit and debit in % of GDP at current prices) (Balance of Payments).
4) Index for exports of goods and services divided by an index for growth of markets (percentage change on preceding year).
5) New methodology as of 2014 (World Bank).
6) (World Economic Forum)
7) Percentage of internal market directives not yet communicated as having been transposed, relative to the total. (Nov. data, May in 2013 and 2015).
8) Deflated house price index (2010=100), Eurostat.
9) Gross capital formation in residential buildings (in % of GDP), Eurostat.

Sources: Eurostat, World Bank, World Economic Forum, Commission services.

about 41% of GDP in 2014. The main euro-area trading partners are Germany, the Netherlands and Finland, while Norway, Denmark and the UK are the biggest non-euro-area partners.

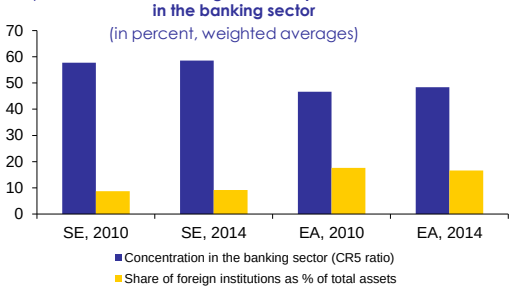
Sweden has attracted a high share of FDI in the tradable sector thanks to good infrastructure and a highly educated labour force. In 2014, more than 80% of the total FDI stock emanated from the EU, with biggest investments originating in the Netherlands, Luxembourg and the UK.

Regarding the business environment, Sweden regularly scores top positions in international rankings, well above most euro-area Member States. Following a slight dip between 2010 and 2013, rankings have improved again over the last two years. Sweden's deficit in the transposition of EU directives was very low (0.4% in 2015), thus meeting the 0.5% target as proposed by the European Commission in the Single Market Act (2011).

The Swedish labour market, to a large extent governed by negotiations between social partners at sectorial level, is characterised by positive labour market outcomes with high employment rates. Sweden has one of the lowest wage dispersions in the EU, with high entry wages and little wage progression. Employment protection of permanent workers is rather high (slightly below the euro-area-OECD countries' average, according to the 2013 OECD employment protection indicator) compared to that of temporary workers . Adjustment by labour mobility is adequate, with a relatively low dispersion of regional unemployment rates. The integration of low-skilled and foreign-born workers remains the key challenge for the Swedish labour market, though, as the employment rate of both groups is significantly below the overall employment rate.

Sweden's financial sector (accounting for more than 400% of GDP) is well integrated into the EU financial sector, especially through interlinkages in the Nordic-Baltic financial cluster. Subsidiaries and branches of the Swedish banking groups hold the majority of the market in Lithuania, Latvia, Estonia and Finland. They also have substantial market shares in Denmark and Norway.

Graph 8.10: **Sweden - Foreign ownership and concentration in the banking sector**
(in percent, weighted averages)



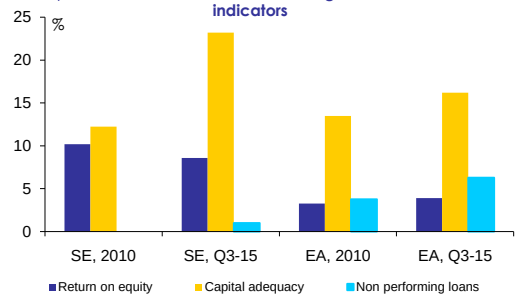
Source: ECB, Structural financial indicators .

Foreign ownership in the Swedish financial market is significantly below the euro-area average (about 9% in 2014) but has increased marginally since 2010. At almost 60%, bank concentration measured by the market share of the largest five

credit institutions in total assets has remained above the euro-area average for the past years.

The capital adequacy of Swedish banks measured by standard regulatory ratios is relatively high at 23% in Q3 2015, compared to the euro-area average (16% in Q3 2015). Moreover, the ratio of non-performing loans (1.0% in Q3 2015) is only a fraction of the euro-area average, which between 2010 and Q3 2015 increased by about 2½ percentage points, reaching more than 6%. High asset quality, cost-efficiency and market concentration support the profitability of Swedish banks, which is among the highest in Europe. The sector's average return on equity (ROE) in Q3 2015 stood at almost 9%.

Graph 8.11: **Sweden - Selected banking sector soundness indicators**

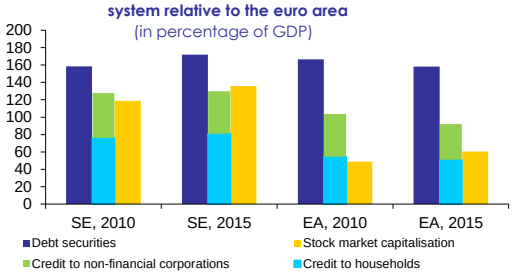


Source: ECB, EC calculations.

House prices in Sweden have been growing almost uninterruptedly over the last 20 years: real house prices doubled during this period and surged by almost 40% since 2008. The growth has been accelerating since late 2011. While real house prices grew at an average rate of 4.7% in 2013 and 8.5% in 2014, their increase accelerated to 13.7% in Q3 2015 compared to the previous year. Residential investment has picked up only marginally from 3.6% of GDP in 2010 to 4.1% of GDP in 2014. Overvalued house prices entail risks of a disorderly and harmful correction, with a potential impact on the banking sector and the real economy. The overall shortage of housing supply can hamper labour mobility and is further exacerbated by the large inflow of refugees in need of affordable housing.

Capital markets in Sweden are very well developed compared to the euro area. The stock of quoted shares issued by Swedish enterprises increased to about 136% of GDP by end-2015 (up from about 119% of GDP in 2010). It thus exceeded by far the 2015 euro-area average of 60% of GDP. The total amount of outstanding debt securities also increased to 172% of GDP in 2015 (plus 13 percentage points since 2010), while the euro-area average decreased to 158% of GDP over the same period. Outstanding bank credit to non-financial companies and households reached almost 130% of GDP (an increase of about 2 percentage points since 2010), compared to 92% in the euro area. The consolidated stock of private sector debt increased from 190% of GDP in 2010 to almost 194% of GDP in 2014. This is the sixth-highest consolidated private sector debt level in the EU and remains significantly above the euro-area average of 138%.

Graph 8.12: **Sweden - Recent development of the financial system relative to the euro area**
(in percentage of GDP)



Note: Debt Securities other than shares, excluding financial derivatives.
Source: ECB, Commission services.

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