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Convergence Report 2018

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REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

CONVERGENCE REPORT 2018

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

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European Commission
Directorate-General for Economic and Financial Affairs

Convergence Report 2018

EUROPEAN ECONOMY x/2018

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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
CZK	Czech koruna
HRK	Croatian kuna
HUF	Hungarian forint
PLN	Polish zloty
RON	Romanian leu (ROL until 30 June 2005)
SEK	Swedish krona
USD	United States dollar

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
CEE	Central and Eastern Europe
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

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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
GDP	Gross domestic product
HICP	Harmonised index of consumer prices
HFSA	Hungarian Financial Supervisory Authority
IDR	In-Depth Review
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
REER	Real effective exchange rate
TFEU	Treaty on the Functioning of the European Union
ULC	Unit labour costs
VAT	Value added tax

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www.parlament.gv.at

CONTENTS

Convergence Report 2018 1

Convergence Report 2018 - Technical annex 3

1. Introduction 5
   - 1.1. ROLE OF THE REPORT 5
   - 1.2. APPLICATION OF THE CRITERIA 6
     - 1.2.1. Compatibility of legislation 7
     - 1.2.2. Price stability 7
     - 1.2.3. Public finances 10
     - 1.2.4. Exchange rate stability 10
     - 1.2.5. Long-term interest rates 13
     - 1.2.6. Additional factors 13

2. Bulgaria 17
   - 2.1. LEGAL COMPATIBILITY 17
     - 2.1.1. Introduction 17
     - 2.1.2. Central Bank independence 17
     - 2.1.3. Prohibition of monetary financing and privileged access 18
     - 2.1.4. Assessment of compatibility 18
   - 2.2. PRICE STABILITY 19
     - 2.2.1. Respect of the reference value 19
     - 2.2.2. Recent inflation developments 19
     - 2.2.3. Underlying factors and sustainability of inflation 20
   - 2.3. PUBLIC FINANCES 22
     - 2.3.1. Recent fiscal developments 22
     - 2.3.2. Medium-term prospects 23
   - 2.4. EXCHANGE RATE STABILITY 24
   - 2.5. LONG-TERM INTEREST RATES 25
   - 2.6. ADDITIONAL FACTORS 25
     - 2.6.1. Developments of the balance of payments 26
     - 2.6.2. Market integration 27

3. Czech Republic 31
   - 3.1. LEGAL COMPATIBILITY 31
     - 3.1.1. Introduction 31
     - 3.1.2. Central Bank independence 31
     - 3.1.3. Prohibition of monetary financing and privileged access 31
     - 3.1.4. Integration in the ESCB 32
     - 3.1.5. Assessment of compatibility 32
   - 3.2. PRICE STABILITY 32
     - 3.2.1. Respect of the reference value 32
     - 3.2.2. Recent inflation developments 33
     - 3.2.3. Underlying factors and sustainability of inflation 33
   - 3.3. PUBLIC FINANCES 36
     - 3.3.1. Recent fiscal developments 36
     - 3.3.2. Medium-term prospects 36
   - 3.4. EXCHANGE RATE STABILITY 37
   - 3.5. LONG-TERM INTEREST RATES 37
   - 3.6. ADDITIONAL FACTORS 38

www.parlament.gv.at

3.6.1. Developments of the balance of payments 38
3.6.2. Market integration 40

4. Croatia 43

4.1. LEGAL COMPATIBILITY 43
4.1.1. Introduction 43
4.1.2. Central Bank independence 43
4.1.3. Prohibition of monetary financing and privileged access 43
4.1.4. Integration in the ESCB 43
4.1.5. Assessment of compatibility 43
4.2. PRICE STABILITY 43
4.2.1. Respect of the reference value 43
4.2.2. Recent inflation developments 44
4.2.3. Underlying factors and sustainability of inflation 44
4.3. PUBLIC FINANCES 46
4.3.1. Recent fiscal developments 46
4.3.2. Medium-term prospects 47
4.4. EXCHANGE RATE STABILITY 48
4.5. LONG-TERM INTEREST RATES 48
4.6. ADDITIONAL FACTORS 49
4.6.1. Developments of the balance of payments 49
4.6.2. Market integration 51

5. Hungary 53

5.1. LEGAL COMPATIBILITY 53
5.1.1. Introduction 53
5.1.2. Central Bank independence 53
5.1.3. Prohibition of monetary financing and privileged access 54
5.1.4. Integration in the ESCB 56
5.1.5. Assessment of compatibility 56
5.2. PRICE STABILITY 56
5.2.1. Respect of the reference value 56
5.2.2. Recent inflation developments 57
5.2.3. Underlying factors and sustainability of inflation 57
5.3. PUBLIC FINANCES 60
5.3.1. Recent fiscal developments 60
5.3.2. Medium-term prospects 61
5.4. EXCHANGE RATE STABILITY 62
5.5. LONG-TERM INTEREST RATES 63
5.6. ADDITIONAL FACTORS 63
5.6.1. Developments of the balance of payments 64
5.6.2. Market integration 65

6. Poland 69

6.1. LEGAL COMPATIBILITY 69
6.1.1. Introduction 69
6.1.2. Central Bank independence 69
6.1.3. Prohibition of monetary financing and privileged access 70
6.1.4. Integration in the ESCB 70
6.1.5. Assessment of compatibility 71
6.2. PRICE STABILITY 71
6.2.1. Respect of the reference value 71
6.2.2. Recent inflation developments 71
6.2.3. Underlying factors and sustainability of inflation 73

www.parlament.gv.at

6.3. PUBLIC FINANCES 74
6.3.1. Recent fiscal developments 74
6.3.2. Medium-term prospects 75
6.4. EXCHANGE RATE STABILITY 76
6.5. LONG-TERM INTEREST RATES 76
6.6. ADDITIONAL FACTORS 77
6.6.1. Developments of the balance of payments 78
6.6.2. Market integration 79

7. Romania 83

7.1. LEGAL COMPATIBILITY 83
7.1.1. Introduction 83
7.1.2. Central Bank independence 83
7.1.3. Prohibition of monetary financing and privileged access 84
7.1.4. Integration in the ESCB 85
7.1.5. Assessment of compatibility 85
7.2. PRICE STABILITY 85
7.2.1. Respect of the reference value 85
7.2.2. Recent inflation developments 86
7.2.3. Underlying factors and sustainability of inflation 86
7.3. PUBLIC FINANCES 89
7.3.1. Recent fiscal developments 89
7.3.2. Medium-term prospects 90
7.4. EXCHANGE RATE STABILITY 90
7.5. LONG-TERM INTEREST RATES 91
7.6. ADDITIONAL FACTORS 92
7.6.1. Developments of the balance of payments 92
7.6.2. Market integration 94

8. Sweden 97

8.1. LEGAL COMPATIBILITY 97
8.1.1. Introduction 97
8.1.2. Central Bank independence 97
8.1.3. Prohibition of monetary financing and privileged access 98
8.1.4. Integration in the ESCB 98
8.1.5. Assessment of compatibility 99
8.2. PRICE STABILITY 99
8.2.1. Respect of the reference value 99
8.2.2. Recent inflation developments 99
8.2.3. Underlying factors and sustainability of inflation 100
8.3. PUBLIC FINANCES 102
8.3.1. Recent fiscal developments 102
8.3.2. Medium-term prospects 103
8.4. EXCHANGE RATE STABILITY 104
8.5. LONG-TERM INTEREST RATES 105
8.6. ADDITIONAL FACTORS 105
8.6.1. Developments of the balance of payments 106
8.6.2. Market integration 107

LIST OF TABLES

2.1. Bulgaria - Components of inflation 20
2.2. Bulgaria - Other inflation and cost indicators 22

www.parlament.gv.at

2.3. Bulgaria - Budgetary developments and projections 22
2.4. Bulgaria - Balance of payments 26
2.5. Bulgaria - Market integration 28
3.1. Czech Republic - Components of inflation 33
3.2. Czech Republic - Other inflation and cost indicators 34
3.3. Czech Republic - Budgetary developments and projections 35
3.4. Czech Republic - Balance of payments 38
3.5. Czech Republic - Market integration 40
4.1. Croatia - Components of inflation 43
4.2. Croatia - Other inflation and cost indicators 44
4.3. Croatia - Budgetary developments and projections 47
4.4. Croatia - Balance of payments 50
4.5. Croatia - Market integration 52
5.1. Hungary - Components of inflation 57
5.2. Hungary - Other inflation and cost indicators 57
5.3. Hungary - Budgetary developments and projections 61
5.4. Hungary - Balance of payments 64
5.5. Hungary - Market integration 64
6.1. Poland - Components of inflation 70
6.2. Poland - Other inflation and cost indicators 71
6.3. Poland - Budgetary developments and projections 75
6.4. Poland - Balance of payments 77
6.5. Poland - Market integration 79
7.1. Romania - Components of inflation 85
7.2. Romania - Other inflation and cost indicators 86
7.3. Romania - Budgetary developments and projections 88
7.4. Romania - Balance of payments 92
7.5. Romania - Market integration 93
8.1. Sweden - Components of inflation 100
8.2. Sweden - Other inflation and cost indicators 100
8.3. Sweden - Budgetary developments and projections 103
8.4. Sweden - Balance of payments 106
8.5. Sweden - Market integration 106

LIST OF GRAPHS

2.1. Bulgaria - Inflation criterion 19
2.2. Bulgaria - HICP inflation 19
2.3. Bulgaria - Inflation, productivity and wage trends 21
2.4. Bulgaria - BGN/EUR exchange rate 24
2.5. Bulgaria - 3-M Sofibor spread to 3-M Euribor 24
2.6. Bulgaria - Long-term interest rate criterion 25
2.7. Bulgaria - Long-term interest rates 25
2.8. Bulgaria - Saving and investment 27
2.9. Bulgaria - Effective exchange rates 27
2.10. Bulgaria - Foreign ownership and concentration in the banking sector 29
2.11. Bulgaria - Selected banking sector soundness indicators 29
2.12. Bulgaria - Recent development of the financial system relative to the euro area 29
3.1. Czech Republic - Inflation criterion 33
3.2. Czech Republic - HICP inflation 33
3.3. Czech Rep. - Inflation, productivity and wage trends 34
3.4. Czech Republic - CZK/EUR exchange rate 37
3.5. Czech Republic - 3-M Pribor spread to 3-M Euribor 37
3.6. Czech Republic - Long-term interest rate criterion 38

www.parlament.gv.at

3.7. Czech Republic - Long-term interest rates 38
3.8. Czech Republic - Saving and investment 39
3.9. Czech Republic - Effective exchange rates 39
3.10. Czech Republic - Foreign ownership and concentration in the banking sector 40
3.11. Czech Republic - Selected banking sector soundness indicators 41
3.12. Czech Republic - Recent development of the financial system relative to the euro area 41
4.1. Croatia - Inflation criterion 44
4.2. Croatia - HICP inflation 44
4.3. Croatia - Inflation, productivity and wage trends 46
4.4. Croatia - HRK/EUR exchange rate 48
4.5. Croatia - 3-M Zibor spread to 3-M Euribor 48
4.6. Croatia - Long-term interest rate criterion 49
4.7. Croatia - Long-term interest rates 49
4.8. Croatia - Saving and investment 50
4.9. Croatia - Effective exchange rates 50
4.10. Croatia - Foreign ownership and concentration in the banking sector 51
4.11. Croatia - Selected banking sector soundness indicators 52
4.12. Croatia - Recent development of the financial system relative to the euro area 52
5.1. Hungary - Inflation criterion 57
5.2. Hungary - HICP inflation 57
5.3. Hungary - Inflation, productivity and wage trends 59
5.4. Hungary - HUF/EUR exchange rate 62
5.5. Hungary - 3-M Bubor spread to 3-M Euribor 62
5.6. Hungary - Long-term interest rate criterion 63
5.7. Hungary - Long-term interest rates 63
5.8. Hungary - Saving and investment 65
5.9. Hungary - Effective exchange rates 65
5.10. Hungary - Foreign ownership and concentration in the banking sector 66
5.11. Hungary - Selected banking sector soundness indicators 66
5.12. Hungary - Recent development of the financial system relative to the euro area 67
6.1. Poland - Inflation criterion 71
6.2. Poland - HICP inflation 72
6.3. Poland - Inflation, productivity and wage trends 73
6.4. Poland - PLN/EUR exchange rate 76
6.5. Poland - 3-M Wibor spread to 3-M Euribor 76
6.6. Poland - Long-term interest rate criterion 76
6.7. Poland - Long-term interest rates 77
6.8. Poland - Saving and investment 78
6.9. Poland - Effective exchange rates 78
6.10. Poland - Foreign ownership and concentration in the banking sector 80
6.11. Poland - Selected banking sector soundness indicators 80
6.12. Poland - Recent development of the financial system relative to the euro area 80
7.1. Romania - Inflation criterion 85
7.2. Romania - HICP inflation 86
7.3. Romania - Inflation, productivity and wage trends 88
7.4. Romania - RON/EUR exchange rate 91
7.5. Romania - 3-M Robor spread to 3-M Euribor 91
7.6. Romania - Long-term interest rate criterion 91
7.7. Romania - Long-term interest rates 92
7.8. Romania - Saving and investment 92
7.9. Romania - Effective exchange rates 94
7.10. Romania - Foreign ownership and concentration in the banking sector 95
7.11. Romania - Selected banking sector soundness indicators 95
7.12. Romania - Recent development of the financial system relative to the euro area 95
8.1. Sweden - Inflation criterion 99

www.parlament.gv.at

8.2. Sweden - HICP inflation 99
8.3. Sweden - Inflation, productivity and wage trends 101
8.4. Sweden - SEK/EUR exchange rate 104
8.5. Sweden - 3-M Stibor spread to 3-M Euribor 104
8.6. Sweden - Long-term interest rate criterion 105
8.7. Sweden - Long-term interest rates 105
8.8. Sweden - Saving and investment 107
8.9. Sweden - Effective exchange rates 107
8.10. Sweden - Foreign ownership and concentration in the banking sector 108
8.11. Sweden - Selected banking sector soundness indicators 109
8.12. Sweden - Recent development of the financial system relative to the euro area 109

LIST OF BOXES

1.1. Article 140 of the Treaty 5
1.2. Assessment of price stability and the reference value 8
1.3. Excessive deficit procedure 11
1.4. Data for the interest rate convergence 13
1.5. The Macroeconomic Imbalance Procedure (MIP) 14

www.parlament.gv.at

Convergence Report 2018

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

www.parlament.gv.at

Convergence Report 2018

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

www.parlament.gv.at

Convergence Report 2018

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 ([1]) 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 ([2]).

In 2016, the Commission and the ECB adopted their latest regular Convergence Reports ([3]). None of the Member States assessed in those reports was deemed to meet the necessary conditions for adopting the euro.

In 2018, 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 2018 and includes a detailed assessment of the progress with convergence, as required by Article 140(1) of the Treaty.

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.).

President Juncker said in his 2017 State of the Union address: "The euro is meant to be the single currency of the European Union as a whole. All but two of our Member States are required and entitled to join the euro once they fulfil all conditions. Member States that want to join the euro must be able to do so." The Commission proposed in its 6 December 2017 "EMU Package" to set up a dedicated work stream (as part of its technical assistance activities) to offer targeted support to Member States on their way to joining the euro ([4]). The technical support will be offered upon request and will cover all policies that can help achieve a high degree of convergence, such as support for reforms in the areas of public financial management, the business environment, the financial sector, labour and product markets, and the public administration. This technical support will be funded through the Structural Reform Support Programme. The Commission also announced that for the period post-2020, it will propose a dedicated convergence facility, as part of the follow-up to the Structural Reform Support Programme, in order to support Member States in their concrete preparation for a smooth participation in the euro area. This is however irrespective of the formal process towards euro adoption, which is part of a specific monitoring process through the Convergence Reports.

([1]) 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.

([2]) The United Kingdom has decided to withdraw from the EU.

([3]) European Commission, Convergence Report 2016, COM(2016) 191 final, 7 June 2016; European Central Bank, Convergence Report 2016, June 2016.

([4]) European Commission, Communication on new budgetary instruments for a stable euro area within the Union framework, COM(2017) 0822 final, 6 December 2017

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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."

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, the 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 23 April 2018.

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).

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 ([5]) 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 (see Box 1.2).

([5]) 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.

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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), 2014 (Greece, Bulgaria and Cyprus) and 2016 (Cyprus and Romania), as their inflation rates deviated by a wide margin from the euro-area average, driven by country-specific factors that limited their scope to act as meaningful benchmarks for other Member States. Table 1 lists the reference value in the Convergence Reports issued since 1998.

(Continued on the next page)

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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
2018	March 2018	Cyprus, Ireland, Finland	1.9	1.4

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 arthmetic 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.

Accordingly, the reference value is currently 1.9%, based on the data of Cyprus (0.2%), Ireland (0.3%), and Finland (0.8%) over the 12-month period covering April 2017-March 2018.

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, 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 ([6]). Medium-term inflation prospects are also assessed by reference to the economies' key structural characteristics, including the functioning of the labour and product markets.

([6]) Based on the Commission services' Spring 2018 Forecast, the inflation reference value is forecast to stand at 2.2% in December 2018.

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 which sets out the way in which government deficit and debt levels are assessed to determine 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 ([7]).

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 ([8]).

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" ([9]). Based on the Council Resolution on the establishment of the ERM II ([10]), 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.

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

([8]) 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.

([9]) 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.

([10]) 97/C 236/03 of 16 June 1997, OJ C 236, 2.8.1997, p.5.

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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, the debt criterion in Article 126(2) of the Treaty was operationalised.

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 when assessing compliance on the basis of the debt criterion. When assessing compliance on the basis of the

([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)

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 075, March 2018: https://ec.europa.eu/info/sites/info/files/economy-finance/ip075_en.pdf

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 24 April 2016 to 23 April 2018.

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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 10-year benchmark bond yields 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 ten Member States, the residual maturity of the benchmark bond is at least 9.5 years. For seventeen Member States, the residual maturity of the benchmark bond is below 9.5 years, in particular for Lithuania with a residual maturity below 7 years. All yields are calculated on the basis of secondary market rates, where available. 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) and in a dedicated page in the ECB website with additional information:
http://www.ecb.europa.eu/stats/financial_markets_and_interest_rates/long_term_interest_rates/html/index.en.html.

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.

The reference value for March 2018 is calculated as the simple average of the average long-term interest rates in Cyprus (2.2%), Ireland (0.8%) and Finland (0.6%), plus 2 percentage points, yielding a reference value of 3.2%.

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

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Box 1.5: **The Macroeconomic Imbalance Procedure (MIP)**

The Macroeconomic Imbalance Procedure (MIP): key elements

A key lesson from the economic and financial crisis was that the economic governance framework in the EMU needed to be further strengthened to better support macroeconomic stability, including in aspects beyond fiscal policy. The Macroeconomic Imbalance Procedure (MIP) responds to that need by aiming at the detection, prevention and correction of macroeconomic imbalances that could harm economic stability in an EU country, the euro area, or the EU as a whole. It was a key element of the legislative package (the "Six-Pack") to enhance the governance structures in EMU adopted in 2011.

No simple and mechanistic criteria are available for the identification of macroeconomic imbalances because drivers of macroeconomic instability are multi-dimensional phenomena whose severity needs to be assessed along several aspects and taking into account also country-specific features, notably linked to the adjustment capacity of the economy. Instead, the MIP relies on a two-step approach for the identification of imbalances.

In a first step for the identification of imbalances under the MIP, the Alert Mechanism Report (AMR) identifies the Member States that require more in-depth investigation on whether they may be affected by macroeconomic imbalances. The AMR builds on an economic reading of a scoreboard of economic and financial indicators with indicative thresholds. The scoreboard aims at covering the different challenges facing the Member States and comprises fourteen indicators of external imbalances and competitiveness developments, internal imbalances and the employment situation ([1]). The scoreboard encompasses variables that the economic literature and recent experiences suggest anticipating or associated with crisis episodes. The scoreboard is a starting point for the analysis in the AMR, which also takes into account additional information and assessment tools and previous in-depth assessments at country level.

In a second step, the analysis carried out in the in-depth reviews (IDRs) for the selected Member States provides the basis for the identification of imbalances by the Commission. IDR analysis makes use of updated and specific information and analytical tools developed by the Commission services and is integrated in the Country Reports published in the European Semester context on annual basis.

If imbalances have been identified, a difference is made between "imbalances" and "excessive imbalances", both implying possible recommendations by the Council upon Commission proposal, which have so far been integrated in the single package of Country-Specific Recommendations (CSRs) under the European Semester. The identification of "excessive imbalances" implies a stronger surveillance process, possibly leading to the launch of the Excessive Imbalance Procedure. The latter provides a framework underpinned by an articulated corrective action plan designed by the concerned Member State, endorsed by the Commission and the Council and monitored by the Commission, and including the possibility of sanctions for euro-area Member States in case of reiterated lack of compliance. The Excessive Imbalance Procedure has never been launched for countries with excessive imbalances, but the Commission has issued prescriptive recommendations and put in place a system of specific monitoring to assess the implementation of policy commitments in these countries.

The 2018 Alert Mechanism Report (AMR) and In-Depth Reviews (IDR)

The Commission published its seventh AMR in November 2017 concluding that IDRs were warranted for 12 Member States, which coincided with the ones that had already been identified with imbalances or excessive imbalances in the previous annual round of application of the MIP. Three of the Member States for which IDRs were prepared are covered in this Convergence Report (Bulgaria, Croatia and Sweden). On the basis of this year's IDRs, in March 2018, the Commission concluded that Bulgaria is experiencing imbalances thereby revising the previous conclusion of excessive imbalances, while Croatia and Sweden continue to experience, respectively, excessive imbalances and imbalances.

([1]) The variables are: current account, net international investment position, real effective exchange rates, unit labour cost, and export market shares; private sector debt, general government debt, private sector credit flow, change in total financial sector liabilities, house prices; unemployment rate, activity rate, long-term and youth unemployment.

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

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the situation and development of the external balance [11]. Market integration is assessed through trade, foreign direct investment and a smooth functioning of the internal market. Moreover, progress in financial integration is examined, together with the main characteristics, structures and trends of the financial sector. Given that Member States which adopt the euro also participate in the banking union, developments in national banking sectors are specifically looked at as well.

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 [12].

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).

[11] 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.

[12] The cut-off date of this Convergence Report does not allow to include the assessment of the 2018 updates of the Convergence Programmes in this Staff Working Document.

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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 2016 Convergence Report. However, no amendments have been made as regards the incompatibilities highlighted in the Commission's 2016 Convergence Report. Therefore, the comments provided in the latter 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.

The Conflict of Interest Prevention and Ascertainment Act of 2008, which regarding the possibility to dismiss the Governor of the BNB had to be brought in line with Article 14.2 of the ESCB/ECB Statute, was fully repealed and replaced by the Act on Corruption Counteraction and Eviction of Illegally Acquired Property of 2018 ([13]). However, similar to the repealed Act, Article 80(1) in conjunction with Article 6(1)(12) of the new Act provides that the ascertainment of a conflict of interest is a ground for dismissal of the Governor of the BNB. Thus, an incompatibility remains and 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 ascertainment of a conflict of interest corresponds to a lack of fulfilment of the conditions required for the performance of the Governor's duties or 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

([13]) State Gazette No. 7/19.01.2018.

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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.

Objectives

The objectives of the BNB (Article 2(2) of the BNB Law) 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, 29, 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, 29, 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 (Article 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).

2.1.4. Assessment of compatibility

The BNB Law and the Act on Corruption Counteraction and Eviction of Illegally Acquired Property 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.

The Commission has understood that the Bulgarian authorities have the intention to amend the BNB Law in the course of 2018. In this context, Bulgarian authorities are invited to consult the ECB on the draft law amending the BNB Law and other related laws, as provided for by Articles

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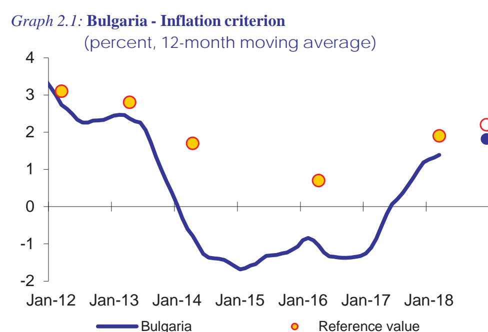
127(4) and 282(5) of the TFEU and to remedy the abovementioned incompatibilities.

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 below the reference value at the time of the last convergence assessment of Bulgaria in 2016. It started to increase steadily soon after, moved into positive territory in June 2017 and has been further increasing afterwards, reaching 1.2% in December 2017. In March 2018, the reference value was 1.9%, calculated as the average of the 12-month average inflation rates in Cyprus, Ireland and Finland plus 1.5 percentage points. The corresponding inflation rate in Bulgaria was 1.4%, i.e. 0.5 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 2.1: **Bulgaria - Inflation criterion**
(percent, 12-month moving average)



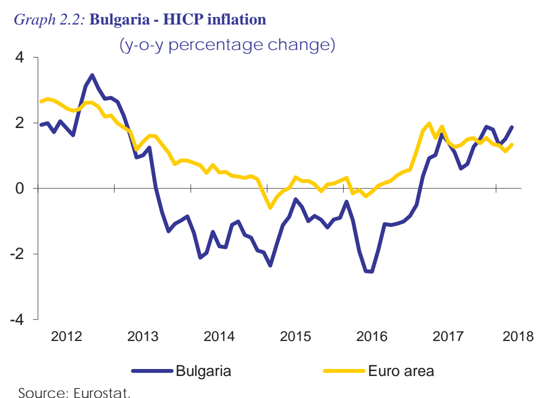
Note: The dots in December 2018 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2018 Forecast.

2.2.2. Recent inflation developments

The annual HICP inflation rate in Bulgaria was negative between mid-2013 and early-2017 due to a combination of several factors, including declining imported commodity prices, subdued domestic demand and reductions in administered prices. With the reversal of these trends, the inflation rate started to gradually increase again in the second half of 2016, after having reached its trough at -2.5% in May. It entered positive territory at the beginning of 2017 and maintained a predominantly growing trajectory since then, reaching 1.2% for the year despite slight downwards fluctuations between April and July. In 2018, inflation continued picking up reaching 1.9% in March. In October 2017, the inflation rate surpassed that of the euro area by 0.12 percentage points and it has remained above it since then.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) fell from 0.4% in October 2015 to -0.8% in May 2016. After that, it started to gradually pick up, entering positive figures in the second half of 2017 and reaching 1.0% by December 2017. This trend continued in 2018, with core inflation standing at 1.9% in March. Services and processed food inflation were the main contributors to this increase. Core inflation was above headline inflation during 2015 and most of 2016, highlighting the effect of plunging energy and unprocessed food prices. As prices in these two categories started to increase rapidly in the final months of 2016, the headline inflation increased above the core inflation in December 2016.

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



Source: Eurostat.

The components of core inflation have been mostly negative in 2016. Processed food inflation, which was the first to turn around already the year before, partly due to rising unprocessed food prices, continued trending up throughout 2016. Despite some fluctuations over the year, it reached 2.5% in December 2017 and fell slightly to 2.3% in March 2018. Services inflation has been pretty volatile over the last years. After starting 2016 in the positive territory, it fell to -1.1% in May 2016. It had recovered by August 2016, only to be falling again until March 2017, when it bottomed at -1.3%. It resumed growth in the ensuing months reaching 1.2% in December 2017 and peaking at 3.7% in March 2018. This increase is in line with the wage increases and positive developments in the labour market that are strengthening domestic demand. Non-energy industrial goods inflation was deeply negative in 2016 reflecting both lower import prices and weak domestic demand for a

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Table 2.1:
Bulgaria - Components of inflation

	2012	2013	2014	2015	2016	2017	Mar-18	weights in total 2018
						(percentage change)[1]		
HICP	2.4	0.4	-1.6	-1.1	-1.3	1.2	1.4	1000
Non-energy industrial goods	-0.8	-1.5	-2.2	-1.6	-1.6	-1.0	-0.8	260
Energy	7.9	-1.7	-3.8	-6.7	-7.0	5.8	5.3	134
Unprocessed food	4.4	4.4	-0.8	0.6	-1.1	5.1	2.9	82
Processed food	1.5	1.3	-0.4	0.6	1.2	2.1	2.3	209
Services	2.4	1.1	-1.3	0.1	-0.6	-0.1	0.9	315
HICP excl. energy and unproc. food	1.2	0.3	-1.3	-0.3	-0.4	0.2	0.7	784
HICP at constant tax rates	2.4	0.4	-1.6	-1.1	-1.5	1.0	1.2	1000
Administered prices HICP	4.9	-1.1	-1.0	1.5	0.1	1.7	2.3	166

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.

long time. Non-energy industrial goods inflation started to recover only in 2017 fuelled by stronger domestic demand and higher import prices, but it remained in negative territory, reaching -0.5% in December 2017 and -0.4% in March 2018.

The producer price index rose by 4.1% in December 2017 compared to the same month of 2016, mostly as a result of price increases in the electricity, gas, steam and air conditioning supply and the mining and quarrying industry.

2.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and cyclical stance

Bulgaria's economy is growing steadily, with the drivers of growth having shifted from the external sector to domestic demand in 2017. Real GDP growth was estimated at 3.6% in 2017, 0.3 percentage points lower than in 2016. Increases in wages and improved household expectations had a positive impact on private consumption over the course of 2017. Public consumption growth was also stronger than in previous years, reflecting mainly increasing public wages and higher spending on intermediate consumption. Investment is slowly recovering from its drop in 2016, as confidence is improving in the business sector. However, the public investment decreased further in 2017 mainly because the implementation of EU funded projects has been slower than expected. Following a very strong performance in 2016, net exports' contribution to GDP growth turned negative, as imports driven by strong domestic demand grew faster in 2017 and export growth slowed down. The GDP growth rate is expected to remain robust with projections of 3.8% for 2018 and 3.7% for 2019. The output gap turned positive in 2017 and it is set to remain positive in 2018 and 2019.

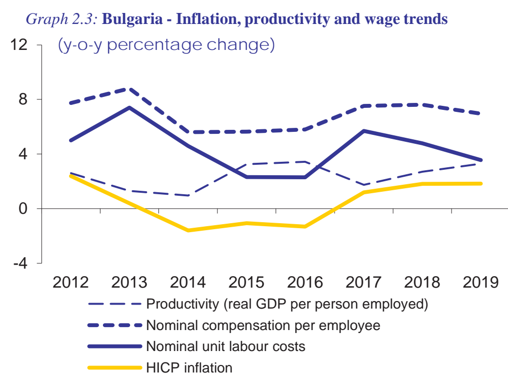
The fiscal stance, as measured by the change in the structural balance, remains tight. The fiscal adjustment which started in 2015, continued in the recent years and the structural fiscal surplus already achieved in 2016 has widened further in 2017. According to the Commission services' Spring 2018 Forecast, the structural surplus is projected to be slightly reduced in 2018 and 2019, indicating a small fiscal expansion owed mostly to a projected higher public investment.

In the context of its currency board arrangement with lev (BGN) pegged to the euro, the most standard monetary policy instruments are not available to Bulgaria. In response to these limitations, the BNB has kept relatively conservative liquidity and capital requirements on the banking sector. Bank interest rates have decreased further over the past two years in line with monetary policy developments in the euro area. Lending to the private sector has been on the recovery path since mid-2016. However, it has remained subdued due to an ongoing corporate deleveraging. The domestic banking crisis which erupted in 2014 has been largely quickly overcome, financial sector soundness has improved and contagion risks have abated. Nevertheless vulnerabilities remain as non-financial corporations' debt, and non-performing loans are still higher than in peer countries, albeit decreasing. The action plan drawn to deal with identified shortcomings in banks' management practices and supervision is being implemented. The collateral valuation practices need to be enhanced in line with EU standards.

Wages and labour costs

The labour market continued to improve over 2016-17. Activity and employment rates increased substantially in this period which, combined with the improved economic outlook, further reduced the unemployment rate from 7.6% in 2016 to 6.2% in 2017. Nominal compensation per employee increased by 5.8% in 2016 and 7.5% in 2017, merely as a response to wage convergence pressures, and skills shortages and mismatches.

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



Source: Eurostat, Commission services' Spring 2018 Forecast.

Labour productivity growth continued to increase, but it is estimated to have flattened from 3.4% in 2016 to 1.7% in 2017. Over 2018-2019, labour productivity is forecast to continue growing as a result of the improvements in the labour market and the ongoing recovery of investment. Nominal unit labour cost (ULC) growth remained at 2.3% in 2016, but exhibited a strong growth of 5.7% in 2017, which is in line with the tightening of the labour market in the private sector and increases in public sector wages. According to the Commission services' Spring 2018 Forecast, ULC growth is expected to continue to be strong in 2018. For 2019, ULC growth is forecast to slow down in line with the evolution of nominal compensation per employee, while remaining well above ULC growth in the euro area.

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 due to 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 until recently, bottoming out at -6% in 2016. This reflected mainly lower international oil prices and the stronger nominal effective exchange rate of the lev. However, this trend was reversed in 2017 with import prices increasing by 3%. This growth in import prices is assumed to continue in 2018, mainly due to the expected movements of global oil prices, pushing upwards energy prices, though at a declining rate.

The nominal effective exchange rate of the lev (measured against a group of 36 trading partners) has appreciated by over 5% since the start of 2016 as the currencies of Bulgaria's major trading partners depreciated against the euro (the US dollar, the pound sterling, the Swiss franc, the Turkish lira, the Russian rouble, the Romanian leu, the Chinese yuan). Almost half of this appreciation was realized in the second half of 2017. While stronger nominal effective exchange rate also contributed to lower import prices over the assessment period, the appreciation of the euro (and hence of the lev) against the US dollar also cushioned somewhat the inflationary pressures of higher oil prices.

Administered prices and taxes

The growth rate of administered prices ([14]) was above headline consumer price inflation over the past two years. The share of administered prices in the HICP basket is relatively high at around 16%, compared to 13% in the euro area. The annual change of a growth rate of administered prices increased from 0.1% in 2016 to 1.7% in 2017. Overall, the contribution of administered prices to headline inflation was neutral in 2016 and about 0.3 percentage points in 2017 (or 22.4% of total HICP growth).

Indirect tax changes had an insignificant effect on inflation over 2016-2017 despite tobacco excise tax increases since 2016. Annual constant-tax HICP was broadly at the same level as headline inflation during the assessment period.

([14]) 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

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Table 2.2:
Bulgaria - Other inflation and cost indicators **(annual percentage change)**

	2012	2013	2014	2015	2016	2017	2018 [1]	2019 [1]
HICP inflation								
Bulgaria	2.4	0.4	-1.6	-1.1	-1.3	1.2	1.8	1.8
Euro area	2.5	1.3	0.4	0.0	0.2	1.5	1.5	1.6
Private consumption deflator								
Bulgaria	3.6	-2.6	0.0	1.2	-0.1	1.1	1.8	1.8
Euro area	1.9	1.1	0.5	0.3	0.4	1.4	1.5	1.6
Nominal compensation per employee								
Bulgaria	7.7	8.8	5.6	5.6	5.8	7.5	7.6	7.0
Euro area	1.8	1.6	1.4	1.4	1.2	1.6	2.4	1.9
Labour productivity								
Bulgaria	2.6	1.3	1.0	3.3	3.4	1.7	2.7	3.3
Euro area	-0.1	0.6	0.7	1.0	0.4	0.8	1.0	1.0
Nominal unit labour costs								
Bulgaria	5.0	7.4	4.6	2.3	2.3	5.7	4.8	3.6
Euro area	1.9	1.0	0.6	0.5	0.7	0.8	1.4	1.0
Imports of goods deflator								
Bulgaria	3.8	-2.8	-2.9	-2.9	-6.0	6.6	1.7	1.4
Euro area	2.6	-2.0	-2.4	-3.4	-3.4	3.4	1.2	0.7

1) Commission services' Spring 2018 Forecast.

Source: Eurostat, Commission services.

Medium-term prospects

Annual HICP inflation is expected to rise further in 2018 and 2019. Core inflation is set to continue to rise in 2018 as growth in household disposable incomes, fuelled by positive labour market developments, boosts private demand. At the same time, global oil prices are expected to continue pushing energy prices upwards. Accordingly, the Commission services' Spring 2018 Forecast projects HICP inflation to average 1.8% in 2018 and 2019.

Risks to the inflation outlook appear broadly balanced. The most significant risks are related to global energy and food price developments, given their relatively large share in the consumer basket. Additional inflation risk factors are supported also by domestic developments, including administered prices changes and higher wage growth.

In 2016, the level of consumer prices in Bulgaria was about 47% of the euro area average and the GDP per capita was about 46% of the euro area average in PPS terms. In line with the catching-up of the Bulgarian economy, further price level convergence is expected.

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

2.3. PUBLIC FINANCES

2.3.1. Recent fiscal developments

The general government budget registered surpluses in 2016 and 2017. The expenditure-to-GDP ratio decreased by 5.5 percentage points between 2015 and 2017, to 35.2%. The reduction in expenditure reflects the lower spending in investment and other expenditure related to the implementation of EU funded programmes. The transition between the two financing periods of EU structural and investment funds had also an impact on the revenue side. Between 2015 and 2017, total revenues decreased by 2.9 percentage points to 36.1% of GDP. This decrease can almost entirely be attributed to lower transfers from EU funds. However, the negative developments on the side of transfers was partly moderated by higher tax revenue, which increased by 1 percentage point of GDP between 2015 and 2017.

The general government balance in 2017 overshot the target of -0.6% of GDP in the 2017 Convergence Programme. The better outcome is mainly owed to a significantly lower public investment relative to the initial target and a better

Table 2.3:
Bulgaria - Budgetary developments and projections **(as percentage of GDP unless indicated otherwise)**

Outturn and forecast [1]	2012	2013	2014	2015	2016	2017	2018	2019
General government balance	-0.3	-0.4	-5.5	-1.6	0.2	0.9	0.6	0.6
- Total revenues	34.1	37.2	36.6	39.1	35.2	36.1	36.4	36.4
- Total expenditure	34.5	37.6	42.1	40.7	35.0	35.2	35.8	35.8
of which:								
- Interest expenditure	0.8	0.7	0.9	0.9	0.9	0.8	0.7	0.7
p.m.: Tax burden	26.7	28.2	28.4	29.1	29.2	30.1	30.2	30.0
Primary balance	0.5	0.4	-4.6	-0.7	1.1	1.7	1.3	1.3
Cyclically-adjusted balance	-0.2	-0.1	-4.9	-1.2	0.3	0.9	0.5	0.5
One-off and temporary measures	0.0	0.0	-3.2	-0.1	0.0	0.0	0.0	0.0
Structural balance [2]	-0.2	-0.1	-1.7	-1.1	0.3	0.9	0.5	0.5
Government gross debt	16.7	17.0	27.0	26.0	29.0	25.4	23.3	21.4
p.m: Real GDP growth (%)	0.0	0.9	1.3	3.6	3.9	3.6	3.8	3.7
p.m: Output gap	-0.4	-0.8	-1.8	-1.3	-0.3	0.1	0.4	0.5

1) Commission services' Spring 2018 Forecast.
2) Cyclically-adjusted balance excluding one-off and other temporary measures.
Source: Commission services.

performance on the revenue side. In structural terms, the adjustment achieved since 2015 is 2 percentage points of GDP. The structural surplus improved further from 0.3% of GDP in 2016 to 0.9% in 2017, while the output gap almost closed in 2017, after being in a negative territory for years.

The general government gross debt peaked in 2016 at the level of 29% of GDP. The positive primary budget balance and the repayment of debt of around 1.5 percentage points of GDP out of accumulated fiscal reserves together with high nominal growth led to a reduction by more than 4 percentage points of GDP in 2017, to 25.4%.

2.3.2. Medium-term prospects

The 2018 budget was adopted by Parliament in December 2017. It aims at a general government deficit of 1% of GDP in cash terms, corresponding to a balanced budget in ESA terms. On the revenues' side, the main measures planned include a further increase of the excise duty on cigarettes in order to reach the EU minimum level, an increase of social security contributions by 1 percentage point, adjustments of the minimum income for which contributions have to be paid and an adjustment of the minimum wage, which is expected to have a positive impact also on direct taxes. On the expenditures' side, the government has decided to increase wages for some categories of teaching staff and security personnel. The medium term plan of the government budget in cash terms provides for reductions of the deficit by 0.5 percentage points per annum until 2020, when it is planned to be balanced. In ESA terms, the surplus that has been achieved already since 2016 is forecast by the government to get to zero in 2018 and again return and remain positive in the medium term.

Given the over-achievement of the consolidation targets in the last few years, the Commission services updated their forecast of the budget balance upwards. The Commission services forecast the general government budget in ESA terms to remain in a surplus of 0.6% of GDP in both 2018 and 2019. Taking into account estimated positive output gap from 2018 onwards, the structural surplus is projected to be slightly lower than the headline one at 0.5% of GDP in both 2018 and 2019. The public-debt-to-GDP ratio is forecast to continue to decrease to 23.3% in 2018 and 21.4% in 2019.

The 2018 Convergence Programme was submitted by the Bulgarian authorities on 19 April 2018. It plans to reduce the headline surplus to zero in 2018 and return to surpluses in 2019 remaining in positive balance until 2021. In structural terms, the government plan targets at balanced to positive budgetary outcomes, well above the medium-term objective for the entire period 2018-2021.

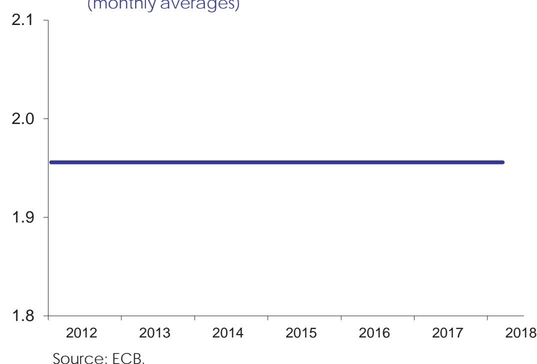
The various components of the Bulgarian fiscal framework have gradually been strengthened over the last few years. Bulgaria is bound by the Fiscal

Compact ([15]) based on its own declaration of intention and has transposed its provisions into the national legal order. The most recent steps of this reform drive were adopted in autumn 2017 with, inter alia, improvements in the design of rules governing expenditure developments and as well as in multi-annual budget planning through the legislated systematic use of no-policy-change scenarios. The Fiscal Council became operational in the first half of 2016, and has started to roll out its activities. However, it faces significant challenges in performing its relatively wide remit, mainly due to the limited analytical resources and financial autonomy. In February 2018, the Parliament decided to increase the size of the Fiscal Council's support staff from three to five experts.

2.4. EXCHANGE RATE STABILITY

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.

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

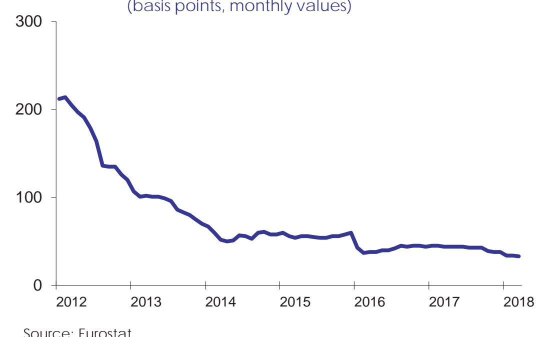


Source: ECB.

Over the past two years, the CBA operated in an environment of strong nominal GDP growth and solid labour market recovery, with improving soundness of the financial sector, recovering credit flows and the abating of the contagion risks in the banking sector which had been observed in the previous years. Furthermore, strong exports, a favourable (mainly deposit driven) 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 20.2 billion to over EUR 23.5 billion between end-2015 and end-2017. International reserves were boosted by some EUR 4 billion due to the issuance of long-term, foreign-currency government debt, inflows of EU funds and an increase of the BNB liabilities towards commercial banks in 2016. International reserves covered around 155% of the monetary base, 55% of broad money (M3) and 47% of GDP at the end-2017. 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 euro area were quite stable over the past two years. The 3-month spread hovered around 45 basis points by the end-2016 and further declined to 33 basis points in March 2018.

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

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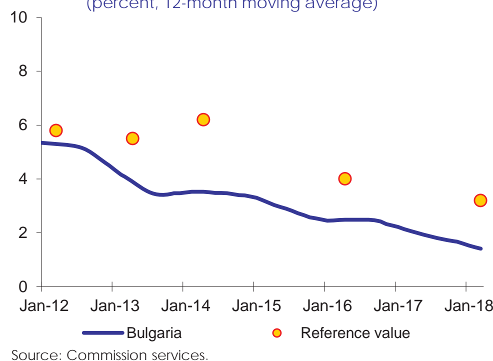
2.5. LONG-TERM INTEREST RATES

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 around 9 years.

The Bulgarian 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion was below the reference value in the 2016 convergence assessment of Bulgaria. It further declined from around 2.5% in mid-2016 to around 1.6% by the end-2017. In March 2018, the latest month for which data are available, the reference value, given by the average of long-term interest rates in Cyprus, Ireland and Finland plus 2 percentage points, stood at 3.2%. In that month, the 12-month moving average of the yield on the Bulgarian benchmark bond stood at 1.4%, i.e. 1.8 percentage points below the reference value.

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

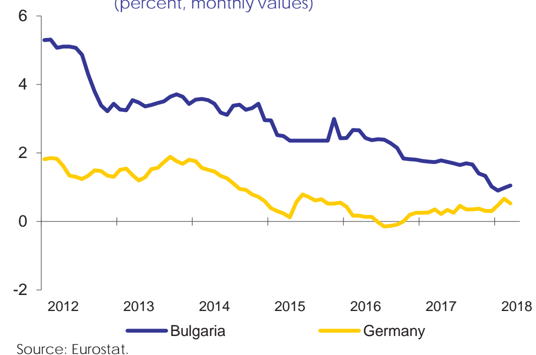


Source: Commission services.

The long-term interest rate of Bulgaria has been on a decreasing path since early 2016, going from 2.44% in January 2016 to 0.90% in January 2018. These developments partly reflect the efforts in implementing measures to strengthen the financial system, but also re-balancing of their asset portfolios towards government long-term bonds by domestic banks, due to low inflation risk and lack of alternative profitable investment.

Bulgarian benchmark bond yields continued to fall throughout 2016-17 mainly due to internal, but also due to external factors. Primarily, they were supported by developments on the secondary market characterised by continuing strong demand for government securities while their supply remained subdued. Falling long-term interest rates were supported also by external forces, i.e. expectations of loose monetary policy in the euro area for an extended period of time.

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



Source: Eurostat.

Spreads to the Bund increased by some 50 basis points in the first half of 2016, reaching about 250 basis points at the peak in July 2016, but has been on decreasing path since then. At the end of 2017, the spread has reached 72 basis points, and it has been further decreasing to about 40 basis points in early 2018.

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, as well as 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 2017, the Commission published its seventh Alert Mechanism Report (AMR 2018) under the Macroeconomic Imbalance Procedure (MIP – see also Box 1.5), which concluded that an in-depth review (IDR) was warranted for Bulgaria. In March 2018, the Commission published its annual country report on Bulgaria ([16]), including an IDR. The analysis concluded that Bulgaria was experiencing macroeconomic imbalances, linked to vulnerabilities in the financial sector coupled with high indebtedness and non-performing loans in the corporate sector. The authorities have made progress in implementing the recommendations addressed after the asset quality and balance sheet reviews, but the legacy issues linked to weak

([16]) https://ec.europa.eu/info/sites/info/files/2018-european-semester-country-report-bulgaria-en.pdf

Table 2.4:
Bulgaria - Balance of payments **(percentage of GDP)**

	2012	2013	2014	2015	2016	2017
Current account	-0.9	1.3	0.1	0.0	2.3	4.5
of which: Balance of trade in goods	-9.5	-7.0	-6.5	-5.8	-2.0	-4.1
Balance of trade in services	6.2	6.3	5.9	6.6	6.1	6.0
Primary income balance	-2.5	-3.8	-3.1	-4.5	-5.1	-1.1
Secondary income balance	5.0	5.7	3.8	3.6	3.3	3.7
Capital account	1.3	1.1	2.2	3.1	2.2	1.0
External balance [1]	0.4	2.4	2.3	3.1	4.5	5.5
Financial account	2.3	2.1	-0.7	6.6	8.4	4.4
of which: Direct investment	-2.5	-3.0	-2.1	-5.1	-1.5	-1.4
Portfolio investment	2.1	0.3	-2.8	-1.3	-1.3	5.2
Other investment [2]	-2.4	6.0	0.0	4.8	4.0	0.7
Change in reserves	5.1	-1.3	4.2	8.2	7.2	-0.2
Financial account without reserves	-2.8	3.4	-4.9	-1.6	1.2	4.6
Errors and omissions	1.8	-0.3	-3.0	3.5	4.0	-1.1
Gross capital formation	21.9	21.3	21.4	21.2	19.1	20.9
Gross saving	21.8	23.4	21.6	21.8	24.5	23.9
Gross external debt	92.6	90.9	97.4	81.3	79.3	74.2
International investment position	-77.9	-73.3	-75.2	-61.2	-46.2	-40.5

1) The combined current and capital account.
2) Including financial derivatives.

Sources: Eurostat, Commission services, Bulgarian National Bank.

governance, asset quality and supervision have not yet been fully dealt with. The robust growth has supported continuous private-sector deleveraging and further decreases in non-performing loan ratios, but stocks are still high, especially in the corporate sector. Labour market improvement has continued despite persistent structural issues. Some measures have been taken to tackle the main sources of imbalances, but further progress is needed to address remaining vulnerabilities in the financial sector and completing the reform of the insolvency framework.

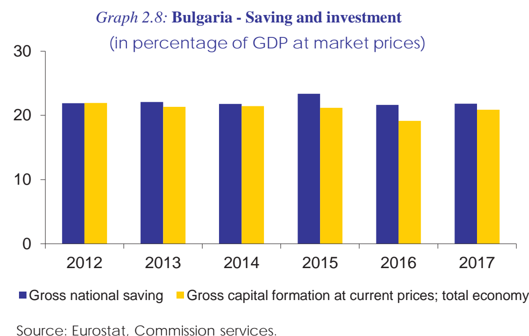
2.6.1. Developments of the balance of payments

Bulgaria's external balance (i.e. the combined current and capital account) has further improved over the last two years. The external surplus further expanded to 4.5% in 2016 and 5.5% of GDP in 2017, mainly on acconut of improved primary income balance. The trade balance of goods as a percentage of GDP remained negative but improved by almost 4 percentage points in 2016 before worsening again by about 2 percentage points in 2017. The trade balance in services remained about 6.0% of GDP in both years owing to stable growth in tourism, transportation and business process outsourcing sectors. The capital account surplus decreased in the last couple of years, from 3.1% of GDP in 2015 to 1.0% of GDP in 2017, mainly due to the fluctuations of inflow of EU funds. The negative primary income balance, has improved in 2017 reflecting a less negative net international investment position due to dividends payments. There were no significant changes in the secondary income balance.

The saving-investment gap of the Bulgarian economy has increased over the last two years. Investment has decreased by 2 percentage points in 2016 and increased by 1.7 percentage points to 20.9% in 2017. Savings were 24.5% of GDP in 2016 and decreased to 23.9% of GDP in 2017. This dynamics of the saving-investment gap was mostly driven by the public sector. On average, the public sector contributed 1.9 percentage points of GDP to the fall of investment and 2.2 percentage points to the rise in savings between 2015 and 2017. Public investment decreased sharply in 2016 and it continued decreasing in 2017 due to slow uptake of the implementation of the EU structural and investment funds. These developments led to the accumulation of the advanced payments on the saving side. The movement in the private sector

was the opposite, but of a smaller magnitude. The positive macroeconomic environment accompanied by low interest rate underpinned confidence and increased investment in 2016, a trend that continued in 2017 but at a slower pace.

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

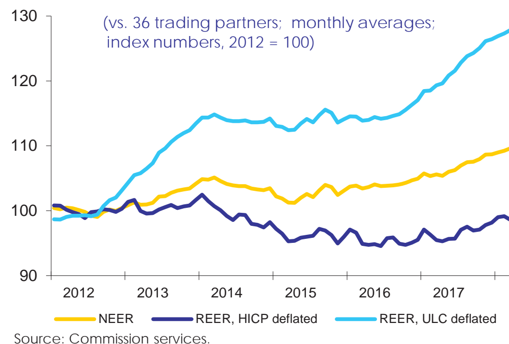


Source: Eurostat, Commission services.

Competitiveness seems to have been preserved in the past two years, although relevant indicators continue to show a somewhat mixed picture. The real effective exchange rate, deflated by ULC, stabilized in 2016. This period of stabilization helped external competitiveness, which was reflected in stronger exports' growth. In 2017, a significant real appreciation worsened the cost competitiveness of Bulgaria but the pressures induced by the real exchange rate movements were partly offset by non-cost related improvements (such as quality). The real effective exchange rate, deflated by HICP, on the contrary, depreciated in 2016 and started to slowly appreciate in 2017. The price competitiveness of Bulgarian exporters remains high, although their relative advantage has been gradually reduced by narrowing differences in inflation with trading partners.

Robust financial account outflows have continued since 2015. Net FDI inflows have remained at low levels by pre-crisis standards, reaching around 0.7% of GDP in 2016 and 1.4% of GDP in 2017. In 2015 and 2016, there was a net inflow of portfolio investment, mainly due to government borrowing. This was reversed in 2017 due to government and corporate deleveraging and the build-up of foreign assets by both financial and non-financial institutions. At the same time, the maturity structure of debt securities has changed from short to long term, indicating lower uncertainty in the borrowing markets. Although still high, gross external debt has improved further in the past two years, from about 80% of GDP in 2016 to around 74% of GDP in 2017. This reduction, accompanied by current account surpluses and lower level of investment inflows, improved also the net international investment position, from around 46% of GDP in 2016 to around 40% of GDP in 2017.

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



Source: Commission services.

According to the Commission services' Spring 2018 Forecast, the external surplus is projected at 3.2% of GDP in 2018 and at 2.7% of GDP in 2019.

2.6.2. Market integration

The 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 stood at around 65% and 69% of GDP in 2016 and 2017, respectively. Trade with the euro area was about 31% of total trade in 2017. Outside the EU, Bulgaria's main trading partners are Russia and China (especially for imports).

FDI inflows decreased from about 3% of GDP in 2013 to 1.4% of GDP in 2017. The stock of FDI amounted to some 78% of GDP in 2016 and around 75% in 2017, with FDI mainly coming from the Netherlands, Austria, Germany, Italy and Greece. Half of all FDI is directed to manufacturing and information and communications technology (ICT), with another 25% going into trade, transport and tourism.

Concerning the business environment, Bulgaria performs relatively worse than most euro-area Member States in international rankings (WEF's Global Competitiveness Index, the World Bank's Ease of Doing Business). The major challenges relate to the institutional framework, including fighting corruption, improving the functioning of the judicial system, reducing the administrative burden on corporations, and improving the quality of public services. Public administration as a whole scores relatively poorly according to the

www.parlament.gv.at

Table 2.5:
Bulgaria - Market integration

	2012	2013	2014	2015	2016	2017
Trade openness [1] (%)	65.9	68.1	69.1	66.4	65.0	68.6
Trade with EA in goods & services [2)+3)] (%)	28.6	29.7	30.7	30.3	29.9	31.4
Export performance (% change) [4]	1.3	6.3	-0.5	3.3	4.4	-2.2
World Bank's Ease of Doing Business Index rankings [5]	66	58	38	38	39	50
WEF's Global Competitiveness Index rankings [6]	62	57	54	54	50	49
Internal Market Transposition Deficit [7] (%)	0.9	0.6	0.7	0.9	0.6	1.7
Real house price index [8]	96.6	97.0	98.5	100.0	107.1	115.2
Residential investment [9] (%)	1.7	1.7	1.6	1.4	2.7	2.8

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.
(November data, as of 2016 date refers to the year of publication).
8) Deflated house price index (2015=100) (Eurostat).
9) Gross capital formation in residential buildings (in % of GDP) (Eurostat).

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

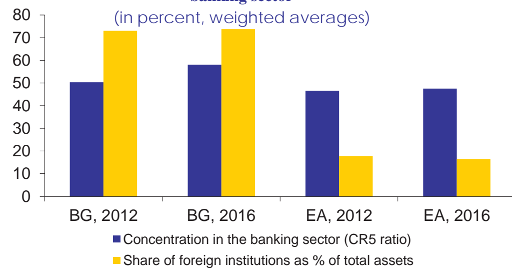
World Bank's Worldwide Governance Indicators. Bulgaria's transposition deficit of EU Directives, on the other hand, was 1.7% in 2016, above the EU average (1.5%) and the target (0.5%) proposed by the European Commission in the Single Market Act (2011), according to the December 2016 Internal Market Scoreboard. The 4th Anti-Money Laundering Directive imposed transposition by 26 June 2017. Bulgaria communicated to the Commission the measures it adopted to transpose the directive on 3 April 2018, only after a reasoned opinion was addressed by the Commission to Bulgaria on 8 December 2017 due to an absence of an appropriate response to the letter of formal notice from 19 July 2017. The Commission is analysing the communicated measures to assess their completeness and conformity with the directive.

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. Activity and employment rates returned to the pre-crisis level (close to 70%) only in 2017. The positive cyclical factors also largely explain the fall of unemployment below 7% in 2017. In a context of economic growth and declining working age population, the unemployment rate is expected to continue to decrease. Structural weaknesses that continue to hinder the labour market include the high share of long-term unemployment in total unemployment, the shrinking working population, the high inactivity rate especially from discouraged workers, skills and qualifications mismatches, and wide disparities between urban and rural areas and between regions. At the same time, in a context of worsening demographics, the labour force is suffering from high emigration and brain drain. Widespread low skills and relatively high social exclusion remain worrisome.

The impact of the ongoing positive labour market developments is not equally spread through the population. The loss of jobs during the crisis was concentrated in specific groups, in particular the low skilled, young, those on pre-retirement and older women. Those without a job for more than a year, inactive youth, Roma, and those living in rural areas continue to face significant difficulties in entering employment. The labour market structural challenges described above have an impact on income inequality and poverty levels which are among the highest in the EU, while the redistribution mechanisms are very limited.

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 increased slightly to 73.8% in 2016. Bank concentration, as measured by the market share of the five largest credit institutions in total assets, increased to 58%, some 10 percentage points above the euro area average in 2016

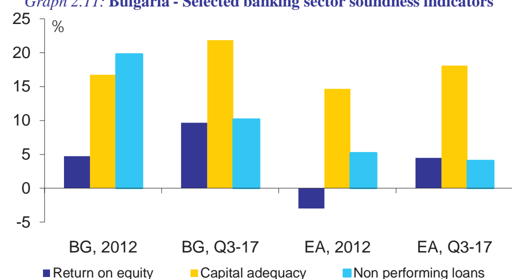
Graph 2.10: **Bulgaria - Foreign ownership and concentration in the banking sector**



Source: ECB, Structural financial indicators.

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 slightly above 22% in the second quarter of 2017 compared to almost 18% in the euro area. The ratio of NPLs to the loan portfolio held by the banking sector has fallen substantially over the last two years, but at 10.6% in the second quarter of 2017, was still well above the euro-area average of 4.3%. The profitability of the domestic banking sector remained above the euro-area level, with an average return on equity (RoE) close to 6% in the second quarter of 2017.

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

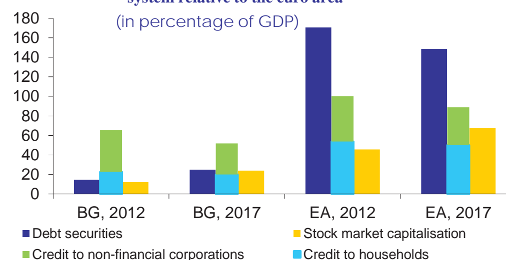


Note: Q3-17 Return on equity is calculated over the last four quarters.
Source: ECB, EC calculations.

The 2016 asset quality review and stress tests in the banking sector showed robust results on aggregate but pockets of vulnerabilities were identified. The independent reviews in the insurance and pension fund sectors also showed that these sectors are overall stable but some capital shortfalls were identified, as well as instances of unsound business practices. A substantial effort has been made to improve banking and non-banking supervision, however, vulnerabilities remain. The implementation of an action plan for banking supervision and the implementation of the action plan for the non-banking sector adopted in September 2017 are still to be completed. A somewhat tighter risk management of related-party exposures in the banking sector and a broader definition of 'related parties' in the non-banking sector in line with international standards have been adopted. Other actions are still due to address remaining vulnerabilities in the financial sector. These include the way both the banking and the non-banking sectors deal with exposures to hard-to-value assets, as well as the treatment of specific reinsurance contracts and inadequate group level supervision in the insurance sector. In the pension funds sector, the concentration of assets on the relatively illiquid traded and non-traded domestic market, and complex ownership and cross-ownership structures require further monitoring.

After the pre-2009 boom, real house prices in Bulgaria had been falling till 2012. Thereafter, the recovery was initially slow, but has accelerated in the last few years. House prices increased by 15.7% in real terms between June 2015 and June 2017 and by 7.2% in the second quarter of 2017 alone. Residential investment reached 2.7% of GDP in 2016 and is estimated at the same level in 2017. The stock of loans for house purchases increased in 2016-2017 by 8.7%.

Graph 2.12: **Bulgaria - Recent development of the financial system relative to the euro area**



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

Relative to GDP, the financial system is smaller in Bulgaria than in the euro area. Domestic bank credit stood at around 52% of GDP in 2016 compared to almost 90% of GDP in the euro area. The capitalization of the stock market fell to 8.7% of GDP in 2016, well below the euro-area average of 61.5%. The debt securities market remains small in comparison with the euro area average (28.3% vs. 154.2% of GDP). The consolidated stock of private sector debt at 104.9% of GDP in 2016 was below the euro-area average of 137.2%.

3. CZECH REPUBLIC

3.1. LEGAL COMPATIBILITY

3.1.1. Introduction

The 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 2016, the ČNB Law was only slightly amended ([17]). However, since there have been no amendments as regards the incompatibilities highlighted in the Commission's 2016 Convergence Report, the comments made in the latter report 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.

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 Court of Justice of the European Union, 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, in 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.

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

([17]) Act 258/2016 Coll. and Act No. 183/2017 Coll. In particular, Act 258/2016 Coll. places further entities under the supervision of the ČNB regarding consumer credits.

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(2) 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 partial absence of reference to 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. The Czech authorities are invited to remedy the abovementioned incompatibilities.

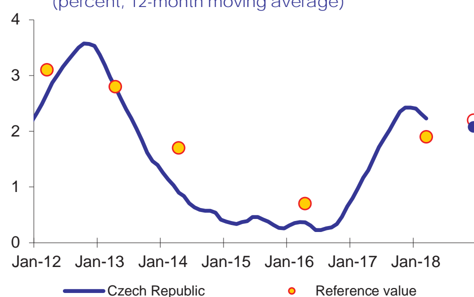
3.2. PRICE STABILITY

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 2016. It declined to 0.2% in mid-2016 and then increased gradually over the next 18 months to 2.4% by end-2017. In March 2018, the reference value was 1.9%, calculated as the average of the 12-month average inflation rates in Cyprus, Ireland and Finland plus 1.5 percentage points. The corresponding inflation rate in the Czech Republic was 2.2%, i.e. 0.3 percentage points above the reference value. The 12-month average inflation rate is projected to decline below the reference value in the months ahead.

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



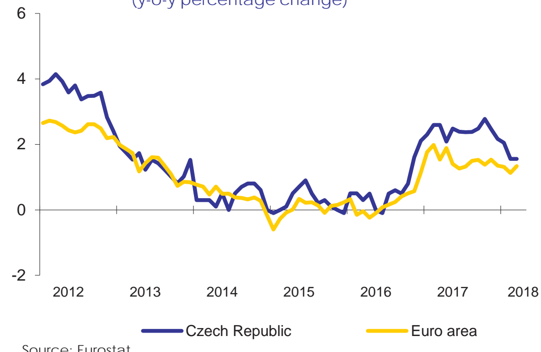
Note: The dots in December 2018 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2018 Forecast.

3.2.2. Recent inflation developments

The annual HICP inflation rate dropped from 0.5% in early 2016 to -0.1% in June 2016 before increasing to above 2% by end-2016. It then floated between 2 and 3% during 2017. The annual HICP inflation rate thus averaged 0.6% in 2016 and 2.4% in 2017. The pick-up in annual inflation in 2017 reflected larger inflation contributions from energy and food prices as well as higher price increases in the service sector. The annual HICP inflation rate dropped to 1.7% in the first quarter of 2018, amid strong base effects and decelerating food prices.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) has mostly exceeded headline inflation since early 2014. This was mainly the result of muted energy price developments which made a negative contribution to HICP inflation in 2014-2016 and only a modestly positive contribution in 2017. Core inflation accelerated in tandem with headline inflation in the second half of 2016, increasing from below 1% in June 2016 to above 2% in late 2016. It then oscillated around 2.6% in 2017 as prices of processed food and services increased at their highest rates since 2012. Domestic industrial producer prices increased in 2017 after having declined for three years.

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 is experiencing an economic upswing. Real GDP expanded by 4.4% in 2017, considerably faster than in 2016 (2.6%). Private consumption was again the main driver of GDP growth in 2017, supported by falling unemployment as well as vigorous wage growth. Following a strong decline in 2016, gross fixed capital formation made a large positive contribution to GDP growth in 2017 owing to revived private investment and increasing support from EU funds. According to the Commission services' Spring 2018 Forecast, domestic demand growth should keep GDP growth at above 3% in both 2018 and 2019. The Czech economy is estimated to have been operating above its potential since early 2017 amid increasingly tight labour market conditions. The positive output gap is estimated to widen slightly in 2018 and 2019.

The fiscal stance, as measured by the change in the structural balance, tightened considerably in 2016 and then remained broadly unchanged in 2017. Specifically, the structural balance recorded a surplus of 1% and 1.2% of GDP in 2016 and 2017 respectively. It is expected to moderate over the forecast period to around 0.2% of GDP in 2019.

The ČNB conducts monetary policy within an inflation targeting framework. In November 2013 it started using the exchange rate as an additional instrument for easing monetary conditions given that its key policy rate (i.e. the 2-week repo rate),

Table 3.1:
Czech Republic - Components of inflation

	2012	2013	2014	2015	2016	2017	Mar-18	weights in total 2018
						(percentage change)[1]		
HICP	3.5	1.4	0.4	0.3	0.6	2.4	2.2	1000
Non-energy industrial goods	-0.5	-0.5	0.4	0.5	0.8	0.7	0.7	255
Energy	7.7	0.6	-3.8	-3.0	-2.5	1.2	0.6	128
Unprocessed food	7.6	7.2	1.2	0.7	0.5	3.1	2.6	79
Processed food	5.0	3.0	2.7	1.1	1.2	4.3	4.1	208
Services	3.1	1.0	0.6	0.9	1.5	2.8	2.7	330
HICP excl. energy and unproc. food	2.5	1.0	1.1	0.8	1.2	2.6	2.5	793
HICP at constant tax rates	2.2	0.4	0.3	0.1	0.4	2.6	2.3	1000
Administered prices HICP	8.3	3.5	0.4	0.5	1.4	1.1	1.3	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.

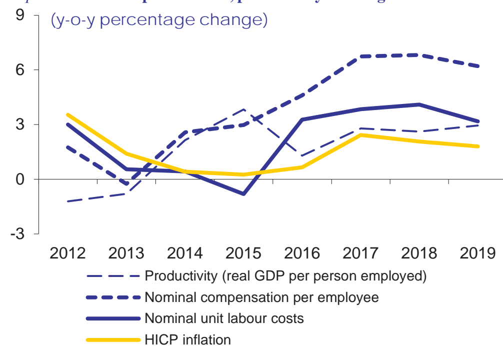
Sources: Eurostat, Commission services.

set at 0.05%, was considered to be at its effective lower bound. The use of the exchange rate as an additional monetary policy instrument was discontinued in April 2017. The decision was supported by macroeconomic data and forecasting scenarios indicating a sustainable fulfilment of the 2% inflation target over the forecast horizon. Subsequently, the ČNB started in August 2017 to gradually hike its main policy rate as annual inflation remained above its 2% inflation target. Its 2-week repo rate was raised in three steps to 0.75% in February 2018.

Wages and labour costs

The labour market has performed well since the economy emerged from recession in late 2013. The unemployment rate declined from 4.0% in 2016 to 2.9% in 2017, i.e. the lowest level in the EU. At the same time, the number of employed persons increased by 1.3% in 2016 and by 1.6% in 2017 despite the decline in working-age population. Nominal wage growth accelerated sharply in 2016 and 2017, reaching 4.6% and 6.7% respectively.

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



Source: Eurostat, Commission services' Spring 2018 Forecast.

Labour productivity accelerated significantly in 2017 following more muted growth in 2016. However, with compensation per employee outstripping productivity growth in both years, and indeed recording the highest growth rates since 2010, nominal unit labour costs rose by 3.3% in 2016 and by 3.8% in 2017. Nominal unit labour costs are expected to continue to increase markedly in 2018 and in 2019.

External factors

Given the size and openness of the Czech economy, import prices have a sizeable effect on domestic price formation. After having fallen in 2015 and 2016, mainly thanks to a decline in primary commodity prices, the imports of goods deflator stabilised in 2017.

Overall, the appreciation of the koruna since April 2017 has tempered import price growth. After having remained broadly stable throughout 2016 and in early 2017, the nominal effective exchange rate (measured against a group of 36 trading partners) appreciated by about 7% between March and December 2017. As a result, Czech import prices remained broadly unchanged in 2017 despite the recovery in primary commodity prices.

Administered prices and taxes

The share of administered prices in the HICP basket has stabilised at around 10-11% since 2011, after a sharp decline over the course of the previous decade. With a weight of 10.3% in 2017, administered prices in the Czech Republic ([18])

([18]) 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:

Table 3.2:

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

	2012	2013	2014	2015	2016	2017	2018[1)]	2019[1)]
HICP inflation								
Czech Republic	3.5	1.4	0.4	0.3	0.6	2.4	2.1	1.8
Euro area	2.5	1.3	0.4	0.0	0.2	1.5	1.5	1.6
Private consumption deflator								
Czech Republic	2.2	0.8	0.6	0.1	0.5	2.5	2.1	1.8
Euro area	1.9	1.1	0.5	0.3	0.4	1.4	1.5	1.6
Nominal compensation per employee								
Czech Republic	1.7	-0.3	2.6	3.0	4.6	6.7	6.8	6.2
Euro area	1.8	1.6	1.4	1.4	1.2	1.6	2.4	1.9
Labour productivity								
Czech Republic	-1.2	-0.8	2.2	3.8	1.3	2.8	2.6	2.9
Euro area	-0.1	0.6	0.7	1.0	0.4	0.8	1.0	1.0
Nominal unit labour costs								
Czech Republic	3.0	0.5	0.4	-0.8	3.3	3.8	4.1	3.2
Euro area	1.9	1.0	0.6	0.5	0.7	0.8	1.4	1.0
Imports of goods deflator								
Czech Republic	3.8	0.0	2.0	-1.9	-3.9	0.1	-3.1	0.9
Euro area	2.6	-2.0	-2.4	-3.4	-3.4	3.4	1.2	0.7

1) Commission services' Spring 2018 Forecast.

Source: Eurostat, Commission services.

accounted for a smaller share of the HICP basket than in the euro area (13.4%). Changes in administered prices were a significant driver of inflation in 2016 as they increased by 1.4%, i.e. more than double of the headline HICP inflation rate. The situation reverted in 2017 when administered prices increased by 1.1%, i.e. around half of the headline inflation rate. Declines in prices for household heating contributed to weak growth in administered prices in 2017 while other categories such as dental services increased noticeably. HICP at constant tax rates was somewhat lower than headline inflation in 2016 and somewhat higher in 2017.

Medium-term prospects

Annual HICP inflation is expected to decline in 2018, mainly because the inflation contribution of food prices (both processed and unprocessed food) should decrease. At the same time, prices of energy and services are expected to exert a stronger inflation contribution than in previous years. According to the Commission services' Spring 2018 Forecast, annual HICP inflation is thus projected to average 2.1% in 2018 and 1.8% in 2019.

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 higher inflationary pressures.

The level of consumer prices in the Czech Republic increased to about 64% of the euro-area average in 2016, with the relative price gap widest for services. This suggests that there is potential for further price level convergence in the long term. After having stagnated at around 78% between 2008 until 2013, Czech GDP per capita in purchasing power standards gradually increased to almost 83% of the euro-area average by 2016.

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.

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http://ec.europa.eu/eurostat/documents/272892/272989/HICP-AP-national-classification-December-2017/a9439235-7b46-4736-984a-0134ca2cd10b

Table 3.3:
Czech Republic - Budgetary developments and projections (as percentage of GDP unless indicated otherwise)

Outturn and forecast [1]	2012	2013	2014	2015	2016	2017	2018	2019
General government balance	-3.9	-1.2	-2.1	-0.6	0.7	1.6	1.4	0.8
- Total revenues	40.5	41.4	40.3	41.1	40.2	40.4	40.3	40.4
- Total expenditure	44.5	42.6	42.4	41.7	39.4	38.8	38.9	39.5
of which:								
- Interest expenditure	1.4	1.3	1.3	1.1	0.9	0.7	0.7	0.7
p.m.: Tax burden	34.3	34.8	33.9	34.1	34.9	35.4	35.4	35.5
Primary balance	-2.5	0.1	-0.8	0.5	1.6	2.3	2.1	1.6
Cyclically-adjusted balance	-3.2	0.1	-1.0	-0.5	0.9	1.2	0.9	0.2
One-off and temporary measures	-1.7	-0.1	-0.3	0.0	-0.1	0.0	0.0	0.0
Structural balance [2]	-1.4	0.2	-0.7	-0.5	1.0	1.2	0.9	0.2
Government gross debt	44.5	44.9	42.2	40.0	36.8	34.6	32.7	31.8
p.m: Real GDP growth (%)	-0.8	-0.5	2.7	5.3	2.6	4.4	3.4	3.1
p.m: Output gap	-1.8	-3.1	-2.6	-0.3	-0.4	0.9	1.2	1.4

1) Commission services' Spring 2018 Forecast.
2) Cyclically-adjusted balance excluding one-off and other temporary measures.
Source: Commission services.

3.3. PUBLIC FINANCES

3.3.1. Recent fiscal developments

The Council decided to abrogate the decision on the existence of an excessive deficit according to Article 126 (12) TFEU in 2014, thereby closing the excessive deficit procedure for the Czech Republic ([19]). Since then, the general government balance improved substantially, from -2.1% of GDP in 2014 to a surplus of 1.6% of GDP in 2017. In terms of expenditure and revenues shares, the total expenditure-to-GDP ratio stood at 38.8% and the revenue-to-GDP ratio at 40.4% in 2017. Public investment levels surged to 5.1% of GDP in 2015 due to the EU funds cycle then dropped sharply in 2016 to 3.3% of GDP and grew in line with nominal GDP in 2017.

The 2017 general government surplus of 1.6% of GDP was significantly better than the 0.4% of GDP surplus target in the 2017 Convergence Programme. This reflected tax-rich growth on the back of strong labour market boosting direct taxes and social security contributions. At the same time, investment growth fell short of previous expectations. Other notable developments were the marked increase of wage scales for public employees and falling debt service payments. The structural balance remained in surplus at around 1.2% of GDP in 2017 as the output gap is estimated to have turned positive.

The general government debt declined to 34.6% of GDP in 2017, remaining well below the 60% threshold.

3.3.2. Medium-term prospects

The 2018 Budget was adopted by the Parliament on 19 December 2017. A headline surplus of 1.3% of GDP was envisaged for 2018 at that time. Revised fiscal data for 2017 indicate a higher surplus for 2018. The budget includes increased social expenditure, reflecting measures such as higher pension indexation and higher outlays on family policies. The wage bill is set to increase by 10% for public employees. On the revenue side, additional discretionary revenues, particularly from reducing tax evasion, have a lower revenue-yielding effect than in previous years. Public investment is forecast to grow appreciably, in part due to the maturing of the current EU funds programming period. Interest payments are forecast to stabilise after three consecutive years of decline.

According to the Commission services' Spring 2018 Forecast, the headline general government balance is projected to decline slightly to 1.4% of GDP in 2018, largely as a result of revived public investment activity and a minor slowdown in tax revenue growth. The revenue-to-GDP ratio is expected to decline slightly to 40.3% while the

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

expenditure-to-GDP ratio is forecast to increase marginally to 38.9%. Based on the no-policy-change assumption, the headline balance is expected to worsen to 0.8% of GDP in 2019. The structural surplus is set to continue shrinking to around 0.2% of GDP by 2019.

The debt-to-GDP ratio is expected to decline below 32% of GDP in 2019. This implies a reduction of around 13 percentage points from its peak in 2013. Better liquidity management, favourable financing conditions and fiscal surpluses in recent years played a key role in the favourable debt dynamics.

Important measures to strengthen the Czech national fiscal framework have been taken since mid-2016, but their effectiveness will depend on the implementation of the new rules. In particular, the Fiscal Responsibility Law adopted in early 2017 introduced two numerical rules for the general government, namely an expenditure ceiling set on the basis of cyclically-adjusted revenue projections and a public debt rule. Moreover, local authorities are subject to more stringent rules on debt management. The National Budgetary Council, tasked with monitoring compliance with fiscal rules, has been set up and its members appointed in early 2018. The Committee on Budgetary Forecast assessing the macroeconomic and fiscal projections produced by the Ministry of Finance is expected to be established in the course of 2018. Finally, a draft law on independent audits aims to address the outstanding full transposition of the Council Directive 2011/85/EU on requirements for national budgetary frameworks.

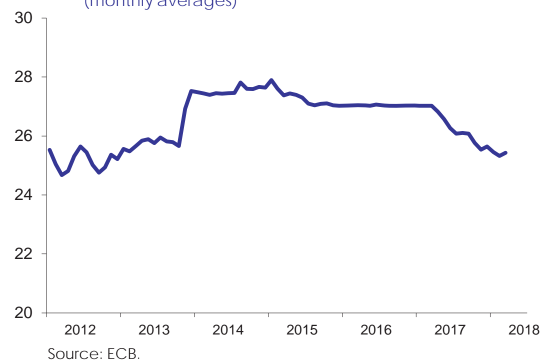
3.4. EXCHANGE RATE STABILITY

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. Between November 2013 and April 2017, the ČNB used 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.

The koruna traded marginally above 27 CZK/EUR throughout 2016 and in early 2017 as foreign exchange market interventions by the ČNB precluded further exchange rate appreciation. Following the expiry of the ČNB's exchange rate commitment in April 2017, the koruna followed a gradual appreciation trend against the euro, strengthening from above 27 CZK/EUR in early April 2017 to below 25.5 CZK/EUR in early 2018.

International reserves held by the ČNB increased from below EUR 60 billion by end-2015 to above EUR 120 billion (64% of GDP) in the first quarter of 2017, largely as a result of its foreign exchange market interventions. They then remained broadly stable up to early 2018.

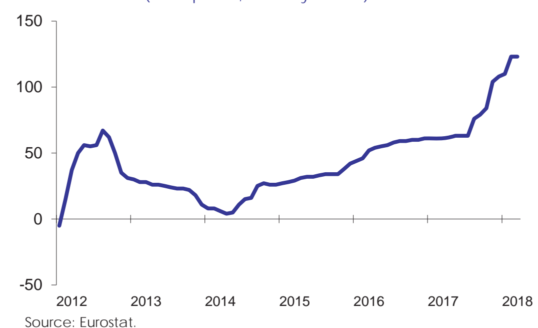
Graph 3.4: **Czech Republic - CZK/EUR exchange rate**
(monthly averages)



Source: ECB.

The 3-month interest rate differential vis-à-vis the euro area remained close to 60 basis points between mid-2016 and mid-2017 as the ČNB and the ECB kept their policy rates unchanged. It then widened over the second half of 2017 and in early 2018 as a result of policy rate hikes by the ČNB. It thus exceeded 120 basis points in early 2018.

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



Source: Eurostat.

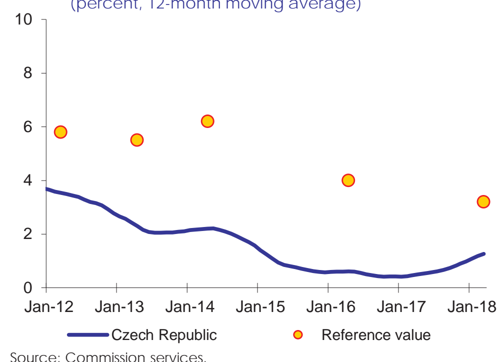
3.5. LONG-TERM INTEREST RATES

Long-term interest rates in the Czech Republic used for the convergence examination reflect

secondary market yields on a basket of government bonds with the average residual maturity of close to, but below, 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 in 2016. It declined to 0.4% in late 2016 and then followed a gradual upward trend throughout 2017. It exceeded 1% in early 2018. In March 2018, the latest month for which data are available, the reference value, given by the average of long-term interest rates in Cyprus, Ireland and Finland plus 2 percentage points, stood at 3.2%. In that month, the 12-month moving average of the yield on the Czech benchmark bond stood at 1.3%, i.e. 1.9 percentage points below the reference value.

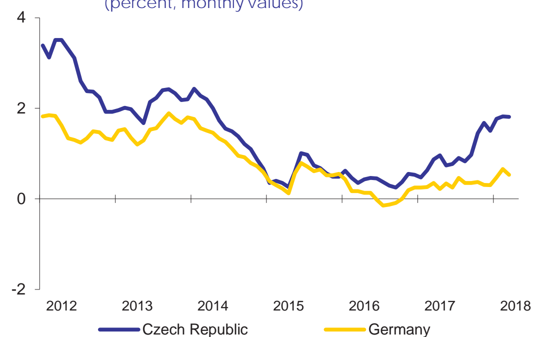
Graph 3.6: **Czech Republic - Long-term interest rate criterion**
(percent, 12-month moving average)



Source: Commission services.

The long-term interest rate of the Czech Republic oscillated around 0.4% in 2016. It then slowly increased to about 1.5% by end-2017 as the ČNB gradually tightened its monetary policy stance. Consequently, the spread against the German long-term benchmark bond ([20]) widened to some 120 basis points. In early 2018, the long-term interest rate increased to about 1.8% with the spread vis-à-vis the German benchmark bond fluctuating around 120 basis points.

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 2017, the Commission published its seventh Alert Mechanism Report (AMR 2018) under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.5), which concluded that since issues related to possible internal risks remained contained, no In-Depth Review (IDR) was warranted for the Czech Republic. Risks relate to the increase in nominal unit labour costs, largely driven by strong wage growth which is projected to accelerate further in the context of a tightening labour market, and to the acceleration in real house price growth. The feedback spiral between house prices and mortgage volumes accelerated while the private sector debt level slightly increased in 2016, but remains at a moderate level.

3.6.1. Developments of the balance of payments

According to balance of payments data, the Czech Republic's external balance (i.e. the combined current and capital account) has remained in surplus since 2013. It, nevertheless, declined to 2% of GDP in 2017 from 2.7% of GDP in 2016, largely as a result of a lower current account surplus. This reflected both a somewhat lower trade surplus as well as a more negative income balance. The capital account balance remained in

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

Table 3.4:
Czech Republic - Balance of payments **(percentage of GDP)**

	2012	2013	2014	2015	2016	2017
Current account	-1.6	-0.5	0.2	0.2	1.6	1.0
of which: Balance of trade in goods	3.0	4.1	5.1	4.1	5.1	4.7
Balance of trade in services	1.9	1.7	1.3	1.7	2.3	2.4
Primary income balance	-5.9	-6.1	-6.0	-5.6	-5.3	-5.2
Secondary income balance	-0.7	-0.3	-0.2	0.0	-0.6	-0.9
Capital account	1.3	2.0	0.8	2.2	1.1	0.9
External balance [1)]	-0.3	1.5	0.9	2.4	2.7	2.0
Financial account	0.3	1.7	1.5	3.8	2.4	2.3
of which: Direct investment	-3.0	0.2	-1.9	1.1	-3.9	-2.7
Portfolio investment	-1.4	-2.3	2.1	-3.6	-3.6	-5.1
Other investment [2)]	2.6	-0.7	-0.4	-1.4	-1.9	-14.0
Change in reserves	2.0	4.5	1.7	7.7	11.8	24.1
Financial account without reserves	-1.7	-2.8	-0.2	-3.9	-9.4	-21.8
Errors and omissions	0.5	0.2	0.5	1.4	-0.2	0.3
Gross capital formation	26.2	24.7	25.9	28.0	26.3	26.4
Gross saving	23.9	23.6	24.6	26.4	26.2	26.9
Gross external debt	60.0	63.2	67.8	68.5	73.3	89.2
International investment position	-45.9	-41.4	-36.6	-32.9	-26.9	-26.4

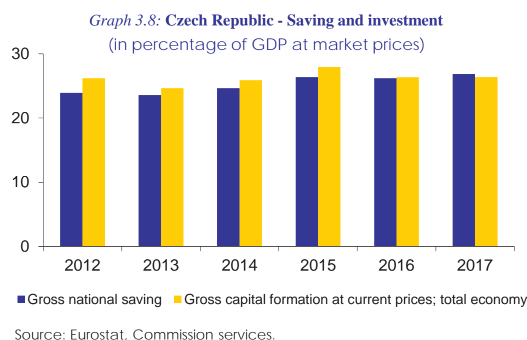
1) The combined current and capital account.
2) Including financial derivatives.

Sources: Eurostat, Commission services, Czech National Bank.

surplus for the 13th consecutive year at close to 1% of GDP in 2017 as a result of the drawdown of funds from the EU budget.

According to national accounts data, the savings-investment balance was negative in the Czech Republic up to 2016. Investment by the general government and the non-financial corporate sectors tend to exceed their savings, while the household and financial corporate sectors tend to save more than they invest. The strong decline of public investment in 2016 shrank the savings-investment gap to -0.1% of GDP. The savings-investment gap then turned positive in 2017 as the gross national saving rate picked up.

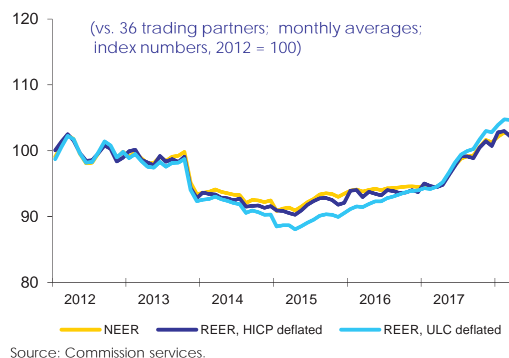
Graph 3.8: **Czech Republic - Saving and investment**
(in percentage of GDP at market prices)



Source: Eurostat, Commission services.

Measured by the export market share, the trade performance improved just marginally in 2016 and 2017. External price and cost competitiveness, as measured by ULC- and HICP-deflated real effective exchange rates, remained roughly unchanged in 2016 but clearly worsened in 2017. The deterioration was largely induced by the nominal effective exchange rate appreciation.

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



Source: Commission services.

The financial account balance of the Czech Republic remained positive in 2016 and 2017. It was mostly affected by rising official reserves since the pace of external asset accumulation by the ČNB further accelerated in the second half of

2016. The increase in official reserves was, however, to a large extent offset by increasing net external liabilities, in particular other investment liabilities, as foreign investors used the liquidity injected by the ČNB to acquire Czech financial assets. As a result, gross external debt also jumped up substantially whereas the net international investment position continued to improve.

According to the Commission services' Spring 2018 Forecast based on national accounts data, the external balance is expected to deteriorate over 2018 and 2019.

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 at close to 90% of GDP. The share of trade with the euro area seems to have stabilised in recent years at around 55% of GDP as neighbouring euro-area countries are among its largest trade partners.

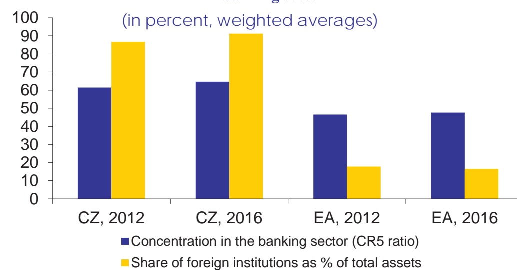
The Czech Republic has attracted a high share of FDI in the tradable sector thanks to its geographical proximity to EU core markets, relatively good infrastructure and a highly educated labour force. FDI inflows mainly originate in the euro area, with investments from the Netherlands, Germany, Austria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

As far as the business environment is concerned, the Czech Republic's position in international rankings seems to have stabilised below the euro-area average in recent years. In the World Bank's Ease of Doing Business, the Czech Republic's worst rankings concern dealing with construction permits and enforcing contracts. According to the World Bank's Worldwide Governance Indicators the Czech Republic performs relatively worse in terms of corruption control and regulatory quality. At the same time, the Czech Republic's deficit in the transposition of EU internal market directives increased to 1.5% in 2017. The 4th Anti-Money Laundering Directive imposed transposition by 26 June 2017 and the Czech Republic notified the Commission of the transposition measures within that deadline. The Commission is analysing these measures to assess their conformity with the directive.

Protection of permanent employees against collective and individual dismissals is relatively strict (as measured by the 2013 OECD employment protection indicator) whereas the duration of unemployment benefits is below the EU average. Cross-border migration flows have remained relatively subdued, although the tightening labour market has started to attract workers from both EU and non-EU countries.

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 with more than 90% of banking sector's assets held in 2016 by foreign institutions via their local branches and subsidiaries. Concentration in the banking sector, as measured by the market share of the largest five credit institutions in total assets, increased to almost 65% in 2016 and thus continued to exceed the euro-area average of 48%.

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 above 17% in the third quarter of 2017, i.e. close to the euro-area average of about 18%. Moreover, it has performed relatively well in terms of profitability as the average annual return on equity (RoE) reached 13% in the third quarter of 2017, compared to 4.5% in the euro area. At the same time, the share of non-performing loans declined close to 2% in while it was at 4% in the euro area.

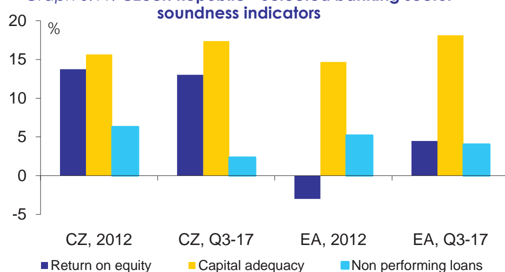
Table 3.5:
Czech Republic - Market integration

	2012	2013	2014	2015	2016	2017
Trade openness [1] (%)	82.7	83.7	90.6	91.5	89.5	90.1
Trade with EA in goods & services [2)+3)] (%)	50.6	51.2	55.7	56.0	55.5	55.5
Export performance (% change) [4]	3.8	-2.4	4.7	1.9	0.7	0.8
World Bank's Ease of Doing Business Index rankings [5]	65	75	44	36	27	30
WEF's Global Competitiveness Index rankings [6]	39	46	37	31	31	31
Internal Market Transposition Deficit [7] (%)	1.9	0.2	0.3	0.3	0.8	1.5
Real house price index [8]	95.3	94.6	96.3	100.0	106.7	116.2
Residential investment [9] (%)	3.7	3.2	3.4	3.6	3.7	3.9

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.
(November data, as of 2016 date refers to the year of publication).
8) Deflated house price index (2015=100) (Eurostat).
9) Gross capital formation in residential buildings (in % of GDP) (Eurostat).

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

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

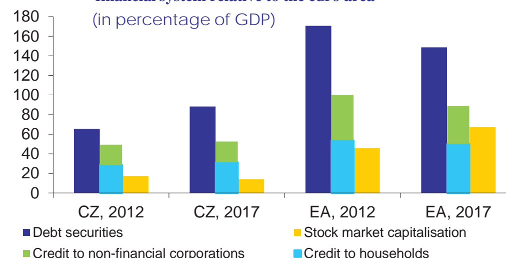


Note: Q3-17 Return on equity is calculated over the last four quarters.
Source: ECB, IMF, EC calculations.

The real house price index has followed an accelerating upward trend since 2013 and exceeded 116% of its 2015 level in 2017. At the same time, the GDP share of residential investment remained broadly stable at below 4% of GDP in recent years even though bank lending to households for house purchase expanded by almost 25% between end-2015 and end-2017.

The financial system in the Czech Republic is smaller relative to GDP than that of the euro area. In 2017, outstanding bank credit to non-financial companies and households reached 52% of GDP in the Czech Republic, compared to almost 90% in the euro area. The valuation of quoted shares issued by Czech enterprises amounted to 14% of GDP while it exceeded 67% in the euro area. The total amount of outstanding debt securities was below 90% of GDP, i.e. far below the euro-area average of 149%. The consolidated stock of private sector debt in the Czech Republic floated around 70% of its GDP between 2010 and 2016, remaining significantly below the euro-area average of 137%.

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 ([21]) and the Act on the Croatian National Bank (the HNB Act) ([22]). 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.

([21]) 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, 5/2014.

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

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 and IX 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 any potential amendments to the HNB Act on the basis of a draft law which is pending in the Croatian Parliament at the moment of writing the 2018 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 2016 convergence assessment of Croatia. It remained negative throughout 2016, bottoming out at -0.8% in September 2016. It returned into positive territory in May 2017 and then continued to gradually increase up to January 2018 when it exceeded 1.3%. In March 2018, the reference value was 1.9%, calculated as the average of the

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Table 4.1:
Croatia - Components of inflation

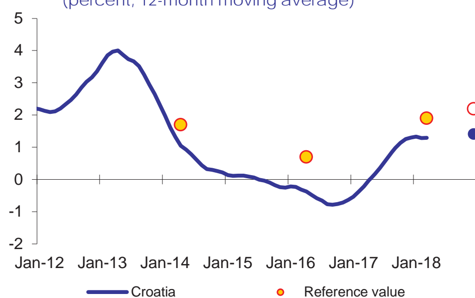
	2012	2013	2014	2015	2016	2017	Mar-18	weights in total 2018
					(percentage change)[1]			
HICP	3.4	2.3	0.2	-0.3	-0.6	1.3	1.3	1000
Non-energy industrial goods	1.2	-0.1	-1.1	0.1	0.6	0.8	0.6	245
Energy	10.8	1.8	0.7	-5.9	-5.7	-0.1	0.3	122
Unprocessed food	5.5	4.5	-3.6	0.8	-0.9	3.7	2.1	72
Processed food	2.7	5.3	0.9	0.6	0.2	2.3	2.2	202
Services	0.7	1.6	1.7	1.4	0.0	1.1	1.4	358
HICP excl. energy and unproc. food	1.6	2.1	0.6	0.8	0.2	1.3	1.4	805
HICP at constant tax rates	2.5	1.9	-0.6	-0.6	-0.8	1.2	1.2	1000
Administered prices HICP	7.6	3.4	1.7	0.4	-1.3	-0.1	0.7	110

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.

12-month average inflation rates in Cyprus, Ireland and Finland plus 1.5 percentage points. The corresponding inflation rate in Croatia was 1.3%, i.e. 0.6 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 4.1: **Croatia - Inflation criterion**



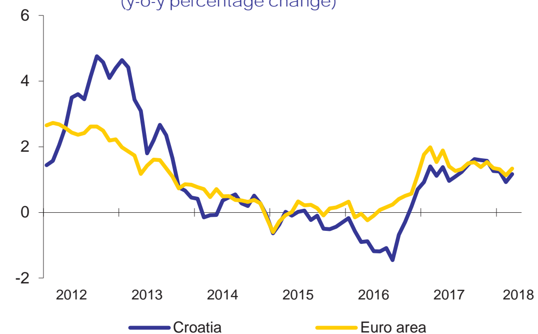
Note: The dots in December 2018 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2018 Forecast.

4.2.2. Recent inflation developments

Annual HICP inflation remained negative throughout most of 2016 due to falling energy and unprocessed food prices. It averaged -0.6% for the year as a whole. Annual inflation rates turned positive in late 2016 and then increased to above 1% in early 2017 thanks to larger inflation contributions from all its main components. Annual inflation rates thereafter oscillated around 1.3% up to January 2018. Annual HICP inflation declined to below 1% in February 2018 and then recovered to 1.2% in March 2018.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) decelerated in 2016, but remained in positive territory at 0.2%. The slowdown was largely due to prices of services which remained on average unchanged in 2016. Core inflation increased again and equalled HICP inflation at 1.3% in 2017. The pickup mainly reflected substantially larger inflation contribution of processed food and services. Domestic industrial producer prices remained roughly unchanged in 2016 and then increased by about 2% in 2017.

Graph 4.2: **Croatia - HICP inflation**



Source: Eurostat.

4.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and cyclical stance

After six years of contraction, economic activity started to recover in 2015. The pace of real GDP growth accelerated to 3.2% in 2016 and moderated to 2.8% in 2017. The output gap is thus estimated to have turned positive in 2017. The recovery was mainly driven by revived private consumption. A marked recovery in private investment started in 2016, but the momentum was curbed in 2017 amidst the crisis in the distressed food-to-retail giant Agrokor and a substantial decline in the uptake of EU funding, particularly in the public

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

	2012	2013	2014	2015	2016	2017	2018 1)	2019 1)
HICP inflation								
Croatia	3.4	2.3	0.2	-0.3	-0.6	1.3	1.4	1.5
Euro area	2.5	1.3	0.4	0.0	0.2	1.5	1.5	1.6
Private consumption deflator								
Croatia	3.2	1.9	-0.5	-0.5	-1.2	1.0	1.4	1.5
Euro area	1.9	1.1	0.5	0.3	0.4	1.4	1.5	1.6
Nominal compensation per employee								
Croatia	0.4	-0.9	-5.2	0.4	-0.2	-1.1	1.1	1.4
Euro area	1.8	1.6	1.4	1.4	1.2	1.6	2.4	1.9
Labour productivity								
Croatia	1.4	2.0	-2.7	1.1	2.9	0.6	1.1	1.1
Euro area	-0.1	0.6	0.7	1.0	0.4	0.8	1.0	1.0
Nominal unit labour costs								
Croatia	-1.0	-2.9	-2.6	-0.7	-3.0	-1.7	0.0	0.3
Euro area	1.9	1.0	0.6	0.5	0.7	0.8	1.4	1.0
Imports of goods deflator								
Croatia	2.9	-0.4	-0.9	-1.2	-2.4	2.5	1.2	1.6
Euro area	2.6	-2.0	-2.4	-3.4	-3.4	3.4	1.2	0.7

1) Commission services' Spring 2018 Forecast.

Source: Eurostat, Commission services.

sector. Exports performed strongly on the back of further gains in goods export market shares and continued expansion of inbound tourism. Going forward, real GDP growth rates are expected to remain roughly unchanged at around 2¾ in 2018 and 2019. Growth should continue to be driven by private consumption, but also investment, both thanks to an expected improvement in absorption of EU funds and a recovery in corporate investment.

The fiscal stance, as measured by the change in the structural balance, was considerably tightened in 2015-2017, on the back of a general containment of expenditure growth combined with buoyant revenues. The structural balance thus improved from -3.4% of GDP in 2014 to 0.4% in 2017. It is expected to deteriorate somewhat in 2018-2019.

The HNB has continued to pursue accommodative monetary policy by preserving high levels of liquidity in the banking system while simultaneously maintaining a broadly stable exchange rate of the kuna against the euro. In early 2016 the monetary policy toolkit was expanded by the introduction of structural repo operations which have been used to provide banks with long-term kuna liquidity ([23]).

Wages and labour costs

The labour market situation continued improving in 2016 and 2017, although both the activity and employment rates remain among the lowest in the EU. From its peak of almost 18% in 2013, the unemployment rate dropped to an estimated 11% in 2017, though in part due to sizeable outbound migration. Total employment has been increasing moderately but steadily in recent years, with some signs of labour market tightening in some sectors. This, coupled with wage hikes in the public sector, resulted in a rebound in wage growth in 2017 (as evidenced by administrative data), after the contraction recorded in previous years and stabilisation in 2016.

Nominal unit labour costs (ULC) continued to decline in 2016 and 2017 as nominal compensation per employee decreased (based on national accounts data), while labour productivity recovered somewhat. Going forward, positive trends in employment are expected to support further wage growth, at roughly the same pace as

([23]) According to the HNB, these operations are aimed at providing banks with longer-term sources of kuna liquidity at an interest rate competitive to interest rates on other banks' kuna liquidity sources, with debt securities of issuers from Croatia maturing after the repurchase date accepted as collateral under the condition that the issuer or the issue has been assigned a credit rating that is at least equal to the rating of the Republic of Croatia.

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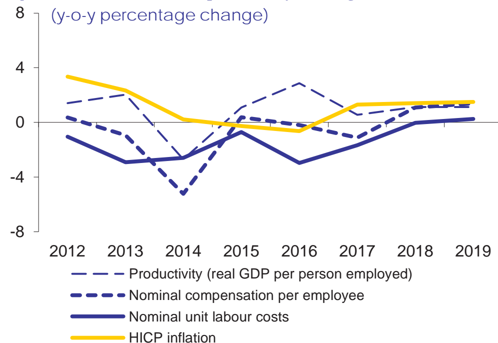
productivity. As a result, nominal ULC should broadly stabilise.

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



Source: Eurostat, Commission services' Spring 2018 Forecast.

External factors

Import prices (measured by the imports of goods deflator) rebounded by 2.5% in 2017 after four years of declines. This mainly reflected oil price developments.

The exchange rate exerted a dampening impact on domestic price developments in 2016 and 2017, as the nominal effective exchange rate (measured against a group of 36 trading partners) has appreciated rather steadily since the end of 2015.

Administered prices and taxes

The weight of administered prices in the Croatian HICP basket ([24]) amounted to 11% in 2018, compared to 13% in the euro area. In 2016, administered prices turned from growing faster than other components to having a cushioning effect on overall inflation. The big drop in administered prices in April 2016 was induced by the government's decision to reduce gas prices. Since then, administered prices have been slowly recovering largely on the back of increasing global energy prices.

Tax changes had overall only marginal impact on headline inflation over the past two years. Whereas excise taxes on tobacco were raised in December 2016 and December 2017, VAT on electricity was moved from the general rate (25%) to a reduced rate of 13% as of January 2017 and excises on motor vehicles were lowered as of January 2018.

Medium-term prospects

According to the Commission services' Spring 2018 Forecast, annual HICP inflation is projected to remain broadly stable as recovering energy prices are likely to offset the lower inflation contribution of unprocessed food. Core inflation is expected to slightly accelerate in 2019 in line with the continued economic expansion. Annual HICP inflation is thus forecast to average 1.4% in 2018 and 1.5% in 2019.

Risks to the inflation outlook are broadly balanced. On the one hand, tightening labour market conditions and related wage pressures could contribute positively to inflation developments. On the other hand, a slower-than-expected GDP expansion, constrained by the economy's low potential growth, could alleviate some of the inflationary pressures.

The relative level of consumer prices in Croatia continued to follow a downward trend, falling to below 65% of the euro-area average in 2016. As a result, there is potential for price level convergence in the long term. However, Croatian GDP per capita in purchasing power standards has stagnated at around 56% of the euro-area average in recent years.

Medium-term inflation prospects will be affected by wage and productivity developments against the backdrop of declining 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 the economy continuing on its recovery path, it will be increasingly important to ensure that wage growth remains in line with productivity growth.

4.3. PUBLIC FINANCES

4.3.1. Recent fiscal developments

In June 2017, based on the Commission's recommendation, the Council abrogated the excessive deficit procedure for Croatia ([25]). The

([24]) According to the Eurostat definition, administered prices in Croatia include *inter alia* gas and heat energy, water supply, refuse and sewerage collection as well as dental, hospital and cultural services. For details, see: http://ec.europa.eu/eurostat/documents/272892/272989/HICP-AP-national-classification-December-2017/a9439235-7b46-4736-984a-0134ca2cd10b

([25]) 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 4.3:
Croatia - Budgetary developments and projections **(as percentage of GDP unless indicated otherwise)**

Outturn and forecast [1]	2012	2013	2014	2015	2016	2017	2018	2019
General government balance	-5.2	-5.3	-5.1	-3.4	-0.9	0.8	0.7	0.8
- Total revenues	42.1	42.4	43.0	44.9	46.3	46.0	45.8	45.4
- Total expenditure	47.3	47.7	48.1	48.4	47.2	45.3	45.1	44.6
of which:								
- Interest expenditure	3.1	3.2	3.4	3.5	3.1	2.7	2.5	2.4
p.m.: Tax burden	35.9	36.3	36.7	37.3	38.0	38.0	38.1	37.8
Primary balance	-2.1	-2.1	-1.7	0.0	2.2	3.4	3.3	3.2
Cyclically-adjusted balance	-3.5	-3.5	-3.2	-2.3	-0.6	0.3	-0.3	-0.6
One-off and temporary measures	0.0	-0.2	0.2	0.0	0.1	-0.1	0.0	0.0
Structural balance [2]	-3.5	-3.2	-3.4	-2.4	-0.7	0.4	-0.3	-0.6
Government gross debt	69.4	80.5	84.0	83.8	80.6	78.0	73.7	69.7
p.m: Real GDP growth (%)	-2.2	-0.6	-0.1	2.3	3.2	2.8	2.8	2.7
p.m: Output gap	-3.7	-3.9	-4.2	-2.4	-0.7	0.9	2.3	3.1

1) Commission services' Spring 2018 Forecast.
2) Cyclically-adjusted balance excluding one-off and other temporary measures.
Source: Commission services.

decision was based on the reduction of the general government deficit to 0.9% of GDP in 2016 – well below both the 3% Treaty threshold and the 2.7% EDP recommendation – and on compliance with the forward-looking element of the debt reduction benchmark. The improvement was facilitated by the strong cyclical contribution as economic growth supported tax revenue, but also by restraint of expenditure growth. While expenditure grew in nominal terms, as a ratio to GDP it decreased from 48.4% in 2015 to 47.2% in 2016. Savings were made in social transfers and interest payments, but the remaining categories of expenditure grew slower than nominal GDP. Meanwhile, government revenue rose sharply from 44.9% to 46.3% of GDP, supported mostly by taxes on products and on income.

The general government balance turned into a surplus of 0.8% of GDP in 2017, compared to the deficit of 1.3% of GDP planned in the 2017 convergence programme. The improvement was achieved on the back of buoyant revenue, driven by a strong tourist season, rising consumption and employment, in spite of the tax cuts that came into force in January 2017. At the same time, expenditure slightly declined in nominal terms, benefitting from decreasing interest costs and lower public investment, but also growth of other expenditure, most notably social spending, below the rate of nominal GDP growth. Only the public sector wage bill recorded a significant increase. In structural terms, the balance improved further to 0.4% of GDP in 2017 from -0.7% of GDP in 2016.

The decrease in the deficit and the pick-up in nominal GDP growth put the general government debt ratio on a declining path: from 83.8% of GDP in 2015 to 78% of GDP in 2017.

4.3.2. Medium-term prospects

The 2018 budget was adopted by the Parliament on 30 November 2017. Based on an expected general government deficit of 1.3% of GDP in 2017, the budget foresees a deficit of 0.5% of GDP in 2018. It incorporates the full-year effect of the 2017 gradual increase in public sector wages as well as expenditure-increasing measures in defence, social and population policies. While there is a risk that the budgetary impact of some of these measures may be underestimated, the revenue side was projected conservatively, with tax revenue growing well below nominal GDP and from an underestimated 2017 base.

The Commission services' Spring 2018 Forecast projects the general government balance to remain in surplus in both 2018 and, on a no-policy-change basis, in 2019, at 0.7% and 0.8% of GDP, respectively. The general government debt is forecast to decline to around 70% of GDP by 2019.

The fiscal framework in Croatia remains relatively weak, following repeated delays with the planned and long overdue adoption of the new Fiscal Responsibility Act and the amendments to the Budget Act. In particular, the domestic medium-term budgetary framework is only indicative for

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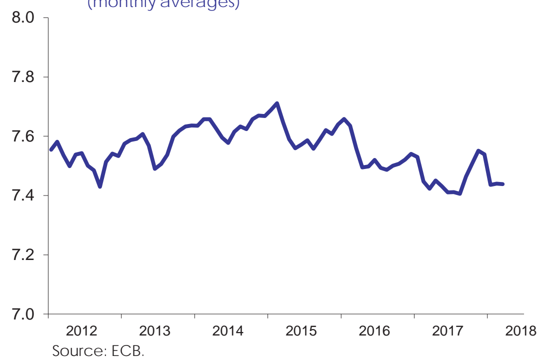
annual fiscal planning and the role of the Fiscal Policy Commission remains weak. In early 2018 the Parliament approved Croatia's adhesion to the intergovernmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, without, however, the intention to be bound by its Fiscal Compact ([26]) provisions before accession to the euro area.

4.4. EXCHANGE RATE STABILITY

The Croatian kuna does not participate in ERM II. The HNB operates a 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. Between early 2016 and early 2018 kuna experienced some appreciation pressures which necessitated foreign exchange purchases from banks by the HNB aimed at the stabilisation of its exchange rate against the euro.

The kuna's exchange against the euro has continued to exhibit a seasonal pattern of temporarily appreciating in spring thanks to foreign exchange inflows generated by the tourism sector. After having appreciated from above 7.6 HRK/EUR in early 2016 to about 7.5 HRK/EUR by mid-2016, it depreciated somewhat in late 2016 and early 2017. It then strengthened again close to 7.4 HRK/EUR by mid-2017 before weakening back to above 7.5 HRK/EUR in late 2017. In early 2018, kuna traded below 7.5 HRK/EUR.

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



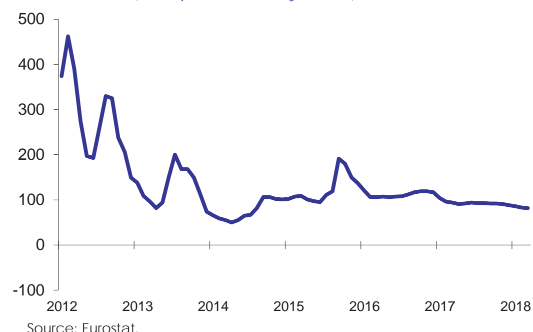
Source: ECB.

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

After having remained close to EUR 13 billion throughout 2016, international reserves held by the HNB increased to above EUR 16 billion in the first quarter of 2017. This also reflected the sovereign issuance of 10-year euro-bonds for EUR 1.25 billion in March 2017 which was used to settle USD 1.5 billion worth of bonds maturing in April 2017. As a result, international reserves declined to EUR 14 billion in the second quarter of 2017 before increasing again to almost EUR 16 billion (32% of GDP) by end-2017, mainly thanks to foreign exchange purchases from banks by the HNB.

Given that the HNB does not frequently change interest rates on its lending and deposit facilities, the evolution of short-term rates mainly reflects changes in kuna liquidity in the banking system. The 3-month interest rate differential against the euro area averaged 112 basis points in 2016 but it stabilised at below 100 basis points in 2017 and early 2018 as short-term money market rates declined in Croatia.

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



Source: Eurostat.

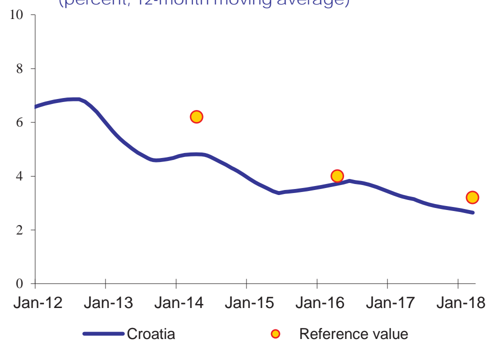
4.5. LONG-TERM INTEREST RATES

Long-term interest rates in Croatia used for the convergence examination reflect 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 2016 convergence assessment of Croatia. After peaking at above 3.8% in June 2016, it declined gradually to below 2.7% in early 2018. In March 2018, the latest month for which data are available, the reference value, given by the average

of long-term interest rates in Cyprus, Ireland and Finland plus 2 percentage points, stood at 3.2%. In that month, the 12-month moving average of the yield on the Croatian benchmark bond stood at 2.6%, i.e. 0.6 percentage points below the reference value.

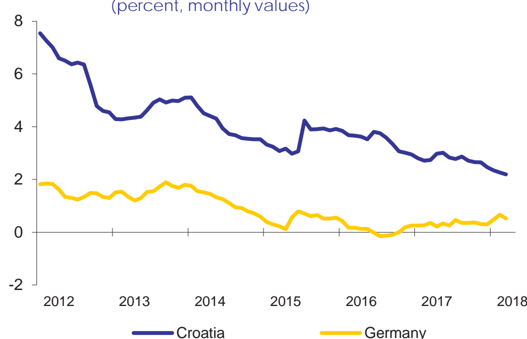
Graph 4.6: **Croatia - Long-term interest rate criterion**
(percent, 12-month moving average)



Source: Commission services.

The long-term interest rate of Croatia remained broadly stable from August 2015 until August 2016, floating between 3.5% and 4%. It declined to about 3% in late 2016 and then mostly hovered below 3% throughout 2017 with the spread to the German long-term benchmark bond ([27]) oscillating around 245 basis points. In early 2018, the long-term interest rate declined to below 2.4% and the spread vis-à-vis the German benchmark bond to below 200 basis points as Croatia received its first rating upgrade since 2004.

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



Source: Eurostat.

4.6. ADDITIONAL FACTORS

In November 2017, the Commission published its seventh Alert Mechanism Report (AMR 2018) under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.5), which concluded that an In-Depth Review (IDR) was warranted for Croatia. In March 2018, the Commission published its annual country report on Croatia ([28]), including an IDR. This report led to the conclusion that Croatia was experiencing excessive macroeconomic imbalances, linked to still high levels of public, private and external debt, all largely denominated in foreign currency, in a context of low potential growth. Strong growth, above its estimated potential, is helping to reduce stock imbalances: public, private and external debt ratios are declining at a fast pace. The banking sector is increasingly profitable and solvent and the stock of non-performing loans continued to decline, but the foreign currency exposure (mainly euro) of corporations and households remains a source of vulnerability. While the economic environment is improving, there has been little advancement in the adoption of policy measures aimed at addressing macroeconomic imbalances, including by raising the still low growth potential.

4.6.1. Developments of the balance of payments

After having declined to 2.5% of GDP in 2016, the current account surplus increased to almost 4% of GDP in 2017. Whereas the trade surplus deteriorated somewhat in 2017, the income balance improved, also due to losses incurred by the largely foreign-owned banking sector in the aftermath of the Agrokor crisis ([29]). The capital account balance, however, declined to 0.5% of GDP in 2017, from above 1% in 2016. As a result, Croatia's external surplus (i.e. the combined current and capital account) increased from 3.6% of GDP in 2016 to 4.2% of GDP in 2017.

These external balance developments reflected the relatively low investment and continued deleveraging by all sectors. While bank credit provision to both households and non-financial corporations started to increase again in 2016, investment activity, measured as percentage of GDP, has so far remained broadly stable.

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

([28]) https://ec.europa.eu/info/sites/info/files/2018-european-semester-country-report-croatia-en.pdf

([29]) With around 30 000 employees and 2.2 % of the total gross value added in the economy, the Agrokor group is the largest private employer in Croatia. Having faced serious financial distress in early 2017, Agrokor was put under extraordinary administration in April 2017.

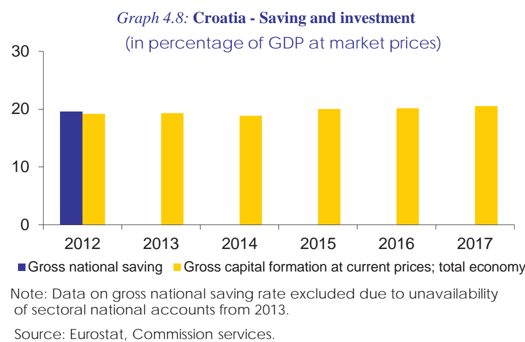
Table 4.4:
Croatia - Balance of payments (percentage of GDP)

	2012	2013	2014	2015	2016	2017
Current account	-0.1	1.0	2.0	4.5	2.5	3.8
of which: Balance of trade in goods	-14.3	-15.0	-15.0	-15.7	-15.8	-16.7
Balance of trade in services	14.8	15.5	16.9	18.0	18.7	19.0
Primary income balance	-3.4	-2.0	-2.0	-0.7	-3.3	-2.3
Secondary income balance	2.8	2.6	2.1	2.9	2.9	3.8
Capital account	0.1	0.1	0.2	0.7	1.1	0.5
External balance [1)]	0.0	1.1	2.1	5.2	3.6	4.2
Financial account	-1.0	-1.0	1.0	4.2	2.4	3.4
of which: Direct investment	-2.8	-1.9	-1.6	-0.6	-4.2	-2.6
Portfolio investment	-4.0	-4.4	1.7	-0.3	2.8	0.3
Other investment [2)]	5.7	1.1	2.2	3.3	4.4	0.3
Change in reserves	0.1	4.2	-1.2	1.7	-0.6	5.3
Financial account without reserves	-1.1	-5.2	2.3	2.5	3.0	-1.9
Errors and omissions	-1.0	-2.1	-1.1	-1.0	-1.2	-0.8
Gross capital formation	19.2	19.3	18.8	20.0	20.2	20.5
Gross saving [3)]	19.6	n.a.	n.a.	n.a.	n.a.	n.a.
Gross external debt	102.8	105.3	107.0	101.9	89.8	83.1
International investment position	-90.6	-88.5	-85.4	-76.5	-70.0	-62.8

1) The combined current and capital account.
2) Including financial derivatives.
3) Data on gross national saving missing due to unavailability of sectoral national accounts from 2013.

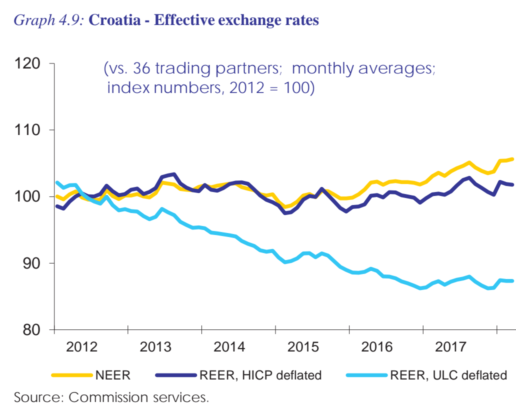
Sources: Eurostat, Commission services, Croatian National Bank.

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



Note: Data on gross national saving rate excluded due to unavailability of sectoral national accounts from 2013.
Source: Eurostat, Commission services.

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



Source: Commission services.

In 2016 and 2017, exports continued to perform strongly, as the economy further increased its export market shares, although at a slower pace than in the previous two years. Based on national accounts, external cost competitiveness, as measured by the ULC-deflated real effective exchange rate, improved somewhat over 2016 and 2017. On the other hand, the HICP-based REER indicates some deterioration in external price competitiveness resulting from the NEER appreciation over this time period.

The financial account continued to display positive balances in 2016 and 2017. This reflected the positive net contribution of portfolio as well as other investment flows. At the same time, net foreign liabilities stemming from foreign direct investment in Croatia continued to increase. While international reserves held by the HNB declined somewhat in 2016, they increased by more than 5% of GDP in 2017. The net international investment position (NIIP) thus improved substantially from about -77% of GDP in 2015 to around -63% of GDP at the end of 2017 while gross external debt declined to 83% of GDP.

According to the Commission services' Spring 2018 Forecast, the external surplus is expected to decline somewhat over 2018 and 2019.

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 has gradually increased in recent years and reached 55% of GDP in 2017 but it still remains relatively low given the small size of the Croatian economy. Trade with the euro area amounted to almost 31% of GDP in 2017 and thus constituted over half of total trade, with Germany, Italy, Slovenia and Austria as Croatia's largest trade partners. There, nevertheless, should be room for a further deepening of trade integration with the euro area.

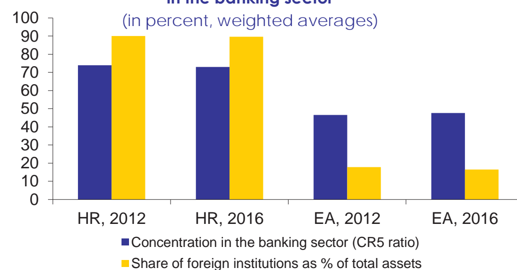
FDI has so far been mainly directed into the banking, real estate and retail sectors, with the largest inflows originated from Austria, the Netherlands and Hungary. On the other hand, Croatia failed to attract significant FDI inflows into the tradable goods sector and it is thus weakly integrated into global supply chains. The unfavourable business environment appears to be the main obstacle to attracting more FDI.

With regard to the business environment, Croatia performs worse than most euro-area Member States according to several commonly used indicators (e.g. the World Bank's Ease of Doing Business Index or the World Economic Forum’s Global Competitiveness Index). Moreover, it has not recorded any significant relative improvement in recent years. In the World Bank's Ease of Doing Business, Croatia's worst rankings concern dealing with construction permits and paying taxes. According to the World Bank's Worldwide Governance Indicators, Croatia performs relatively poorly in terms of regulatory quality as well as voice and accountability. At the same time, Croatia's deficit in the transposition of EU internal market directives increased to 2.2% in 2017. The 4th Anti-Money Laundering Directive imposed transposition by 26 June 2017. Croatia communicated the measures it adopted to transpose the directive on 28 November 2017 after the Commission had addressed to Croatia a letter of formal notice on 19 July 2017. The Commission is analysing these measures to assess their conformity with the directive.

Activity and employment rates remain low compared to the euro-area average, which is partly related to underlying policies in place, such as early retirement schemes and pension eligibility criteria. The relaxation in employment protection legislation in 2013-14 resulted in a significant increase in the use of temporary contracts. Employment on permanent contracts, however, picked up again in 2017. After attaining a peak of 11 % in 2013, the long-term unemployment rate has been steadily decreasing to pre-crisis levels and stood at 6.6% in 2016 (still above the euro-area average of 5%). Long-term unemployment affects particularly low skilled workers who remain insufficiently targeted by active labour market policy measures. Non-harmonised and still inefficient wage setting frameworks in the public sector hampers the government’s control over the public wage bill and may weigh on wage responsiveness in the economy.

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. Concentration in its banking sector is relatively high, with the largest five banking institutions accounting for more than 70% of sectors' total assets, compared to on average 48% in the euro-area countries.

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 banking system in Croatia is well capitalized, with capital adequacy ratio exceeding 20% in the third quarter of 2017, compared to 18% in the euro area. However, the share of non-performing loans (NPLs) has remained relatively elevated at close to 10% in the third quarter of 2017 while it declined to 4% in the euro area. Profitability of the banking sector has been quite volatile in recent years but the annual return on equity (RoE) on average exceeded 5% in the third quarter of 2017 and was thus above the euro-area average of 4.5%. Reflecting the important role of the euro in the

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Table 4.5:
Croatia - Market integration

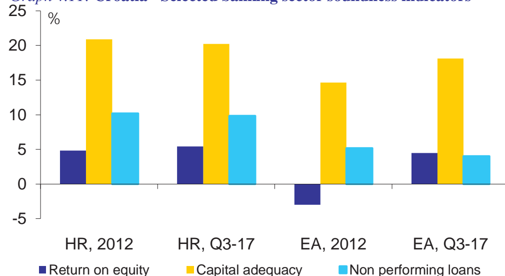
	2012	2013	2014	2015	2016	2017
Trade openness [1] (%)	43.9	44.6	46.9	50.3	51.9	54.7
Trade with EA in goods & services [2)+3)] (%)	22.0	23.7	26.7	28.8	29.4	30.6
Export performance (% change) [4]	-1.2	0.1	1.9	5.2	1.7	0.6
World Bank's Ease of Doing Business Index rankings [5]	84	89	65	40	43	51
WEF's Global Competitiveness Index rankings [6]	81	75	77	77	74	74
Internal Market Transposition Deficit [7] (%)	n.a.	n.a.	0.6	0.1	0.3	2.2
Real house price index [8]	109.9	103.6	102.5	100.0	102.12	105.1
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.
(November data, as of 2016 date refers to the year of publication).
8) Deflated house price index (2015=100) (Eurostat).
9) Gross capital formation in residential buildings (in % of GDP) (Eurostat).

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

banking sector, the share of foreign currency deposits amounted to about 60% by end-2017.

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

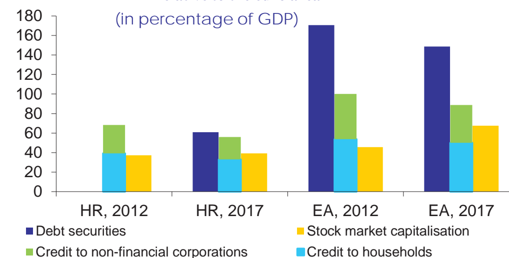


Note: Q3-17 Return on equity is calculated over the last four quarters.
Source: ECB, HNB, EC calculations.

The real house price index started to increase again in 2016 and reached 105% of its 2015 level in 2017. Bank lending to households for house purchase also picked up in late 2017 while construction activity has started showing signs of recovery.

The financial system in Croatia is smaller relative to GDP than that of the euro area. In 2017, outstanding bank credit to Croatian non-financial corporations and households amounted to about 56% of GDP, compared to almost 90% in the euro area. The majority of bank loans is denominated in euro but lending to households in kuna has followed an upward trend since 2013. The valuation of quoted shares issued by Croatian enterprises amounted to less than 40% of GDP while it exceeded 67% in the euro area. The debt securities market corresponding to 61% of GDP was largely dominated by government securities and thus remained far less developed that the euro-area market encompassing debt securities in the nominal value of almost 150% of GDP. The GDP share of consolidated private sector debt declined gradually from 125% in 2010 to 106% in 2016 and thus remained below the euro-area average of 137%.

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 past 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. After this the MNB Act was amended at several occasions ([30]), including some amendments since the most recent convergence exercise of 2016 ([31]).

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.

([30]) 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.

([31]) The amendments concern inter alia the implementation of EU financial legislation when carrying out supervisory tasks, the publication of certain information by the MNB, the provisions on proceedings of the MNB and the information requirements of the MNB towards the European Supervisory Authorities.

Section 153(6) of the MNB Act provides for the possibility for members of the Monetary Council (including the Governor) and MNB employees to take on roles in the management, boards of trustees or supervisory boards of foundations and business associations under majority ownership of the MNB established by the MNB under Section 162(2) of the MNB Act without being subject to the conflict of interest rules provided for in Section 152(1) to (5) of the MNB Act, including any formal disclosure requirement. Hence, for those activities the MNB officials involved, including the Governor, are fully shielded from any scrutiny. Moreover, Section 153(6) of the MNB Act also provides for an explicit exemption to the rule of Section 156(1) of the MNB Act which determines that members of the Monetary Council (including the Governor) may only perform other activities which are compatible with their central bank decision-making duties. Hence, under national law such members may undertake activities in the MNB's foundations and business associations that are incompatible with their central bank decision-making duties. The provision conflicts with Section 162(2) of the MNB Act which provides that the MNB may only establish foundations and business associations in line with its tasks and primary objective of ensuring price stability. Moreover, central bank decision making duties always have to be performed in compliance with Article 130 of the TFEU. The exemption therefore seems to imply that the latter principles of primary Union law may be disregarded by members of the Monetary Council when acting in the context of the foundations and business associations under MNB ownership. Therefore, the incompatibility needs to be removed.

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 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 Governors, 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 ESCB/ECB Statute. 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 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

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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.

Section 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.

Section 162(3) and (4) of the MNB Act lay down the conditions of disclosure of data by a company related to the MNB ([32]) ([33]). Furthermore, Section 162(5) provides for supervision of the State Audit Office of the operations of foundations established by the MNB. 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.

Pursuant to Section 162(2) of the MNB Act, the MNB may establish business associations under majority of MNB ownership, or foundations. In order to dispel any concerns from the perspective of Article 123 of the TFEU, the provision should be amended by providing for a clear framework delimiting the operations of such foundations and the volumes or resources which the MNB could endow them with, enabling them to purchase large volumes of Hungarian government securities ([34]). Moreover, the exemption provided under Section 153(6) of the MNB Act to the rule of Section 156(1) of the MNB Act which determines that members of the Monetary Council (including the Governor) may only perform other activities which are compatible with their central bank decision-making duties is incompatible with Article 123 of the TFEU. The exemption provided for in national law seems to imply that the prohibition of monetary financing enshrined in Article 123 of the TFEU may be disregarded by members of the Monetary Council (including the Governor) when acting in the context of the foundations and business associations under MNB ownership. This incompatibility needs to be removed.

([32]) 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.

([33]) Section 162(3) and (4) of the MNB Act were adopted in order to remedy a law which was previously found unconstitutional by the Hungarian Constitutional Court (Decision Hungarian Constitutional Court – No 8/2016 of 31 March 2016). 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.

([34]) In line with their articles of association the MNB foundations have to invest their endowment in low-risk securities such as government bonds and Treasury bills, property, art, and cash and then use the proceeds from those investments to fund themselves and provide financing for achieving their goals.

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5.1.4. Integration in the ESCB

Objectives

Section 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 Section 3(2) of the MNB Act is reduced to supporting the economic policy in Hungary. The provision has to be aligned to the secondary objective of the ESCB enshrined in Article 127(1) of the TFEU and Article 2 of the ESCB/ECB Statute 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(1), 9, 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), 9, 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.));
- 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. The Hungarian authorities are invited to remedy the abovementioned incompatibilities.

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 2016. It fell further to 0.2% by August 2016 and then increased gradually to 2.4% by end-2017. In March 2018, the reference value was 1.9%, calculated as the average of the 12-month average inflation rates in Cyprus, Ireland and Finland plus 1.5 percentage points. The corresponding inflation rate in Hungary was 2.2%, i.e. 0.3 percentage points above the reference value. The 12-month average inflation rate is projected to remain above the reference value in the months ahead.

Table 5.1:
Hungary - Components of inflation

	2012	2013	2014	2015	2016	2017	Mar-18	weights in total 2018
					(percentage change)[1]			
HICP	5.7	1.7	0.0	0.1	0.4	2.4	2.2	1000
Non-energy industrial goods	2.6	0.3	0.0	0.8	1.0	0.5	0.4	224
Energy	8.6	-6.1	-6.6	-7.4	-3.7	4.2	1.9	146
Unprocessed food	6.2	6.9	-1.9	3.6	0.0	1.8	2.4	77
Processed food	9.0	4.8	2.4	0.5	1.0	3.9	4.8	209
Services	4.1	3.6	2.3	2.2	1.8	1.9	1.9	344
HICP excl. energy and unproc. food	5.0	3.0	1.6	1.3	1.4	2.1	2.3	776
HICP at constant tax rates	3.5	1.2	0.0	0.0	0.6	2.9	2.7	1000
Administered prices HICP	5.1	-4.0	-5.1	-0.2	0.9	1.1	1.2	162

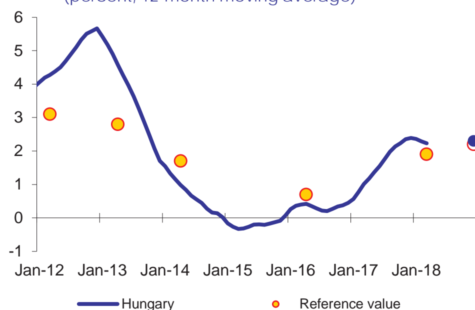
1) Measured by the arithmetic average of the latest 12 monthly indices relative to the arithmetic average of the 12 monthly indices in the previous period.

Sources: Eurostat, Commission services.

5.2.2. Recent inflation developments

Over the last two years Hungary exited from a very low inflation environment. Annual HICP inflation was in negative territory in mid-2016, but it turned positive in September 2016, as energy prices increased. At end-2016, inflation started to rise steeply, reaching 2.9% by February 2017 and it slightly moderated thereafter, mostly explained by energy price fluctuations. Overall, in 2016, headline inflation remained low at an average of 0.4% for the year as a whole and it increased to 2.4% in 2017, due to rising food and energy price inflation. During the last two years, annual HICP in Hungary was higher than in the euro area, except in mid-2016 when Hungary recorded negative inflation.

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

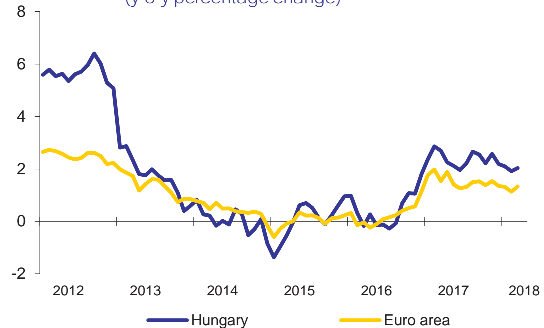


Hungary — Reference value

Note: The dots in December 2018 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2018 Forecast.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) was less volatile than HICP inflation over the past two years. It stood at around 1.4% throughout 2016 and early 2017, before increasing to around 2.5% by August 2017 and remaining at around that level till early 2018. The rise in core inflation was largely due to processed food, which was on a rising inflation trend, partly reflecting increases in excise duties on tobacco. Non-energy industrial goods inflation moderated slightly in 2017 while services inflation remained at a moderate level despite fast expansion of disposable income and wage costs. While the inflation of labour intensive services rose at a relatively fast pace, inflation of other services, in particular telecommunication was negative in 2017. Domestic industrial producer prices inflation was over 3% at end-2017, signalling the presence of cost price pressures.

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



Hungary — Euro area

Source: Eurostat.

5.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and cyclical stance

Hungary's real GDP increased by 4% in 2017 after a temporary lull in 2016. In 2017, GDP grew above potential helped by a supportive external environment and accommodative domestic policies. Consumer confidence strengthened and private consumption was supported by rapid wage rises and continued employment growth. Gross

Table 5.2:

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

	2012	2013	2014	2015	2016	2017	2018[1)]	2019[1)]
HICP inflation								
Hungary	5.7	1.7	0.0	0.1	0.4	2.4	2.3	3.0
Euro area	2.5	1.3	0.4	0.0	0.2	1.5	1.5	1.6
Private consumption deflator								
Hungary	6.2	1.8	0.9	-0.2	-0.2	2.3	2.3	3.0
Euro area	1.9	1.1	0.5	0.3	0.4	1.4	1.5	1.6
Nominal compensation per employee								
Hungary	1.7	1.8	0.8	-1.5	4.0	7.9	7.4	5.6
Euro area	1.8	1.6	1.4	1.4	1.2	1.6	2.4	1.9
Labour productivity								
Hungary	-1.8	1.0	-0.6	0.9	-0.4	2.0	3.1	2.7
Euro area	-0.1	0.6	0.7	1.0	0.4	0.8	1.0	1.0
Nominal unit labour costs								
Hungary	3.6	0.8	1.4	-2.4	4.4	5.8	4.2	2.8
Euro area	1.9	1.0	0.6	0.5	0.7	0.8	1.4	1.0
Imports of goods deflator								
Hungary	4.3	-0.9	0.1	-1.1	-2.4	1.9	2.0	1.6
Euro area	2.6	-2.0	-2.4	-3.4	-3.4	3.4	1.2	0.7

1) Commission services' Spring 2018 Forecast.

Source: Eurostat, Commission services.

fixed capital formation grew by around 17% year-on-year in 2017. The resumption of EU funds' absorption under the new multiannual financial framework was an important driver of the acceleration. Business and household investment also increased dynamically as the global economic recovery improved the prospects for businesses and strong demand for new homes spurred the construction of dwellings. Fiscal policy measures and favourable financing conditions further supported domestic demand. Trade flows accelerated in 2017 and net exports contributed negatively to GDP growth. According to the Commission services Spring 2018 Forecast, GDP growth is projected to 4.0% in 2018, slowing down to 3.2% in 2019. The output gap is positive and widened further in 2017.

The fiscal policy stance, as measured by the change in the structural balance, slightly tightened in 2016, but it significantly loosened in 2017 (by some 1¼% of GDP). According to the Commission services' Spring 2018 Forecast, which is based on a no-policy change assumption, the fiscal stance is expected to remain expansionary in 2018, followed by a partial reversal of this effect in 2019.

Monetary policy, conducted within an inflation targeting framework ([35]), has remained highly accommodative. The MNB reduced its policy rate to 0.9% by May 2016 and has left it unchanged since then, while signalling that the base rate will stay at this level at least until mid-2019. The central bank loosened its policy further via gradually limiting access to the three-month deposit facility and injecting additional forint liquidity via FX swap tenders. The MNB reduced its overnight deposit rate from minus 5 basis points to minus 15 basis points in September 2017. It also made efforts to lower long-term rates, including via new unconventional measures, such as the Mortgage bond purchase programme and IRS tenders, which were both announced in November 2017. In view of the recovery in private sector lending, the MNB ended its SME-financing Funding for Growth Scheme in early-2017. Net lending to the private sector increased moderately in an environment of negative real interest rates.

Wages and labour costs

Employment continued to expand in 2016 and 2017 to reach new historic highs. The improvement in the labour market started already

([35]) 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).

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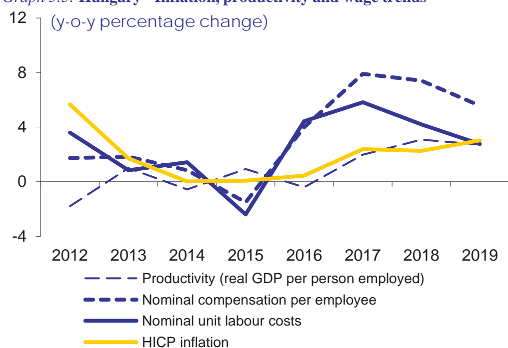
in 2013, supported by a public work scheme. In 2017, the number of public workers decreased significantly but private labour demand quickly absorbed the difference. As a result, the unemployment rate fell to a record low of 4.2% in that year. Employment growth slowed down at the end of 2017 as the labour market became increasingly tight. Labour shortage generated strong wage growth and nominal wages rose by more than 12% in 2017.

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



Source: Eurostat, Commission services' Spring 2018 Forecast.

Labour productivity growth was negative in 2016 and 2% in 2017. Nominal compensation per employee started to increase strongly in 2016, albeit from a low level. It increased sharply further in 2017, but less so than nominal wages, due to a 5 pp. cut in social security contributions. As a result, nominal unit labour cost rose by 4.4% and 5.8% in both 2016 and 2017, well above the euro area average. Looking ahead, compensation per employee growth is set to remain high in 2018, but it is to slow down somewhat in 2019. As productivity is projected to increase by around 3% in both years, nominal ULC growth is projected to moderate to below 3% by 2019.

External factors

Given the high degree of openness of the Hungarian economy, developments in import prices play an important role in domestic price formation. Import prices are mainly influenced by energy and commodity prices, which also represent a relatively high weight in the HICP basket. Growth of import prices (measured by the imports of goods deflator), had a strong deflationary effect in 2016, while in 2017 a similarly strong inflationary impact started to dominate, both mostly explained by fluctuations in the international oil price.

Over the last two years exchange rate fluctuations influenced import price dynamics only marginally. The forint's nominal effective exchange rate (measured against a group of 36 trading partners) appreciated on average by 0.5% in 2016 and by further 1.7% in 2017. The change of the nominal effective exchange rate would suggest deflationary pressures, but the pass-through of the exchange rate appreciation to consumer prices appears much smaller than in the past. Looking ahead, rising import prices are expected to contribute positively, but moderately to inflation, as the global recovery continues in 2018.

Administered prices and taxes

The share of administered prices ([36]) in the HICP basket is relatively high in Hungary at around 16%, compared to the euro area average (13%). Administered prices increased by 0.9% in 2016 and 1.1% in 2017, chiefly on account of dynamic inflation of pharmaceutical products and recreational and sport activities. However, regulated energy and other utility prices practically did not change in 2016 and 2017. Overall, administered prices had a minor effect on headline inflation, contributing just 0.2 pp. in both 2016 and 2017.

Changes in taxation had an overall downward effect on inflation in 2016-2017. Excise duty temporarily increased on fuel for three months at the end of 2016. Excise duty on tobacco increased by 29% in three steps in 2016-2017. In 2016, VAT was reduced on pork carcasses and new flats from 27% to 5%. In 2017 VAT was reduced on eggs and poultry from 27% to 5%, on fresh milk from 18% to 5%, on internet and restaurant services from 27% to 18%. Overall, changes in taxation lowered headline inflation by 0.2 pp. in 2016 and by 0.5 pp. in 2017. Starting from 2018, the VAT on internet and restaurant services was reduced further as well as the VAT on fish and pork offal, which would have a downward effect on headline inflation. However, some carry over effects of the increase in excise duties will play a role as well in 2018.

([36]) 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/HICP-AP-classification-2001-February-2017/

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Medium-term prospects

Inflation picked up in 2017 and is projected to increase further as domestic price pressures develop. Price growth is expected to be broad based, as energy prices rise further and services inflation increases on the back of strong wage growth. Inflation can be foreseen to rise towards the central bank’s target of 3%. Accordingly, the Commission services' Spring 2018 Forecast projects HICP inflation to average 2.3% in 2018 and 3.0% in 2019.

Risks to the inflation outlook appear to be on the upside. These risks relate mainly to a stronger-than-expected recovery of wages, as they are expected to continue to grow rapidly, affected also by minimum wage hikes. Households' returning confidence, rising asset prices and intensifying lending could also strongly increase consumption and thus inflation. Slower than expected global economic growth represents the main potential downside risks.

The level of consumer prices in Hungary stood at about 58% of the euro area average in 2016, with the relative price gap larger for services than for goods. This suggests that there is a significant potential for further price level convergence in the long term, as GDP per capita in PPS (around 63% of the euro area average in 2016) increases 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 ([37]). Since then, the general government deficit has been kept below 3% of GDP. Overall, the headline deficit did not not change notably during 2016 and 2017. It decreased to 1.7% of GDP in 2016 from 1.9% in the previous year, and then rose to 2.0% in 2017. Total government revenue and expenditure relative to GDP declined by more than 3.5 pp. between 2015 and 2017. The revenue-to-GDP ratio dropped from 48.2% in 2015 to 44.9% in 2016 and then further to 45.5% in 2017. To a considerable extent, this development resulted from decreased EU fund absorption. Despite some recovery in EU co-financed projects in 2017, the level of EU funds spent still remained some 3 pp. below the level seen in 2015. At the same time, government revenues without EU funds also decreased over this period. This reflected significant tax cuts (in particular the reduction of the employers' social contribution and corporate income tax rates in 2017), which were partly compensated by extra revenues due to dynamic wage growth and temporary revenue windfalls benefiting corporate income tax proceeds. Apart from decreased EU funds, declining interest outlays and social transfers and one-off receipts from land sales (accounted as negative expenditure) also contributed to the moderation of the expenditure ratio. However, these savings were partially absorbed by increased capital expenditure, public wage bill and other current spending.

The 2017 budgetary outturn over-achieved the deficit target set in the 2017 Convergence Programme by 0.4 pp. of GDP. While tax receipts exceeded the plans, spending on goods and services turned out to be considerably lower than expected. These deficit-improving developments were just partly offset by higher-than-planned capital expenditure from domestic sources and extra spending on public wages and social transfers. Following a temporary economic slowdown in 2016, the budgetary position significantly benefited from the acceleration of economic recovery in 2017. The strong growth of major tax bases reduced the fiscal impact of tax cuts, whereas nominal spending increases were counterbalanced by a favourable denominator effect regarding the expenditure-to-GDP ratio. At the same time, the structural balance deteriorated sharply reflecting the widening of the output gap in the positive territory. While the fiscal stance somewhat tightened in 2016, the structural balance declined from around –1.8% of GDP to –3.0% in 2017, well below the country's MTO (i.e. –1.5% of GDP).

([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

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Table 5.3:
Hungary - Budgetary developments and projections **(as percentage of GDP unless indicated otherwise)**

Outturn and forecast [1]	2012	2013	2014	2015	2016	2017	2018	2019
General government balance	-2.4	-2.6	-2.6	-1.9	-1.7	-2.0	-2.4	-2.1
- Total revenues	46.1	46.7	46.8	48.2	44.9	44.5	44.7	45.0
- Total expenditure	48.5	49.3	49.4	50.1	46.5	46.5	47.1	47.1
of which:								
- Interest expenditure	4.6	4.5	4.0	3.5	3.2	2.8	2.6	2.5
p.m.: Tax burden	38.4	38.0	38.2	38.9	39.4	38.5	37.4	37.4
Primary balance	2.2	1.9	1.4	1.6	1.6	0.8	0.1	0.3
Cyclically-adjusted balance	-0.6	-1.3	-2.2	-2.0	-1.8	-2.8	-3.6	-3.3
One-off and temporary measures	0.7	0.1	-0.1	0.0	-0.1	0.4	0.0	0.0
Structural balance [2]	-1.3	-1.4	-2.1	-2.0	-1.8	-3.1	-3.6	-3.3
Government gross debt	78.4	77.1	76.6	76.7	76.0	73.6	73.3	71.0
p.m: Real GDP growth (%)	-1.6	2.1	4.2	3.4	2.2	4.0	4.0	3.2
p.m: Output gap	-3.7	-2.7	-0.7	0.3	0.3	1.6	2.4	2.3

1) Commission services' Spring 2018 Forecast.
2) Cyclically-adjusted balance excluding one-off and other temporary measures.
Source: Commission services.

The government debt-to-GDP ratio has been on a gradually declining path since 2011, albeit it still remained high for a middle income economy. It fell from 76.7% in 2015 to 73.6% by the end of 2017. The debt ratio decreased by 0.7 pp. in 2016. Although it was helped by a high primary surplus, the slowdown of nominal GDP growth made an adverse effect. With the debt ratio falling by a further 2.4 pp., the pace of debt reduction increased in 2017. This was thanks to the acceleration of nominal GDP growth, despite the contraction of the primary surplus and a sizeable debt-increasing effect stemming the pre-financing needs of EU funds.

5.3.2. Medium-term prospects

The 2018 budget was adopted by the Hungarian Parliament on 20 June 2017. It targets a headline deficit of 2.4% of GDP, indicating a continued fiscal expansion. Revenue-side measures, amounting to a deficit-increasing effect around 0.6% of GDP in net terms, most notably include a further reduction of employers' social contribution ([38]) and lowering of the VAT rate on selected items such as restaurant meals, fish food and internet. These tax cuts are expected to be partly compensated by extra tax revenues triggered by minimum wage increases and expected yields from measures aiming at improved tax collection efficiency. The budget also counts on a considerable deficit-increasing effect stemming from the phasing out of one-off receipts from land sales and a temporary extra revenue component in corporate income tax. To counterbalance this, government spending overall was set to grow rather moderately relative to the nominal GDP, but still above the rate of inflation.

The Commission services' Spring 2018 Forecast projects the current year's general government deficit at 2.4% of GDP, in line with the official target. The forecast estimates lower-than-budgeted tax revenues reflecting a more conservative economic growth projection. However, the impact of this on the deficit is offset by the assumed slower-than-planned expansion of capital spending due to expected delays in implementation. Based on a no-policy-change assumption, the deficit is projected to decrease to 2.1% of GDP in 2019. In structural terms the fiscal stance is estimated to loosen further in 2018, with the structural balance deteriorating to around –3 ½%, while some reversal is projected in 2019. At the same time, the debt ratio is expected to decline further to [below 71% by the end of 2019, supported by sustained high nominal GDP growth.]

The fiscal framework in Hungary is well-developed, after the wide-ranging revamp launched in 2011 has resulted in a set of rules and procedures to control debt accumulation. The most recent steps taken in autumn 2017 reinforced the domestic budget balance rules by clarifying their binding effect for the entire budget process.

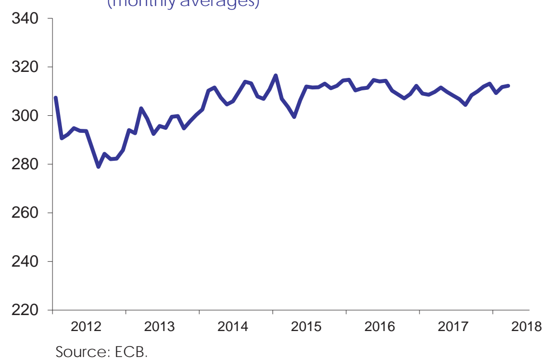
([38]) The budget initially incorporated 2 pp. reduction of the social contribution rate, which was increased to 2.5 pp in late 2017.

Nonetheless, some noteworthy shortcomings remain, weighing on the transparency and quality of fiscal policy-making. Specifically, the role of the Fiscal Council in scrutinizing and shaping fiscal policies is persistently weak, in contrast with its constitutionally-enshrined veto power over the annual budget bill. The implementation of the recently adopted medium-term budgetary framework has not yet delivered its desired effect to genuinely lengthen the fiscal planning horizon beyond its annual focus.

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).

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

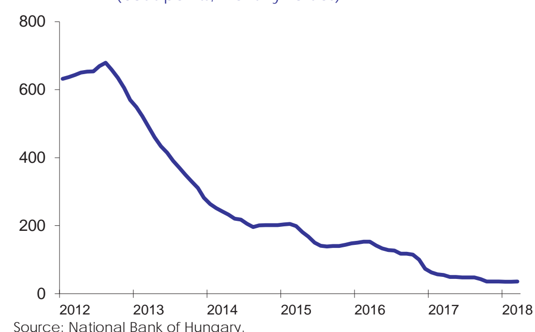


Source: ECB.

The forint was broadly stable against the euro over the past two years trading around 310 HUF/EUR. There were some forint appreciation pressures due to loose monetary policy in the euro area and improving economic fundamentals of Hungary, as indicated e.g. by credit rating agency upgrades. These pressures were, however, stopped by MNB announcements of new monetary easing measures. Notably, the forint strengthening between May and October 2016 of about 2 percent was ended with the introduction of volume caps on the three-month deposit facility and the forint liquidity providing FX swap tenders. A similar forint appreciation of about 2 percent between April and August 2017 was arrested by MNB's verbal intervention, hinting at the introduction of new instruments, which were then eventually announced in November 2017. Inter-day exchange rate volatility was on a declining trend during the past two years and the annual volatility peaks were the lowest among those of the last decade. In early 2018, the forint's exchange rate against the euro was at around 311 HUF/EUR.

International reserves decreased from around EUR 30bn at end-2015 to around EUR 24bn on average during the past two years. The level of international reserves was mainly influenced by sovereign debt management decisions (e.g. the very limited international bond issuance since 2014), 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 23bn by end-2017, which corresponded to about 19% of GDP. Hungary repaid the last tranches of its 2008 EU-IMF financial assistance in November 2014 (EUR 2bn) and early April 2016 (EUR 1.5bn) to the EU.

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



Source: National Bank of Hungary.

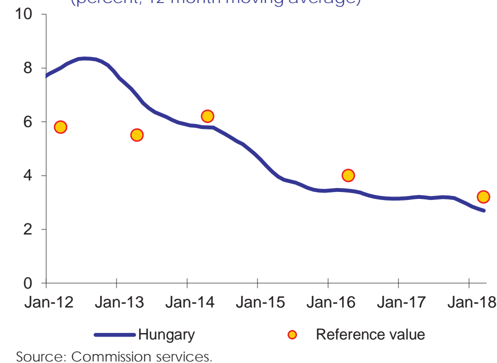
Short-term interest rate differentials vis-à-vis the euro area decreased from around 140 basis points in April 2016 to below 40 basis points by October 2017 and have remained around that level since then. The MNB reduced its policy rate by 15 basis points in May 2016 and kept it unchanged at 0.9% since then. Further decrease of the interest rate differential was driven by the gradual capping of the volume of the three-month deposit facility and the injection of additional forint liquidity, against the background of stable three-month euro-area money market rates. In early 2018, the 3-month

spread vis-à-vis the euro area reached around 40 basis points.

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 close to, but below 10 years.

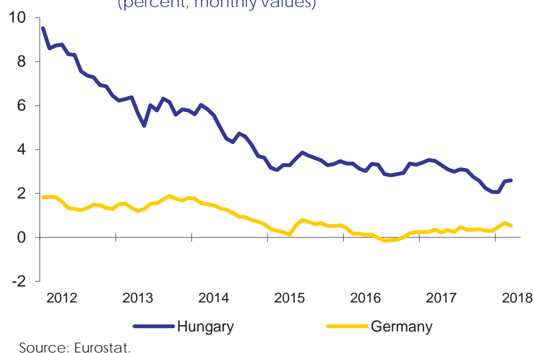
Graph 5.6: **Hungary - Long-term interest rate criterion**
(percent, 12-month moving average)



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 2016 convergence assessment of Hungary. It then gradually decreased from 3.4% to below 3% by end-2017. In March 2018, the latest month for which data are available, the reference value, given by the average of long-term interest rates in Cyprus, Ireland and Finland plus 2 percentage points, stood at 3.2%. In that month, the 12-month moving average of the yield on the Hungarian benchmark bond stood at 2.7%, i.e. 0.5 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 to around 2.8% by August 2016, before it rose to 3.5% by February 2017. It then started to decline again and reached 2.1% in December 2017, reflecting the MNB's efforts to extend even more its monetary stimulus to long-term rates, mainly via mortgage bond purchases and IRS tenders. Hungary's long-term interest rate increased to around 2.6% by February 2018, in an environment of rising yields in major advanced economy bond markets. The long-term spread vis-à-vis the German benchmark bond stood at around 200 basis points in early 2018 ([39]).

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 2017, the Commission published its seventh Alert Mechanism Report (AMR 2018) under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.5), which concluded that issues related to the housing market and labour market existed but since overall risks remained contained, no In-Depth Review (IDR) was warranted for Hungary. There are signs of emerging capacity constraints and price pressures in the economy, which warrant attention. Real house prices, in particular, have continued to increase rapidly, albeit from undervalued levels. However, the still high share of non-performing mortgage loans could benefit from a recovery in the housing market through their improved marketability. At the same time, while there have been gains in export market shares, supported by a growing car industry, cost competitiveness has deteriorated as reflected in dynamic growth in unit labour costs.

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

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

	2012	2013	2014	2015	2016	2017
Current account	1.7	3.8	1.5	3.4	6.0	2.8
of which: Balance of trade in goods	2.9	3.3	2.0	4.0	4.1	1.9
Balance of trade in services	3.8	3.7	4.4	4.9	5.9	5.8
Primary income balance	-4.2	-2.6	-4.2	-4.5	-2.5	-4.1
Secondary income balance	-0.8	-0.6	-0.7	-1.0	-1.5	-0.9
Capital account	2.5	3.6	3.7	4.6	0.0	1.2
External balance [1)]	4.3	7.3	5.2	8.0	6.0	4.0
Financial account	4.7	6.2	4.1	5.9	3.3	1.9
of which: Direct investment	-2.2	0.0	-2.7	-2.3	-2.4	-1.7
Portfolio investment	-1.5	-3.0	3.0	5.1	4.3	3.1
Other investment [2)]	11.7	8.1	3.1	7.6	6.8	0.5
Of which International financial assistance	3.9	5.0	1.9	0.0	1.3	0.0
Change in reserves	-3.3	1.1	0.7	-4.4	-5.4	0.0
Financial account without reserves	8.0	5.1	3.3	10.4	8.7	1.9
Errors and omissions	0.4	-1.1	-1.1	-2.1	-2.6	-2.1
Gross capital formation	19.5	21.0	23.3	21.8	19.8	22.5
Gross saving	21.2	24.8	24.8	25.2	25.9	25.5
Gross external debt	157.4	144.7	144.6	130.0	122.2	103.0
International investment position	-93.6	-83.1	-80.3	-68.4	-60.0	-54.8

1) The combined current and capital account.
2) Including financial derivatives.

Sources: Eurostat, Commission services, Magyar Nemzeti Bank.

5.6.1. Developments of the balance of payments

According to balance of payments data, after peaking at 8% of GDP in 2015, the surplus of Hungary's external balance (i.e. the combined current and capital account) declined to around 6% of GDP in 2016 and to 4% of GDP in 2017. The current account surplus also reached 6% of GDP in 2016, as the trade in services and the income balances improved. In 2017, it lowered to around 3% of GDP as the surplus on the trade in goods balance decreased and the income balance slipped back. The surplus of the capital account disappeared in 2016 as absorption of EU funds halted temporarily due to the switch to the new multiannual financial framework. In 2017, the capital account recorded a surplus again, as absorption of EU funds resumed.

Hungary's savings-investment surplus increased significantly in 2016 as gross fixed capital formation dropped markedly. The decline was due to the lower absorption of EU funds at the end of the 2007-2013 Multiannual Financial Framework. In addition, the already high saving rate increased further in 2016, due to the corporate sector. In 2017, the savings-investment surplus decreased as investment picked up rapidly and savings started to decrease on improving consumer confidence. Overall investment as a share of GDP largely fluctuated between 2015 and 2017, reflecting the stop-and-go effect of EU funds. In 2017, the investment rate remained at a somewhat low level compared to the pre-crisis years.

Over the last two years price and cost competitiveness indicators of Hungary have deteriorated. The nominal effective exchange rate of the forint and the real-effective exchange rate deflated by HICP appreciated slightly in 2016 and somewhat more in 2017. The real-effective exchange rate deflated by ULC increased markedly both in 2016 and 2017, due to the fast wage growth and improving labour market. Hungary's export performance slightly deteriorated in 2016, but improved in 2017.

Mirroring a continuous external surplus, the financial account has also been positive. Direct investment registered a net inflow of 2.4% of GDP in 2016 and 1.7% of GDP in 2017. Portfolio investment net outflows reached 4.3% of GDP in 2016 and 3.1% in 2017, partly reflecting the withdrawal of foreign investors from forint-denominated government securities. Other investment continued to register large outflows in 2016, but its net flows stabilised in 2017, while

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Table 5.5:
Hungary - Market integration

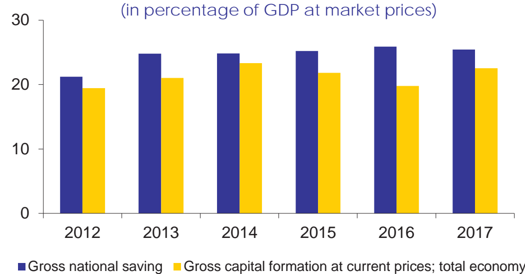
	2012	2013	2014	2015	2016	2017
Trade openness [1] (%)	92.0	91.6	92.4	93.5	94.2	95.4
Trade with EA in goods & services [2)+3)] (%)	50.5	50.7	53.0	53.8	54.5	54.2
Export performance (% change) [4]	-2.5	1.6	4.9	4.2	-0.5	1.2
World Bank's Ease of Doing Business Index rankings [5]	54	54	54	42	41	48
WEF's Global Competitiveness Index rankings [6]	60	63	60	63	69	60
Internal Market Transposition Deficit [7] (%)	1.4	0.5	0.7	0.6	0.4	0.8
Real house price index [8]	89.3	85.5	88.3	100.0	113.61	120.5
Residential investment [9] (%)	2.0	1.8	1.9	2.2	2.4	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.
(November data, as of 2016 date refers to the year of publication).
8) Deflated house price index (2015=100) (Eurostat).
9) Gross capital formation in residential buildings (in % of GDP) (Eurostat).

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

international reserves followed a very similar pattern to this in 2016 and 2017. The decrease of gross external debt proceeded in 2016 and 2017 at a fast pace, reaching 103% of GDP at the end of this period. The net international investment position improved from around -94% of GDP in 2012 to around -55% of GDP by end-2017.

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

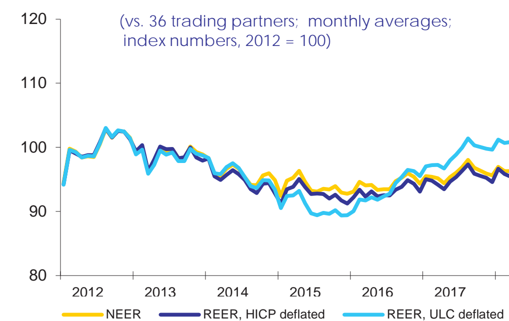


Source: Eurostat, Commission services.

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, the last instalment was repaid in early April 2016.

According to the Commission services' Spring 2018 Forecast, which is based on national accounts data, the external surplus is expected to remain at around 4% of GDP in both 2018 and 2019.

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



Source: Commission services.

5.6.2. Market integration

The Hungarian economy is highly integrated with the euro area through trade and investment linkages. Trade openness increased from 92% in 2012 to 95% in 2017, reflecting the deeper integration of the Hungarian economy into continental and global supply chains. Flows with the euro area dominate trade, accounting for around 54% of the total trade in goods and services. The main goods trading partners in 2017 were all euro-area countries, namely Germany, Austria, Slovakia and Italy.

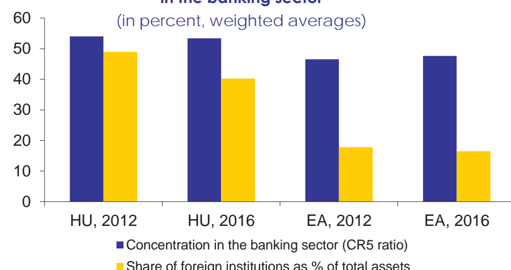
The stock of FDI in Hungary amounted to about 66% of GDP in 2016 (excluding SPEs), with FDI mainly originating from Germany, the Netherlands and Austria. The main recipient sectors of FDI were services (mostly 'professional, scientific and technical activities', trade and financial

intermediation) and manufacturing (30% 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. In the World Bank's Ease of Doing Business Hungary scores particularly poorly with regards getting electricity and protecting minority investors. In the World Bank's Worldwide Governance Indicators Hungary performs relatively worse in terms of "voice and accountability" and control of corruption, but they also point to problems with regulatory quality. According to the latest data, 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 4th Anti-Money Laundering Directive imposed transposition by 26 June 2017, and Hungary notified the Commission of the adopted measures within that deadline. The Commission is analysing these measures to assess their conformity with the directive.

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 have strengthened labour supply. Both domestic and international labour mobility is rather low in Hungary, although the latter has increased since the financial crisis.

Graph 5.10: **Hungary - Foreign ownership and concentration in the banking sector**
(in percent, weighted averages)

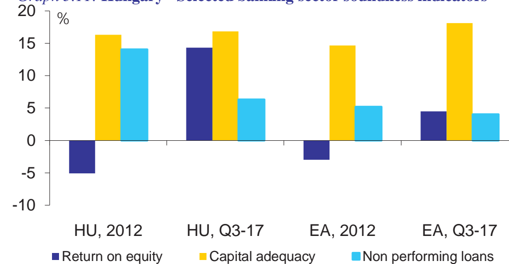


Source: ECB, Structural financial indicators.

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 40.2% in 2016 from 48.9% in 2012), reflecting the government's strategy to increase domestic ownership in the sector. Bank concentration, as measured by the market share of the largest five credit institutions in total assets, decreased to 53.4%, above the euro-area average of 47.6%.

The Hungarian banking system remains well-capitalized, with a capital adequacy ratio of around 17% at end-September 2017, which is somewhat below that of the euro area. Banks' profitability has recovered over the past two years and the sector's return on equity reached more than 14% in the year to end-September 2017, well above the 4.5% average of the euro area. Profits were boosted also by the unwinding of earlier provisions which makes it unlikely that this RoE-level will be sustainable in the current low interest rate environment and given the still low efficiency of the sector. The improvement of the loan portfolio quality continued and the NPL ratio reached 6.3% in September 2017, which is still above the average of the euro area. Thus, the Hungarian banking system slowly leaves behind the legacy of the previous decade's credit bubble.

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



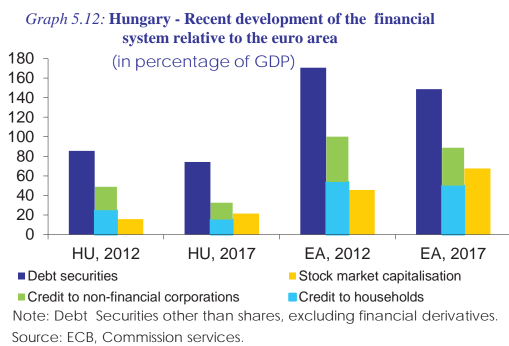
Note: Q3-17 Return on equity is calculated over the last four quarters.
Source: ECB, EC calculations.

The housing market recovery that started in 2014 continued in 2016 and 2017 with sizeable increases in real house prices in both years, supported by a new housing support scheme introduced by the government. Residential investment increased from historical lows reached in 2013-2014, but remained well below the levels seen in the last decade. The stock of housing loans in real terms broadly stagnated in 2017 compared to 2016, but new lending became very dynamic towards the end of the year.

The financial system in Hungary is smaller relative to GDP than that of the euro area. Domestic bank credit fell to 32% of GDP by the end-2017, split broadly evenly between households and non-financial corporations. Most household loans in

foreign currency were redenominated to forint loans by law effective from early 2015. The total capitalization of the Budapest Stock Exchange amounted to about 22% of GDP in 2017, well below the stock-market capitalization of the euro-area. The debt securities market remains small in comparison with the euro area average (74% against 149% of GDP) and is mainly used for re-financing public debt. The consolidated stock of private sector debt fell from around 102% in 2012 to around 71% of GDP in 2017, which is significantly below the private debt level of the euro-area.

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 2017, item 1373. The NBP Act has been slightly amended since the 2016 Convergence Report ([40]). In absence of any legislative action regarding the issues mentioned in the 2016 Convergence Report, the comments provided in the latter report are largely repeated in the 2018 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 an explicit 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 with the principle of central bank independence.

Article 23(1)(2) of the NBP Act 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 the 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

([40]) The amendments stem from the Law on the Bank Guarantee Fund, Deposit Guarantee Scheme and Resolution of 10 June 2016 (Dziennik Ustaw of 2016, item 996) and the Law on the amendment of the Law on the payment services and some other laws of 30 November 2016 (Dziennik Ustaw of 2016, item 1997).

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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.

The Commission recalls the recent changes in the judicial system threatening the judicial independence of the Polish Supreme Court and its First President ([41]), who also chairs the State Tribunal pursuant to Article 199(2) of the Polish Constitution. In this context, the NBP Act would benefit from an explicit clarification that the Governor of the NBP has the possibility to seek legal redress against his/her dismissal by the State Tribunal before the Court of Justice of the European Union, as enshrined in Article 14.2 of the ESCB/ECB Statute.

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 to the territory of the Republic of Poland (Article 2(3) of the NBP Act);

- definition and implementation of monetary policy (Articles 227(1) and (6) 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, 31-37 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

([41]) Cf. Commission Proposal for a Council Decision on the determination of a clear risk of a serious breach by the Republic of Poland of the rule of law, COM(2017) 835 final, para. 115-122.

Table 6.1:
Poland - Components of inflation

	2012	2013	2014	2015	2016	2017	Mar-18	weights in total 2018
	(percentage change)[1]							
HICP	3.7	0.8	0.1	-0.7	-0.2	1.6	1.4	1000
Non-energy industrial goods	0.9	-0.3	-0.9	-0.8	-1.5	-0.9	-0.9	313
Energy	8.0	-1.7	-1.2	-4.9	-3.7	2.9	1.8	135
Unprocessed food	4.2	3.3	-1.7	-1.7	1.6	4.6	4.5	76
Processed food	4.4	2.1	1.6	-0.3	0.7	2.5	2.5	176
Services	3.5	1.6	1.3	1.7	1.8	2.4	2.3	300
HICP excl. energy and unproc. food	2.8	1.0	0.6	0.3	0.3	1.1	1.1	789
HICP at constant tax rates	3.4	0.5	-0.3	-0.7	-0.2	1.6	1.4	1000
Administered prices HICP	5.3	1.8	1.2	1.0	2.1	1.2	1.2	146

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.

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);
- incomplete 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

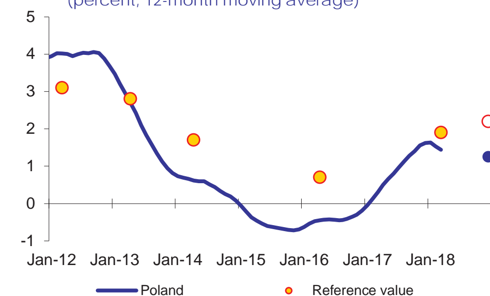
As regards the independence of the central bank, the prohibition on monetary financing and the central bank integration into the ESCB at the time of euro adoption, the legislation in Poland, in particular the NBP Act and the Constitution of the Republic of Poland are not fully compatible with the compliance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

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 2016. It then remained around -0.5% until autumn 2016, before it started to increase gradually, reaching 1.6% by end-2017. In March 2018, the reference value was 1.9%, calculated as the average of the 12-month average inflation rates in Cyprus, Ireland and Finland plus 1.5 percentage points. The corresponding inflation rate in Poland was 1.4%, i.e. 0.5 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**
(percent, 12-month moving average)



Note: The dots in December 2018 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2018 Forecast.

6.2.2. Recent inflation developments

Annual HICP inflation stayed negative between July 2014 and September 2016. In the first three quarters of 2016 it remained broadly stable fluctuating between -0.6% and -0.2%. After turning minimally positive in October 2016, inflation increased fast to a local high of 1.9% in February 2017 and gradually declined again to 1.3% in June 2017. The second half of 2017 was marked by a gradual inflation increase before it jumped to 2.0% in November and receded again to 1.6% in January 2018 before declining sharply to 0.7% in February-March 2018. This somewhat volatile pattern is explained by the strong swings in the dynamics of energy and unprocessed food prices during the analysed period. These reflected

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

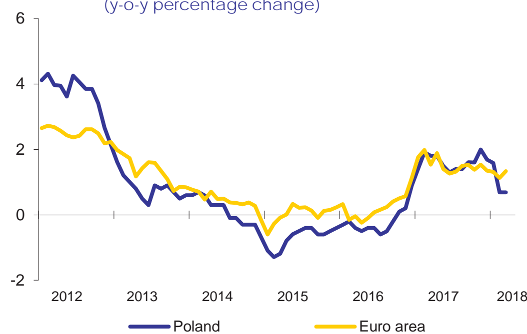
	2012	2013	2014	2015	2016	2017	2018 1)	2019 1)
HICP inflation								
Poland	3.7	0.8	0.1	-0.7	-0.2	1.6	1.3	2.5
Euro area	2.5	1.3	0.4	0.0	0.2	1.5	1.5	1.6
Private consumption deflator								
Poland	3.3	0.4	-0.1	-1.1	-0.4	1.9	1.5	2.5
Euro area	1.9	1.1	0.5	0.3	0.4	1.4	1.5	1.6
Nominal compensation per employee								
Poland	3.6	1.7	2.2	1.7	5.1	4.0	6.8	7.4
Euro area	1.8	1.6	1.4	1.4	1.2	1.6	2.4	1.9
Labour productivity								
Poland	1.5	1.5	1.5	2.3	2.4	3.2	3.5	3.4
Euro area	-0.1	0.6	0.7	1.0	0.4	0.8	1.0	1.0
Nominal unit labour costs								
Poland	2.0	0.2	0.6	-0.6	2.6	0.7	3.2	3.9
Euro area	1.9	1.0	0.6	0.5	0.7	0.8	1.4	1.0
Imports of goods deflator								
Poland	5.8	-1.2	-2.2	-1.3	-0.3	1.5	1.6	1.7
Euro area	2.6	-2.0	-2.4	-3.4	-3.4	3.4	1.2	0.7

1) Commission services' Spring 2018 Forecast.

Source: Eurostat, Commission services.

mainly developments in the global markets rather than Poland-specific factors. The relative stability of the zloty exchange rate in 2016 and its appreciation in 2017 coupled with slow price growth in Poland's trade partners dented import prices. Gradually strengthening nominal wage growth and higher producer prices' growth throughout most of 2017 contributed towards some increase in services and processed food prices. Strong market competition had a partially countervailing effect on them.

Graph 6.2: **Poland - HICP inflation**



Source: Eurostat.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) stayed in a narrow band of between 0.1% and 0.4% in the first ten months of 2016. It then increased to 1.3% in April 2017, to subsequently stay broadly stable until January 2018 at between 1.1% and 1.4%. In February 2018 core inflation declined significantly to 0.6% with a March reading at 0.4%. Non-energy industrial goods prices continued decreasing on an annual basis, but their deflation moderated somewhat from around -1.5% during most of 2016 to between -1.2% and -0.7% during 2017. This reflected still rather weak inflationary pressures and strong competition in global markets. Processed food price inflation gradually rose from 0% in January 2016 to 2.3% in March 2017 and after a correction in April 2017 (1.8%) generally followed an upward trend for the remainder of 2017 to 3% in December. In early 2018 it eased somewhat to 2%. This partly reflected a trend of rising unprocessed food prices during 2017 and subsequent easing in early 2018 and partly other demand and supply factors such as rising wages and a strong increase in private consumption. Strongly rising domestic demand and increasing difficulty in hiring adequately skilled workers leading to rising wages also played a role for services inflation. Its fast increase in the first month of 2017 was also related to rising housing rental costs, costs of TV subscriptions and postal services. In turn, a slowdown of services inflation in February-March 2018 was affected by sector-specific factors, such as a decline of financial services charges. Domestic industrial producer price inflation exceeded 6% in early 2017, but declined to around 1% in early 2018.

6.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and cyclical stance

Real GDP increased by 3.0% in 2016, a sizeable slowdown from 3.8% in 2015. In 2017 growth rebounded to 4.6%, well above estimates of potential output growth of around 3-3.5% and well above the euro area average. Growth was mainly driven by private consumption, benefiting from favourable labour market conditions, increased social benefits, consumer confidence gradually improving to record-high levels and comparatively low lending interest rates. After a sharp contraction in 2016, investment recovered in the second half of 2017. The output gap is estimated to have been closed in 2017 and a positive gap is expected to widen somewhat with projected robust real GDP growth of 4.3% in 2018 and 3.7% in 2019. Growth is projected to remain driven by domestic demand, with strong private consumption supported by rising wages and high consumer confidence, strong growth of public and a more gradual revival of private investment.

The fiscal stance, as measured by the change in the structural balance, was tightened in 2015 and 2016. In 2017 the fiscal stance as defined by this indicator remained neutral. A limited pro-cyclical expansion is expected in 2018, before the structural balance stabilises in 2019.

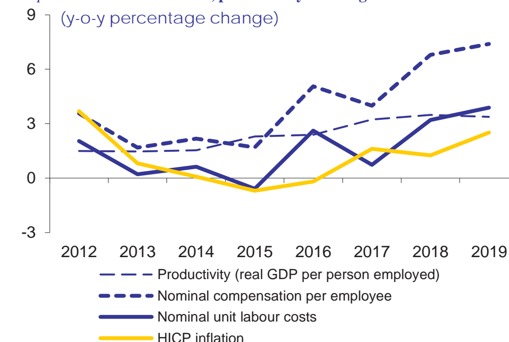
Monetary policy, conducted within an inflation targeting framework ([42]) remained accommodative over the past two years. The Monetary Policy Council (MPC) has kept the policy rate unchanged at 1.5% since March 2015. The growth rate of net bank credit to the non-financial private sector remained moderate, despite the historically low interest rates.

Wages and labour costs

Employment has been consistently on the rise since mid-2013 reaching the highest level since comparable data are available at the end of 2017 (both in terms of absolute numbers and of employment rate). In line with this, the unemployment rate has declined steadily since 2013, reaching record low levels of 4.9% in 2017.

Labour productivity growth rose slightly from 2.3% in 2015 to 2.4% in 2016 and it strengthened to 3.2% in 2017. Compensation per employee increased by around 5% in 2016, but its growth rate moderated to 4% in 2017. This translated into nominal ULC growing by 2.6% in 2016 and 0.7% in 2017, after a decline in 2015. With unemployment at record lows and expectations of a further reduction, wage pressures are expected to strengthen with ULC growth of over 3% in 2019.

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



Source: Eurostat, Commission services' Spring 2018 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) stayed negative between 2013 and 2016. 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. Higher oil prices translated into the deflator turning positive in 2017 (1.5%), despite some appreciation of the zloty during the year. Imported inflation is forecast to remain positive during 2018-2019.

Administered prices and taxes

The increase of administered prices ([43]), with a weight of around 15% in the HICP basket (compared to 13% in the euro area), exceeded HICP inflation in 2016, but was below HICP inflation in 2017. The average annual increase in administered prices was 2.1% in 2016 and 1.2% in 2017. The faster growth of administrative prices in

([42]) 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.

([43]) 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-2001-February-2017/

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2016 was mainly related to hikes in costs of selected legal services, while the dynamics of electricity prices was below overall HICP. Gas prices fell strongly in 2016 and to lesser extent also in 2017, while heat energy prices, after a moderate increase in 2016, decreased in 2017.

The impact of tax measures on overall consumer price developments was close to zero in 2016 and 2017 as constant tax inflation was exactly in line with headline inflation in 2016 and 2017.

Medium-term prospects

Looking ahead, inflation is expected to continue to gradually increase. The stronger zloty exchange rate in 2018, after an appreciation in late 2017 is expected to partly counteract strengthening pressure from accelerating wages amid a further tightening of the labour market. The Commission services' Spring 2018 Forecast projects annual HICP inflation to average 1.3% in 2018 and 2.5% in 2019.

Risks to the inflation outlook appear to be tilted to the upside. Wage growth could accelerate faster than currently projected and its pass through to prices can become stronger than was recently observed. Global commodity prices and the zloty exchange rate can surprise both ways with ensuing higher or lower inflationary pressure.

The level of consumer prices in Poland was at around 52% of the euro-area average in 2016. This suggests a significant potential for price level convergence in the long term, as GDP per capita in PPS (about 64% of the euro-area average in 2016) increases towards the euro-area average. On the other hand, in the last decade the 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, to make better use of increased labour immigration and to facilitate the effective allocation of labour market resources will play an important role in limiting wage pressures, resulting inter alia from negative demographic developments. As to product markets, there is scope to enhance the competitive environment, especially in the services and energy sectors. At the macro level, an appropriate monetary policy response to macroeconomic developments and 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 ([44]). The general government deficit declined from 2.3% of GDP in 2016 to 1.7% in 2017. The ratio of total government expenditure to GDP followed a downward trend between 2010, when it amounted to 45.8% of GDP and 2016 when it bottomed at 41.1% of GDP. The ratio increased marginally to 41.2% in 2017. Total government revenue remained at 38.8% of GDP in 2016 and increased to 39.6% of GDP in 2017. Its evolution was driven by better tax collection, especially of indirect taxes, and a very good situation on the labour market supporting income taxes and social security contributions.

The 2017 headline deficit (1.7% of GDP) turned out to be significantly lower than forecast in the 2017 edition of the Convergence Programme (2.9% of GDP). This difference stemmed mainly from higher actual revenue supported inter alia by measures to improve tax compliance. At the same time, expenditure, in particular gross fixed capital formation, remained at a lower level than projected in the Convergence Programme. In turn, the structural deficit followed a different path. After having reached 2½% of potential GDP in 2015, it decreased to 2% of potential GDP in 2016 and remained stable in 2017. This occurred in the context where Poland's economic situation and growth performance created particularly favourable conditions for a structural and permanent fiscal consolidation.

The general government debt, following its increase to 54.2% of GDP in 2016 (from 51.1% of GDP in 2015), decreased to 50.6% of GDP in 2017. The evolution of the general government debt in 2016 and 2017 was driven mainly by fiscal deficits and valuation effects reflecting the fluctuation of the zloty exchange rate, as around

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

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Table 6.3:

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

Outturn and forecast [1]	2012	2013	2014	2015	2016	2017	2018	2019
General government balance	-3.7	-4.1	-3.6	-2.6	-2.3	-1.7	-1.4	-1.4
- Total revenues	39.1	38.5	38.6	38.9	38.8	39.6	40.3	40.5
- Total expenditure	42.9	42.6	42.3	41.6	41.1	41.2	41.7	41.9
of which:								
- Interest expenditure	2.7	2.5	1.9	1.8	1.7	1.6	1.5	1.5
p.m.: Tax burden	33.0	32.9	32.9	33.3	34.5	35.0	35.5	35.5
Primary balance	-1.1	-1.6	-1.7	-0.9	-0.6	-0.1	0.1	0.1
Cyclically-adjusted balance	-3.8	-3.4	-3.0	-2.3	-2.0	-2.0	-2.2	-2.2
One-off and temporary measures	0.1	0.0	-0.2	0.0	0.0	0.0	0.0	0.0
Structural balance [2]	-3.9	-3.4	-2.8	-2.3	-2.0	-2.0	-2.2	-2.2
Government gross debt	53.7	55.7	50.3	51.1	54.2	50.6	49.6	49.1
p.m: Real GDP growth (%)	1.6	1.4	3.3	3.8	3.0	4.6	4.3	3.7
p.m: Output gap	0.2	-1.4	-1.2	-0.6	-0.6	0.7	1.5	1.5

1) Commission services' Spring 2018 Forecast.

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

Source: Commission services.

one third of the Polish debt was denominated in foreign currencies.

6.3.2. Medium-term prospects

The 2018 budget was adopted on 11 January 2018. It implies a continuation of major policies implemented in 2017. On the expenditure side, social spending is set to rise further. This will be driven in particular by the full-year impact of the lowering of the retirement age, which entered into force in the fourth quarter of 2017. On the revenue side, a further increase in tax collection is expected. It is set to occur mainly thanks to macroeconomic developments and additional measures to increase tax compliance, especially in the area of indirect taxation. The 2018 budget law projects the general government headline deficit at 2.7% of GDP, significantly higher than projected in the Commission services' Spring 2018 Forecast 1.4% of GDP. This is due to the assumption of a full execution of the central government expenditure in the budget.

According to the Commission services' Spring 2018 Forecast, under a no-policy-change scenario, the general government headline deficit is set to stabilise at 1.4% of GDP in 2019. Simultaneously, against the background of strong economic growth and a consequently increasing positive output gap, the structural general government balance is forecast to deteriorate from around 2% of GDP in 2017 to 2¼% of GDP in 2019. The general government debt-to-GDP ratio is forecast to decrease to 49.1% in 2019. However, considering that an important part of the sovereign debt is denominated in foreign currencies, the debt projections are subject to considerable uncertainty.

The national fiscal framework in Poland is overall strong. The numerical fiscal rules, which contain debt and expenditure rules, are the strongest element of the framework. A debt threshold anchored in the Constitution covers the general government, while a separate debt rule concerns local governments. Most of the general government sector is subject to the stabilising expenditure rule applied for the first time for the 2015 budget. The amendments to the rule in late 2015 that allowed for higher expenditure limits in the 2016 budget raised concerns about its credibility. Since then, the rule has not been modified and the authorities have been committed to it. Medium-term budgetary planning is based on the Multiannual State Financial Plan which covers four years and serves as a basis for the preparation of annual budgets, but does not provide targets for them. A reform to strengthen budgetary planning and procedures is underway. Poland has no fully-fledged fiscal council and has no plans to set it up. Some functions performed typically by fiscal councils are performed by different separate bodies, but this fragmented set-up reduces their impact.

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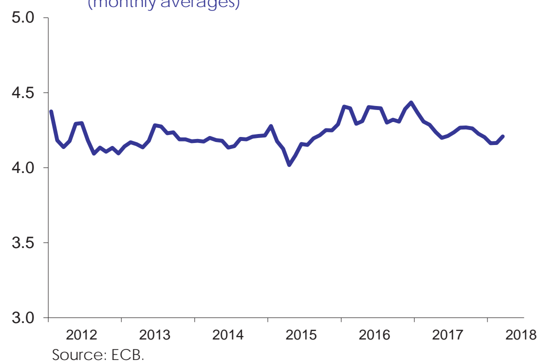
6.4. EXCHANGE RATE STABILITY

The Polish zloty does not participate in ERM II. Since April 2000, Poland has been operating 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.

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



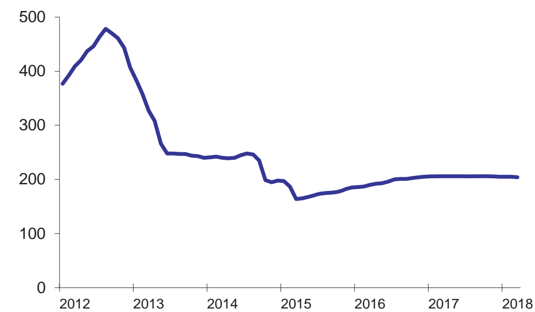
Source: ECB.

The zloty was trading at around 4.4 against the euro between April 2016 and late 2016, mainly within the range of 4.3-4.5 PLN/EUR. It appreciated between December 2016 and May 2017, cumulatively by almost 6%. The zloty then weakened somewhat against the euro until early October 2017 (to around 4.3 PLN/EUR) to subsequently strengthen again during the rest of 2017. Inter-day exchange rate volatility spiked in summer and then again in late 2016, but it moderated over 2017. In early 2018, the zloty's exchange rate against the euro was at about 4.2 PLN/EUR. Poland had benefited from a Flexible Credit Line arrangement with the IMF between 2009 and November 2017.

International reserves held by the NBP increased from around EUR 90 billion in early 2016 to EUR 108 billion by end-2016. During 2017 reserves decreased gradually to around EUR 94 billion by the beginning of 2018. The reserve-to-GDP ratio was at around 20% by end-2017. The level of international reserves was mainly influenced by reverse repo transactions, sovereign debt management decisions, inflows of EU funds and FX fluctuations.

Short-term interest rate differentials vis-à-vis the euro area increased slightly in 2016 from around 190 to about 200 basis points. They remained remarkably stable at around that level in 2017 and in early 2018, in line with the unchanged policy rates of the NBP and the ECB. In early 2018, the 3-month spread vis-à-vis the euro area stood at around 200 basis points.

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

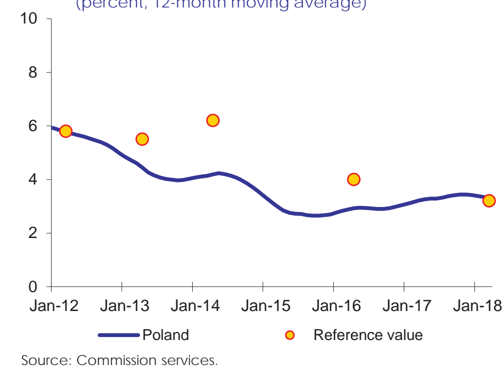


Source: Eurostat.

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 with a residual maturity of around 9 years.

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



Source: Commission services.

The Polish 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 last convergence assessment in 2016. It remained at a level slightly below 3% in most of 2016 before starting to gradually rise to about 3.4% by end-2017. In March 2018, the latest month for which data are available, the reference value, given by the average of long-term interest rates in Cyprus, Ireland and Finland plus 2 percentage points, stood at 3.2%. In that month, the 12-month moving average of the yield on the Polish benchmark bond stood at 3.3%, i.e. 0.1 percentage points above the reference value.

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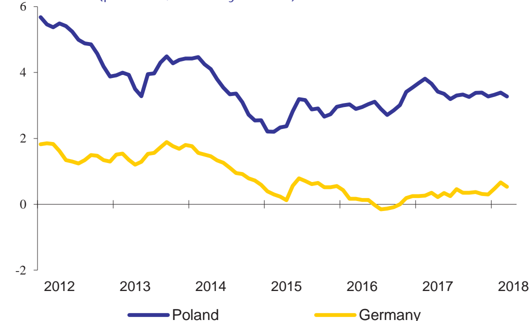
Table 6.4:
Poland - Balance of payments **(percentage of GDP)**

	2012	2013	2014	2015	2016	2017
Current account	-3.7	-1.3	-2.1	-0.6	-0.3	0.3
of which: Balance of trade in goods	-2.1	-0.1	-0.8	0.5	0.7	0.2
Balance of trade in services	1.5	1.9	2.2	2.5	3.3	4.0
Primary income balance	-3.1	-3.0	-3.4	-3.4	-4.0	-3.8
Secondary income balance	0.0	-0.1	-0.1	-0.2	-0.3	0.0
Capital account	2.2	2.3	2.4	2.4	1.0	1.3
External balance [1)]	-1.5	1.0	0.4	1.8	0.8	1.6
Financial account	-2.3	-1.1	-1.1	0.1	-0.1	0.3
of which: Direct investment	-1.2	-0.8	-2.4	-2.1	-1.2	-0.3
Portfolio investment	-3.9	0.0	0.4	0.7	-0.8	-1.0
Other investment [2)]	0.6	-0.5	0.7	1.4	-2.9	3.1
Change in reserves	2.2	0.2	0.1	0.2	4.8	-1.5
Financial account without reserves	-4.5	-1.3	-1.3	-0.1	-4.9	1.8
Errors and omissions	-0.8	-2.1	-1.5	-1.7	-0.9	-1.3
Gross capital formation	21.0	19.0	20.4	20.5	19.5	19.7
Gross saving	17.7	18.5	19.0	20.7	20.4	20.4
Gross external debt	72.1	70.5	71.2	70.4	75.1	67.8
International investment position	-65.3	-68.9	-69.1	-62.1	-60.7	-60.7

1) The combined current and capital account.
2) Including financial derivatives.

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

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



Source: Eurostat.

The long-term interest rate of Poland increased from below 3% in April 2016 to around 3.8% in early 2017, against the background of rising global long-term yields. Long-term interest rates then decreased in the following months and the benchmark for Poland reached around 3.2% in June 2017. Thereafter it slighlty increased again, mainly reflecting the general economic recovery which fuelled expectations of monetary tightening by major central banks resulting in globally higher long-term yields. Poland's long-term interest rate reached around 3.3% in early 2018.

The long-term interest rate spread vis-à-vis the German benchmark bond generally hovered around 300 basis points over the past two years, with the exception of late 2016 and early 2017 when it was somewhat higher. It was around 270 basis points in early 2018 ([45]).

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 2017, the Commission published its seventh Alert Mechanism Report (AMR 2018) under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.5), which concluded that issues related to the external investment position

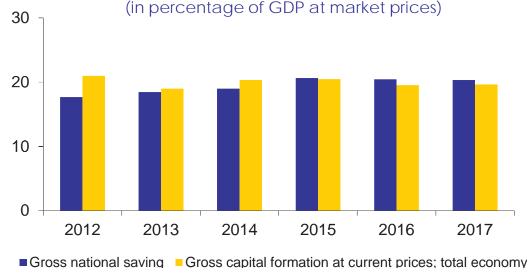
([45]) The reference to the German benchmark bond is included for illustrative purposes, as a proxy of the euro area long-term AAA yield.

existed but since overall risks remained limited, no In-Depth Review (IDR) was warranted for Poland. The current account deficit is now close to balance, allowing the net international investment position, which remains negative and relatively large, to improve slightly. However, external vulnerabilities appear to be contained, given that foreign direct investments account for a major part of foreign liabilities, while net foreign debt has continued to gradually decline in recent years.

6.6.1. Developments of the balance of payments

Poland's external balance (i.e. the combined current and capital account) has stayed positive since 2013, backed by a continued improvement in the trade balance. The deficit in the current account balance had decreased consistently since 2014 and turned into a slight surplus in 2017. The trade in goods balance shifted into a surplus in 2015 and has stabilised in positive territory since then, partially reflecting a drop in prices of imported energy commodities. The gradual improvement in the current account position was also supported by consistently strong performance of export of services. In 2014-2016, the negative primary income balance somewhat widened and the secondary income balance turned slightly negative. In 2017, the income balances remained broadly stable with a slight improvement.

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

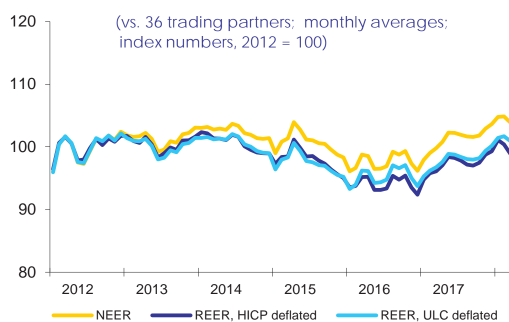


Source: Eurostat, Commission services.

After several years of a gradual increase, gross national saving (as a percentage of GDP) has stabilised since 2015. The 2016 fall in gross saving of the corporate and the government sectors was offset by higher savings by households. In 2017, the corporate sector gross saving rebounded and partially compensated for decreased household savings. At the same time, gross fixed capital formation (as a percent of GDP) declined in 2016 and recovered weakly in 2017. This was mainly driven by rising public investment spending. The private sector investment remained weak, and in relation to GDP is still below the levels observed among Poland's regional peers.

Poland's external competitiveness has remained robust. Poland's export performance (as measured by the growth of its exports relative to its markets) substantially improved in 2016, but in 2017 the pace of improvement slowed down. This was consistent with cost-competitiveness developments. After some years of depreciation, both the nominal and real effective exchange rate stayed relatively stable in 2016, before appreciating in 2017.

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



Source: Commission services.

In the financial account of the balance of payments, direct investment recorded a decreasing net inflow of 1.2% of GDP in 2016 and 0.3 % of GDP in 2017, compared with an average of 3.4% of GDP per annum over the 2005 – 2015 period. The portfolio investment showed net inflows in 2016 and 2017, primarily due to decreased residents' holdings of equity abroad and moderate inflows of non-residents' financing of the sovereign debt market. Other investment registered some net inflows in 2016, followed by a noticeable outflow in 2017.

According to the Commission services' Spring 2018 Forecast, which is based on national accounts data, the external balance is expected to remain around 1.5% of GDP in both 2018 and 2019.

Total gross external debt increased considerably from 70.4% of GDP in 2015 to 75.1% of GDP in 2016, but then decreased to 67.8% of GDP in 2017, with the negative net international investment position (NIIP) stabilising at around 61% of GDP in 2016 and 2017. Although this is well beyond the indicative threshold set in the MIP scoreboard (-35% of GDP), a major part of the

Table 6.5:
Poland - Market integration

	2012	2013	2014	2015	2016	2017
Trade openness [1] (%)	45.9	46.9	48.5	49.7	51.3	53.1
Trade with EA in goods & services [2)+3)] (%)	25.1	25.6	26.9	28.0	29.1	30.1
Export performance (% change) [4]	3.3	3.8	3.1	4.0	5.2	2.6
World Bank's Ease of Doing Business Index rankings [5]	55	45	32	25	24	27
WEF's Global Competitiveness Index rankings [6]	41	42	43	41	36	39
Internal Market Transposition Deficit [7] (%)	2.1	1.8	1.0	0.7	1.4	1.5
Real house price index [8]	101.1	96.3	97.4	100.0	102.3	104.3
Residential investment [9] (%)	3.2	3.0	3.0	2.5	3.0	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.
(November data, as of 2016 date refers to the year of publication).
8) Deflated house price index (2015=100) (Eurostat).
9) Gross capital formation in residential buildings (in % of GDP) (Eurostat).

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

NIIP consists of the accumulated stock of foreign direct investments. Since May 2009, the stability of the balance of payments had been supported by precautionary access to the IMF's Flexible Credit Line (FCL) arrangement. Poland gradually exited from the arrangement, lowering the size of the FCL in January 2015, 2016 and 2017 before terminating the access in November 2017.

6.6.2. Market integration

Poland's economy is well integrated with the euro area through both trade and investment linkages. Trade openness increased from 46% in 2012 to some 53% of GDP in 2017. The share of trade with euro-area partners expressed in percentage of GDP has also been increasing in recent years, reaching 30% in 2017. Poland's main euro-area trade partners are Germany, the Netherlands, Italy and France, while outside the euro area the main partners are the Czech Republic, Russia and the United Kingdom.

FDI inflows to Poland have mainly originated from the Netherlands, Germany, Luxembourg and France, which together provided over 50% of the FDI stock at the end of 2016. 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 around the average of euro-area Member States in international rankings. In the World Bank's Ease of Doing Business Poland scores comparatively poorly with regard to starting a business, followed by the sub-index related to enforcing contracts. In the World Bank's Worldwide Governance Indicators Poland performs relatively weakly in terms of "political stability and no violence" and the rule of law. According to the latest data, Poland lags behind in the transposition of EU directives as the deficit was at 1.5%, which is substantially above the target (0.5%) proposed by the European Commission in the Single Market Act (2011).

The 4th Anti-Money Laundering Directive imposed transposition by 26 June 2017. Poland communicated to the Commission adopted measures that partially transpose the directive on 17 April 2018, only after a reasoned opinion was addressed by the Commission to Poland on 8 December 2017 due to an absence of an appropriate response to the letter of formal notice from 19 July 2017. The Commission is analysing the communicated measures to assess their completeness and conformity with the directive.

The labour market situation is the best in Poland´s recent history and employment rates have risen to the point that labour shortages are affecting business activity. Overall, the labour market appears flexible as it is easy to arrange atypical work contracts and employ non-EU nationals and employment protection legislation does not appear to be very strict (as also measured by the 2013 OECD employment protection indicator). The

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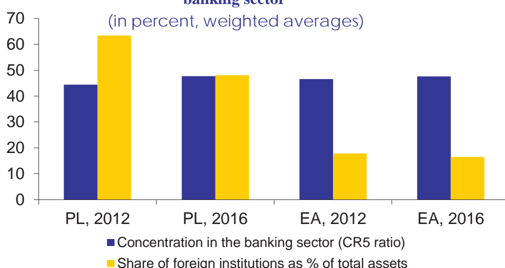
structural labour market challenges include low participation of certain groups and lack of labour market flexibility in some areas, such as a limited use of part-time employment arrangements. Existing barriers to labour market participation include disincentives to work originating from the benefit system and limited access to long-term care and childcare. Domestic labour mobility is hampered by sector-specific arrangements (such as the special social security system for farmers), shortcomings in the housing market and the transport infrastructure. After a steady rise in immigration in recent years, non-EU workers (especially from Ukraine) now play an important role in the Polish labour market.

Poland's financial sector is well integrated within the overall EU financial system. Foreign ownership in total assets of the Polish banking sector decreased from around 63% in 2012 to around 48% by 2016, in line with the government's strategy to boost domestic ownership. 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% at end-2016.

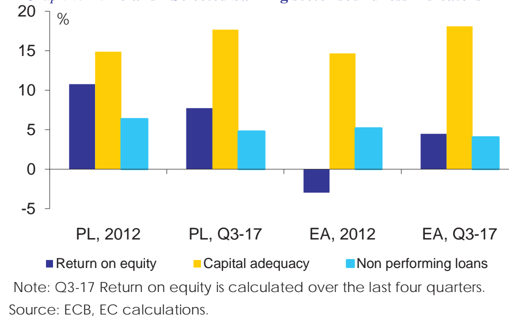
Graph 6.10: **Poland - Foreign ownership and concentration in the banking sector**



Source: ECB, Structural financial indicators.

The capital adequacy ratio of the banking sector increased to around 18% by end-September 2017, which is close to the average of the euro area. The amount of non-performing loans fell to 4.8%, somewhat above the euro-area average NPL level. Profitability, as measured by return on equity (ROE) decreased from double-digit levels early in the decade to around 8% by the third quarter of 2017, which is above the average of the euro area. The lower bank profitability in recent years is explained mainly by record low interest rates, higher fiscal burden on banks via the tax on financial sector assets and higher contributions to the Bank Guarantee Fund. In the future, profitability of the banking sector could be negatively affected also by pending proposals to address the issue of foreign-currency denominated mortgage loans.

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

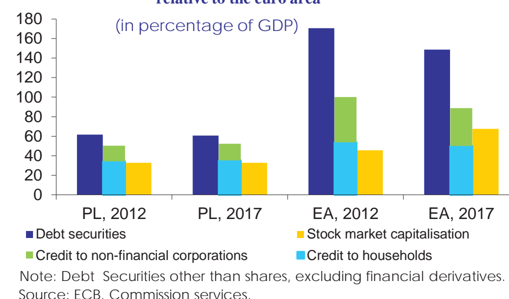


Note: Q3-17 Return on equity is calculated over the last four quarters.
Source: ECB, EC calculations.

According to Eurostat, real house prices in Poland started to increase slowly in 2014, following an earlier decline during 2011-2013. Real house prices grew by about 2% in 2017. Investment in dwellings has remained relatively stable at around 2.5-3% of GDP, while net bank lending for house purchase remained weak.

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 52% of GDP in 2017 from around 50% in 2012. The share of foreign-currency denominated loans (mainly in Swiss franc and to lesser extent in euro) continued to decline, but it still amounted to about one-third of outstanding total housing loans. Sovereign-bank links became stronger in Poland not only via increasing state-ownership, but also though the rising share of the bank tax deductible sovereign bonds in banks' balance sheet (reaching around 14% of the total at end-2017).

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 reached 33% of GDP in 2017, the same level as in 2012. The debt securities market is one of most liquid in the region but remains small in comparison with the euro area (61% against 149%

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of GDP) and is dominated by government bonds. Consolidated private sector debt increased from around 73% in 2012 to 76% of GDP in 2017, significantly below the euro-area average.

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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 2016. Therefore, the comments provided in the Convergence Report 2016 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 Finance 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.

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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 7.1.2., 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

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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).

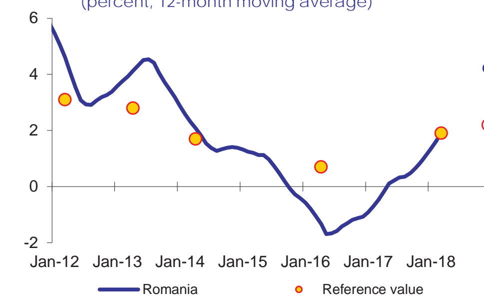
7.1.5. Assessment of compatibility

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. The Romanian authorities are invited to remedy the abovementioned incompatibilities.

7.2. PRICE STABILITY

7.2.1. Respect of the reference value

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



Note: The dots in December 2018 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2018 Forecast.

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 Romania in 2016. It has increased steadily since then, moving into positive territory since May 2017 and gradually increasing to 1.1% by December 2017. In March 2018, the reference value was 1.9%, calculated as the average of the 12-month average inflation rates in Cyprus, Ireland and Finland plus 1.5 percentage points. The corresponding inflation rate in Romania was 1.9%, i.e. at the reference value. The 12-month average

Table 7.1:
Romania - Components of inflation

	2012	2013	2014	2015	2016	2017	Mar-18	weights in total 2018
				(percentage change)[1]				
HICP	3.4	3.2	1.4	-0.4	-1.1	1.1	1.9	1000
Non-energy industrial goods	2.4	2.0	1.6	1.0	-0.7	0.9	1.1	274
Energy	6.9	4.1	2.3	-2.7	-4.4	0.5	3.3	121
Unprocessed food	0.6	6.4	-0.7	-3.4	-2.5	2.9	3.3	153
Processed food	3.5	2.3	0.2	-1.6	-0.9	2.2	3.0	214
Services	4.2	2.6	3.1	2.2	0.7	-0.5	0.4	238
HICP excl. energy and unproc. food	3.3	2.3	1.7	0.7	-0.2	0.8	1.4	725
HICP at constant tax rates	3.2	3.0	1.1	1.2	2.1	2.0	2.5	1000
Administered prices HICP	5.3	6.0	2.0	1.6	-2.5	-2.3	-0.7	109

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.

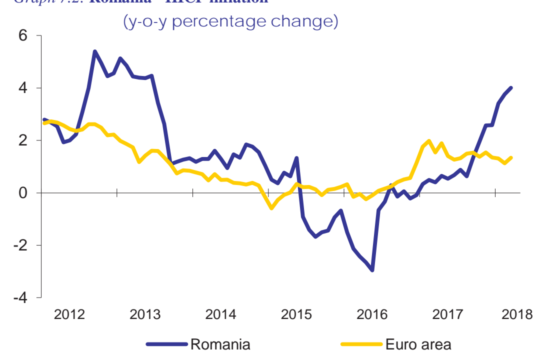
inflation rate is projected to increase well above the reference value in the months ahead.

7.2.2. Recent inflation developments

Inflation in recent years has been markedly influenced by successive reductions of the VAT rates for different categories of products and in 2016, also by decreasing global oil prices. Inflation entered negative territory in June 2015, mainly on account of a cut of the VAT rate on food from the standard 24% rate to a reduced 9% and persistently weak energy inflation. Inflation further declined in the first quarter of 2016 after the standard VAT rate was cut by 4 percentage points to 20%. After reaching a -3% low in May 2016, HICP inflation progressively increased, but remained subdued due to a further 1 percentage point cut in the standard VAT rate in January 2017 and a reduction in excise duties on fuel. Inflation started to accelerate in the second half of 2017, moving from 0.6% in August to 2.6% in December 2017. Overall, HICP inflation was 1.1% in 2017. Inflation further accelerated in early 2018 as the effect of the January 2017 tax cuts faded away, reaching 4% in March.

In 2016, core inflation (measured as HICP inflation excluding energy and unprocessed food) was slightly negative (-0.2%) but significantly higher than headline HICP inflation (-1.1%). This sharp difference mainly reflecting the steep drop of energy prices (-4.4%) that was in line with declining global fuel prices. Over the course of the 2017, core inflation increased by more than 1.5 percentage points, from 0.3% in January to 1.9% in December and reached 0.8% for the year as a whole. Core inflation in 2017 was slightly lower than headline inflation (1.1%) as energy price inflation remained subdued (0.5%) due to lower excise duties on fuel between January and October.

Graph 7.2: **Romania - HICP inflation**



Source: Eurostat.

Both processed and unprocessed food price inflation were negative in 2016, mainly due to the 4 percentage points VAT rate cut taking effect in January. In 2017, processed and unprocessed food price inflation turned positive despite a further 1 percentage point cut in the VAT rate. Similarly, non-energy industrial goods price inflation was negative (-0.7%) in 2016 and turned positive (0.9%) in 2017. Services price inflation remained subdued in both 2016 (0.7%) and 2017 (-0.5%).

Producer prices in industry, which had fallen for three consecutive years, accelerated in 2017 and grew by 3.6% for the year as a whole.

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 4.8%

Table 7.2:
Romania - Other inflation and cost indicators **(annual percentage change)**

	2012	2013	2014	2015	2016	2017	2018 1)	2019 1)
HICP inflation								
Romania	3.4	3.2	1.4	-0.4	-1.1	1.1	4.2	3.4
Euro area	2.5	1.3	0.4	0.0	0.2	1.5	1.5	1.6
Private consumption deflator								
Romania	4.6	2.6	1.2	0.9	0.9	2.0	4.2	3.4
Euro area	1.9	1.1	0.5	0.3	0.4	1.4	1.5	1.6
Nominal compensation per employee								
Romania	9.4	3.8	6.7	1.9	10.1	16.0	8.7	6.7
Euro area	1.8	1.6	1.4	1.4	1.2	1.6	2.4	1.9
Labour productivity								
Romania	6.4	4.4	2.3	5.3	5.8	4.2	3.6	3.9
Euro area	-0.1	0.6	0.7	1.0	0.4	0.8	1.0	1.0
Nominal unit labour costs								
Romania	2.9	-0.6	4.3	-3.3	4.1	11.3	4.9	2.7
Euro area	1.9	1.0	0.6	0.5	0.7	0.8	1.4	1.0
Imports of goods deflator								
Romania	7.5	-6.5	-1.9	-1.3	-1.4	4.9	4.0	3.1
Euro area	2.6	-2.0	-2.4	-3.4	-3.4	3.4	1.2	0.7

1) Commission services' Spring 2018 Forecast.

Source: Eurostat, Commission services.

in 2016, with private consumption serving as the main motor of growth. Real GDP growth accelerated further to almost 7% in 2017 as private consumption continued booming, spurred by indirect tax cuts and significant hikes in both public and private wages. After contracting in 2016, investment returned to growth in 2017 on the back of rising private investment in both machinery and equipment and residential housing. Public investment, however, fell sharply for the second consecutive year. The boom in private consumption also drove an acceleration of imports. As a consequence, despite relatively strong export growth, net exports have worked as a drag on real GDP growth. The growth of private consumption is expected to temper in 2018, as inflation is expected to weight more heavily on real disposable incomes and wage growth is expected to slow down. Consequently, Commission services' Spring 2018 Forecast GDP growth to decelerate to 4.5% in 2018 and 3.9% in 2019. The output gap is estimated to have turned positive in 2017 and is forecast to remain relatively stable over the forecast horizon.

The fiscal stance, as measured by the change in the structural balance, has been loosened since 2016 and continues to be pro-cyclical. The structural deficit has been on an increasing path since 2015. According to the Commission services' Spring 2018 Forecast, the structural deficit is projected to increase further, to 3¾ ¼% in 2018 and 4¼% in 2019.

The BNR, operating within an inflation targeting framework [46], increased the key policy rate in January and February 2018 by a total of 50 basis points to 2.25%, the first policy rate hikes in almost a decade. Reserve requirement ratio for foreign currency denominated liabilities was further reduced to 8% in May 2017 but kept unchanged afterwards. Reserve requirement ratio for leu denominated liabilities has been kept at 8% since May 2015. Credit growth turned positive (1.2%) in 2016 on the back of a robust growth of mortgages, although corporate and consumer credit continued to contract. Credit growth further picked up in 2017 (4.3%) as mortgages continued to grow while both corporate and consumer credit returned to growth in the second half of the year.

Wages and labour costs

Labour market conditions have improved in line with the strong economic growth in 2016-17. Against the background of an improved economic outlook, activity and employment rates increased substantially in this period while the unemployment rate decreased from 5.9% in 2016

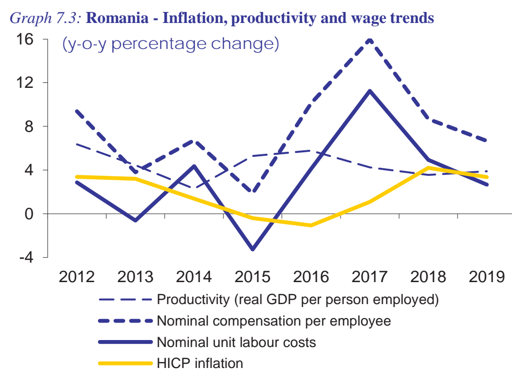
[46] As from 2013, the BNR follows a flat multi-annual inflation target of 2.5% (± 1 percentage point.).

to 4.9% in 2017, the lowest level in more than 20 years.

The very tight labour market, coupled with a declining labour force due to a shrinking working age population and persistent skills shortages, have led to an acceleration of wage growth in recent years. The nominal compensation per employee increased by 10% in 2016 and 16% in 2017, also driven by public-sector wage increases and 19% and 16% minimum wage hikes in May 2016 and February 2017, respectively. Wages are expected to continue to grow in 2018, albeit at a slower pace, due to further increases in public wages and an additional 9% increase in the net minimum wage which took effect in January.

Labour productivity per person grew by 5.8% in 2016 and 4.2% in 2017. Over 2018-19 labour productivity is forecast to continue growing by more than 3% per year. The growth of labour compensation outpaced that of productivity in 2016 and 2017, resulting in significant increases in nominal unit labour costs (4.2% in 2016 and 10.3% in 2017), which could weigh on Romania's competitiveness. According to the Commission services' Spring 2018 Forecast, ULC are expected to continue growing in 2018 and 2019 – albeit a somewhat slower pace than in 2016-17.

Graph 7.3: **Romania - Inflation, productivity and wage trends**



Source: Eurostat, Commission services' Spring 2018 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 price inflation in Romania, given the large weight of these categories in the Romanian HICP and the fact that Romania is a net importer of both energy and food.

Import price inflation (measured by the imports of goods deflator) was negative and significantly below consumer price inflation in 2016 as the price of fuel commodities declined. With the price of fuel commodities increasing again, import price inflation in 2017 was positive and rose significantly above the inflation rate.

Fluctuations of the leu have only moderately influenced import price dynamics in recent years. The nominal effective exchange rate (measured against a group of 36 trading partners) has remained broadly stable in the last two years.

Administered prices and taxes

Changes in administered prices and indirect taxes have considerably influenced inflation developments in recent years. Administered prices (47) have a slightly larger weight in the Romanian HICP basket than in the euro area (14.1% compared to 13.4% in 2017). The average annual change in administered prices was -2.5% in 2016 and -2.3% in 2017, substantially below headline inflation rate. 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 declining global commodity prices in 2016. In 2017, electricity prices increased somewhat while gas prices remained stable, but other administrated prices declined.

Tax changes have markedly influenced inflation in Romania in the last two years. HICP inflation measured at constant taxes was 2.1% in 2016, more than 3 percentage points higher than the headline HICP inflation rate, reflecting a reduction in the standard VAT rate from 24% to 20%. In 2017, HICP inflation measured at constant taxes was 2%, almost 1 percentage point higher than the headline inflation rate, as the standard VAT rate was further cut to 19% and excise duties on fuel were reduced between January and October 2017.

(47) 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

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Table 7.3:
Romania - Budgetary developments and projections **(as percentage of GDP unless indicated otherwise)**

Outturn and forecast [1]	2012	2013	2014	2015	2016	2017	2018	2019
General government balance	-3.7	-2.1	-1.3	-0.8	-3.0	-2.9	-3.4	-3.8
- Total revenues	33.6	33.2	33.6	35.0	31.6	30.5	30.9	31.1
- Total expenditure	37.2	35.4	35.0	35.8	34.6	33.4	34.3	34.9
of which:								
- Interest expenditure	1.7	1.8	1.6	1.6	1.5	1.3	1.4	1.4
p.m.: Tax burden	27.8	27.3	27.4	28.0	26.6	25.8	26.0	25.9
Primary balance	-1.9	-0.4	0.3	0.8	-1.5	-1.6	-2.0	-2.4
Cyclically-adjusted balance	-1.9	-0.9	-0.3	0.1	-2.5	-3.3	-3.9	-4.2
One-off and temporary measures	0.5	0.0	0.0	0.3	-0.4	0.0	-0.1	0.0
Structural balance [2]	-2.4	-0.9	-0.3	-0.2	-2.1	-3.3	-3.8	-4.2
Government gross debt	36.9	37.5	39.1	37.7	37.4	35.0	35.3	36.4
p.m: Real GDP growth (%)	1.2	3.5	3.1	4.0	4.8	6.9	4.5	3.9
p.m: Output gap	-5.1	-3.6	-3.1	-2.5	-1.5	1.2	1.4	1.1

1) Commission services' Spring 2018 Forecast.
2) Cyclically-adjusted balance excluding one-off and other temporary measures.
Source: Commission services.

Medium-term prospects

According to the Commission services' Spring 2018 Forecast, annual HICP inflation is projected to increase to 4.2% in 2018 as demand pressures mount and the effect of the January 2017 tax cuts fades away. The reversal of the January excise duties cut in October 2017 and higher global oil prices should further push up energy prices and hence inflation in 2018. As the growth in energy prices tempers, inflation is forecast to decline to 3.4% in 2019.

Risks to the inflation outlook are broadly balanced. Downside risks stem from possible additional cuts in indirect taxes, which could have a dampening effect on inflation. Upside risks to the projection relate mainly to a stronger-than-expected build-up of domestic demand and wage pressures. The size and timing of the impact on inflation of the BNR's ongoing monetary tightening also remains uncertain.

In 2016, the level of consumer prices in Romania was about 51% of the euro area average and the GDP per capita was about 55% of the euro area average in PPS terms. In line with the catching-up of the Romanian economy, further price level convergence is expected.

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.

7.3. PUBLIC FINANCES

7.3.1. Recent fiscal developments

Since 2016 the authorities have been pursuing an expansionary, pro-cyclical fiscal policy, driven by indirect tax cuts and increases to public wages and old-age pensions. In particular, the standard VAT rate was cut by 4 percentage points in 2016 and by an additional 1 percentage point in 2017. On the expenditure side, public wages were significantly increased both in 2017 and in 2018. The government has been also pursuing significant increases to old-age pensions, going beyond the standard pension indexation mechanism. On the other hand, public investment fell in 2016 and 2017 to a post- EU accession low.

The headline deficit increased sharply from 0.8% of GDP in 2015 to 3.0% in 2016 and slightly fell to 2.9% in 2017. Due to the fiscal measures undertaken and due to economic growth above potential, the structural deficit increased from around ¼% of potential GDP in 2015 to around 2% in 2016 and 3¼% in 2017. General government debt fell from 37.7% of GDP in 2015 to 35% of in 2017, thanks to strong GDP growth.

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Since 2016 Romania has been diverging from its Medium-Term budgetary Objective as required by the Council in regulation 1466/97. As a consequence, a significant deviation procedure (SDP) was launched in spring 2017. On 16 June the Council issued a recommendation asking Romania for an annual structural adjustment of 0.5% of GDP in 2017. On 22 November the Commission concluded that Romania did not take effective action in response to the Council recommendation so that on 5 December the Council issued a revised recommendation in which it asked for a structural adjustment of 0.8% of GDP in 2018.

7.3.2. Medium-term prospects

The 2018 budget was adopted by Parliament in December 2017. It aims at a general government deficit of just below 3% of GDP. The unified wage law enacted in summer 2017 increased gross wages in the public sector by 25% in January 2018 and contains additional increases for doctors and teachers. Old-age pensions will continue to be increased beyond the standard pension indexation mechanism. A shift of social security contributions from the current 22.75% for employers and 16.5% for employees to 2.25% and 35%, respectively, will partially contain the fiscal cost of the increases of gross wages in the public sector in 2018. Moreover, the personal income flat tax (PIT) rate has been cut from 16% to 10%.

The Commission in the spring 2018 forecast projects the general government budget deficit to increase to 3.4% of GDP in 2018 and to 3.8% in 2019. The structural deficit is projected to increase to around 3¾% and 4¼% in 2018 and 2019, respectively. The public-debt-to-GDP ratio is forecast to increase to 35.3% in 2018 and 36.4% in 2019.

Over the last decade, Romania has significantly strengthened its fiscal framework in terms of principles and rules grounded in legislation (in particular the Fiscal Responsibility Law) and the setting-up of an independent Fiscal Council. Romania is bound by the Fiscal Compact based on its own declaration of intention and has transposed its provisions in the national legal order. However, the fiscal framework's implementation track record has been poor in recent years. While the structural balanced-budget rule requires compliance with or convergence to the medium-term budgetary objective (with a lower deficit limit of 1% of GDP), in 2016 the structural deficit increased well above the medium-term objective, thus breaching the rule. Both the 2017 and 2018 budgets target a headline deficit of close to 3% of GDP, which in the presence of an increasing output gap implies a further deterioration of the structural balance, again contrary to the structural balanced-budget rule. Additionally, both in 2016 and 2017 budget amendments were adopted in breach of the rules prohibiting increases during the fiscal year of the headline and primary deficit ceilings, of personnel expenditure and of total government expenditure excluding EU funds. The medium-term fiscal plans are not adequately guiding the budgetary process; as in each of the last three years the fiscal strategy – which sets out the medium-term budgetary planning – was adopted at the same time as the budget law and way past the statutory deadline. Finally, the Fiscal Council's 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 ([48]). *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 displayed a stable behaviour until September 2016, when it has started to depreciate. Leu's depreciation was spurred by Romania's pro-cyclical fiscal policy leading to increase in imports and a higher current account deficit and by higher inflation expectations. The exchange rate reached 4.63 RON/EUR at the end of 2017 and continued to depreciate in early 2018 up to 4.66 RON/EUR in March 2018, reaching the highest level since 2012.

([48]) 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.

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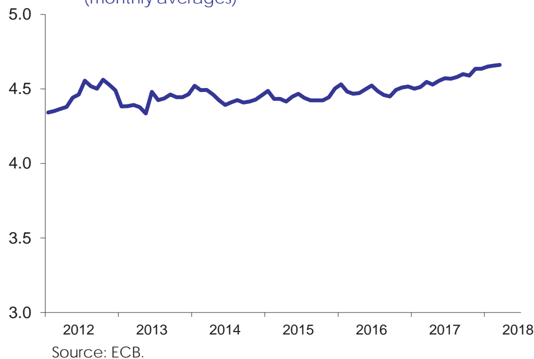
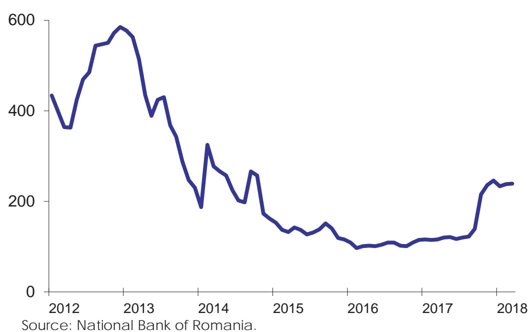


Graph 7.4: **Romania - RON/EUR exchange rate**
(monthly averages)
Source: ECB.

During the two years before this assessment, the leu depreciated against the euro by about 4%. In comparison with other regional peers operating under floating exchange rate, the leu's exchange rate against the euro remains relatively less volatile.

The NBR's gross international reserves were on an increasing path over much of 2016-17 period, going from around 35bn EUR in the first quarter of 2016 to almost 39bn EUR in the second quarter of 2017. Romanian gross international reserves decreased in the second half of 2017 due to the central bank's reduction of the banks' required reserves denominated in foreign currency, re-payments of financial assistance loans to the European Commission and World Bank and due to possible central bank foreign exchange intervention aimed at preventing a steeper depreciation of the local currency. The international reserves level was at around 37bn EUR or 20% of GDP by end-2017. In 2018, international reserves kept decreasing.



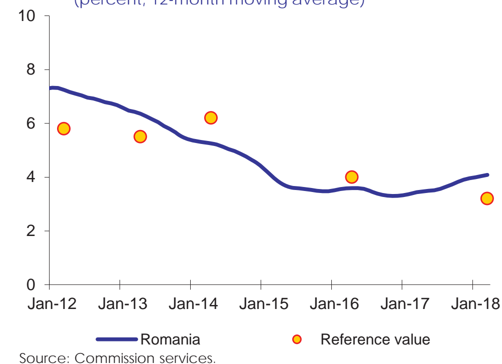
Graph 7.5: **Romania - 3-M Robor spread to 3-M Euribor**
(basis points, monthly values)
Source: National Bank of Romania.

Short-term interest rate differentials vis-à-vis the euro area were stable between 100 and 110 basis points over the course of 2016 and started to increase afterwards. The increase was especially pronounced in the second half of 2017 and the spread reached almost 250 basis points by the end of 2017. In January and February 2018, the NBR increased the key policy rate for the first time in almost a decade. Further monetary policy tightening is expected in the light of recent increases in inflation and due to the upside inflationary risks stemming from the announced pro-cyclical fiscal measures. In March 2018, the 3-month spread vis-à-vis the euro area stood at around 240 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 9 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 2016. Since then, it declined further to around 3.3% in October 2016 before increasing moderately again over the rest of 2016 and 2017. In March 2018, the latest month for which data are available, the reference value, given by the average of long-term interest rates in Cyprus, Ireland and Finland plus 2 percentage points, stood at 3.2%. In that month, the 12-month moving average of the yield on the Romanian benchmark bond stood at 4.1%, i.e. 0.9 percentage points above the reference value.

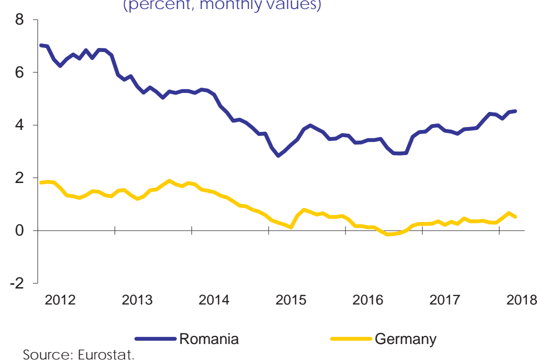


Graph 7.6: **Romania - Long-term interest rate criterion**
(percent, 12-month moving average)
Source: Commission services.

Long-term interest rates declined gradually from some 3.5% in April 2016 to 2.9% in September

2016. In October 2016, they started to increase until March 2017 when they reached a new high at 4.5%. These movements reflected expectations of higher domestic short-term interest rates related to fiscal developments and an international environment of increasing long-term yields. At the same time, the long-term spread vis-à-vis the German benchmark bond declined from around 340 basis points in April 2016 to below 300 basis points in October 2016 when it started to increase again. In March 2018, it stood at 400 basis points ([49]).

Graph 7.7: **Romania - Long-term interest rates**
(percent, monthly values)



Source: Eurostat.

7.6. ADDITIONAL FACTORS

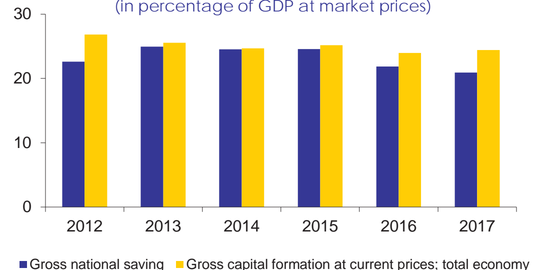
The Treaty (Article 140 TFEU) calls for an examination of other factors relevant to economic integration and convergence to be taken into account in the assessment. The assessment of the additional factors – including balance of payments developments, product, labour and financial market integration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

In November 2017, the Commission published its seventh Alert Mechanism Report (AMR 2018) under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.5), which concluded that issues related to the external investment position and the sustainability of the fiscal policy existed but since macroeconomic risks remained contained, no In-Depth Review (IDR) was warranted for Romania. The current account deficit deteriorated in 2016 on the back of strong private consumption, but strong GDP growth allowed for an improvement of the negative net international investment position, in particular by reducing net external debt. Reflecting catching-up dynamics, most of the net international investment position relates to net foreign direct investment liabilities, which mitigates external risks. Public debt as a share of GDP declined slightly in 2016 and remains relatively low. However, the fiscal deficit is set to remain high in the medium term, with a negative impact on the public debt dynamics.

7.6.1. Developments of the balance of payments

Romania's external balance (i.e. the combined current and capital account) has been progressively deteriorating. Since 2014, the external position has been worsening on account of widening current account deficits and, in 2017, stood at 1.2% of GDP, the lowest level in five years. Despite increasing export market shares, the growth of imports spurred by booming private consumption has persistently outpaced that of exports. The positive balance of trade in services driven mainly by exports of transportation and IT services continued to be above 4% of GDP in 2016 and 2017, but could not offset the negative and widening deficit in the trade of goods. The balance of primary incomes has remained negative reflecting mainly the outflow of investment income linked to the country's negative net international investment position. The balance of secondary income, which consists mainly of remittances, continues to be positive but was outweighed by the negative balance of primary income. The capital account surplus was relatively stable as a share of GDP up to 2016 but dropped significantly afterwards, reflecting the slow uptake of projects financed by EU funds under the 2014-2020 programming period.

Graph 7.8: **Romania - Saving and investment**
(in percentage of GDP at market prices)



Source: Eurostat, Commission services.

([49]) 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)**

	2012	2013	2014	2015	2016	2017
Current account	-4.8	-1.1	-0.7	-1.2	-2.1	-3.4
of which: Balance of trade in goods	-6.9	-4.0	-4.3	-4.9	-5.4	-6.3
Balance of trade in services	1.9	3.3	3.9	4.2	4.5	4.2
Primary income balance	-1.7	-2.2	-1.3	-2.4	-2.6	-2.6
Secondary income balance	2.0	1.9	1.1	1.7	1.5	1.4
Capital account	1.4	2.1	2.6	2.4	2.5	1.2
External balance [1]	-3.4	1.0	2.0	1.2	0.4	-2.2
Financial account	-2.5	1.1	1.9	1.4	0.9	-1.8
of which: Direct investment	-1.9	-2.0	-1.8	-1.8	-2.7	-2.4
Portfolio investment	-2.6	-3.8	-1.9	0.0	-0.6	-1.5
Other investment [2]	3.1	5.5	6.6	3.6	2.8	1.9
Of which International financial assistance	1.1	3.3	3.0	1.8	0.1	0.6
Change in reserves	-1.1	1.4	-0.9	-0.4	1.3	0.2
Financial account without reserves	-1.4	-0.3	2.9	1.8	-0.4	-2.0
Errors and omissions	0.9	0.1	0.0	0.2	0.5	0.4
Gross capital formation	26.8	25.6	24.7	25.2	24.0	24.4
Gross saving	22.6	24.9	24.5	24.6	21.9	20.9
Gross external debt	75.3	68.2	63.0	57.4	55.3	50.3
International investment position	-67.4	-62.6	-57.3	-54.6	-49.9	-46.6

1) The combined current and capital account.
2) Including financial derivatives.

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

Current account developments in Romania also reflect the evolution of the savings-investment balance. Romania's saving-investment balance deteriorated in 2016-17. Gross national saving as a share of GDP fell to 21.8% in 2016 and 21.3% in 2017, mainly due to a decline in gross public savings. Investment also declined as a share of GDP to 24% in 2016 and 24.4% in 2017.

Export performance has been strong in 2016-17 despite growing unit labour costs and an effective exchange rate. Export market shares increased by 8.5% in 2016, the highest rate of growth in the EU, and by 3.3% in 2017.

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 EU-IMF programme and two successor programmes (2011-2013 and 2013-2015) has enabled Romania to regain full market access since mid-2011. The latter two programmes were treated as precautionary and no drawings were made. Romania has repaid all liabilities to the IMF and 77% of its liabilities to the EU. Post-programme surveillance, which started in October 2015 after the end of the third programme, has ended at the beginning of April 2018, when 70% of the financial assistance from the European Union has been repaid. The outstanding amount (EUR 1.15 bn of the EUR 5 bn loan under the first programme) is equivalent to 0.6% of GDP.

After net FDI inflows had improved reaching an average of 2% of GDP in 2013-2015, they further increased to above 2.5% of GDP in 2016-17. After 2015, the net portfolio inflows have started to increase gradually reaching 1.5% of GDP in 2017. Other investment continued to record net outflows over and 2016 and 2017. Despite a widening of the current account deficit, Romania's net international investment position continued to improve on the back of high nominal GDP growth rates and declined to -49.9% of GDP in 2016 and -46.6% in 2017. Gross external debt was 55.3% in GDP in 2016 and 50.3% in 2017.

According to the Commission services' Spring 2018 Forecast, the external balance is expected to continue worsening in 2018 and 2019, mainly due to a widening trade deficit. The current account deficit is expected to be 3.6% in 2018 and 3.9% in 2019. The capital account surplus, however, is expected to improve, reflecting a higher absorption of EU funds under the 2014-2020 programme.

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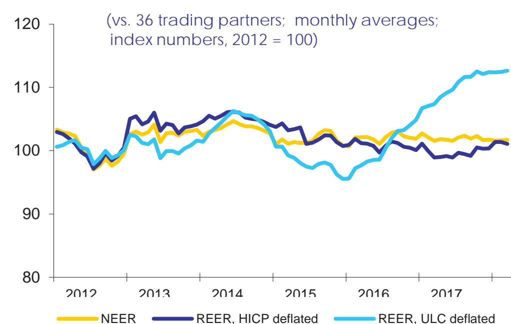
Table 7.5:
Romania - Market integration

	2012	2013	2014	2015	2016	2017
Trade openness [1] (%)	43.8	44.0	45.0	44.9	45.1	45.7
Trade with EA in goods & services [2+3] (%)	22.7	24.0	24.6	25.0	25.4	25.8
Export performance (% change) [4]	0.6	16.9	3.9	0.8	5.2	4.0
World Bank's Ease of Doing Business Index rankings [5]	72	73	48	37	36	45
WEF's Global Competitiveness Index rankings [6]	78	76	59	53	62	68
Internal Market Transposition Deficit [7] (%)	1.2	0.4	1.1	1.0	1.1	2.0
Real house price index [8]	104.4	101.4	98.1	100.0	105.0	109.2
Residential investment [9] (%)	3.1	2.4	2.4	2.4	2.6	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.
(November data, as of 2016 date refers to the year of publication).
8) Deflated house price index (2015=100) (Eurostat).
9) Gross capital formation in residential buildings (in % of GDP) (Eurostat).

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

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 2016 and 2017 stood at around 45% of GDP, respectively. In 2017 Romania's main trading partners within the euro area are Germany, Italy and France, while outside the euro area it mainly trades with Hungary, the United Kingdom, and Poland. The share of trade with the euro area expressed in percentage of GDP has been increasing in recent years and has stabilized at around 25% in 2016 and 2017.

Romania attracted substantial amounts of FDI in the past decade. However, FDI inflows have been volatile in recent years. Net FDI inflows increased by 47% in 2016 but declined by 21% in 2017. The inward FDI stock reached 44.7% of GDP in 2016 and 42.6% in 2017. FDI inflows originate mainly from euro-area Member States, with the Netherlands, Austria and Germany accounting for about half of the FDI stock at the end of 2017.

Concerning the business environment, the performance of the country is relatively weak compared to most euro-area Member States in international rankings. In the WEF's Global Competitiveness Index, Romania's position is still low and deteriorating (68 out of 137), with government efficiency, bureaucracy and the quality of infrastructure as the most problematic factors. On the World Bank's Ease of Doing Business indicator Romania's rank has also deteriorated. The most problematic issues include dealing with construction permits and getting electricity. Moreover, the ranking in terms of public administration performance (including government effectiveness, control of corruption, voice and accountability, political stability and no violence, regulatory quality and rule of law) scores relatively poorly according to the World Bank's Worldwide Governance Indicators. According to the December 2017 Internal Market Scoreboard, Romania's transposition deficit of EU Directives was at 2.0%, above the EU average of 1.5% and above the target (0.5%) proposed by the European Commission in the Single Market Act (2011). The 4th Anti-Money Laundering Directive imposed transposition by 26 June 2017. A reasoned opinion was addressed by the Commission to Romania on

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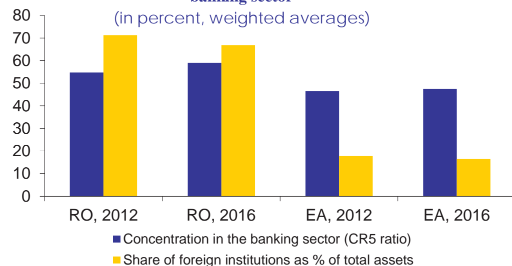
8 December 2017 due to an absence of an appropriate response to the letter of formal notice from 19 July 2017. Transposition measures are expected to be adopted in May 2018.

The Romanian labour market suffers from significant structural challenges. Unfavourable demographic trends are expected to continue for the foreseeable future. Population aging, limited internal labour mobility and continued emigration represent a significant drag on potential economic growth. Despite recent improvements, labour force participation rates remain well below EU averages. Skills shortages and mismatches also have an adverse impact on the quality and quantity of labour supplied. Undeclared work continues to distort the labour market. Minimum wage increases are decided in a discretionary manner, and social partners' involvement in policy making is very limited.

Graph 7.10: **Romania - Foreign ownership and concentration in the banking sector**

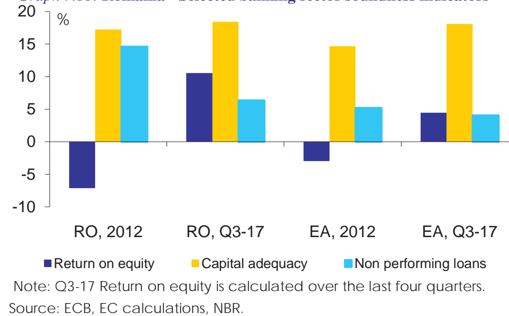


Source: ECB, Structural financial indicators

The Romanian financial sector continues to be 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 stood at 67% in 2016, well above the euro area average of nearly 17%. Concentration in the banking sector, as measured by the market share of the largest five credit institutions increased to 59% in 2016 and 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 19% at the end of 2017, well above the euro area average. The banking system returned to profit in 2015 and remained profitable through 2017 (return on equity was 12.7% in Q4 2017). Non-performing loans (90 days overdue) have increased significantly in the post-crisis period (i.e. from below 2% in 2007).

Graph 7.11: **Romania - Selected banking sector soundness indicators**

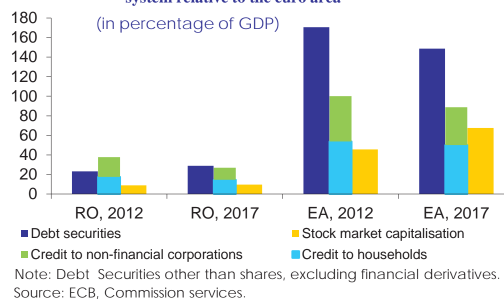


Note: Q3-17 Return on equity is calculated over the last four quarters.
Source: ECB, EC calculations, NBR.

However, the measures implemented since 2014 to facilitate the write off and sale of non-performing loans led to their decline from above 20% in 2014 to below 7% by the end of 2017.

Romania has continued to show a comparatively low penetration of financial services. Insurance penetration (i.e. the ratio between gross written premiums for life and non-life insurance and GDP) in Romania is still one of the lowest in the EU, whereas the insurance market continues to remain highly dependent on compulsory car insurance. The private pension system including mandatory pension funds (Pillar II) and voluntary pension funds (Pillar III) recorded a positive trend until 2017. The total net assets of the Pillar II pension funds increased from 0.2% of GDP in 2008 to roughly 4.6% of GDP in 2017. However, starting in January 2018, the government reduced the social security contributions to the private mandatory pension pillar (Pillar II) from 5.1% to 3.75% of gross wages.

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.

House prices adjusted downwards in the wake of the crisis but have started to grow again since 2015. Real house prices increased by 7.1% in 2016 and by a further 5% in 2017.

The size of the financial sector in Romania is relatively small compared to the Euro Area. Romania still lags considerably behind the euro area as regards bank credit to the private non-financial sector (26.9% of GDP in 2017). The share of foreign-currency loans to the private non-financial sector decreased from a peak of around 62% of total loans in 2012 to 37% at the end of 2017, 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.

Equity and debt markets in Romania remain considerably underdeveloped. In 2017, stock market capitalisation (9.6% of GDP) remained significantly below the euro area average (67.5% of GDP). The debt securities market remained only a fraction of the euro area average (28.8% vs. 148.7% of GDP) and continued to be dominated by issuances of government debt (T-bills and bonds denominated in both leu and foreign currency), whereas the issuance of corporate and municipal bonds remains very limited. Consolidated private sector debt has continued to decline from the peak of 74% of GDP observed in 2010 to 56% in 2016, the lowest level in the EU.

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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), the Riksbank Act from 1988, as amended, and the Law on Exchange Rate Policy from 1998. No amendments to these legal acts were passed with regard to the incompatibilities and the imperfections mentioned in the 2016 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 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 since 2013 but those 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. When 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 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 as 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. 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 Instrument 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 Instrument of Government); Articles 1 to 4 of the Law on Exchange Rate Policy of 1998;
- 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 Instrument 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

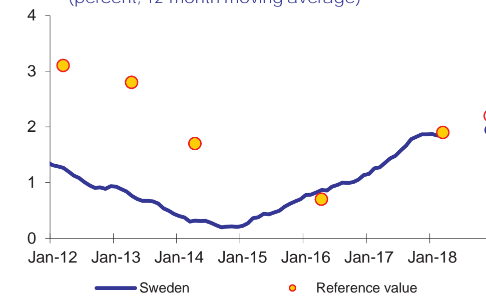
As regards the prohibition on monetary financing, the independence of the Riksbank as well as its integration into the ESCB at the time of euro adoption, the legislation in Sweden, in particular the Riksbank Act and the Instrument of Government as part of the Swedish Constitution, is not fully compatible with the compliance duty under Article 131 of the TFEU. It is understood that the Swedish Parliament is currently examining a review of the Riksbank Act and the monetary policy framework in general and will report on the matter by end-May 2019 at the latest. In this context the Swedish authorities are invited to remedy the abovementioned incompatibilities.

8.2. PRICE STABILITY

8.2.1. Respect of the reference value

The twelve-month average inflation rate, which is used for the convergence evaluation, was above the reference value at the time of the last convergence assessment of Sweden in 2016. The twelve-month average inflation rate in Sweden has then been increasing through October 2017, when it reached 1.8% and broadly stabilised after. In March 2018, the reference value was 1.9%, calculated as the average of the 12-month average inflation rates in Cyprus, Ireland and Finland plus 1.5 percentage points. The corresponding inflation rate in Sweden was 1.9%, i.e. at the reference value. The 12-month average inflation rate is projected to decline below the reference value in the months ahead.

Graph 8.1: **Sweden - Inflation criterion**
(percent, 12-month moving average)

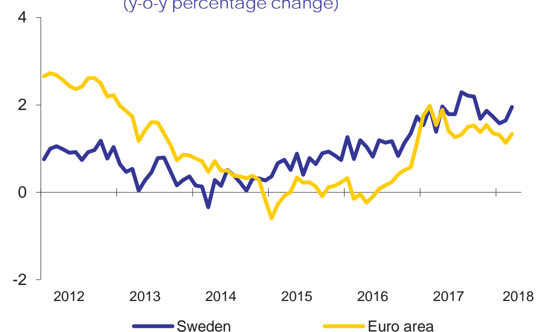


Note: The dots in December 2018 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2018 Forecast.

8.2.2. Recent inflation developments

HICP inflation in Sweden started to pick-up in 2016. The recovering oil prices, tax hikes ([50]) as well as expanding domestic demand supported by an accommodative monetary policy resulted in an average inflation rate of 1.1% in 2016, up from 0.7% the year before. In 2017, HICP inflation increased to 1.9%, driven by services and energy prices and the weakening of the krona. On a year-on-year basis it went above 2% in the summer, driven by a temporary surge in service prices. Since then HICP inflation fell back to 1.6% in January and stood at 2.0% in March 2018.

Graph 8.2: **Sweden - HICP inflation**
(y-o-y percentage change)



Source: Eurostat.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) grew at the same rate as headline inflation in 2016 (1.1%) and stood at 1.5% in 2017. In particular, inflation

([50]) Changes in taxes and subsidies occurred in January 2016 but also higher administrative prices, banking services and foreign flights.

Table 8.1:
Sweden - Components of inflation

	2012	2013	2014	2015	2016	2017	Mar-18	weights in total 2018
(percentage change)[1]								
HICP	0.9	0.4	0.2	0.7	1.1	1.9	1.9	1000
Non-energy industrial goods	-1.0	-0.8	-0.4	0.3	1.1	0.1	0.0	290
Energy	0.5	-1.4	-2.0	-4.7	1.0	5.3	4.6	89
Unprocessed food	1.6	3.5	0.0	4.1	2.6	2.2	1.7	61
Processed food	2.4	1.3	1.0	2.1	0.5	2.1	2.3	137
Services	1.8	1.1	0.9	1.3	1.3	2.2	2.5	423
HICP excl. energy and unproc. food	1.0	0.5	0.5	1.1	1.1	1.5	1.6	850
HICP at constant tax rates	1.3	0.4	0.2	0.5	1.0	1.7	1.7	1000
Administered prices HICP	3.0	2.0	1.7	1.3	0.9	2.1	2.1	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.

in the service sector surged from 1.3% in 2016 to 2.2% in 2017 reflecting partly the new methodology for measuring prices of package holidays ([51]). Processed food prices rate of inflation increased from 0.5% in 2016 to 2.1% in 2017. Non-energy industrial goods prices rose by 1.1% in 2016 and were broadly unchanged in 2017. Producer price inflation was slightly negative in 2016 before turning strongly positive in 2017 on the back of higher energy prices.

8.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and cyclical stance

After a strong performance in 2016, Sweden's economic growth remained solid in 2017 and is expected to remain solid 2018 but to moderate in 2019. Real GDP expanded by 3.2% in 2016, making Sweden a front-runner in the economic expansion among EU countries, before slowing to 2.4% in 2017. Strong domestic demand, in particular buoyant investment growth, supported by an expansionary monetary policy, contributed to economic growth in both 2016 and 2017. Real GDP is projected to grow around 2.6% in 2018 before decelerating to 2.0% in 2019, as domestic demand flattens and the economic cycle matures. The output gap has turned slightly positive since 2016, after some years in negative territory, and is expected to turn slightly negative again in 2019.

The fiscal stance, as measured by changes in the structural balance, was restrictive in 2016 and 2017 and is expected to become expansionary in 2018 before turning restrictive in 2019.

Monetary policy, conducted within an inflation targeting framework ([52]), has remained expansionary. In response to low inflationary pressures and initially sluggish economic growth, the Riksbank gradually cut its main policy rate from 2% in autumn 2011 to minus 0.5% in February 2016 and has kept it unchanged since.

Additionally, in February 2015, the Riksbank started conducting purchases of Swedish government bonds and continuously reinvested redemptions and coupon payments in the government bond portfolio. As a result, Riksbank's total holdings of domestic government bonds amounted to a cumulative SEK 320 billion (about half of the outstanding stock) by mid-March 2018.

In 2017 inflation was close to target but, in spite of strong economic growth and a tight labour market, inflationary pressures did not seem to be on a firm upward path over the medium-term. Still, the Executive Board of the Riksbank decided in December 2017 to halt the asset purchase programme but announced that it would reinvest, starting in January 2018, the bonds maturing in 2019 in order to attain a relatively even pace of purchases going forward. The Riksbank at its latest meeting in April 2018 indicated that it expected to

([51]) From 2017 Statistics Sweden changed its handling of seasonal prices of package holidays. For more details about the new methodology, see Statistics Sweden: http://www.scb.se/contentassets/6dc31ffdd808460eb498b66419042afb/andringar-i-kpi-fran-2017-en-editetr_feb_mt.pdf

([52]) Since 1995, the Riksbank has targeted increases in the domestic CPI with the aim of keeping inflation at 2%. In September 2017 the Riksbank changed its target from measuring inflation in terms of CPI to CPIF (CPI with the interest rate component kept unchanged) resulting in higher inflation rates.

Table 8.2:
Sweden - Other inflation and cost indicators (annual percentage change)

	2012	2013	2014	2015	2016	2017	2018 1)	2019 1)
HICP inflation								
Sweden	0.9	0.4	0.2	0.7	1.1	1.9	1.9	1.7
Euro area	2.5	1.3	0.4	0.0	0.2	1.5	1.5	1.6
Private consumption deflator								
Sweden	0.5	0.7	1.1	0.9	1.0	1.7	1.9	2.1
Euro area	1.9	1.1	0.5	0.3	0.4	1.4	1.5	1.6
Nominal compensation per employee								
Sweden	3.1	1.9	2.2	2.7	2.8	2.1	2.7	2.4
Euro area	1.8	1.6	1.4	1.4	1.2	1.6	2.4	1.9
Labour productivity								
Sweden	-1.0	0.3	1.2	3.0	1.5	0.1	1.0	0.7
Euro area	-0.1	0.6	0.7	1.0	0.4	0.8	1.0	1.0
Nominal unit labour costs								
Sweden	4.1	1.7	1.0	-0.3	1.3	2.0	1.7	1.8
Euro area	1.9	1.0	0.6	0.5	0.7	0.8	1.4	1.0
Imports of goods deflator								
Sweden	-1.9	-3.7	1.2	-0.1	-2.3	4.6	4.9	1.7
Euro area	2.6	-2.0	-2.4	-3.4	-3.4	3.4	1.2	0.7

1) Commission services' Spring 2018 Forecast.

Source: Eurostat, Commission services.

start raising the repo rate at a slow pace towards the end of 2018.

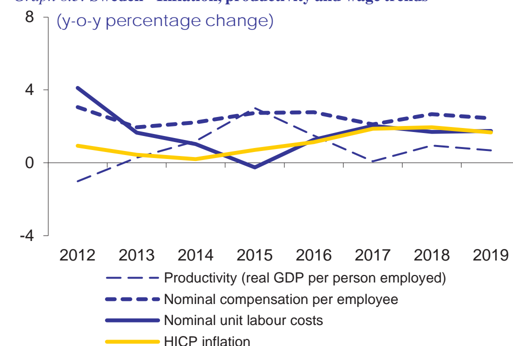
Wages and labour costs

Employment recovered quickly following the financial crisis and has been expanding at a strong pace since, growing at 1.7% in 2016 and 2.3% in 2017. This rise was driven primarily by services, the public sector, and construction, while the number of employed persons in manufacturing and energy sectors decreased. Employment in the public sector is expected to grow over the coming years particularly in healthcare and education as the population is ageing and the number of migrants has been growing, including of school-age migrants.

In spite of strong employment growth, the decline in the unemployment rate has been moderate, decreasing from 6.9% in 2016 to 6.7% in 2017, due to migrants joining the labour force, and is expected to hover around 6.3% over the next two years.

Growth of nominal compensation per employee increased from 1.9% in 2013 to 2.8% in 2016. In the first half of 2017, the exporting industry agreed to annual wage increases of about 2.2% for the period 2017-2019. This relatively modest outcome was the result of negotiations that started in 2016, with a mandate to maintain cost competitiveness vis a vis major trading partners. Since then, other sectors have closely followed this benchmark agreement. Against this backdrop, growth of nominal compensation per employee is expected to have slowed at 2.1% in 2017, and is projected to increase again to 2.7% in 2018 before decelerating in 2019 to 2.4% according to the Commission services' Spring 2018 Forecast.

Graph 8.3: **Sweden - Inflation, productivity and wage trends**



Source: Eurostat, Commission services' Spring 2018 Forecast.

Given these wage developments, increase in cost competitiveness is expected to remain contained. Growth in labour productivity has been slowing from 3.0% in 2015 to 0.1% in 2017. It is forecast to remain subdued in 2018 and 2019, not above 1.0%. Nominal unit labour costs growth (ULC), was at 1.3% in 2016 and increased to 2.0% in

2017. ULCs are projected to stabilize below 2.0% as from 2018. Against this backdrop price pressures from labour costs are expected to remain limited in 2018-2019.

External factors

Given the 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 few years. In 2016, the import deflator was negative despite higher commodity prices due to the dampening effect of the krona appreciation. The import deflator turned strongly positive in 2017 as the krona started depreciating. The import deflator is expected to remain positive in 2018 and 2019.

The real effective exchange rate (measured against a group of 36 trading partners) remained broadly stable in 2016 and 2017. In 2016, domestic prices continued to grow slower than Sweden's main trading partners offsetting the small increase in the nominal effective exchange rate. This trend was reversed in 2017. Overall, Swedish cost developments do not pose major challenges to competitiveness.

Administered prices and taxes

The share of administered prices ([53]) in the Swedish HICP basket amounts to 15%, a value slightly above the euro-area average of 13%. The most important item in the administrate price basket is rents (7% of total HICP). In contrast to 2016, administrative price inflation outpaced total HICP inflation in 2017, increasing from 0.9% in 2016 to 2.1% in 2017. This is largely explained by strong increase in charges for combined passenger transport and for social protection by about 7% each in 2016 and 2017, while rent prices increased by a modest 0.9%.

Tax changes also contributed somewhat to higher headline inflation as the pace at which HICP at constant taxes increased over the past two years was slower than the one of HICP.

Medium-term prospects

HICP inflation is projected to remain broadly stable and to hover slightly below the Riksbank's 2% target in 2018-2019. Oil prices are projected to exert upward pressure on the HICP in 2018 but muted wage developments are expected to dampen somewhat this effect. Accordingly, the Commission Spring 2018 Forecast projects annual average inflation at 1.9% in 2018 and 1.7% in 2019.

Risks to the inflation outlook appear to be broadly balanced. The Riksbank has announced its intention to begin increasing the repo rate at a slow pace, a move entailing some risks of appreciation. An appreciating krona could dampen the currently projected inflation trajectory. The Riksbank has indicated that should the krona appreciate too quickly, it would stand ready to take the appropriate measures.

The level of consumer prices in Sweden relative to the euro area has gradually increased since Sweden joined the EU in 1995. In 2016, the Swedish price level was at 122% of the euro-area average. At the same time, the GDP per capita level in Sweden has remained stable over the past ten years, reaching about 116% of the euro-area average in PPS in 2016.

In the medium term, inflation could gradually rise given the high capacity utilisation and acute skill shortages that have been reported over the last year. However, there is uncertainty how resource pressure will feed to inflation, and low wage expectations will continue weighing on consumer price developments.

8.3. PUBLIC FINANCES

8.3.1. Recent fiscal developments

Sweden’s general government surplus increased from 1.2% of GDP in 2016 to 1.3% of GDP in 2017. Revenue collection, underpinned by solid economic growth, surprised on the upside. By contrast, expenditure for taking in and integrating asylum seekers, was lower than expected in 2016-2017.

([53]) According to the Eurostat definition, fully administered prices in Sweden include prices or charges for water supply, refuse and sewerage collection, social protection, postal services, and combined passenger transport. Mainly administered prices include actual rents for housing, pharmaceutical products, hospital, dental and other medical services, and education. For details, see http://ec.europa.eu/eurostat/web/hicp/methodology/hicp-administered-prices

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Table 8.3:
Sweden - Budgetary developments and projections **(as percentage of GDP unless indicated otherwise)**

Outturn and forecast [1]	2012	2013	2014	2015	2016	2017	2018	2019
General government balance	-1.0	-1.4	-1.6	0.2	1.2	1.3	0.8	0.9
- Total revenues	50.4	50.6	49.6	49.8	50.6	50.3	49.7	49.3
- Total expenditure	51.4	52.0	51.1	49.6	49.4	49.1	48.9	48.4
of which:								
- Interest expenditure	0.9	0.8	0.7	0.4	0.4	0.4	0.3	0.2
p.m.: Tax burden	43.1	43.5	43.2	43.6	44.6	44.5	44.0	43.9
Primary balance	-0.1	-0.6	-0.9	0.6	1.6	1.6	1.1	1.1
Cyclically-adjusted balance	0.2	0.1	-0.3	0.3	0.9	1.2	0.7	1.0
One-off and temporary measures	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Structural balance [2]	0.2	0.1	-0.3	0.3	0.9	1.2	0.7	1.0
Government gross debt	38.1	40.7	45.5	44.2	42.1	40.6	38.0	35.5
p.m: Real GDP growth (%)	-0.3	1.2	2.6	4.5	3.2	2.4	2.6	2.0
p.m: Output gap	-2.1	-2.6	-2.1	-0.1	0.4	0.1	0.1	-0.3

1) Commission services' Spring 2018 Forecast.
2) Cyclically-adjusted balance excluding one-off and other temporary measures.
Source: Commission services.

The expenditure-to-GDP ratio decreased from 49.4% of GDP in 2016 to 49.1% in 2017, a decrease by 0.3 similar in size to the decrease in the revenues-to-GDP ratio from 50.6% to 50.3% of GDP between 2016 and 2017.

The 2017 general government surplus was higher than the surplus of 0.3% of GDP targeted in the 2017 Convergence Programme. The structural balance surplus increased and reached 0.9% of GDP in 2016 and 1.2% in 2017.

The government debt-to-GDP ratio decreased to 40.6% in 2017, i.e. down by 1.5 percentage points compared to 2016 on the back of strong economic growth and prudent fiscal management.

8.3.2. Medium-term prospects

The 2018 budget bill, which was adopted on 15 December 2017, included new measures to address key government priorities. These measures result in additional tax cuts (for a total effect of SEK-7.2 billion or -0.1 % of GDP as they are partially compensated by some tax increases) and new spending totalling about 0.9% of GDP. The amended 2018 spring bill proposed additional new reforms worth SEK2.6 billion (0.1% of GDP). These measures focus on labour market and migrant integration, climate and environment, education, health and defence.

As a result the budget balance surplus is foreseen to decline in 2018 and slightly increase in 2019 as expenditure measures are waning off. According to the Commission services' Spring 2018 Forecast, which is based on a no-policy-change assumption, the general government balance will stabilise at a lower level, reaching 0.8% of GDP in 2018 and 0.9% in 2019 while the structural balance is set to decline to 0.7% in 2018 before increasing again to 1.0% of potential GDP in 2019. The revenue-to-GDP ratio is expected to decline to 49.3% of GDP in 2019 while expenditures are forecast to decrease to around 48.4% of GDP.

Gross government debt is well below the 60% of GDP Treaty reference value and is expected to continue its gradual decline in the coming years, reaching 38.0% of GDP in 2018 and 35.5% of GDP in 2019, mainly on the back of strong economic growth and a low interest rate environment.

Building on a strong institutional set-up and a robust fiscal track record, the Swedish authorities, following extensive deliberations within a dedicated parliamentary Committee (Surplus Target Committee), adopted a fiscal governance reform package in late 2017, with effect from 2019 onwards.

While the main conceptual pillars of the existing framework were preserved with some numerical modifications and clarifications, a number of new elements were added. Some of those elements contributed to bring the Swedish national provisions in line with the Budgetary Frameworks

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Directive, [54] e.g. introducing a new debt anchor as an explicit multi-annual debt objective or mandating the Fiscal Council with the regular assessment of government's economic forecasts.

One of the main features of the reform was the lowering of the 1% of GDP surplus target defined over the cycle (in place since 2007) to 0.33 % of GDP with effect from 2019. This new target would continue to allow Sweden to partially accommodate the projected increase in the costs of the pension system while maintaining adequate safety margins for economic fluctuations. In addition, the mechanisms for monitoring the revised surplus target were clarified [55], thereby addressing some identified shortcomings and adding credibility to the new target. Additionally, a correction mechanism in case of deviation from the target of the rule was introduced. Furthermore, the structural balance rule was complemented by a new debt anchor set at 35% of GDP of the general government, consistent with the surplus target and which includes a correction mechanism.

The Fiscal Policy Council (Finanspolitiska rådet) received a stronger mandate. It will exert a more prominent role in assessing compliance with the rules and will conduct the regular evaluation of the government's economic forecasts. However, the nomination procedure for the Council's members has also been amended, rendering the process more politically guided. The current selection process, which gave full autonomy to the Council itself in electing its members, will be replaced on 1 July 2018 by one steered by a nomination committee which will include, among others, the Chair and Deputy Chair of the Riksdag’s Finance Committee. While motivated by the desire to give the independent body more democratic legitimacy and increase its responsibilities and diversity, this change was opposed by former and current members of the Council because it may decrease the members’ autonomy.

[54] The Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States, available at: http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:32011L0085

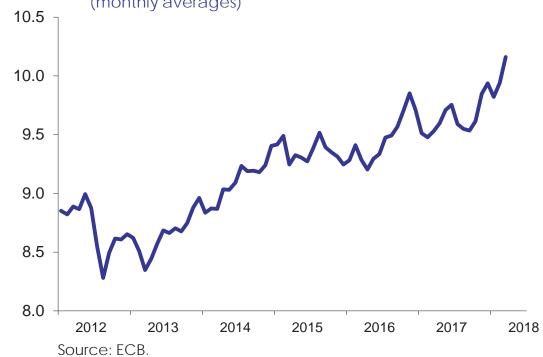
[55] Specifically, the fulfilment of the target will be assessed on the basis of a single indicator (i.e. the structural balance over the current and subsequent year) instead of the previous system of several indicators whose relative weights were not defined.

8.4. EXCHANGE RATE STABILITY

The Swedish krona does not participate in ERM II. As indicated above, the Riksbank pursues inflation targeting under a floating exchange rate regime.

The krona continued depreciating against the euro since 2013, with a total depreciation of more than 19% in early 2018 compared to the 2013 peak. In 2016 and 2017 the depreciating trend continued but slowed down compared with previous years. The krona fluctuated around 9.5 euro in 2016 and 9.6 euro in 2017. In March 2018 the krona reached a value of above 10 krona per euro.

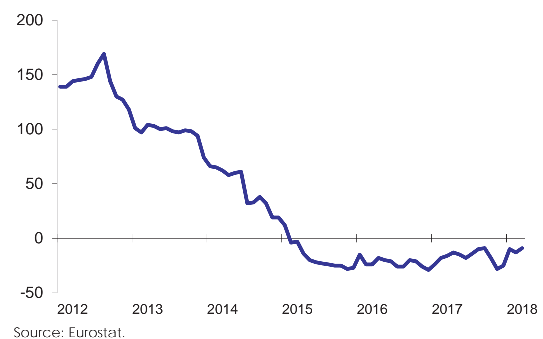
Graph 8.4: **Sweden - SEK/EUR exchange rate** (monthly averages)



Source: ECB.

Short-term interest rate spreads vis-à-vis the euro area turned negative (euro area short-term interest rates being higher than Swedish ones) since February 2015, when the Riksbank introduced a negative policy rate, cutting its repo rate to minus 0.1%. Following the additional cuts introduced by the Riksbank in February 2016, the repo rate reached today's level of minus 0.5%.

Graph 8.5: **Sweden - 3-M Stibor spread to 3-M Euribor** (basis points, monthly values)



Source: Eurostat.

These moves widened the 3-months STIBOR-EURIBOR spread to about on average -20 basis points during 2016-2017, with fluctuations between broadly -30 basis points (November 2016

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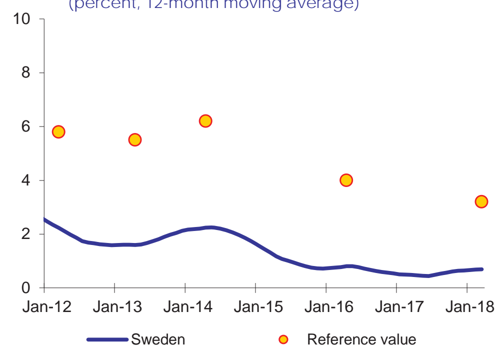
and September 2017 respectively) and -10 basis points (July 2017). In early 2018 the spread stood at around -10 basis points.

After averaging slightly less than SEK 500 billion in early 2016, international reserves crossed again the SEK 500 billion threshold reached a year earlier in May 2016, where they have remained since, with SEK 540 billion by the end of 2016. In the last quarter of 2017, international reserves hoovered around the level of SEK 520 billion, or 11% of GDP. Since December 2015, the Riksbank can intervene on foreign exchange markets in order to prevent a de-anchoring of inflation expectations due to a strengthening krona. The level of international reserves has remained pretty stable since.

8.5. LONG-TERM INTEREST RATES

Long-term interest rates used to assess adherence to the convergence criterion reflect secondary market yields on a single benchmark government bond with a residual maturity of above ten years.

Graph 8.6: **Sweden - Long-term interest rate criterion**
(percent, 12-month moving average)

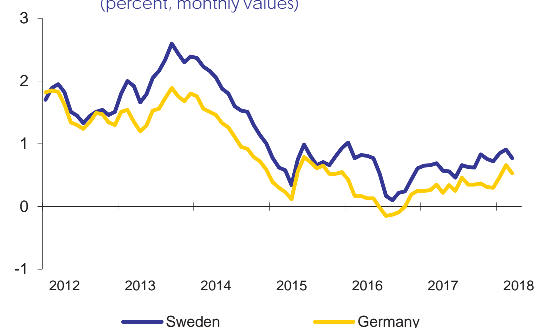


Source: Commission services.

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 2016 convergence assessment of Sweden. Average long-term rates in Sweden continued to stay below 1% over the last two years, where they have been since June 2015. They were on a continuously declining trajectory until June 2017, when they reached 0.5%, to increase back to 0.7% in December 2017. In March 2018, the latest month for which data are available, the reference value, given by the average of long-term interest rates in Cyprus, Ireland and Finland plus 2 percentage points, stood at 3.2%. In that month, the 12-month moving average of the yield on the Swedish benchmark bond stood at 0.7%, i.e. 2.5 percentage points below the reference value.

In term of monthly data, long-term interest rates, while always remaining below 1% since the 2016 Convergence Report, have recovered from the August 2016 all-time low of 0.1%, reaching 0.9% in early 2018, which remains very low by historical standards. The compression of Swedish long-term interest rates reflected the continuation of the expansionary monetary policy stance, with negative policy rates and the continued acquisition of governments bonds as a response to the low domestic inflation environment. The safe-haven status of Swedish government bonds was confirmed also over the last two years with the yields of the Swedish benchmark government bond following the German benchmark bond, even if less closely than in previous years. Thus long-term interest spreads vis-à-vis the German benchmark bond remained extremely low, even if they increased from the negative values of the summer 2016. They remained in the range of 20 to 40 basis points until the last quarter of 2017 when they slightly moved above this range. In March 2018 they were above 50 basis points ([56]).

Graph 8.7: **Sweden - Long-term interest rates**
(percent, monthly values)



Source: Eurostat.

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

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

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Table 8.4:
Sweden - Balance of payments **(percentage of GDP)**

	2012	2013	2014	2015	2016	2017
Current account	5.6	5.2	4.5	4.5	4.2	3.2
of which: Balance of trade in goods	4.0	3.2	3.0	2.8	2.3	2.4
Balance of trade in services	1.2	1.7	1.3	2.2	2.1	1.0
Primary income balance	2.4	2.0	1.9	1.2	1.1	1.4
Secondary income balance	-2.0	-1.8	-1.8	-1.7	-1.4	-1.6
Capital account	-0.2	-0.2	-0.1	-0.2	-0.1	-0.1
External balance [1)]	5.4	5.0	4.4	4.3	4.1	3.0
Financial account	1.6	3.7	2.7	2.0	-3.4	1.2
of which: Direct investment	2.4	4.6	0.9	1.5	-1.2	1.6
Portfolio investment	-3.1	-8.4	4.1	-2.7	1.2	-1.4
Other investment [2)]	2.2	4.9	-2.2	2.9	-4.2	0.9
Change in reserves	0.1	2.6	0.0	0.3	0.8	0.1
Financial account without reserves	1.5	1.1	2.7	1.8	-4.2	1.1
Errors and omissions	-3.9	-1.3	-1.7	-2.3	-7.5	-1.9
Gross capital formation	22.6	22.5	23.3	24.3	24.7	25.7
Gross saving	28.2	27.6	28.1	28.8	29.4	29.8
Gross external debt	187.3	185.0	190.7	181.7	174.2	174.3
International investment position	-15.8	-16.1	-2.3	-1.2	5.0	9.6

1) The combined current and capital account.
2) Including financial derivatives.

Sources: Eurostat, Statistics Sweden, Commission services.

Member State's ability to integrate into the euro area without difficulties.

In November 2017, the Commission published its seventh Alert Mechanism Report (AMR 2018) under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.5), which concluded that an In-Depth Review (IDR) was warranted for Sweden. In March 2018, the Commission published its annual country report on Sweden ([57]), including an IDR. This report led to the conclusion that Sweden continued to experience macroeconomic imbalances, as overvalued house price levels coupled with a continued rise in household debt poses risks of a disorderly correction. The already high household debt remains on an upward path. House prices have been growing at fast pace virtually for much of the past 20 years. Negative growth has been recorded in the last quarter of 2017. Still, valuation indicators suggest that house prices remain very high relative to fundamentals. Awareness of mounting risks among authorities is high, and in recent years measures have been taken to rein in mortgage debt growth and raise housing construction. However, policy steps implemented so far have not been sufficient to address overvaluation in the housing sector, and key policy gaps remain.

8.6.1. Developments of the balance of payments

According to Balance of Payments data, Sweden's current account surplus has gradually been declining from 5.6% of GDP in 2012 to 3.2% of GDP in 2017. The decline in the balance of trade in goods and in the primary income balance contributed to the decline in the current account surplus, only partially compensated for by the increase in the services balance until 2016. In 2017 the service balance posted a marked decrease. The secondary income balance improved in 2016, thus contributing to support the overall current account balance, but this improvement was partially reversed in 2017. Current transfers have delivered a 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.

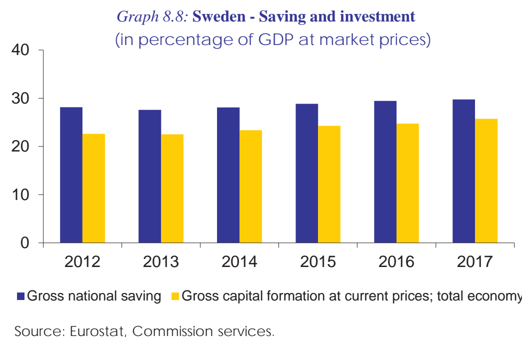
According to National Accounts data, Sweden's large savings-investment surplus persisted in 2016 and 2017, primarily on the back of high net

([57]) https://ec.europa.eu/info/sites/info/files/2018-european-semester-country-report-sweden-en.pdf

savings by the private sector, but also due to fiscal surpluses. This reflects increased precautionary savings and a pension regime with defined contributions. Gross fixed capital continued increasing and gross capital formation reached around 26% of GDP in 2017.

Sweden's export market share has been declining overall since the early 2000s. The export market share decreased by about 0.3% and 0.6% in 2016 and 2017 respectively following an average increase by about 2.0% in 2014-2015, which appeared largely driven by a denominator effect related to the temporary global slowdown rather than a structural change in the long-run trend. The decline in export market share is linked to changing global trade patterns affecting most mature, industrialised economies with a similar focus on high-value-added exports, and does not suggest any underlying competitiveness issues.

Graph 8.8: **Sweden - Saving and investment**
(in percentage of GDP at market prices)



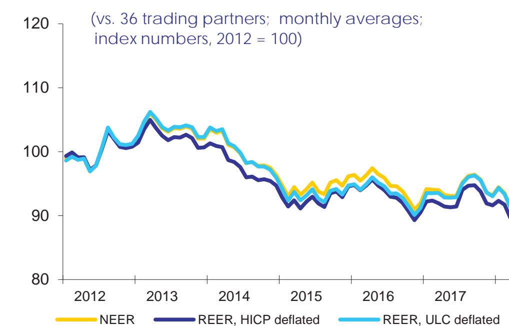
Source: Eurostat, Commission services.

This conclusion is buttressed by the benign change in cost competitiveness indicators. The real effective exchange rate remained broadly stable in 2016-2017. Unit labour costs (ULC) have been growing in line with Sweden's main trading partners over the same period.

Sweden's net international investment position has been positive since 2014, reaching 5% of GDP in 2016 and almost 10% in 2017. Sweden's financial account shows relatively large fluctuations over time. However, the financial account balance consistently reflects Sweden's role as a net FDI investor abroad, with the exception of 2016. The balance of portfolio investments fluctuated from negative in 2016 to positive in 2017. External reserves increased somewhat in 2016 and 2017. External debt has been on a declining trend, and decreased by more than 15 percentage points since 2014, from above 190% of GDP in 2014 to 174.3% of GDP in 2017. This development largely mirrors prudent fiscal management and the decline in gross government debt.

According to the Commission services' Spring 2018 Forecast, which is based on National Accounts data, net exports are expected to contribute positively to real GDP growth in 2018 and 2019, while the current account surplus is expected to remain above 4.0% of GDP over the forecast period.

Graph 8.9: **Sweden - Effective exchange rates**



Source: Commission services.

8.6.2. Market integration

Sweden is well integrated with the euro area through trade and investment linkages. Trade openness of the Swedish economy has remained rather stable with values above 40% of GDP since 2012 and went above this threshold in 2017 at almost 42% of GDP. The main euro-area trading partners are Germany, the Netherlands and Finland, while Norway, Denmark and the UK are the main non-euro-area partners.

The level of inward FDI has remained stable. Over the period 2016-2017 more than 80% of the total FDI stock originating from the EU, with the largest share from the Netherlands, the UK, Luxembourg, Finland and Germany.

Regarding the business environment, Sweden regularly scores top positions in international rankings, well above most euro-area Member State and currently ranks in the top ten at global level, with respect to the World Bank's Ease of Doing Business indicator and to the WEF's Global Competitiveness Index. Sweden also tops rankings in the public administration performance according to the World Bank's Worldwide Governance Indicators. Sweden's deficit in the transposition of EU directives in 2017 was at 1.4%, below the EU average, after meeting the 0.5% target as proposed

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Table 8.5:
Sweden - Market integration

	2012	2013	2014	2015	2016	2017
Trade openness 1) (%)	42.3	40.3	41.2	41.5	40.3	41.6
Trade with EA in goods & services 2)+3) (%)	18.0	17.5	17.6	17.6	17.6	18.3
Export performance (% change) 4)	-1.5	-3.6	1.4	2.6	-0.2	-0.7
World Bank's Ease of Doing Business Index rankings 5)	13	14	11	8	9	10
WEF's Global Competitiveness Index rankings 6)	4	6	10	9	9	7
Internal Market Transposition Deficit 7) (%)	0.6	0.1	0.3	0.2	0.4	1.4
Real house price index 8)	78.7	82.4	89.2	100.0	107.6	112.5
Residential investment 9) (%)	3.4	3.5	4.0	4.6	5.2	5.7

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.
(November data, as of 2016 date refers to the year of publication).
8) Deflated house price index (2015=100) (Eurostat).
9) Gross capital formation in residential buildings (in % of GDP) (Eurostat).

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

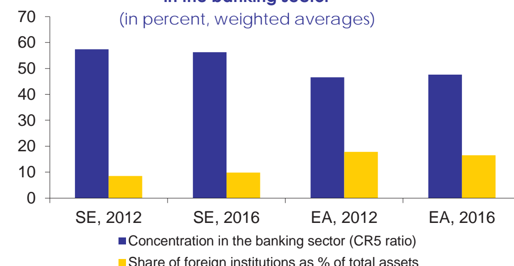
by the European Commission in the Single Market Act (2011) between 2011 and 2016. In particular, the 4th Anti-Money Laundering Directive imposed transposition by 26 June 2017, and Sweden notified the Commission of the transposition measures within that deadline. The Commission is analysing these measures to assess their conformity with the directive.

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 relatively 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 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. Nordea’s move to Finland will have significant implications for the Swedish banking sector as it would reduce the asset-to-GDP ratio of the Swedish banking sector by over 100 GDP points.

Foreign ownership in the Swedish financial market has been persistently lower than the euro-area average and remained below 10% in 2016, against a euro area average of 16.5%. At almost 60%, bank concentration measured by the market share of the largest five credit institutions in total assets has remained significantly above the euro-area average, which was 48% at the end of 2016.

Graph 8.10: **Sweden - Foreign ownership and concentration in the banking sector**
(in percent, weighted averages)



Source: ECB, Structural financial indicators .

The capital adequacy of Swedish banks measured by standard regulatory ratios is relatively high, just above 26% in the second quarter 2017, compared to the euro area average (18% in the second quarter 2017). Moreover, the ratio of non-

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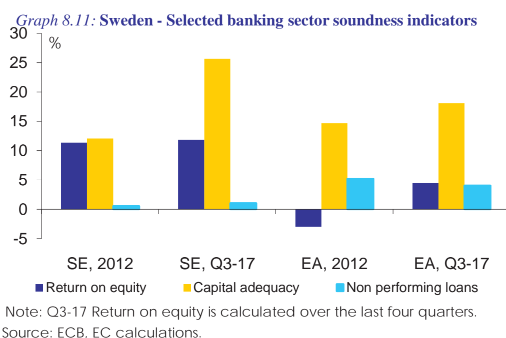
performing loans (0.5% in the second quarter 2017) is back to 2012 levels and is significantly lower than the euro area average, which remains above 4%. High asset quality, cost-efficiency and market concentration support the profitability of Swedish banks, which is among the highest in Europe. The sector's average return on equity (ROE) in the second quarter 2017 stood above 6%, double than the euro area average of above 3%.

House prices in Sweden have been gradually falling in autumn 2017, but this follows a long period of virtually uninterrupted strong growth. Real house prices have more than tripled over the past two decades, significantly outpacing income growth. House price inflation peaked in 2015 at about 12 % in real terms, but since then there has been a notable loss of momentum: in 2016, real house prices rose by 7.6 % and in autumn 2017 the housing market experienced a gradual decline but prices remain above fundamentals. Residential investment has picked up significantly in recent years, from 3.6% of GDP in 2010 to 5.1% of GDP in 2016, and is now roughly in line with the EU average. Overvalued house prices entail risks of a disorderly deleveraging process, potentially with a significant broader impact on the banking sector and the real economy. In addition, the ongoing housing shortage has negative knock-on effects on labour mobility and social equality.

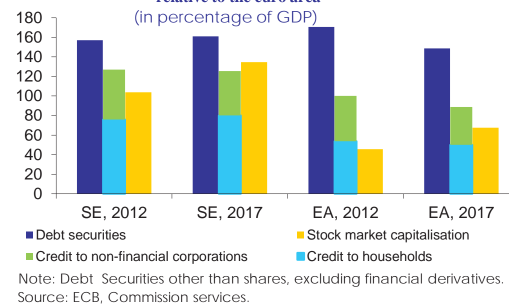
Graph 8.11: **Sweden - Selected banking sector soundness indicators**



Note: Q3-17 Return on equity is calculated over the last four quarters.
Source: ECB, EC calculations.

Capital markets in Sweden are very well developed compared to the euro area. The capitalization index, measuring the ratio to GDP of the value of the stock of quoted shares issued by Swedish enterprises stood at about 135% at the end of 2016, thus broadly stabilizing at the level of the end of 2015 (well up from about 105% of GDP in 2012). This compares to a euro-area capitalization index of 68%.

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.

The total amount of outstanding debt securities stood at 161% of GDP, 4 percentage points above the 2012 level. Outstanding bank credit to non-financial companies and households stood at about 126% of GDP (roughly the same level as in 2012). More than 60% of this credit was given to households. The private sector started slowly deleveraging, with a consolidated stock of private sector debt that slightly decreased to 189% of GDP in 2016, down from the peak at 195% of GDP in 2013. This is significantly above the euro-area average which stood at 137% in 2016.

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