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signed by Mr Jordi AYET PUIGARNAU, Director

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To: Mr Jeppe TRANHOLM-MIKKELSEN, Secretary-General of the Council of
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European Union)

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Brussels, 23.5.2018
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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)**

{SWD(2018) 350 final}

1. PURPOSE OF THE REPORT

The euro is meant to be the single currency of the European Union as a whole. It is now used every day by around 342 million people in 19 Member States ("euro area"). The euro is the second most used currency worldwide. Sixty other countries and territories around the world, home to 175 million people, have chosen to use the euro as their currency or to peg their own currency to it.

Article 140(1) of the Treaty on the Functioning of the European Union (hereafter TFEU) requires the Commission and the European Central Bank (ECB) to report to the Council, at least once every two years, or at the request of a Member State with a derogation¹, on the progress made by the Member States in fulfilling their obligations regarding the achievement of economic and monetary union. The latest Commission and ECB Convergence Reports were adopted in June 2016.

The 2018 Convergence Report covers the following seven Member States with a derogation: Bulgaria, the Czech Republic, Croatia, Hungary, Poland, Romania and Sweden². A more detailed assessment of the state of convergence in those Member States is provided in a Technical Annex to this Report.

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

The financial and economic crisis, along with the euro-area sovereign debt crisis, has exposed gaps in the economic governance system of the Economic and Monetary Union (EMU) and showed that its instruments need to be used more comprehensively. With the aim of ensuring a sustainable functioning of EMU, an overall strengthening of economic governance in the Union has been undertaken. The assessment of convergence is thus aligned with the broader European Semester approach which takes an integrated look at the economic policy challenges facing the EMU in ensuring fiscal sustainability, competitiveness, financial market stability and economic growth. The key innovations in the area of governance reform, reinforcing the assessment of each Member State's convergence process and its sustainability, include *inter alia* the strengthening of the excessive deficit procedure by the 2011 reform of the Stability and Growth Pact and new instruments in the area of surveillance of macroeconomic imbalances. In particular, this report takes into account the findings under the Macroeconomic Imbalances Procedure³.

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

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

³ The Commission published its seventh Alert Mechanism Report (AMR) in November 2017 and the conclusions of the corresponding in-depth reviews in March 2018.

These crises also revealed the existence of undesirable links between national banking sectors and their sovereigns and unleashed strong fragmentation forces in financial markets. The Banking Union was created to break those links and reverse fragmentation, as well as to ensure better risk diversification across Member States and adequate financing of the economy. Several key elements of the Banking Union are already established, i.e. the Single Rulebook, the Single Supervisory Mechanism (SSM) and the Single Resolution Fund (SRF). Member States which adopt the euro will also participate in the Banking Union. Such participation is irrespective of the assessment of the convergence criteria undertaken in this report.

As part of the package on deepening Europe's EMU presented on 6 December 2017, the European Commission proposed 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 euro⁴. This proposal was reflected in the amendment to the Structural Reform Support Programme Regulation⁵. The Commission also announced that for the period post-2020, it will propose a dedicated convergence facility 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 conducted through the Convergence Reports.

Convergence criteria

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

The **price stability criterion** is defined in the first indent of Article 140(1) TFEU: *“the achievement of a high degree of price stability [...] will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability”*.

Article 1 of the Protocol on the convergence criteria further provides that *“the criterion on price stability [...] shall mean that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1.5 percentage points that of, at most, the three best-performing Member States in terms of price stability. Inflation shall be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions”*⁶. The requirement of sustainability implies that the satisfactory inflation performance must essentially be attributable to the behaviour of input costs and other factors influencing price developments in a structural manner, rather than the influence of temporary factors. Therefore, the convergence examination includes an assessment of the factors that have an impact on the inflation outlook and is complemented by a

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

⁵ Proposal for a Regulation of the EP and of the Council amending Regulation (EU) 2017/825, COM(2017) 825 final, 2017/0334(COD), 6 December 2017.

⁶ For the purpose of the criterion on price stability, inflation is measured by the Harmonised Index of Consumer Prices (HICP) defined in Council Regulation (EC) No 2494/95.

reference to the most recent Commission services' forecast of inflation⁷. Related to this, the report also assesses whether the country is likely to meet the reference value in the months ahead.

The inflation reference value was calculated to be 1.9% in March 2018⁸, with Cyprus, Ireland and Finland as the three 'best-performing Member States'⁹.

The convergence **criterion dealing with public finances** is defined in the second indent of Article 140(1) TFEU as “*the sustainability of the government financial position: this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 126(6)*”. Furthermore, Article 2 of the Protocol on the convergence criteria states that this criterion means that “*at the time of the examination the Member State is not the subject of a Council decision under Article 126(6) of the said Treaty that an excessive deficit exists*”. As part of an overall strengthening of economic governance in EMU, the secondary legislation related to public finances was enhanced in 2011, including the new regulations amending the Stability and Growth Pact¹⁰.

The TFEU refers to the **exchange rate criterion** in the third indent of Article 140(1) as “*the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the euro*”.

Article 3 of the Protocol on the convergence criteria provides: “*The criterion on participation in the exchange rate mechanism of the European Monetary System (...) shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against the euro on its own initiative for the same period*”¹¹.

The relevant two-year period for assessing exchange rate stability in this report is 24 April 2016 to 23 April 2018. In its assessment of the exchange rate stability criterion, the Commission takes into account developments in auxiliary indicators such as foreign reserve developments and short-term interest rates, as well as the role of policy measures, including foreign exchange interventions, and international financial assistance wherever relevant, in maintaining exchange rate stability. Currently none of the Member States assessed in this Convergence Report participates in ERM II. Entry into ERM II is decided upon request of a Member State by consensus of all ERM II participants¹².

⁷ All forecasts for inflation and other variables in the current report are from the Commission services' Spring 2018 Forecast. The Commission services' forecasts are based on a set of common assumptions for external variables and on a no-policy-change assumption while taking into consideration measures that are known in sufficient detail.

⁸ The cut-off date for the data used in this report is 23 April 2018.

⁹ The respective 12-month average inflation rates were 0.2%, 0.3% and 0.8%.

¹⁰ A directive on minimum requirements for national budgetary frameworks, two new regulations on macroeconomic surveillance and three regulations amending the Stability and Growth Pact (SGP) entered into force on 13 December 2011 (one out of two new regulations on macroeconomic surveillance and one out of three regulations amending the SGP include new enforcement mechanisms for euro-area Member States). Besides the operationalisation of the debt criterion in the Excessive Deficit Procedure, the amendments introduced a number of important novelties in the Stability and Growth Pact, in particular an expenditure benchmark to complement the assessment of progress towards the country-specific medium-term budgetary objective.

¹¹ 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.

¹² ERM II participants are the euro-area finance ministries, the ECB, non-euro area ERM II finance ministries and central banks.

The fourth indent of Article 140(1) TFEU requires “*the durability of convergence achieved by the Member State with a derogation and of its participation in the exchange rate mechanism being reflected in the **long-term interest rate levels***”. Article 4 of the Protocol on the convergence criteria further lays down that “*the criterion on the convergence of interest rates (...) shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best-performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions*”.

The interest rate reference value was calculated to be 3.2% in March 2018¹³.

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

2. BULGARIA

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

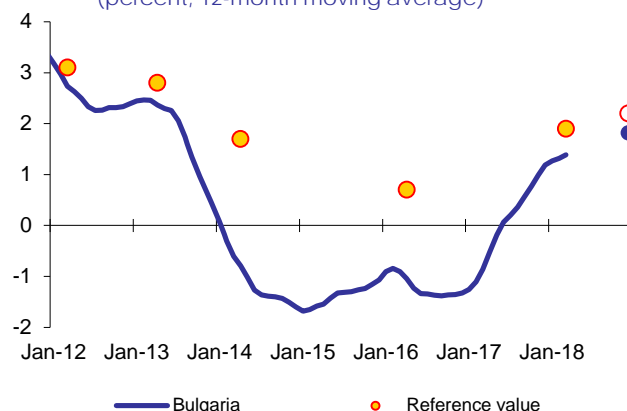
Legislation in Bulgaria – in particular the Law on the Bulgarian National Bank – **is not fully compatible** with the compliance duty under Article 131 TFEU. Incompatibilities and imperfections exist in the fields of central bank independence, the prohibition of monetary financing and central bank integration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

Bulgaria fulfils the criterion on price stability. The average inflation rate in Bulgaria during the 12 months to March 2018 was 1.4%, below the reference value of 1.9%. It is projected to remain below the reference value in the months ahead.

The annual HICP inflation rate in Bulgaria was negative between mid-2013 and early-2017, due to combination of several factors, i.e. declining imported commodity prices, subdued domestic demand and reductions in administered prices. In 2016, it dropped from -0.4% in January to about -2.5% in mid-2016, when it started to increase. In December 2016, it reached -0.5%, and continued to increase until April 2017, when it stood at 1.7%. In May-July 2017, inflation again temporarily declined, but soon reverted to increasing path reaching about 1.9% in November 2017. The pick-up in annual inflation in 2017 reflected larger inflation contributions from energy and food prices. Inflation has dropped again in early 2018 and reverted to 1.9% in March 2018.

¹³ The reference value for March 2018 is calculated as the simple average of the average long-term interest rates of Cyprus (2.2%), Ireland (0.8%) and Finland (0.6%), plus two percentage points.

Graph 2a: Bulgaria - Inflation criterion since 2012
(percent, 12-month moving average)

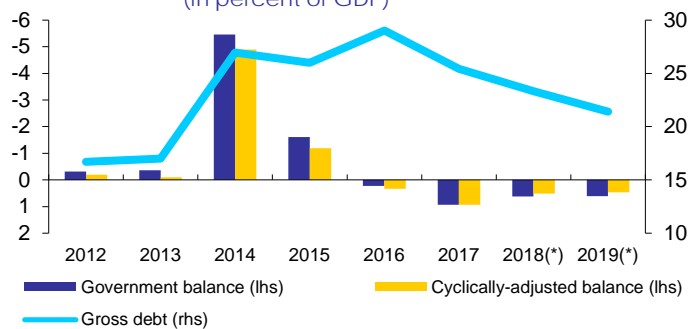


Note: The dots in December 2018 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2018 Forecast.

Inflation is expected to rise further as a result of internal factors, i.e. a boost in private demand fuelled by an expected increase of the households' disposable incomes, and as a result of external forces, i.e. an expected increase in global oil prices and their spill-overs to energy prices. Accordingly, the Commission services' Spring 2018 Forecast projects HICP inflation to average 1.8% in 2018 and 2019. The relatively low price level in Bulgaria (about 47% of the euro-area average in 2016) suggests significant potential for price level convergence in the long term.

Bulgaria fulfils the criterion on public finances. Moreover, based on the assessment of the 2018 Convergence Programme, Bulgaria is expected to comply with the Stability and Growth Pact in 2018 and 2019. Bulgaria is not the subject of a Council Decision on the existence of an excessive deficit. The general government budget balance was 0.2% and 0.9% of GDP in 2016 and 2017, respectively. According to the Commission services' Spring 2018 Forecast, it is projected to remain positive at 0.6% of GDP in both 2018 and 2019, under a no-policy-change assumption. The gross public debt ratio decreased to 25.4% of GDP in 2017 and it is projected to further decrease to 23.3% of GDP in 2018 and to 21.4% of GDP in 2019. The Bulgarian fiscal framework has recently been strengthened by successive legislative steps, which now require implementation.

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



(*) Commission services' Spring 2018 Forecast.
Source: Eurostat, Commission services.

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

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

Bulgaria fulfils the criterion on the convergence of long-term interest rates. The average long-term interest rate in Bulgaria in the year up to March 2018 was 1.4%, below the reference value of 3.2%. Long-term interest rates in Bulgaria declined from 2.4% in January 2016 to 0.9% in January 2018. Yield spreads vis-à-vis German benchmark bond increased by some 50 basis points in the first half of 2016 reaching about 250 basis points in July 2016, but have been on a decreasing path since then. At the end of 2017 the spread reached 72 basis points, further decreasing to below 40 basis points in early 2018.

Additional factors have also been examined, including balance of payments developments and integration of markets. Bulgaria's external balance recorded a significant surplus, reaching 4.5% and 5.5% of GDP in 2016 and 2017, respectively. The Bulgarian economy is well integrated with the euro area through trade and investment linkages. On the basis of selected indicators related to the business environment, Bulgaria performs worse than most euro-area Member States. Major challenges also relate to the institutional framework including corruption and government efficiency. Bulgaria's financial sector is well integrated with the EU financial sector, in particular through a high level of foreign ownership in its banking system. In the context of the Macroeconomic Imbalance Procedure, Bulgaria was subject to an in-depth review in 2018, which concluded that Bulgaria experiences macroeconomic imbalances (thereby revising the previous conclusion of excessive imbalances), linked to vulnerabilities in the financial sector coupled with high indebtedness and non-performing loans in the corporate sector. Persistent structural weaknesses prevent labour market to improve faster.

3. THE CZECH REPUBLIC

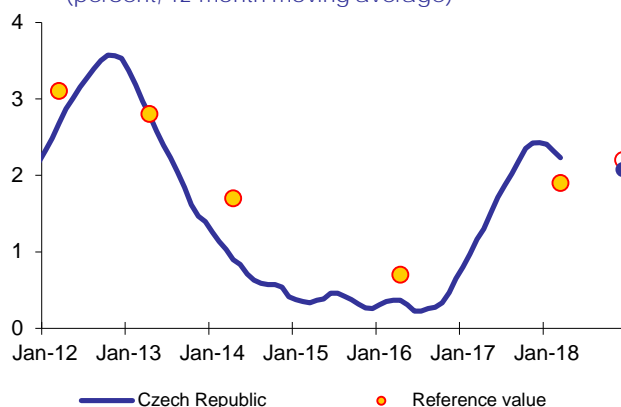
In the light of its assessment on legal compatibility and on the fulfilment of the convergence criteria, and taking into account the additional relevant factors, the Commission considers that the Czech Republic does not fulfil the conditions for the adoption of the euro.

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

The Czech Republic does not fulfil the criterion on price stability. The average inflation rate in the Czech Republic during the 12 months to March 2018 was 2.2%,

above the reference value of 1.9%. It is projected to decline below the reference value in the months ahead.

Graph 3a: Czech Republic - Inflation criterion since 2012
(percent, 12-month moving average)

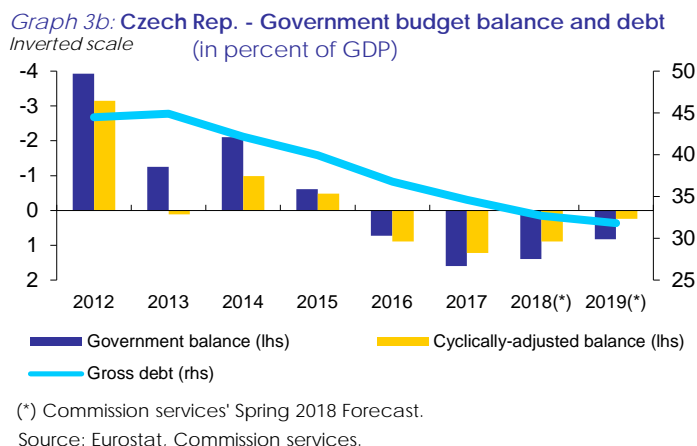


Note: The dots in December 2018 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2018 Forecast.

The 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. Annual inflation declined in early 2018 and stood at 1.6% in March 2018.

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. As a result, the Commission services' Spring 2018 Forecast projects annual HICP inflation to average 2.1% in 2018 and 1.8% in 2019. The price level in the Czech Republic (about 64% of the euro-area average in 2016) suggests potential for further price level convergence in the long term.

The Czech Republic fulfils the criterion on public finances. Moreover, based on the assessment of the 2018 Convergence Programme, the Czech Republic is expected to comply with the Stability and Growth Pact in 2018 and 2019. The Czech Republic is not the subject of a Council Decision on the existence of an excessive deficit. The general government balance improved substantially, from -2.1% of GDP in 2014 to a surplus of 1.6% of GDP in 2017. According to the Commission services' Spring 2018 Forecast, the general government balance is projected at 1.4% of GDP in 2018 and 0.8% of GDP in 2019, under a no-policy-change assumption. The gross public debt ratio declined from its peak of 44.9% of GDP in 2013 to below 35% of GDP in 2017. It is projected to fall below 32% of GDP in 2019. The Czech fiscal framework was strengthened with the adoption of the Fiscal Responsibility Law in early 2017, but its effectiveness will depend on the implementation of the new rules.



The Czech Republic does not fulfil the exchange rate criterion. The Czech koruna is not participating in ERM II. The Czech Republic operates a floating exchange rate regime, allowing for foreign exchange market interventions by the central bank. 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. 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. During the two years before this assessment, the koruna appreciated against the euro by more than 6%.

The Czech Republic fulfils the criterion on the convergence of long-term interest rates. The average long-term interest rate in the Czech Republic in the year to March 2018 was 1.3%, below the reference value of 3.2%. 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. The spread against the German benchmark bond fluctuated around 120 basis points in early 2018.

Additional factors have also been examined, including balance of payments developments and integration of markets. The external balance of the Czech Republic recorded a surplus of 2.7% of GDP in 2016 and 2% of GDP in 2017. The Czech economy is highly integrated with the euro area through trade and investment linkages. On the basis of selected indicators relating to the business environment, the scores received by the Czech Republic in international rankings seem to have stabilised below the euro-area average in recent years. The Czech financial sector is highly integrated into the EU financial sector, in particular through a high degree of foreign ownership of financial intermediaries.

4. CROATIA

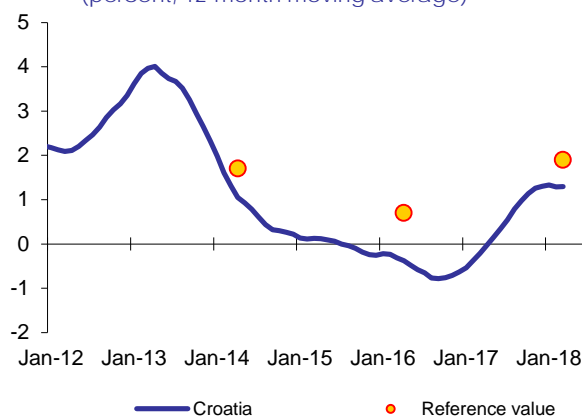
In the light of its assessment on legal compatibility and on the fulfilment of the convergence criteria, and taking into account the additional relevant factors, the Commission considers that Croatia does not fulfil the conditions for the adoption of the euro.

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

Croatia fulfils the criterion on price stability. The average inflation rate in Croatia during the 12 months to March 2018 was 1.3%, below the reference value of 1.9%. It is expected to remain below the reference value in the months ahead.

Annual HICP inflation remained negative throughout most of 2016 due to falling energy and unprocessed food prices. It thus 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% until early 2018. Annual inflation stood at 1.2% in March 2018.

Graph 4a: Croatia - Inflation criterion since 2012
(percent, 12-month moving average)

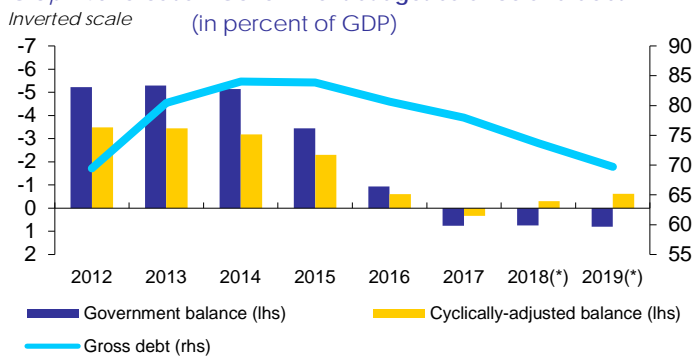


Note: The dots in December 2018 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2018 Forecast.

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 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. The price level in Croatia (about 65% of the euro-area average in 2016) suggests potential for price level convergence in the long term.

Croatia fulfils the criterion on public finances. Moreover, based on the assessment of the 2018 Convergence Programme, Croatia is expected to comply with the Stability and Growth Pact in 2018 and 2019. Croatia is not the subject of a Council Decision on the existence of an excessive deficit. The general government balance turned into a surplus of 0.8% of GDP in 2017. The Commission services' Spring 2018 Forecast projects the general government balance to remain broadly stable at 0.7% of GDP in 2018 and 0.8% of GDP in 2019. The general government debt is forecasted to decline to around 70% of GDP by 2019. Following repeated delays with the adoption of the planned reform acts, the Croatian fiscal framework has remained relatively weak in all major aspects, most notably the design of numerical rules, the binding power of medium-term plans, and the set-up of its national fiscal council.

Graph 4b: Croatia - Government budget balance and debt



Croatia does not fulfil the exchange rate criterion. The Croatian kuna is not participating in ERM II. The HNB operates a tightly managed floating exchange rate regime, using the exchange rate as the main nominal anchor to achieve its primary objective of price stability. Between early 2016 and early 2018 the kuna experienced some appreciation pressures which necessitated foreign exchange purchases from banks by the HNB aimed at stabilising its exchange rate against the euro. The kuna's exchange against the euro has continued to exhibit a seasonal pattern of temporary appreciating in spring thanks to foreign exchange inflows generated by the tourism sector. During the two years before this assessment, the kuna appreciated against the euro by almost 2%.

Croatia fulfils the criterion on the convergence of long-term interest rates. The average long-term interest rate in Croatia in the year to March 2018 was 2.6%, below the reference value of 3.2%. 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. 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.

Additional factors have also been examined, including balance of payments developments and integration of markets. Croatia's external surplus increased from 3.6% of GDP in 2016 to 4.2% of GDP in 2017 benefiting from an improvement in the income balance. The Croatian economy is well integrated with the euro area through trade and investment linkages. On the basis of selected indicators relating to the business environment, Croatia performs worse than most euro-area Member States. Major challenges also relate to the institutional framework including regulatory quality. The financial sector is highly integrated into the EU financial system through foreign ownership of domestic banks. In the context of the Macroeconomic Imbalance Procedure, Croatia was subject to an in-depth review in 2018 which found that it continued to experience excessive macroeconomic imbalances linked to high levels of public, private and external debt, all largely denominated in foreign currency, in a context of low potential growth.

5. HUNGARY

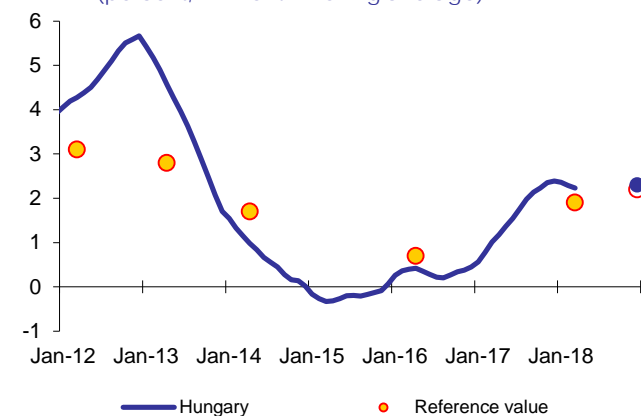
In the light of its assessment on legal compatibility and on the fulfilment of the convergence criteria, and taking into account the additional relevant factors, the

Commission considers that Hungary does not fulfil the conditions for the adoption of the euro.

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

Hungary does not fulfil the criterion on price stability. The average inflation rate in Hungary during the 12 months to March 2018 was 2.2%, above the reference value of 1.9%. It is projected to remain above the reference value in the months ahead.

Graph 5a: Hungary - Inflation criterion since 2012
(percent, 12-month moving average)



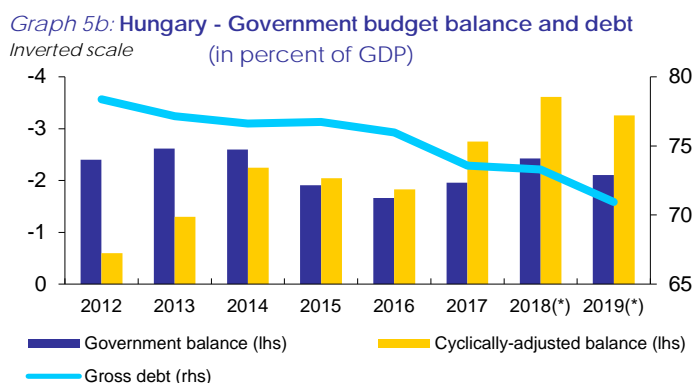
Note: The dots in December 2018 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2018 Forecast.

Annual HICP inflation in Hungary over the last two years exited from very low levels, including negative values in mid-2016. Inflation then started to rise steeply, reaching 2.9% by February 2017 before moderating thereafter, due mostly to energy price fluctuations. From spring 2017, processed food prices put increasing upward pressure on HICP inflation, keeping the headline figure above 2% in 2017. In early 2018 inflation declined again, mainly thanks to energy and durable goods prices. In March 2018, annual HICP inflation stood at 2.0%.

Inflation is projected to decrease slightly to 2.3% in 2018 and to increase to 3.0% in 2019 according to the Commission services' Spring 2018 Forecast, as services inflation is expected to increase on the back of strong wage growth. The relatively low price level in Hungary (about 58% of the euro-area average in 2016) suggests significant potential for further price level convergence in the long term.

Hungary fulfils the criterion on public finances. Hungary is not the subject of a Council Decision on the existence of an excessive deficit. However, the Commission recommends opening a Significant Deviation Procedure for Hungary in light of the significant observed deviation from the requirements of the Stability and Growth Pact in 2017. Based on the assessment of the 2018 Convergence Programme, there is a risk of a significant deviation from the requirements also in 2018 and 2019.

Therefore, significant further measures will be needed as of 2018 to comply with the provisions of the Stability and Growth Pact. The general government deficit decreased to 1.7% of GDP in 2016, compared to 1.9% in 2015, and then rebounded to 2.0% in 2017. According to the Commission services' Spring 2018 Forecast, it is projected to increase to 2.4% of GDP in 2018 and thereafter to moderate at 2.1% of GDP in 2019, under a no-policy-change assumption. The gross public debt ratio decreased to 73.6% of GDP in 2017 and it is projected to decrease further to 73.3% of GDP in 2018 and to 71.0% of GDP in 2019. The Hungarian fiscal framework is well-developed around stringent rules and procedures of debt control across all layers of general government; however, some noteworthy weaknesses (most notably, the feeble role of medium-term fiscal planning) still remain.



(*) Commission services' Spring 2018 Forecast.
 Source: Eurostat, Commission services.

Hungary does not fulfil the exchange rate criterion. The Hungarian forint is not participating in ERM II. Hungary operates a floating exchange rate regime, allowing for foreign exchange market interventions by the central bank. The forint weakened from around 311 HUF/EUR in March 2016 to 314 HUF/EUR in mid-2016, before strengthening to 307 HUF/EUR by October 2016, when the MNB introduced volume caps on the three-month deposit facility. The forint then traded around 310 HUF/EUR until mid-2017, when a new appreciation wave drove it to near 304 HUF/EUR in August 2017. Following the MNB's verbal intervention, hinting at the introduction of new instruments and the cutting of the overnight deposit rate to minus 15 basis points, the forint returned to somewhat below 310 HUF/EUR after September 2017. In March 2018, the forint was broadly at the same level against the euro, as two years earlier.

Hungary fulfils the criterion on the convergence of long-term interest rates. The average long-term interest rate in the year to March 2018 was 2.7%, below the reference value of 3.2%. The monthly average long-term interest rate 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 its monetary stimulus even more to long-term rates. Hungary's long-term interest rate increased to around 2.6% by February 2018, in an international environment of rising yields. The long-term spread vis-à-vis the German benchmark bond stood around 200 basis points in early 2018.

Additional factors have also been examined, including balance of payments developments and integration of markets. The external balance recorded large surpluses over the past two years, although it deteriorated in 2017, mainly on account

of the trade balance. The Hungarian economy is highly integrated with the euro area through trade and investment linkages. On the basis of selected indicators relating to the business environment, Hungary performs worse than most euro-area Member States. Hungary's financial sector is well integrated into the EU financial system.

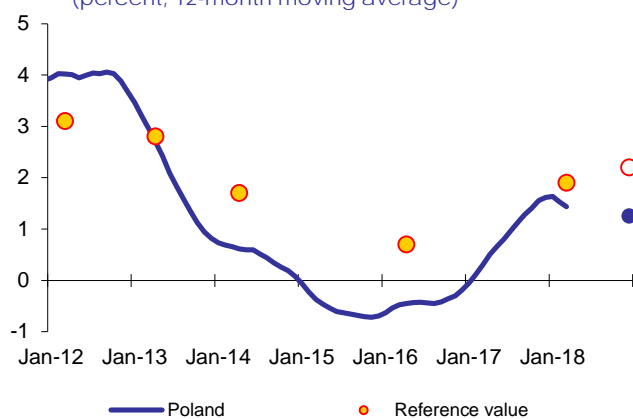
6. POLAND

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

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

Poland fulfils the criterion on price stability. The average inflation rate in Poland during the 12 months to March 2018 was 1.4%, below the reference value of 1.9%. It is expected to remain below the reference value in the months ahead.

Graph 6a: Poland - Inflation criterion since 2012
(percent, 12-month moving average)



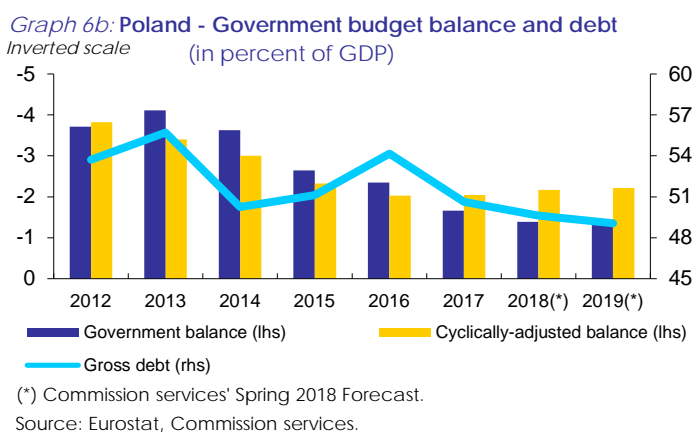
Note: The dots in December 2018 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2018 Forecast.

Annual HICP inflation turned positive in October 2016 and increased fast to a local high of 1.9% in February 2017, before declining to 1.3% in June 2017. The second half of 2017 was marked by a gradual inflation increase before it jumped to 2% in November and receded to 1.7% in December 2017. It fell sharply further to 0.7% in February 2018. This somewhat volatile pattern is explained by strong swings in the dynamics of energy and unprocessed food prices. In March 2018, annual HICP inflation stood at 0.7%.

Inflation is projected to decrease to 1.3% in 2018 and to increase to 2.5% in 2019 according to the Commission services' Spring 2018 Forecast, due mainly to strengthening pressure from accelerating wages amid further tightening of the labour

market. The relatively low price level in Poland (about 52% of the euro-area average in 2016) suggests significant potential for price level convergence in the long term.

Poland fulfils the criterion on public finances. Poland is not the subject of a Council Decision on the existence of an excessive deficit. However, based on the assessment of the 2018 Convergence Programme, there is a risk of significant deviation from the Stability and Growth Pact requirements in 2018 so that further measures will be needed as of 2018 to comply with the provisions of the Stability and Growth Pact. The general government deficit declined from 2.6% in 2015 to 2.3% of GDP in 2016. The deficit-to-GDP ratio improved to 1.7% in 2017 and according to the Commission services' Spring 2018 Forecast it is projected to improve further to 1.4% of GDP in both 2018 and 2019, under a no-policy-change assumption. The general government debt-to-GDP ratio is forecast to decrease from 50.6% in 2017 to 49.1% in 2019. Poland's domestic fiscal framework is overall strong, with weaknesses mainly in the areas of budgetary planning and procedures, and independent monitoring.



Poland does not fulfil the exchange rate criterion. The Polish zloty is not participating in ERM II. Poland operates a floating exchange rates regime, allowing for foreign exchange market interventions by the central bank. The zloty traded at around 4.4 against the euro between April 2016 and late 2016. It appreciated between December 2016 and May 2017, cumulatively by almost 6%. The zloty then weakened somewhat until early October 2017 (to around 4.3 PLN/EUR) to subsequently strengthen during the rest of 2017. Poland gradually exited from the Flexible Credit Line arrangement it had with the IMF since 2009, terminating the access in November 2017. During the two years before this assessment, the zloty appreciated against the euro by about 2%.

Poland does not fulfil the criterion on the convergence of long-term interest rates. The average long-term interest rate in the year to March 2018 was 3.3%, above the reference value of 3.2%. The monthly average long-term interest rate increased from below 3% in April 2016 to around 3.8% in early 2017. Long-term interest rates then decreased to around 3.2% by June 2017, before slightly increasing again thereafter. The long-term interest rate spread vis-à-vis the German benchmark bond stood at around 270 basis points in early 2018.

Additional factors have also been examined, including balance of payments developments and integration of markets. Poland's external balance has been in surplus since 2013, backed by a continued improvement in the trade balance. The

Polish economy is well integrated with the euro area through trade and investment linkages. On the basis of selected indicators relating to the business environment, Poland performs around the average of euro-area Member States. Poland's financial sector is well integrated into the EU financial sector.

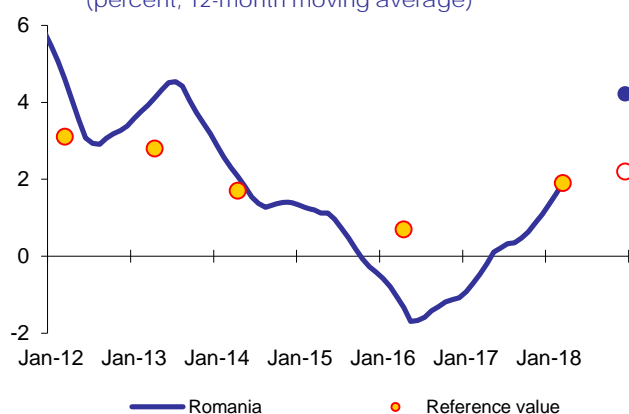
7. ROMANIA

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

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

Romania does not fulfil the criterion on price stability. The average inflation rate in Romania during the 12 months to March 2018 was 1.9%, at the reference value of 1.9%. It is, however, projected to increase well above the reference value in the months ahead.

Graph 7a: Romania - Inflation criterion since 2012
(percent, 12-month moving average)



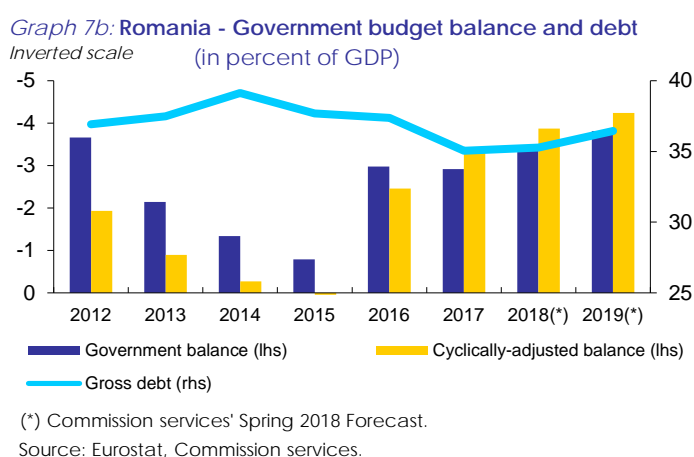
Note: The dots in December 2018 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2018 Forecast.

Annual HICP inflation was on a downward path in 2016, mainly driven by successive VAT cuts and low global oil prices. After reaching a low of almost -3% in May 2016, it remained in negative territory for most of 2016. In 2017, inflation increased progressively, but remained subdued due to a further 1 percentage point cut in the standard VAT rate and a reduction in excise duties on fuel in January 2017. Inflation started to accelerate in the second half of 2017 mainly on account of rising food prices and the reversal of the January excise duties cut in October, moving from 0.6% in August to 2.6% in December 2017. Inflation continued to increase in early

2018 as the effect of the January 2017 tax cuts faded away, reaching 4.0% in March 2018.

According to the Commission services' Spring 2018 Forecast, annual HICP inflation is projected to rise to 4.2% in 2018 and then to decline to 3.4% in 2019 as energy price inflation moderates. The relatively low price level in Romania (about 51% of the euro-area average in 2016) suggests significant potential for price level convergence in the long term.

Romania fulfils the criterion on public finances. Romania is not the subject of a Council Decision on the existence of an excessive deficit. However, Romania is the subject to a significant deviation procedure (SDP) due to the significant observed deviation from the medium-term budgetary objective in 2016. In autumn 2017, it was found not to have delivered effective action under the SDP and a revised recommendation was issued. Moreover, the Commission recommends opening again a Significant Deviation Procedure for Romania in light of the significant observed deviation from the requirements of the Stability and Growth Pact also in 2017. Based on the assessment of the 2018 Convergence Programme, there is a risk of a significant deviation from the requirements also in 2018 and 2019. Therefore, significant further measures will be needed as of 2018 to comply with the provisions of the Stability and Growth Pact, in light of a strongly deteriorating fiscal outlook. The headline deficit increased from 0.8% of GDP in 2015 to 3.0% and 2.9% of GDP in 2016 and 2017, respectively, as 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. According to the Commission services' Spring 2018 Forecast, it is projected to deteriorate to 3.4% of GDP in 2018 and to 3.8% in 2019, under a no-policy-change assumption. The general government debt ratio is forecast to continue to increase to 35.3% in 2018 and 36.4% in 2019. The provisions of Romania's fiscal framework are strong. However, the fiscal framework's track record of effective implementation has been poor in recent years as shown by the worsening structural balance and the circumvention of expenditure rules through intra-year budget amendments.



Romania does not fulfil the exchange rate criterion. The Romanian leu is not participating in ERM II. Romania operates a floating exchange rate regime, allowing for foreign exchange market interventions by the central bank. The leu's exchange rate against the euro displayed a stable behaviour until September 2016, when it has started to moderately depreciate. The main drivers of the depreciation were a pro-

cyclical fiscal policy boosting trade and current account deficits and 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. In comparison with other regional peers operating under floating exchange rates, leu's exchange rate against the euro was relatively less volatile. During the two years before this assessment, the leu depreciated against the euro by about 4%.

Romania does not fulfil the criterion on the convergence of long-term interest rates. The average long-term interest rate in Romania in the year to March 2018 was 4.1%, above the reference value of 3.2%. Long-term interest rates declined gradually to some 3% in October 2016, when they started to increase again. They have been on an increasing path to date, reaching 4.5% in early 2018. 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.

Additional factors have also been examined, including balance of payments developments and the integration of markets. Romania's external balance has been deteriorating progressively since 2015 and in 2017 turned negative for the first time in five years. On the basis of selected indicators related to the business environment, Romania performs worse than most euro-area Member States. Major challenges also relate to the institutional framework including corruption and government efficiency. Romania's financial sector is well integrated with the EU financial sector, in particular through a high level of foreign ownership in its banking system.

8. SWEDEN

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

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

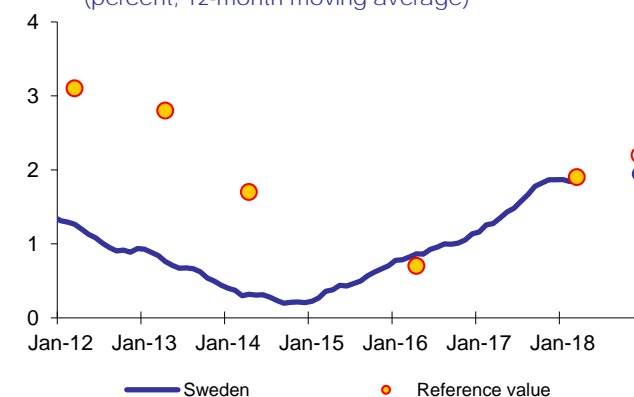
Sweden fulfils the criterion on price stability. The average inflation rate in Sweden during the 12 months to March 2018 was 1.9%, at the reference value of 1.9%. It is projected to decline below the reference value in the months ahead.

Sweden's average inflation rate reached 1.9% in 2017, up from 1.1% in 2016, with main increases in services and energy prices mainly due to krona depreciation and the continued expansion of domestic demand supported by the accommodative monetary policy of the Riksbank. In March 2018, annual HICP inflation stood at 2.0%.

HICP inflation is likely to remain broadly stable in the course of 2018. Oil prices are projected to exert upward pressure on the HICP in 2018. However, muted wage growth, which is projected to remain moderate and has been subdued due to global

competitive pressures, low wage expectations and untapped labour force, is expected to dampen somewhat the effect from higher oil prices. Accordingly, the Commission services' Spring 2018 Forecast projects annual average inflation at 1.9% in 2018 and 1.7% in 2019. The price level in Sweden is relatively high (about 122% of the euro-area average in 2016).

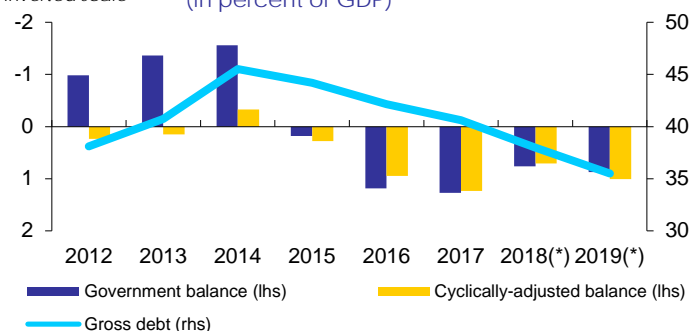
Graph 8a: Sweden - Inflation criterion since 2012
(percent, 12-month moving average)



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.

Sweden fulfils the criterion on public finances. Sweden is not the subject of a Council Decision on the existence of an excessive deficit. Moreover, based on the assessment of the 2018 Convergence Programme, Sweden is expected to continue complying with the provisions of the Stability and Growth Pact in 2018 and 2019. The general government surplus slightly increased from 1.2% of GDP in 2016 to 1.3% of GDP in 2017, still supported by revenue performance, which, 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. According to the Commission services' Spring 2018 Forecast, the general government surplus is expected to reach 0.8% of GDP in 2018 and 0.9% in 2019. The gross general government debt-to-GDP ratio decreased to 40.6% in 2017 and is expected to gradually decline to 38.0% of GDP in 2018 and 35.5% of GDP in 2019. Sweden has a strong fiscal framework, which was subject to reforms in late 2017, including lowering the surplus target to 0.33% of GDP (from 1% previously), introducing a new debt anchor and strengthening the mandate of the Fiscal Policy Council.

Graph 8b: Sweden - Government budget balance and debt
Inverted scale (in percent of GDP)



(*) Commission services' Spring 2018 Forecast.
Source: Eurostat, Commission services.

Sweden does not fulfil the exchange rate criterion. The Swedish krona is not participating in ERM II. Sweden operates a floating exchange rate regime, allowing for foreign exchange market interventions by the central bank. The krona continued the depreciating trend started early 2013. The depreciation took place against the background of continued monetary easing and of a widening three-months STIBOR-EURIBOR spread during 2016-2017, with fluctuations between broadly -30 basis points and -10 basis points. In early 2018 the spread stood at around -10 basis points. During the two years before this assessment, the krona averaged a SEK/EUR rate of 9.6 and depreciated against the euro by about 10%.

Sweden fulfils the criterion on the convergence of long-term interest rates. The average long-term interest rate in Sweden in the year to March 2018 was 0.7%, well below the reference value of 3.2%. Swedish long-term interest rates on a monthly basis started recovering from their all-time low of 0.1% in August 2016, reaching 0.9% in early 2018, which remains very low by historical standards. The spread 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 stood at 53 basis points

Additional factors have also been examined, including balance of payments developments and integration of markets. Sweden's external balance has remained in surplus, posting a 4.2% of GDP in 2016 and 3.2% in 2017. Sweden's economy is well integrated with the euro area through trade and investment linkages. On the basis of selected indicators relating to the business environment, Sweden performs better than most euro area Member States. Sweden's financial sector is well integrated into the EU financial sector. In the context of the Macroeconomic Imbalance Procedure, Sweden was identified as warranting a further in-depth review. The latter found that Sweden continues to experience macroeconomic imbalances as overvalued house price levels coupled with a continued rise in household debt poses risks of a disorderly correction. Awareness of mounting risks among authorities is high, and policy steps were taken to rein in mortgage debt growth and raise housing construction. However, the latter have not been sufficient to address the imbalances so far.