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COVER NOTE

From:	Mr Mario DRAGHI, President of the European Central Bank
date of receipt:	23 May 2018
To:	Mr Donald TUSK, President of the European Council
Subject:	ECB Convergence report 2018 - Part 2.

Delegations will find attached the second part of the European Central Bank's Convergence report 2018.

Encl.:

ECB Convergence Report May 2018 - Part 2

3 The state of economic convergence

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

As regards compliance with the convergence criteria, some progress has been made since the ECB's 2016 Convergence Report (see Table 3.1). Although dispersion in inflation rates has declined, two of the seven countries examined in the report are above the reference value, as compared to one in 2016. Long-term interest rate differentials versus the euro area have continued to decline in four of the seven countries considered in the report, but two countries are above the reference value, whereas all the countries were below in 2016. None of the countries participates in the exchange rate mechanism (ERM II), and some of the currencies have experienced sizeable fluctuations against the euro over the last few years.
Progress has been made on reducing fiscal imbalances in most of the countries examined in this report.

Table 3.1

Overview table of economic indicators of convergence

		Price stability	Government budgetary developments and projections			Exchange rate		
		HICP inflation [1]	Country in excessive deficit [2], [3]	General government surplus (+)/ deficit (-) [4]	General government debt [4]	Currency participating in ERM II [3]	Exchange rate vis-à-vis euro [3], [5]	Long-term interest rate [6]
Bulgaria	2016	-1.3	No	0.2	29.0	No	0.0	2.3
	2017	1.2	No	0.9	25.4	No	0.0	1.6
	2018	1.4	No	0.6	23.3	No	0.0	1.4
Czech Republic	2016	0.6	No	0.7	36.8	No	0.9	0.4
	2017	2.4	No	1.6	34.6	No	2.6	1.0
	2018	2.2	No	1.4	32.7	No	3.5	1.3
Croatia	2016	-0.6	Yes	-0.9	80.6	No	1.1	3.5
	2017	1.3	Yes	0.8	78.0	No	0.9	2.8
	2018	1.3	No	0.7	73.7	No	0.4	2.6
Hungary	2016	0.4	No	-1.7	76.0	No	-0.5	3.1
	2017	2.4	No	-2.0	73.6	No	0.7	3.0
	2018	2.2	No	-2.4	73.3	No	-0.7	2.7
Poland	2016	-0.2	No	-2.3	54.2	No	-4.3	3.0
	2017	1.6	No	-1.7	50.6	No	2.4	3.4
	2018	1.4	No	-1.4	49.6	No	1.7	3.3
Romania	2016	-1.1	No	-3.0	37.4	No	-1.0	3.3
	2017	1.1	No	-2.9	35.0	No	-1.7	4.0
	2018	1.9	No	-3.4	35.3	No	-1.9	4.1
Sweden	2016	1.1	No	1.2	42.1	No	-1.2	0.5
	2017	1.9	No	1.3	40.6	No	-1.8	0.7
	2018	1.9	No	0.8	38.0	No	-4.6	0.7
Reference value [7]		1.9		-3.0	60.0			3.2

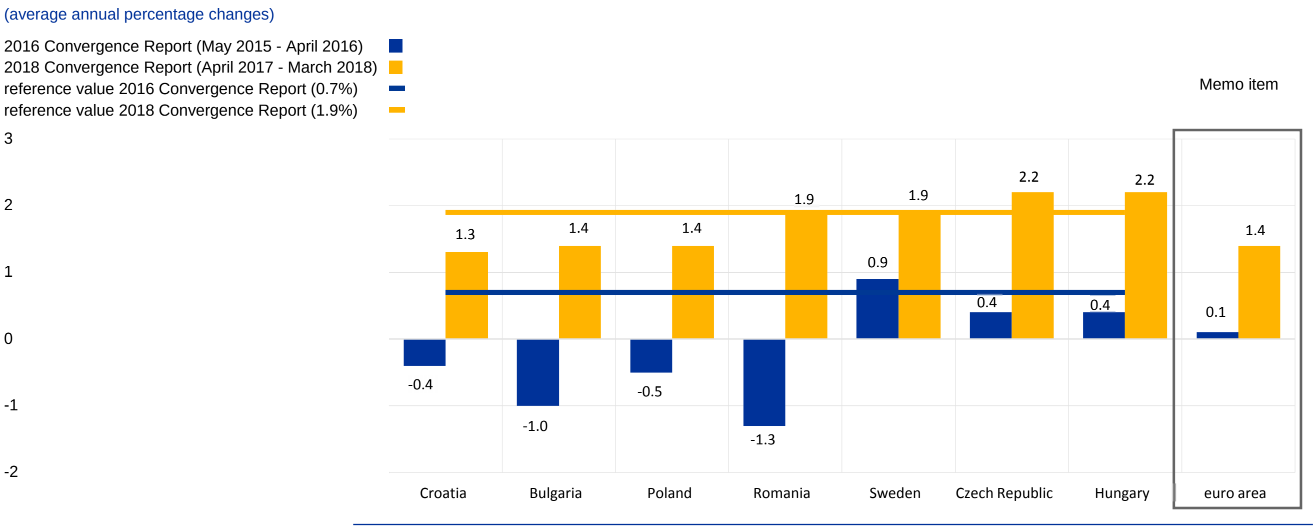
Sources: European Commission (Eurostat, Directorate-General for Economic and Financial Affairs) and European System of Central Banks.
1) Average annual percentage change. Data for 2018 refer to the period from April 2017 to March 2018.
2) Refers to whether a country was subject to an EU Council decision on the existence of an excessive deficit for at least part of the year.
3) The information for 2018 refers to the period up to the cut-off date for statistics (3 May 2018).
4) As a percentage of GDP. Data for 2018 are taken from the European Commission's Spring 2018 Economic Forecast.
5) Average annual percentage change. A positive (negative) number denotes appreciation (depreciation) vis-à-vis the euro.
6) Average annual interest rate. Data for 2018 refer to the period from April 2017 to March 2018.
7) The reference values for HICP inflation and long-term interest rates refer to the period from April 2017 to March 2018; for the general government balance and debt, the reference values are defined in Article 126 of the Treaty on the Functioning of the European Union and the related Protocol (No 12) on the excessive deficit procedure.

The economic environment has significantly improved since the publication of the previous Convergence Report. Economic activity has been on a solid footing, driven by robust private consumption and a pick-up in investment in most EU Member States and has been broad-based in the countries covered by the report. This mainly reflects favourable employment developments, dynamic wage growth, accommodative monetary policy and, in some countries, accommodative fiscal policy as well as positive development in the global economy. The strengthening of economic activity has led to significant improvements in the labour market in all the countries under review, with labour market conditions becoming tight in some countries, although in Croatia the unemployment rate has remained relatively high. In all countries, further progress has been made towards correcting external imbalances and reducing dependence on external funding, particularly in the banking sector. This has enhanced the resilience of most of the countries under review. However, some countries still have significant vulnerabilities of various kinds, which, if not adequately tackled, are likely to slow the convergence process over the long term.

Regarding the price stability criterion, the 12-month average inflation rate was above the reference value of 1.9% in two of the seven countries examined in the report (see Chart 3.1). The Czech Republic and Hungary recorded inflation rates above the reference value, while they were at value in Romania and Sweden, below in Bulgaria and Poland, and well below in Croatia. In the 2016 Convergence Report, Sweden was the only country that recorded an inflation rate above the applicable reference value at that time of 0.7%.

Chart 3.1

HICP inflation

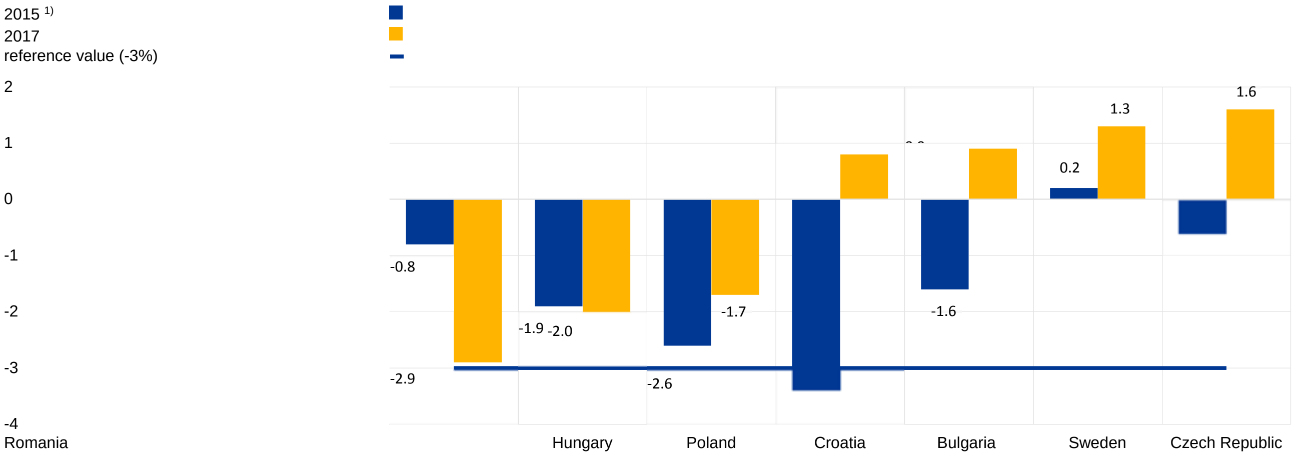


Source: Eurostat.

At the time of publication of this report, no country under review is subject to an excessive deficit procedure, unlike at the time of the previous report when Croatia was in such a procedure. All the countries under review are compliant with the deficit criterion. Only in the cases of Croatia and Hungary do the debt ratios exceed the threshold of 60% of GDP, but they are on a sufficiently diminishing trajectory and approaching 60% of GDP at a satisfactory pace and can therefore be deemed compliant with the Stability and Growth Pact. The excessive deficit procedure in Croatia, which was opened in January 2014, was abrogated in June 2017. In Romania, the headline fiscal deficit stood just below the 3% of GDP reference value in 2017, while the other countries under review either posted deficits well below the threshold or were in surplus (see Chart 3.2a). As in the 2016 Convergence Report, Croatia and Hungary were the only countries with a general government debt-to-GDP ratio above the 60% reference value in 2017. In both countries, the debt ratio declined compared with 2015. In Poland it was slightly above 50% in 2017, in the Czech Republic, Romania and Sweden the ratio was above 30%, while in Bulgaria it was above 20% (see Chart 3.2b).

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

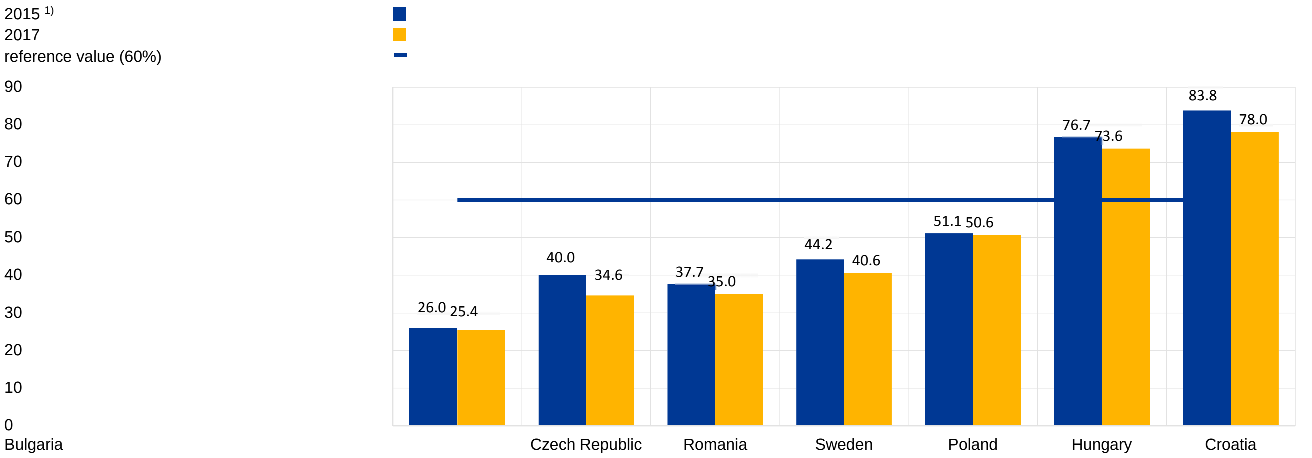
(percentages of GDP)



Source: Eurostat.
1) Data have been revised slightly since the 2016 Convergence Report.

Chart 3.2b
General government gross debt

(percentages of GDP)



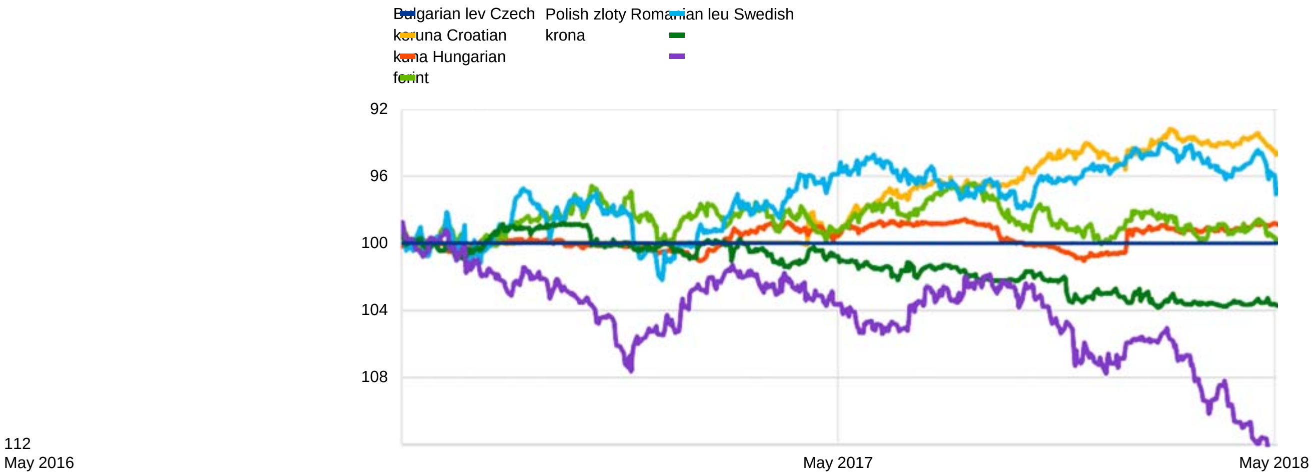
Source: Eurostat.
1) Data have been revised slightly since the 2016 Convergence Report.

As regards the exchange rate criterion, none of the countries under review participates in ERM II. In most of the countries the exchange rate exhibited relatively high volatility over the two-year reference period. The exceptions were Bulgaria, which has a currency board vis-à-vis the euro, and Croatia, which operates a tightly managed float. The Polish zloty, the Czech koruna and, to a lesser degree, the Hungarian forint, appreciated against the euro over the reference period, while the Romanian leu and the Swedish krona depreciated (see Chart 3.3).

Chart 3.3

Bilateral exchange rates vis-à-vis the euro

(index: average of May 2016 = 100; daily data; 4 May 2016 - 3 May 2018)



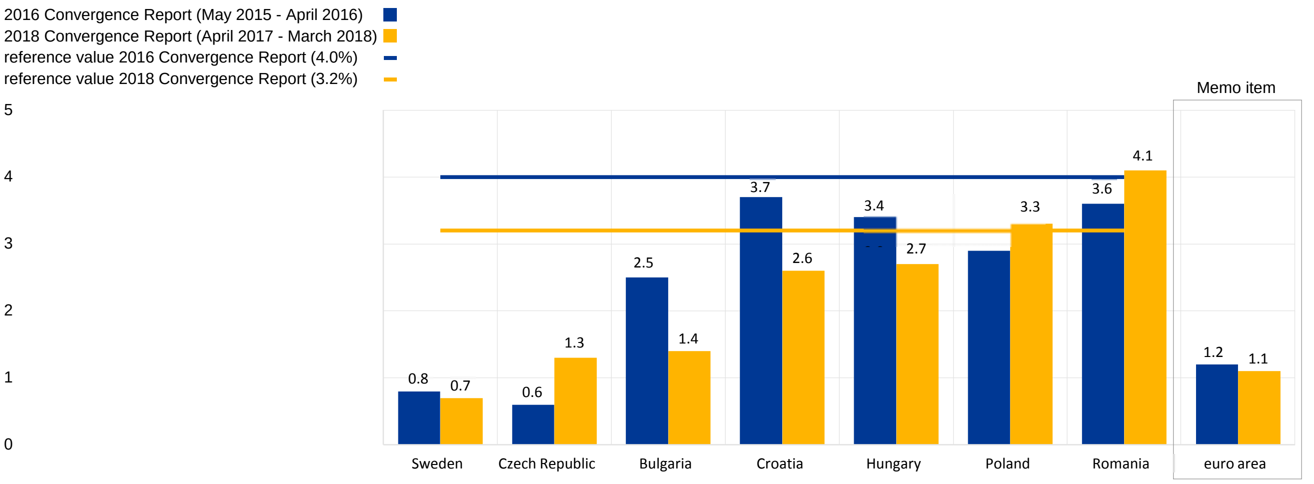
Source: ECB.
Note: An upward (downward) movement indicates appreciation (depreciation) of the local currency.

With regard to the convergence of long-term interest rates, five of the seven countries under review recorded long-term interest rates below the reference value, which was 3.2% (see Chart 3.4). Interest rates were above the reference value in Poland and Romania. The lowest values were recorded in the Czech Republic and Sweden.

Chart 3.4

Long-term interest rates

(percentages, annual average)



Sources: Eurostat and ECB.

When considering compliance with the convergence criteria, sustainability is essential. Convergence must be achieved on a lasting basis and not just at a given point in time. The first decade of EMU showed that weak fundamentals, an excessively loose macroeconomic stance at country level and overly optimistic expectations about convergence in real incomes pose risks not only for the countries concerned but also for the smooth functioning of the euro area as a whole.

Compliance with the numerical convergence criteria at a point in time is, by itself, not a guarantee of smooth membership of the euro area. Countries joining the euro area should thus demonstrate the sustainability of their convergence processes and their capacity to live up to the permanent commitments which euro adoption represents. This is in the country's own interest, as well as in the interest of the euro area as a whole.

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

3.1 The price stability criterion

In March 2018 two of the seven countries under review recorded a 12-month average inflation rate above the reference value of 1.9% for the price stability criterion. Inflation significantly accelerated in the EU over the reference period, mainly owing to robust economic growth and rising energy and commodity prices. This was reflected in a reference value of 1.9% (see Box 1 in Chapter 2). In all the countries examined, inflation significantly accelerated and has been in positive territory. The Czech Republic and Hungary recorded inflation rates above the reference value, while they were at value in Romania and Sweden, below in Poland and Bulgaria, and well below in Croatia.

Over the past ten years both the average level and the volatility of inflation have varied significantly across the countries examined. Over this period, Romania and Hungary recorded an average HICP inflation rate at or above 3%. In Bulgaria, the Czech Republic, Croatia and Poland, the average inflation rate was closer to 2%. In Sweden, inflation has averaged 1.4% over the past ten years.

During this period, price dynamics were particularly volatile in Bulgaria, although inflation in the Czech Republic, Croatia, Hungary, Poland and Romania also fluctuated within a relatively wide range. Sweden recorded the lowest volatility in inflation rates. The marked cross-country differences in the average level and the volatility of inflation over the longer term contrast with the small inflation differentials over the reference period from April 2017 to March 2018, indicating the progress made towards convergence over the past year. In some countries, in particular Bulgaria, cumulated unit labour cost increases over the past five to ten years were much stronger than cumulated HICP increases.

The longer-term price developments mirrored a more volatile macroeconomic environment in many countries. In most of the countries under review, average annual inflation peaked in 2008, before declining substantially in 2009 amid an abrupt economic downturn and a fall in global commodity prices. In the subsequent years, price developments became more heterogeneous, partly reflecting differences in the strength of the economic recovery and country-specific measures related to administered prices. In 2013 inflation embarked on a downward trend in all countries under review, reaching historical lows and often even negative levels. This broad-based movement mainly reflected developments in global commodity prices, low imported inflationary pressures and persistent spare capacity in some countries. The developments in global commodity prices have had a particularly pronounced impact on central and eastern European economies, given the relatively large weights of energy and food in their HICP baskets. In some of the countries under review, cuts in administered prices and indirect taxes or a strengthening of the nominal effective exchange rate also exerted downward pressure on inflation.
Against this backdrop, monetary policy conditions have been loosened considerably in recent years. In 2017, inflation significantly accelerated owing to the strengthening of economic activity, mainly driven by solid domestic demand and rising energy and commodity prices.

Inflation is expected to increase further in the coming years, and there are concerns regarding the sustainability of inflation convergence over the longer term in most of the countries examined. According to the European Commission’s Spring 2018 Economic Forecast, despite an unexpected decline in inflation in some countries at the beginning of 2018, inflation is expected to increase further in most countries over the forecast horizon. This mainly reflects continued solid growth combined with a tightening labour market in some countries. Inflation is expected, however, to decline slightly in Sweden and to moderate in the Czech Republic, falling to below 2.0% in both countries over the forecast horizon. The risks to the price outlook are broadly balanced in all countries. A key downside risk relates to uncertainties regarding developments in the global economy, which could reduce external price pressures. In most of the countries under review, upside risks to inflation could arise from stronger than expected domestic price and wage pressures amid robust economic activity and tightening labour market conditions as well as uncertainties relating to the oil price outlook. Looking further ahead, in many of the central and eastern European countries under review, the catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area, unless this is counteracted by an appreciation of the nominal exchange rate. In addition, in some countries strong past and current increases in unit labour costs pose an upside risk to HICP inflation going forward.

An environment that is conducive to sustainable price stability in, among others, the countries covered in this report requires stability-oriented economic policies, structural reforms and measures to safeguard financial stability. Achieving or maintaining an environment supportive of price stability will crucially depend on the implementation of further structural reforms. In particular, wage increases should reflect labour productivity growth at firm level and take into account labour market conditions and developments in competitor countries. In addition, continued reform effort is needed to further improve the functioning of labour and product markets and maintain favourable conditions for economic expansion and employment growth. To that end, measures to support stronger governance and further improvements in the quality of institutions are essential in the central and eastern European economies. Given the limited room for manoeuvre for monetary policy under the tightly managed exchange rate regime in Croatia, as well as the currency board framework in Bulgaria, it is imperative that other policy areas support the capacity of these economies to maintain price stability, cope with country-specific shocks and avoid the build-up of macroeconomic imbalances. Financial sector and supervisory policies should be aimed at further safeguarding financial stability. In order to further bolster confidence in the financial system, the national competent authorities should continue to improve their supervisory practices by, among other things, following the applicable recommendations from the relevant international and European bodies and by collaborating closely with other national supervisors of EU Member States within the supervisory colleges.

3.2 The government budgetary position criterion

At the time of publication of this report, no country under review is subject to an excessive deficit procedure. At the time of the previous Convergence Report, only Croatia was in an excessive deficit procedure, which was opened in January 2014 with a deadline for correction of 2016. The procedure was abrogated in June 2017 in line with the required correction time limit. All the other countries under review posted a fiscal deficit-to-GDP ratio at or below the 3% reference value in 2017. Romania recorded a deficit of 2.9% of GDP, just below the 3% threshold.

There were deficits of 2.0% in Hungary and 1.7% in Poland. Croatia and Bulgaria posted surpluses of 0.8% and 0.9% of GDP, and Sweden and the Czech Republic surpluses of 1.3% and 1.6% of GDP, respectively.

Between 2015 and 2017 the fiscal balance improved in all the countries covered by this report, with the notable exception of Romania, while Hungary's deficit ratio was unchanged. In Bulgaria, the Czech Republic and Sweden, the improvement in the headline deficit ratio outcomes is mainly explained by structural consolidation, with a lesser contribution from the cyclical upswing, while, for Croatia and Poland, the cyclical upswing mostly explains the consolidation with structural consolidation exerting a smaller positive effect. The very small deterioration in the deficit ratio in Hungary and the significant one in Romania are mainly explained by a loosening fiscal stance, partially offset by more favourable macroeconomic developments.

For 2018, the European Commission forecasts that the deficit-to-GDP ratio will be below the 3% reference value in all countries, with the notable exception of Romania. In 2018 the fiscal balance in Romania is projected to deteriorate by almost half a percentage point compared with the previous year to −3.4% of GDP, which would be in breach of the Maastricht criteria. The deficit in Hungary is projected to reach 2.4% of GDP. Poland is projected to reduce its deficit ratio by almost 1/3 percentage point, to 1.4% of GDP. Bulgaria, Croatia, the Czech Republic and Sweden are forecast to record slightly declining surplus ratios compared with those they posted in the previous year. In 2018 the Czech Republic is projected to reach a surplus of 1.4% of GDP, while Sweden, Croatia and Bulgaria are projected to record surplus ratios of 0.8%, 0.7% and 0.6% of GDP, respectively.

In 2017, in Croatia and Hungary the debt ratio was above 60% of GDP, while in the other countries under review the debt levels were below or well below this threshold (see Table 3.1 and Chart 3.2b). Between 2015 and 2017, the government debt-to-GDP ratio decreased in all countries under review. The debt ratio fell by 5.9 percentage points in Croatia, 5.4 percentage points in the Czech Republic, 3.6 percentage points in Sweden, 3.1 percentage points in Hungary and 2.6 percentage points in Romania, while in Bulgaria and Poland the reduction in the debt ratio was less pronounced – by 0.6 and 0.5 percentage point of GDP respectively. Taking a longer perspective, between 2008 and 2017, the government debt-to-GDP ratio increased strongly in Croatia (by 39.0 percentage points), Romania (by 22.6 percentage points) and Bulgaria (by 12.4 percentage points), while in the other countries the changes were smaller.

For 2018, the European Commission projects a downward path for the debt ratios in all countries, with the exception of Romania. The Commission's projections also indicate that the debt ratio will remain below or well below the 60% reference value in all countries in 2018, with the exception of Croatia and Hungary.

Looking ahead, it is essential for the countries examined to achieve and/or maintain sound and sustainable fiscal positions. Romania – which is projected to breach the deficit ratio threshold in 2018, and could subsequently be subject to an excessive deficit procedure – should ensure compliance with the rules of the Stability and Growth Pact. Romania has been subject to a significant deviation procedure under the preventive arm of the Stability and Growth Pact since June 2017, given sizable procyclical fiscal expansion measures. Further consolidation is also required in Hungary and Poland to attain their medium-term budgetary objectives. In this respect, particular attention should be paid to limiting expenditure growth to a rate below the medium-term potential economic growth rate, in line with the expenditure benchmark rule of the revised Stability and Growth Pact. Moreover, countries whose debt-to-GDP ratio exceeds the reference value should ensure that the ratio is declining sufficiently, in accordance with the provisions of the Pact. Further consolidation would also make it easier to deal with the budgetary challenges related to adverse demographic developments as well as to build up buffers to allow automatic stabilisers to work. Strong national fiscal frameworks that are fully in line with EU rules and implemented effectively should support fiscal consolidation and limit slippages in public expenditure, while helping to prevent a re-emergence of macroeconomic imbalances. Overall, fiscal strategies should be consistent with comprehensive structural reforms to increase potential growth and employment.

3.3 The exchange rate criterion

None of the countries examined in this report participates in ERM II. The countries under review operate under different exchange rate regimes.

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

The Croatian kuna and the Romanian leu traded under exchange rate regimes involving – to different degrees – a managed float vis-à-vis the euro. In the case of the Croatian kuna, this was reflected in low exchange rate volatility compared with the other currencies under review, amid low short-term interest rate differentials vis- à-vis the euro area. The exchange rate of the Romanian leu against the euro showed a relatively high degree of volatility, with short-term interest rate differentials vis-à-vis the euro area remaining at somewhat high and, on average, increasing levels throughout the reference period. In 2009 Romania was granted an international financial assistance package, led by the EU and the IMF, followed by a precautionary financial assistance programme in 2011 and a successor programme in 2013, which expired in 2015 when Romania entered post-programme surveillance. As these agreements helped reduce financial vulnerabilities, they may also have contributed to reducing exchange rate pressures over the reference period.

All other currencies traded under flexible exchange rate regimes amid high exchange rate volatility in most countries. As regards the Czech Republic, however, between 2013 and April 2017 this involved a commitment by Česká národní banka not to let the koruna appreciate above a level close to 27 korunas to the euro. Short-term interest rate differentials vis-à-vis the euro area were small in the Czech Republic and Sweden, but relatively large in Hungary and Poland. In the case of Poland, a Flexible Credit Line arrangement with the IMF, designed to meet the demand for crisis-prevention and crisis-mitigation lending, was in place until November 2017. As this arrangement helped to reduce risks related to financial vulnerabilities, it may also have contributed to reducing the risk of exchange rate pressures. In Sweden, over the reference period, Sveriges Riksbank maintained a swap agreement with the ECB which, as it helped to reduce financial vulnerabilities, may also have had an impact on exchange rate developments.

3.4 The long-term interest rate criterion

Over the reference period, five of the seven countries under examination recorded average long-term interest rates that were – to varying degrees – below the 3.2% reference value. In Sweden, long-term interest rates were below

1%. In the Czech Republic and Bulgaria, interest rates were slightly below 1.5%, while, in Croatia and Hungary, they were close to, but lower than, 3%. In Poland and Romania, interest rates were above the 3.2% reference value.

Since the 2016 Convergence Report, the dynamics of long-term interest rate spreads vis-à-vis the euro area average have been rather heterogeneous across the countries under review. This heterogeneity reflects differences in both the cyclical position and the financial markets' assessment of the countries' external and internal vulnerabilities, including developments in budgetary performance and the prospects for sustainable convergence.

3.5 Other relevant factors

According to the European Commission, most of the countries under review have made progress in addressing imbalances in their economies, albeit to different degrees. The European Commission's in-depth reviews, the results of which were published on 7 March 2018, concluded that Bulgaria and Sweden were experiencing macroeconomic imbalances and that Croatia was experiencing an excessive macroeconomic imbalance. While the macroeconomic imbalance in Bulgaria is no longer assessed as excessive, the economy faces imbalances in the form of remaining fragilities in the financial sector combined with relatively high corporate indebtedness. As regards Sweden, the Commission found that high private debt and overvalued house prices continue to make the economy vulnerable to macroeconomic shocks, while policy measures to address these imbalances have so far been insufficient. As regards Croatia, the Commission found that, despite significant improvements, private and public debt, largely denominated in foreign currencies, remain a source of vulnerability for the economy, while policies have not yet contributed to boosting the long-run growth potential and the economy's overall adjustment capacity. Although the European Commission classified the other countries under review as having no imbalances, those countries also face various challenges.

The external positions of most countries have further improved in recent years. The MIP scoreboard shows that three-year average current account balances improved further in 2016 and 2017 (see Table 3.2) in almost all countries under review, while, in Sweden, the large current account surplus continued to narrow. Surpluses were also observed in Hungary, Croatia, Bulgaria and the Czech Republic, whereas deficits were reported in Poland and Romania.

In almost all countries under review, negative net international investment positions as a share of GDP have diminished, but remain at high levels. The net foreign liabilities of the central and eastern European countries are mainly in foreign direct investment, which is assessed as constituting a stable form of financing. In 2017 the net international investment position was beyond the indicative threshold of -35% of GDP in five of the seven countries under review. Net foreign liabilities were smallest in the Czech Republic (24.6% of GDP), while Sweden recorded a positive net international investment position (10.4% of GDP).

In terms of price and cost competitiveness, over the three-year period from 2014 to 2017, HICP-deflated real effective exchange rates depreciated to different degrees in most of the countries examined, with the Czech Republic being the only exception. The three-year growth rate of unit labour costs, which in the pre-crisis years stood at very high levels in almost all countries, has generally remained below the indicative threshold of 12% over recent years, but remained high in Bulgaria and Romania. Over the five-year period from 2013 to 2017, gains in export market shares were experienced in all countries except Sweden.

House prices continued to increase in all countries under review. This follows a downward correction from the high levels reached in the pre-crisis phase. Sweden has recorded particularly strong increases in house prices over recent years, partly owing to supply-side bottlenecks and historically low interest rates, while house prices in Hungary have started to pick up substantially.

Table 3.2

Scoreboard for the surveillance of macroeconomic imbalances

Table 3.2a – External imbalances and competitiveness indicators

		Current account balance [1]	Net international investment position [2]	Real effective exchange rate, HICP-deflated [3]	Export market share [4]	Nominal unit labour costs [5]
Bulgaria	2015	0.4	-61.2	-4.2	11.9	14.9
	2016	0.8	-46.2	-4.7	8.3	9.5
	2017	2.2	-40.5	-3.4	15.5	10.6
Czech Republic	2015	0.0	-33.2	-8.1	-2.3	0.1
	2016	0.7	-26.9	-3.6	3.7	2.9
	2017	0.9	-27.2	5.1	9.3	6.4
Croatia	2015	2.4	-76.3	0.2	-6.4	-6.1
	2016	2.9	-69.7	0.1	8.2	-6.2
	2017	3.5	-61.3	-0.4	20.1	-5.3
Hungary	2015	2.9	-67.1	-7.1	-8.0	-0.2
	2016	3.6	-60.3	-5.1	1.3	3.3
	2017	4.0	-54.6	-0.1	13.8	7.8
Poland	2015	-1.3	-61.0	-1.3	8.9	0.3
	2016	-1.0	-60.1	-5.0	20.9	2.0
	2017	-0.2	-61.9	-3.7	27.1	2.4
Romania	2015	-1.0	-53.7	2.8	21.3	0.3
	2016	-1.3	-49.4	-2.5	24.0	5.1
	2017	-2.2	-45.7	-5.6	36.8	12.0
Sweden	2015	4.8	-1.2	-8.2	-10.5	2.4
	2016	4.4	5.0	-9.1	-6.7	2.0
	2017	4.0	9.4	-5.6	-4.5	3.0
Threshold		-4.0/+6.0	-35.0	+/-11.0	-6.0	+12.0

Table 3.2b – Internal imbalances and unemployment indicators

		Internal imbalances						New unemployment indicators		
		House prices, consumption-deflated [6]	Private sector credit flow, consolidated [2]	Private sector debt, consolidated [2]	Financial sector liabilities [6]	General government debt [2]	Unemploy-ment rate [7]	Activity rate [8]	Long-term unemploy-ment [8]	Youth unemploy-ment [8]
Bulgaria	2015	1.6	-0.3	110.5	6.2	26	11.2	2.2	-1.2	-6.4
	2016	7.1	4.0	104.9	11.1	29	9.4	0.3	-2.9	-11.1
	2017	7.5	.	.	.	25	7.6	2.3	-3.5	-10.8
Czech Republic	2015	3.8	0.3	68.1	8.1	40	6.1	2.4	-0.6	-6.9
	2016	6.7	4.4	68.7	14.5	37	5.0	2.1	-1.4	-8.4
	2017	8.9	.	.	.	35	4.0	2.4	-1.6	-7.9
Croatia	2015	-2.4	-1.4	113.2	1.9	84	16.9	3.1	0.0	0.1
	2016	2.1	-0.1	105.8	3.3	81	15.6	1.9	-4.4	-18.1
	2017	2.9	.	.	.	78	13.6	0.3	-5.5	-17.9
Hungary	2015	13.3	-2.5	84.5	0.7	77	8.2	4.9	-1.9	-10.9
	2016	13.6	-3.4	77.5	19.6	76	6.6	5.4	-2.6	-13.6
	2017	6.1	0.4	70.7	-8.5	74	5.4	4.2	-2.0	-9.7
Poland	2015	2.6	3.5	78.9	2.4	51	9.0	1.6	-1.1	-5.7
	2016	2.3	4.6	81.6	8.9	54	7.6	1.8	-2.2	-9.6
	2017	2.0	2.8	76.4	6.4	51	6.2	1.7	-2.3	-9.0
Romania	2015	1.9	0.2	59.1	4.0	38	6.9	1.3	0.0	-0.9
	2016	5.0	0.6	55.8	7.6	37	6.5	0.7	-0.3	-3.1
	2017	4.0	.	.	.	35	5.9	1.6	-0.8	-5.6
Sweden	2015	12.1	7.5	188.4	2.4	44	7.8	1.4	0.0	-3.3
	2016	7.6	7.6	188.6	9.0	42	7.4	1.0	-0.1	-4.6
	2017	4.6	.	.	.	41	7.0	1.0	-0.2	-5.1
Threshold		+6.0	+14.0	+133.0	+16.5	+60	+10.0	-0.2	0.5	2.0

Sources: European Commission (Eurostat, Directorate-General for Economic and Financial Affairs) and European System of Central Banks.
Note: This table includes data available as of 3 May 2018, i.e. the cut-off date for this report, and therefore differs from the scoreboard published in the Alert Mechanism Report of November 2017.

1) As a percentage of GDP, three-year average.
2) As a percentage of GDP.
3) Three-year percentage change relative to 41 other industrial countries. A positive value indicates a loss of competitiveness.
4) Five-year percentage change.
5) Three-year percentage change.
6) Year-on-year percentage change.
7) Three-year average.
8) Three-year percentage point change.

A relatively long period of credit expansion prior to the financial crisis left the private non-financial sector with high – though moderately declining – levels of accumulated debt in some of the countries under review. This continues to constitute a key vulnerability in those countries. Strong credit growth, especially in loans for house purchase in Sweden, continues to require close monitoring. In 2017 Sweden recorded a particularly high level of private sector debt, at close to 190% of GDP.

Financial sector policies in the countries under review should be aimed at ensuring that the financial sector makes a sound contribution to economic growth and price stability, and supervisory policies should be geared towards stabilising the supervisory framework, which is a precondition for joining the Single Supervisory Mechanism (SSM). In order to further support confidence in the financial system, the national competent authorities should continue to improve their supervisory practices, inter alia, by following the applicable recommendations of the relevant international and European bodies and by closely collaborating with national supervisors of other EU countries within the supervisory colleges.

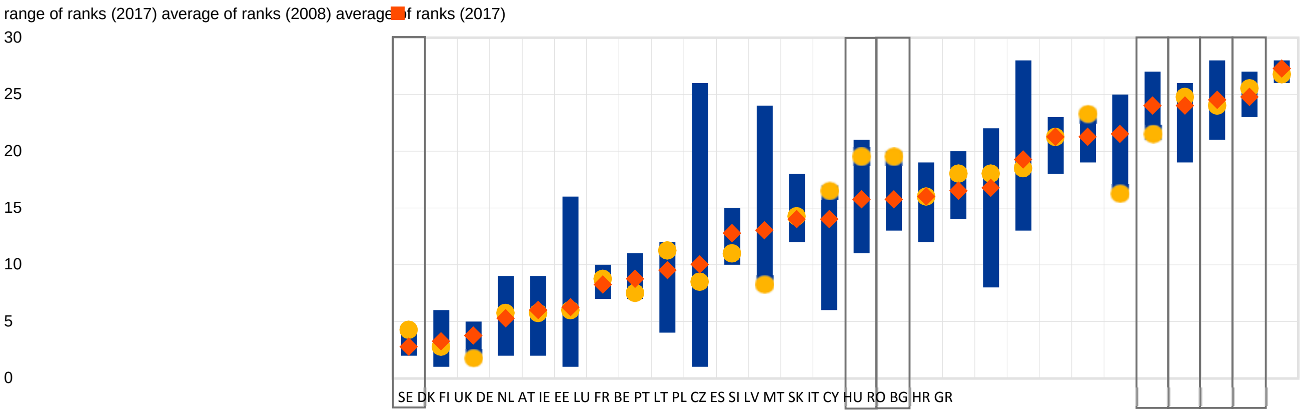
The adjustment process resulted in relatively high levels of unemployment in some of the countries under review, but unemployment has been on a declining path in recent years. In Croatia, high levels of long-term and youth unemployment continue to highlight the severity of domestic imbalances.
Unemployment – which has generally been accompanied by a worsening of skill and/or cross-regional mismatches – is a vulnerability in many countries and poses a risk to the convergence of real incomes, also in view of adverse demographic trends.

The strength of the institutional environment is another important factor in the analysis of the sustainability of economic integration and convergence. In several central and eastern European countries, removing the existing rigidities and impediments to the efficient use and allocation of production factors would help to enhance economic potential. These reflect, for example, weaknesses in the business environment, the relatively low quality of institutions, weak governance and corruption. By hampering potential output growth, the institutional environment may also undermine a country's debt-servicing ability and make economic adjustments more difficult. It may also affect a country's ability to implement necessary policy measures.

The quality of institutions and governance is relatively weak in all countries under review except Sweden. This can pose risks for economic resilience and the sustainability of convergence. Specific institutional indicators broadly confirm an overall picture of weak quality of institutions and governance in most of the countries, although with some notable differences (see Charts 3.5 and 3.6). In particular, Croatia, Bulgaria, Romania and Hungary have the lowest quality of institutions and governance among the countries under review. In January 2016 the European Commission opened a rule of law procedure against Poland.

Chart 3.5

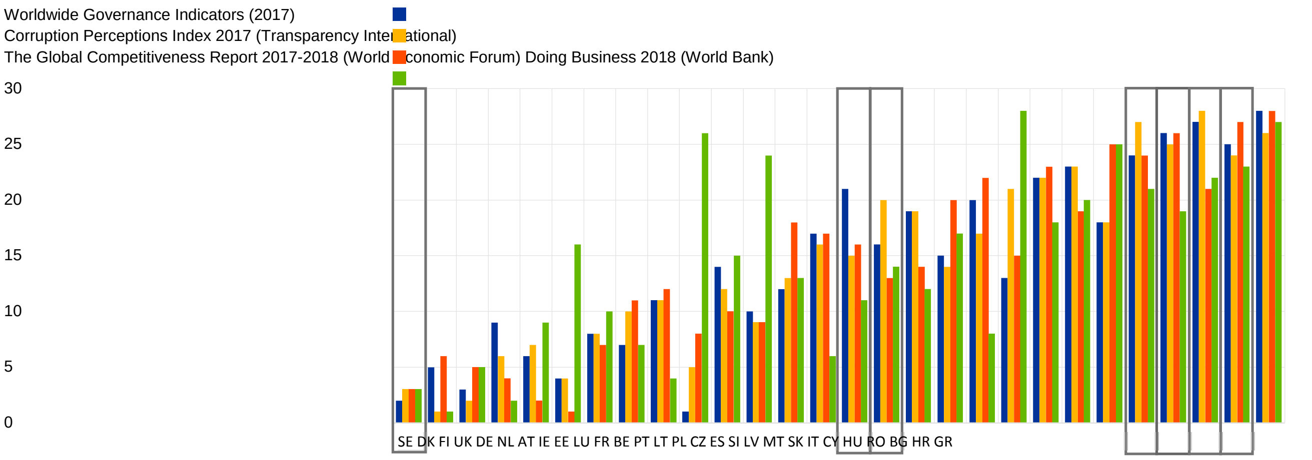
Overview of EU country rankings in terms of institutional quality



Sources: Worldwide Governance Indicators 2017, The Global Competitiveness Report 2017-2018 (World Economic Forum), Corruption Perceptions Index 2017 (Transparency International) and Doing Business 2018 (World Bank).
Notes: Countries are ranked from one (best performer in the EU) to 28 (worst performer in the EU) and ordered according to their average position in the 2017 rankings. In the Doing Business report, Malta has only been covered since the 2013 report and Cyprus only since 2010.

Chart 3.6

EU country rankings in terms of institutional quality by individual indicator



Sources: Worldwide Governance Indicators 2017, The Global Competitiveness Report 2017-2018 (World Economic Forum), Corruption Perceptions Index 2017 (Transparency International) and Doing Business 2018 (World Bank).
Note: Countries are ranked from one (best performer in the EU) to 28 (worst performer in the EU) and ordered according to their average position in the 2017 rankings.

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

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

4 Country summaries

4.1 Bulgaria

In March 2018 the 12-month average rate of HICP inflation in Bulgaria was 1.4%, i.e. below the reference value of 1.9% for the criterion on price stability. Over the past ten years this rate has fluctuated within a wide range, from −1.7% to 12.6%, and the average for that period was moderate, standing at 2.2%. Looking ahead, there are serious concerns regarding the sustainability of inflation convergence in Bulgaria over the longer term, also taking into account the recent increase in unit labour costs. The catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area. In order to prevent the build-up of excessive price pressures and macroeconomic imbalances, the catching-up process must be supported by appropriate policies.

Bulgaria's general government balance and debt complied with the Maastricht criteria in 2017. Bulgaria has been subject to the preventive arm of the Stability and Growth Pact since 2012. The European Commission's Spring 2018 Economic Forecast indicates compliance with the requirements of the Pact. Furthermore, Bulgaria faces low risks to fiscal sustainability over the medium and long run, partly as a result of its favourable initial budgetary position. A prudent fiscal policy and further fiscal structural reforms remain essential for safeguarding sound public finances in the future.

In the two-year reference period from 4 May 2016 to 3 May 2018, the Bulgarian lev did not participate in ERM II, but its exchange rate was fixed at 1.95583 levs per euro within the framework of a currency board. Over the past ten years Bulgaria's current and capital account has improved significantly from the very large external deficit recorded in 2008, while the country's net foreign liabilities declined gradually, but remained high.

Over the reference period from April 2017 to March 2018, long-term interest rates in Bulgaria stood at 1.4% on average and were thus below the 3.2% reference value for the interest rate convergence criterion. Long-term interest rates in Bulgaria have decreased since 2009, with 12-month average rates declining from above 7% to below 1.5%.

Achieving an environment that is conducive to sustainable convergence in Bulgaria requires stability-oriented economic policies and wide-ranging structural reforms. With regard to macroeconomic imbalances, the European Commission selected Bulgaria for a further in-depth review in its Alert Mechanism Report 2018 and concluded that Bulgaria is experiencing macroeconomic imbalances. The sustainability of convergence and economic resilience would benefit from wide-ranging structural reforms to enhance structural resilience, the business environment, financial stability, institutional quality and governance. In order to further bolster confidence in the financial system, the national competent authorities should continue to improve their supervisory practices, among other things, by following the applicable recommendations from the relevant international and European bodies, and by collaborating closely with other national supervisors of EU Member States within the supervisory colleges.

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

4.2 Czech Republic

In March 2018 the 12-month average rate of HICP inflation in the Czech Republic was 2.2%, i.e. above the reference value of 1.9% for the criterion on price stability. Over the past ten years this rate has fluctuated within a relatively wide range, from 0.2% to 6.6%, and the overall average for that period was moderate, standing at 1.9%. Looking ahead, there are concerns regarding the sustainability of inflation convergence in the Czech Republic over the longer term. The catching-up process may result in positive inflation differentials vis-à-vis the euro area, unless this is counteracted by an appreciation of the nominal exchange rate. In order to prevent the build-up of excessive price pressures and macroeconomic imbalances, the catching-up process must be supported by appropriate policies.

The Czech Republic's general government budget balance and debt complied with the Maastricht criteria in 2017. The Czech Republic has been subject to the preventive arm of the Stability and Growth Pact since 2014. The European Commission's Spring 2018 Economic Forecast projects the structural balance to remain positive, thus complying with both the medium-term objective and the other requirements of the preventive arm over the forecast horizon. The fiscal risk is low over all time horizons, though an ageing population poses a challenge over the long term. Broadening the scope of the current fiscal framework reforms, strictly enforcing the existing rules, improving the debt management framework, enhancing the efficiency of public expenditure (and of public investment in particular), and addressing the challenges posed by the adverse long-term demographic trends are necessary to ensure sound public finances.

In the two-year reference period from 4 May 2016 to 3 May 2018, the Czech koruna did not participate in ERM II. Until April 2017 it traded under an exchange rate regime involving a commitment by Česká národní banka not to let the currency appreciate beyond a level of 27 korunas per euro. This commitment was subsequently discontinued, as the conditions for sustainable fulfilment of the 2% inflation target in the future had been met. Accordingly, Česká národní banka reverted to the previous flexible exchange rate regime. The exchange rate of the Czech koruna against the euro exhibited a low degree of volatility over the reference period. On 3 May 2018 the exchange rate stood at 25.5850 korunas per euro, i.e.
5.3% stronger than its average level in May 2016. Over the past ten years the current account has improved, while the country's net foreign liabilities have declined steadily.

Over the reference period from April 2017 to March 2018, long-term interest rates in the Czech Republic stood at 1.3% on average and thus remained well below the 3.2% reference value for the interest rate convergence criterion.
Long-term interest rates in the Czech Republic have decreased since 2009, with 12-month average rates declining from almost 5% to slightly above 1.0%.

Achieving an environment that is conducive to sustainable convergence requires conducting price stability-oriented economic policies, including targeted structural reforms that are geared to ensuring macroeconomic stability. With regard to macroeconomic imbalances, the European Commission did not select the Czech Republic for an in-depth review in its Alert Mechanism Report 2018. Nevertheless, the targeted structural reforms with regard to labour and product market policies, as well as the business environment, need to be stepped up in order to boost potential growth. In order to further bolster confidence in the financial system, the national competent authorities should continue to improve their supervisory practices, among other things, by following the applicable recommendations from the relevant international and European bodies, and by collaborating closely with other national supervisors of EU Member States within the supervisory colleges.

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

4.3 Croatia

In March 2018 the 12-month average rate of HICP inflation in Croatia was 1.3%, i.e. well below the reference value of 1.9% for the criterion on price stability.
Over the past ten years this rate has fluctuated within a relatively wide range, from −0.8% to 6.0%, and the average for that period was moderate, standing at 1.8%. Looking ahead, there are concerns regarding the sustainability of inflation convergence in Croatia over the longer term. The catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area. In order to prevent the build-up of excessive price pressures and macroeconomic imbalances, the catching-up process must be supported by appropriate policies.

Croatia's general government budget balance complied with the Maastricht criterion in 2017, while its debt ratio was above the reference value, albeit diminishing in line with the Stability and Growth Pact's debt reduction benchmark. Croatia was subject to the corrective arm of the Stability and Growth Pact from 2014, and exited the excessive deficit procedure in June 2017. The European Commission's Spring 2018 Economic Forecast foresees a government balance and debt path compliant with the requirements of the Stability and Growth Pact. The Commission's 2017 Debt Sustainability Monitor suggests that Croatia faces a high debt sustainability risk over the medium term. A prudent fiscal policy is

therefore required in order to further reduce the public debt level. Over the long term, while Croatia appears to be at low risk owing to the projected decrease in
age-related spending, the low level of, and projected further decline in, the benefit ratio raise concerns about the adequacy of the pension system. A prudent fiscal policy that further enhances, in compliance with the requirements of the Stability and Growth Pact, the efficiency of both revenue and expenditure, should put the debt ratio on a long-lasting downward path. This will reduce the risks arising from adverse demographic and emigration trends, as well as from contingent liabilities.

In the two-year reference period from 4 May 2016 to 3 May 2018, the Croatian kuna did not participate in ERM II, but traded under an exchange rate regime involving a tightly managed floating of the currency's exchange rate. The exchange rate of the Croatian kuna against the euro exhibited, on average, a low degree of volatility over the reference period. On 3 May 2018 the exchange rate stood at 7.415 kuna per euro, i.e. 1.1% stronger than its average level in May 2016. Croatia's current and capital account has improved over the past ten years and the country's net foreign liabilities have declined, but remain high.

Over the reference period from April 2017 to March 2018, long-term interest rates in Croatia stood at 2.6% on average and thus remained below the 3.2% reference value for the interest rate convergence criterion. Long-term interest rates in Croatia have decreased since 2009, with 12-month average rates declining from around 8% to below 3%.

Achieving an environment that is conducive to sustainable convergence in Croatia requires stability-oriented economic policies and wide-ranging structural reforms. With regard to macroeconomic imbalances, the European Commission selected Croatia for an in-depth review in its Alert Mechanism Report 2018 and concluded that Croatia is experiencing excessive macroeconomic imbalances. In terms of structural reforms, there is considerable scope and an urgent need for reforms aimed at increasing overall productivity and raising the potential growth of the economy. In particular, action should be taken to improve the institutional and business environment, as well as the country's corporate governance standards, to boost competition in the product markets, to reduce mismatches in the labour market and to enhance the quantity and quality of the labour supply, as well as the efficiency of the public administration and the judicial system. Significant efforts should also be made to ensure that Croatia improves the efficiency of its absorption of EU funds. In order to further bolster confidence in the financial system, the national competent authorities should continue to improve their supervisory practices, among other things, by following the applicable recommendations from the relevant international and European bodies, and by collaborating closely with other national supervisors of EU Member States within the supervisory colleges.

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

4.4 Hungary

In March 2018 the 12-month average rate of HICP inflation in Hungary was 2.2%, i.e. above the reference value of 1.9% for the criterion on price stability. Over the past ten years this rate has fluctuated within a relatively wide range, from −0.3% to 7.3%, and the average for that period was elevated, standing at 3.0%. Looking ahead, there are concerns regarding the sustainability of inflation convergence in Hungary over the longer term. The catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area, unless this is counteracted by an appreciation of the nominal exchange rate. In order to prevent the build-up of excessive price pressures and macroeconomic imbalances, the catching-up process must be supported by appropriate policies.

Hungary's general government deficit complied with the Maastricht criterion in 2017, whereas its debt ratio was above the reference value. Hungary has been subject to the preventive arm of the Stability and Growth Pact since 2013. The European Commission's Spring 2018 Economic Forecast points to a high risk of a significant deviation from the adjustment path towards the medium-term objective over the 2018-19 period. Hungary is at medium risk of fiscal stress over the long term and high risk over the medium term. An ageing population poses a challenge to the sustainability of public finances. Determined progress towards the medium-term objective in line with preventive-arm requirements, as well as further reform of the fiscal governance framework, are needed to safeguard the sustainability of public finances.

In the two-year reference period from 4 May 2016 to 3 May 2018, the Hungarian forint did not participate in ERM II, but traded under a flexible exchange rate regime. The exchange rate of the Hungarian forint against the euro exhibited, on average, a relatively high degree of volatility over the reference period. On 3 May 2018 the exchange rate stood at 314.06 forints per euro, i.e. 0.2% stronger than its average level in May 2016. Over the past ten years Hungary's current and capital account has improved markedly. This has contributed to some reduction in the country's net foreign liabilities, which nevertheless remain high.

Over the reference period from April 2017 to March 2018, long-term interest rates in Hungary were 2.7% on average and thus remained below the 3.2% reference value for the interest rate convergence criterion. Long-term interest rates in Hungary have been on a downward path since 2009, with 12-month average rates declining from above 9% to below 3%.

Achieving an environment that is conducive to sustainable convergence in Hungary requires stability-oriented economic policies and wide-ranging structural reforms. With regard to macroeconomic imbalances, the European Commission did not select Hungary for an in-depth review in its Alert Mechanism Report 2018. However, Hungary would benefit from structural reforms aimed at promoting private sector-led growth, such as by improving the governance of institutions and by cutting red tape and the tax burden where excessive. In order to further bolster confidence in the financial system, the national competent authorities should continue to improve their supervisory practices, among other things, by following the applicable recommendations from the relevant international and European bodies, and by collaborating closely with other national supervisors of EU Member States within the supervisory colleges.

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

4.5 Poland

In March 2018 the 12-month average rate of HICP inflation in Poland was 1.4%, i.e. below the reference value of 1.9% for the criterion on price stability. Over the past ten years this rate has fluctuated within a relatively wide range, from −0.7% to 4.3% and the average for that period was moderate, standing at 2.0%. Looking ahead, there are concerns regarding the sustainability of inflation convergence in Poland over the longer term. The catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area, unless this is counteracted by an appreciation of the nominal exchange rate. In order to prevent the build-up of excessive price pressures and macroeconomic imbalances, the catching-up process must be supported by appropriate policies.

Poland's general government deficit and debt complied with the Maastricht criteria in 2017. Poland has been subject to the preventive arm of the Stability and Growth Pact since 2015, when the ECOFIN Council decided to abrogate the excessive deficit procedure. However, the European Commission's Spring 2018 Economic Forecast points to the risk of a significant deviation from the requirements of the preventive arm in 2018. Moreover, in the medium and long run, Poland faces medium risks to fiscal sustainability. Therefore, further progress towards the medium-term objective in line with preventive-arm requirements is essential for ensuring sound public finances over the medium and long term. The favourable medium-term macroeconomic outlook should be used to build up fiscal buffers and introduce the necessary reforms.

In the two-year reference period from 4 May 2016 to 3 May 2018, the Polish zloty did not participate in ERM II, but traded under a flexible exchange rate regime. The exchange rate of the Polish zloty against the euro exhibited, on average, a relatively high degree of volatility over the reference period. On 3 May 2018 the exchange rate stood at 4.2628 zlotys per euro, i.e. 3.2% stronger than its average level in May 2016. Poland's current and capital account has improved over the past ten years, while the country's net foreign liabilities remain high.

Over the reference period from April 2017 to March 2018, long-term interest rates in Poland stood at 3.3% on average and were thus just above the reference value of 3.2% for the interest rate convergence criterion. Long-term interest rates in Poland have decreased since 2009, with 12-month average rates declining from approximately 6% to around 3%.

Achieving an environment that is conducive to sustainable convergence in Poland requires stability-oriented economic policies, policy measures safeguarding financial stability and targeted structural reforms. With regard to macroeconomic imbalances, the European Commission did not select Poland for an in-depth review in its Alert Mechanism Report 2018. It is essential to preserve the currently strong financial position of the banking sector in order to maintain foreign investors' confidence and ensure its sound contribution to economic growth, which should be supported by well targeted structural reforms aimed at reducing frictions in labour markets, enhancing competition in product markets and speeding up innovation, privatisation and infrastructure modernisation. In order to further bolster confidence in the financial system, the national competent authorities should continue to improve their supervisory practices, among other things, by following the applicable recommendations from the relevant international and European bodies, and by collaborating closely with other national supervisors of EU Member States within the supervisory colleges.

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

4.6 Romania

In March 2018 the 12-month average rate of HICP inflation in Romania was 1.9%, i.e. at the reference value of 1.9% for the criterion on price stability. Over the past ten years this rate has fluctuated within a relatively wide range, from −1.7% to 8%, and the average for that period was elevated, standing at 3.4%. Looking ahead, there are serious concerns regarding the sustainability of inflation convergence in Romania over the longer term. The catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area, unless this is counteracted by an appreciation of the nominal exchange rate. In order to prevent the build-up of excessive price pressures and macroeconomic imbalances, the catching-up process must be supported by appropriate policies.

Romania's general government deficit and debt complied with the Maastricht criteria in 2017. Romania, which has been subject to the preventive arm of the Stability and Growth Pact since 2013, is subject to a significant deviation procedure under the preventive arm, which started in June 2017. According to the European Commission's Spring 2018 Economic Forecast, Romania will not have complied with its medium-term objective from 2016 onwards, and is at risk of a significant deviation from the preventive arm requirements also in 2018 and 2019. Furthermore, expansionary fiscal measures are expected to push the deficit above the 3% of GDP threshold in 2018 and put the debt ratio on an upward path. The Commission's 2017

Debt Sustainability Monitor points to high sustainability risks in the medium term, largely driven by the deterioration in the forecast structural primary balance. Medium sustainability risks are foreseen in the long term, mainly due to the unfavourable initial budgetary position and, to a lesser extent, to the rising cost of healthcare and long-term care. Further reforms in these areas and significant consolidation measures are needed to ensure a rapid return to the medium-term objective and to safeguard the sustainability of public finances.

In the two-year reference period from 4 May 2016 to 3 May 2018, the Romanian leu did not participate in ERM II, but traded under a flexible exchange rate regime involving a managed floating of the currency's exchange rate. The exchange rate of the Romanian leu against the euro exhibited, on average, a relatively high degree of volatility over the reference period. On 3 May 2018 the exchange rate stood at 4.6658 lei per euro, i.e. 3.7% weaker than its average level in May 2016. Romania's current and capital account has improved substantially over the past ten years, while the country's net foreign liabilities have declined, but remain high.

Over the reference period from April 2017 to March 2018, long-term interest rates in Romania stood at 4.1% on average and were thus above the 3.2% reference value for the interest rate convergence criterion. Long-term interest rates in Romania have decreased since 2009, with 12-month average rates declining from close to 10% to around 4%.

Achieving an environment that is conducive to sustainable convergence in Romania requires stability-oriented economic policies and wide-ranging structural reforms. With regard to macroeconomic imbalances, the European Commission did not select Romania for an in-depth review in its Alert Mechanism Report 2018. Nevertheless, there is considerable scope and a need for measures aimed at improving the institutional and business environment, boosting investment and competition in product markets, reducing sizeable skill mismatches and shortages, and enhancing both the quality and efficiency of the public administration and the judicial system. Significant efforts should also be made to improve Romania's weak absorption of EU funds. In order to further bolster confidence in the financial system, the national competent authorities should continue to improve their supervisory practices, among other things, by following the applicable recommendations from the relevant international and European bodies, and by collaborating closely with other national supervisors of EU Member States within the supervisory colleges.

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

4.7 Sweden

In March 2018 the 12-month average rate of HICP inflation in Sweden was 1.9%, i.e. at the reference value of 1.9% for the criterion on price stability. Over the past ten years this rate has fluctuated within a range from 0.2% to 3.4%, and the average for that period was subdued, standing at 1.4%. Sweden's GDP per capita is already above the euro area level. Looking ahead, monetary policy and the stability-oriented institutional framework should continue to support the achievement of price stability in Sweden.

Sweden's general government budget balance and debt complied with the Maastricht criteria in 2017. Sweden has been subject to the preventive arm of the Stability and Growth Pact since it came into force in 1998. According to the European Commission's Spring 2018 Economic Forecast, Sweden is expected to comply with its medium-term budgetary objective over the forecast horizon. From a debt sustainability perspective, Sweden faces low risks over the medium and long term. Continued compliance with the medium-term objective over the coming years would ensure that the track record of sound public finances is further enhanced.

In the two-year reference period from 4 May 2016 to 3 May 2018, the Swedish krona did not participate in ERM II, but traded under a flexible exchange rate regime. The exchange rate of the Swedish krona against the euro exhibited, on average, a relatively high degree of volatility over the reference period. On 3 May 2018 the exchange rate stood at 10.6045 kronor per euro, i.e. 14.09% weaker than its average level in May 2016. Over the past ten years Sweden has recorded large current account surpluses and, more recently, its net international investment position turned positive.

Over the reference period from April 2017 to March 2018, long-term interest rates in Sweden stood at 0.7% on average and thus remained well below the 3.2% reference value for the interest rate convergence criterion. Long-term interest rates in Sweden have decreased since 2009, with 12-month average rates declining from above 3% to below 1%.

Maintaining an environment that is conducive to sustainable convergence in Sweden requires the continuation of stability-oriented economic policies, targeted structural reforms and measures to safeguard financial stability. With regard to macroeconomic imbalances, the European Commission concluded in its Alert Mechanism Report 2018 that Sweden is still experiencing macroeconomic imbalances. Against this backdrop, further steps are needed to address the risks to macroeconomic stability arising from historically high house prices and the associated high and rising level of household indebtedness. In order to further bolster confidence in the financial system, the national competent authorities should continue to improve their supervisory practices, among other things, by following the applicable recommendations from the relevant international and European bodies, and by collaborating closely with other national supervisors of EU Member States within the supervisory colleges.

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