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CONVERGENCE REPORT 2014
(prepared in accordance with Article 140(1) of the Treaty on the Functioning of the European Union)

{COM(204) 326 final}

Convergence Report 2014

ABBREVIATIONS

Member States

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

Currencies

EUR	Euro
ECU	European currency unit
BGN	Bulgarian lev
CZK	Czech koruna
HRK	Croatian kuna
LTL	Lithuanian litas
HUF	Hungarian forint
PLN	Polish zloty
RON	Romanian leu (ROL until 30 June 2005)
SKK	Slovak koruna
SEK	Swedish krona
DEM	Deutsche Mark
USD	US dollar
SDR	Special Drawing Rights

Central Banks

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

Other abbreviations

AMR	Alert Mechanism Report
BoP	Balance of Payments
BPO	Business process outsourcing
BSE	Budapest Stock Exchange
CAR	Capital adequacy ratio
CBA	Currency board arrangement
CDS	Credit Default Swaps
CEE	Central and Eastern Europe

CIS	Commonwealth of Independent States
CIT	Corporate Income Tax
CPI	Consumer price index
CR5	Concentration ratio (aggregated market share of five banks with the largest market share)
EC	European Community
ECB	European Central Bank
EDP	Excessive Deficit Procedure
EERP	European Economic Recovery Plan
EMI	European Monetary Institute
EMS	European Monetary System
EMU	Economic and monetary union
ERM II	Exchange rate mechanism II
ESA 95	European System of Accounts
ESCB	European System of Central Banks
EU	European Union
Eurostat	Statistical Office of the European Union
FESE	Federation of European Securities Exchanges
FDI	Foreign direct investment
FGS	Funding for Growth Scheme
FSA	Financial Supervisory Authority
FSAP	Financial Sector Action Plan
GDP	Gross domestic product
HICP	Harmonised index of consumer prices
HFSA	Hungarian Financial Supervisory Authority
KNF	Komisja Nadzoru Finansowego (Polish Financial Supervision Authority)
MFI	Monetary Financial Institution
MIP	Macroeconomic Imbalance Procedure
MTO	Medium-term objective
NCBs	National central banks
NEER	Nominal effective exchange rate
NIK	Najwyższa Izba Kontroli (Poland's Supreme Chamber of Control)
NPL	Non-performing loans
OJ	Official Journal
OJL	Official Journal Lex
PIT	Personal Income Tax
PPS	Purchasing Power Standard
PPP	Purchasing Power Percentage
R&D	Research and development
REER	Real effective exchange rate
SITC	Standard International Trade Classification
SKOK	Spółdzielcze Kasy Oszczędnościowo-Kredytowe (Credit Union)
TEC	Treaty establishing the European Community
TFEU	Treaty on the Functioning of the European Union
ULC	Unit labour costs
VAT	Value added tax
VSE	Vilnius Stock Exchange
WSE	Warsaw Stock Exchange
ZSE	Zagreb Stock Exchange

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1. INTRODUCTION

1.1. ROLE OF THE REPORT

The euro was introduced on 1 January 1999 by eleven Member States. The decision [1] by the Council (meeting in the composition of the Heads of State or Government) on 3 May 1998 in Brussels on the eleven Member States deemed ready to participate in the single currency had, in accordance with the Treaty (Article 121(4) TEC) [2], been prepared by the Ecofin Council on a recommendation from the Commission. The decision was based on the two Convergence Reports made by the Commission [3] and the European Monetary Institute (EMI), respectively [4]. These reports, prepared in accordance with Article 121(1) TEC [5], examined whether the Member States satisfied the convergence criteria and met the legal requirements.

Since then, Greece (2001), Slovenia (2007), Cyprus and Malta (2008), Slovakia (2009), Estonia (2011) and Latvia (2014) have adopted the euro.

Those Member States which are assessed as not fulfilling the necessary conditions for the adoption of the euro are referred to as "Member States with a derogation". Article 140 of the Treaty lays down provisions and procedures for examining the situation of Member States with a derogation (Box 1.1). At least once every two years, or at the request of a Member State with a derogation, the Commission and the European Central Bank (ECB) prepare Convergence Reports for such Member States. Denmark and the United Kingdom negotiated opt-out arrangements before the adoption of the Maastricht Treaty [6] and do not participate in the third stage of EMU. Until these Member States indicate that they wish to participate in the third stage and adopt the euro, they are not the subject of an assessment as to whether they fulfil the necessary conditions.

In 2012, the Commission and the ECB adopted their latest regular Convergence Reports [7]. At that time, none of the Member States assessed was deemed to meet the necessary conditions for adopting the euro.

On 5 March 2013, Latvia submitted a request for a convergence assessment. Following the Convergence Report 2013 on Latvia and on the basis of a proposal by the Commission, the Ecofin Council decided in July 2013 that Latvia fulfilled the necessary conditions for adopting the euro as of 1 January 2014 [8].

In 2014, two years will have elapsed since the last regular reports were prepared. Denmark and the United Kingdom have not expressed a wish to enter the third stage of EMU. Therefore, this convergence assessment covers Bulgaria, the Czech Republic, Croatia, Lithuania, Hungary, Poland, Romania and Sweden. This Commission Staff Working Document is a Technical Annex to the Convergence Report 2014 and includes a detailed assessment of the progress with convergence.

The financial and economic crisis, along with the recent euro-area sovereign debt crisis, has exposed gaps in the current economic governance system of the Economic and Monetary Union (EMU) and showed that its existing instruments need to be used more comprehensively. With the aim of ensuring a sustainable functioning of EMU, an overall strengthening of economic governance in the Union has been undertaken. Accordingly, this Commission Staff Working Document makes references where appropriate to procedures that help to strengthen the assessment of each Member

(1) OJ L 139, 11.5.1998, pp. 30-35
(2) The numbering of Treaty articles cited in this report corresponds to the one of the Treaty on the Functioning of the European Union (TFEU) except when explicitly mentioned. Article 121(4) TEC does no longer exist in the TFEU, as it refers to the first countries deemed ready to adopt the euro on 1 January 1999.
(3) Report on progress towards convergence and recommendation with a view to the transition to the third stage of economic and monetary union, COM(1998)1999 final, 25 March 1998.
(4) European Monetary Institute, Convergence Report, March 1998.
(5) The content of this article is now included in Article 140(1) TFEU.
(6) Protocol (No 16) on certain provisions relating to Denmark, Protocol (No 15) on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland.
(7) European Commission, Convergence Report 2012, COM(2012) 257 final, 12 May 2010; European Central Bank, Convergence Report 2012, May 2012.
(8) Council Decision of 9 July 2013 (OJ L 195, 18.7.2013, p. 24–26).

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

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

— the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability,

— the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 126(6),

— the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the euro,

— the durability of convergence achieved by the Member State with a derogation and of its participation in the exchange-rate mechanism being reflected in the long-term interest-rate levels.

The four criteria mentioned in this paragraph and the relevant periods over which they are to be respected are developed further in a Protocol annexed to the Treaties. The reports of the Commission and the European Central Bank shall also take account of the results of the integration of markets, the situation and development of the balances of payments on current account and an examination of the development of unit labour costs and other price indices.

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

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

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

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

States' convergence process and its sustainability. In particular, it incorporates references to the strengthened surveillance of macroeconomic imbalances (see sub-section 1.2.6.).

The remainder of the first chapter presents the methodology used for the application of the assessment criteria. Chapters 2 to 10 examine, on a country-by-country basis, fulfilment of the convergence criteria and other requirements in the order in which they appear in Article 140(1) (see Box 1.1). The cut-off date for the statistical data included in this Convergence Report was 15 May 2014.

1.2. APPLICATION OF THE CRITERIA

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

1.2.1. Compatibility of legislation

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

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

- Second, in accordance with Articles 123 and 124 of the Treaty, the compliance of the national legislation is verified against the prohibition of monetary financing and privileged access. The prohibition of monetary financing is laid down in Article 123(1) of the Treaty, which prohibits overdraft facilities or any other type of credit facility with the ECB or the central banks of Member States in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States; and the purchase directly from these public sector entities by the ECB or central banks of debt instruments. As regards the prohibition on privileged access, the central banks, as public authorities, may not take measures granting privileged access by the public sector to financial institutions if such measures are not based on prudential considerations.

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

1.2.2. Price stability

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

Article 1 of the Protocol on the convergence criteria further stipulates that "the criterion on price stability […] shall mean that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1.5 percentage points that of, at most, the three best performing Member States in terms of price stability. Inflation shall be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions".

Since national consumer price indices (CPIs) diverge substantially in terms of concepts, methods and practices, they do not constitute the appropriate means to meet the Treaty requirement that inflation must be measured on a comparable basis. To this end, the Council adopted on 23 October 1995 a framework regulation ([9]) setting the legal basis for the establishment of a harmonised methodology for compiling consumer price indices in the Member States. This process resulted in the production of the Harmonised Indices of Consumer Prices (HICPs), which are used for assessing the fulfilment of the price stability criterion. Until December 2005, HICP series had been based on 1996 as the reference period.

A Commission Regulation (EC) No 1708/2005 provided the basis for a change of the HICP index

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

Box 1.2: **Assessment of price stability and the reference value**

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

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

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

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

The notion of '**best performer in terms of price stability**' is not defined explicitly in the Treaty. It is appropriate to interpret this notion in a non-mechanical manner, taking into account the state of the economic environment at the time of the assessment. In previous Convergence Reports, when all Member States had a positive rate of inflation, the group of best performers in terms of price stability naturally consisted of those Member States which had the lowest positive average rate of inflation. In the 2004 report, Lithuania was not taken into account in the calculation of the reference value because its negative rate of inflation, which was due to country-specific economic circumstances, was significantly diverging from that of the other Member States, making Lithuania a de facto outlier that could not be considered as 'best performer' in terms of price stability. In 2010, in an environment characterised by exceptionally large common shocks (the global economic and financial crisis and the associated sharp fall in commodity prices), a significant number of countries faced episodes of negative inflation rates (the euro area average inflation rate in March 2010 was only slightly positive, at 0.3%). In this context, Ireland was excluded from the best performers, i.e. the only Member State whose average inflation rate deviated by a wide margin from that of the euro area and other Member States, mainly due to the severe economic downturn in that country. In 2013, Greece was excluded from the best performers, as its inflation rate and profile deviated by a wide margin from the euro area average (the country's average 12-month inflation was at that time 0.4% and that of the euro area 2.2%, with the gap between the two forecast to increase further), mainly reflecting the severe adjustment needs and exceptional situation of the Greek economy. At the current juncture, it is warranted to identify Greece, Bulgaria and Cyprus as outliers, as their inflation rates deviated by a wide margin from the euro area average, driven by country-specific factors that limit their scope to act as meaningful benchmarks for other Member States. In case of Greece and Cyprus, negative inflation mainly reflected the severe adjustment needs and exceptional situation of the economy. In case of Bulgaria, it was due to an unusually strong combination of disinflationary factors, i.a. a good harvest, administrative energy price reductions and declining import prices. In April 2014, the 12-month average inflation rate of Greece, Bulgaria and Cyprus were respectively -1.2%, -0.8% and -0.4% and that of the euro area 1.0%.

(Continued on the next page)

Box (continued)

Table 1:
Inflation reference value in previous and current Convergence Reports

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

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

Sources: Eurostat and Commission services.

base reference period from 1996=100 to 2005=100 ([10]).

As has been the case in past convergence reports, a Member State's average rate of inflation is measured by the percentage change in the arithmetic average of the last 12 monthly indices relative to the arithmetic average of the 12 monthly indices of the previous period. The reference value is calculated as the arithmetic average of the average rate of inflation of the three 'best-performing Member States in terms of price stability' plus 1.5 percentage points. Accordingly, the reference value is currently 1.7%, based on the data of Latvia (0.1%), Portugal (0.3%) and Ireland (0.3%) over the 12-month period covering May 2013-April 2014. Greece, Bulgaria and Cyprus were identified as outliers, as their inflation rates deviated by a wide margin from the euro area average reflecting country-specific economic circumstances (see Box 1.2)

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

Inflation sustainability implies that the satisfactory inflation performance must essentially be due to the adequate behaviour of input costs and other factors influencing price developments in a structural manner, rather than reflecting the influence of cyclical or temporary factors. Therefore, this Technical Annex also takes account of the role of the macroeconomic situation and cyclical position in inflation performance, developments in unit labour costs as a result of trends in labour productivity and nominal compensation per head, developments in import prices to assess how external price

([10]) Commission Regulation (EC) No 1708/2005 of 19 October 2005 laying down detailed rules for the implementation of Council Regulation (EC) No 2494/95 as regards the common index reference period for the harmonised index of consumer prices, and amending Regulation (EC) No 2214/96.

Box 1.3: **Excessive deficit procedure**

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

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

- whether the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value, specified in the Protocol on the EDP as 3 percent of GDP, unless:
  - either the ratio has declined substantially and continuously and reached a level that comes close to the reference value;
  - or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;
- whether the ratio of government debt to gross domestic product exceeds a reference value, specified in the Protocol on the EDP as 60 percent of GDP, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

According to the Protocol on the excessive deficit procedure, the Commission provides the statistical data for the implementation of the procedure. As part of the application of this Protocol, Member States have to notify data on government deficits, government debt, nominal GDP and other associated variables twice a year, before 1 April and before 1 October ([2]). After each reporting date, Eurostat examines whether the data are in conformity with ESA95 ([3]) rules and related Eurostat decisions and, if they are, validates them.

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

([1]) OJ L 209, 2.8.1997, p. 6. Regulation as amended by Regulation (EC) No 1056/2005 (OJ L 174, 7.7.2005, p. 5).
([2]) Council Regulation (EC) No 479/2009 on the application of the Protocol on the excessive deficit procedure (OJ L 145, 10.06.2009, p1).
([3]) European System of National and Regional Accounts, adopted by Council Regulation (EC) No 2223/96 (OJ L 310, 30.11.1996, p. 1). Regulation as last amended by Regulation (EC) No 400/2009 of the European Parliament and of the Council (OJ L 126, 21.5.2009, p. 11).
([4]) In particular, potential growth, including the various contributions, cyclical developments, and the private sector net savings position.
([5]) In particular, the record of adjustment towards the medium-term budgetary objective, the level of the primary balance and developments in primary expenditure, the implementation of policies in the context of the prevention and correction of excessive macroeconomic imbalances and in the context of the common growth strategy of the Union, as well as the overall quality of public finances, in particular the effectiveness of national budgetary frameworks.
([6]) In particular, its dynamics and sustainability, including, risk factors including the maturity structure and currency denomination of the debt, stock-flow adjustment and its composition, accumulated reserves and other financial assets, guarantees, in particular those linked to the financial sector, and any implicit liabilities related to ageing and private debt, to the extent that it may represent a contingent implicit liability for the government.

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Box (continued)

incurred in the form of bilateral and multilateral support between Member States in the context of safeguarding financial stability, and the debt related to financial stabilisation operations during major financial disturbances.

The Council and the Commission shall make a balanced overall assessment of all the relevant factors. Those factors shall be taken into account in the steps leading to the decision on the existence of an excessive deficit when assessing compliance on the basis of the debt criterion. When assessing compliance on the basis of the deficit criterion in a country with a debt ratio exceeding the reference value, those factors shall be taken into account in the steps leading to the decision on the existence of an excessive deficit subject to the double condition that the deficit is close to the reference value and its excess over it is temporary. Due consideration is foreseen for pension reforms introducing a multi-pillar system including a mandatory, fully-funded pillar and the net cost of the publicly managed pillar. ([7])

In the next step of the procedure, the Economic and Financial Committee (EFC) formulates an opinion on the Commission report, within at most two weeks after its publication (Article 126(4), Article 3.1 of Regulation 1467/97). If it considers that an excessive deficit exists or may occur, the Commission addresses an opinion to the Council (Article 126(5)). Then, on the basis of a Commission proposal and after an overall assessment, which includes any observation that the concerned Member State may have, the Council decides, whether an excessive deficit exists (Article 126(6)). Article 3.3 of Regulation 1467/97 specifies that any such decision has to be adopted as a rule within four months of the fiscal notification dates (1 April, 1 October).

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

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

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

([7]) Where the excess of the deficit over the reference value reflects the implementation of a pension reform introducing a multi-pillar system that includes a mandatory, fully funded pillar, the Council and the Commission shall also consider the cost of the reform when deciding on the existence of an excessive deficit, as long as the deficit does not significantly exceed a level that can be considered close to the reference value, and the debt ratio does not exceed the reference value, provided that overall fiscal sustainability is maintained.

(Continued on the next page)

Box (continued)

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

More information about the EU fiscal surveillance framework could be found in the *Vademecum on the Stability and Growth Pact*, European Economy. Occasional Papers. **151**. May 2013: http://ec.europa.eu/economy_finance/publications/occasional_paper/2013/op151_en.htm

developments have impacted on domestic inflation. Similarly, the impact of administered prices and indirect taxes on headline inflation is also considered.

From a forward-looking inflation perspective, the report includes an assessment of medium-term prospects for price developments. The analysis of factors that have an impact on the inflation outlook – cyclical conditions, labour market developments and credit growth – is complemented by a reference to the most recent Commission services' forecast of inflation. That forecast can subsequently be used to assess whether the Member State is likely to meet the reference value also in the months ahead ([11]). Medium-term inflation prospects are also assessed by reference to the economies' key structural characteristics, including the functioning of the labour and product markets.

1.2.3. Public finances

The convergence criterion dealing with the government budgetary position is defined in the second indent of Article 140(1) of the Treaty as "the sustainability of the government financial position: this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 126(6)". Furthermore, Article 2 of the Protocol on the convergence criteria states that this criterion means that "at the time of the examination the Member State is not the subject of a Council decision under Article 126(6) of the said Treaty that an excessive deficit exists".

The convergence assessment in the budgetary area is thus directly linked to the excessive deficit procedure which is specified in Article 126 of the Treaty and further clarified in the Stability and Growth Pact (see Box 1.3 for further information on the excessive deficit procedure as strengthened by the 2011 reform of the Stability and Growth Pact). The details of the excessive deficit procedure are defined in Regulation 1467/97 as amended in 2005 and 2011 (most recently under the "Six-Pack") which sets out the way in which government deficit and debt levels are assessed to determine whether an excessive deficit exists, under article 126 of TFEU. The convergence assessment in the budgetary area is therefore judged by whether the Member State is subject to a Council decision under 126(6) on the existence of an excessive deficit ([12]).

Long-term sustainability of public finances deserves particular attention at a time when the financial crisis has significantly impacted on the fiscal positions and debt levels in many Member States. In response to this, economic governance in the EMU was substantially strengthened in 2011, which included, *inter alia*, the operationalisation of the debt criterion in the Excessive Deficit Procedure ([13]).

([11]) Based on the Commission services' 2014 Spring Forecast, the inflation reference value is forecast to stand at 1.8% in December 2014.

([12]) The definition of the general government deficit used in this report is in accordance with the excessive deficit procedure, as was the case in previous convergence reports. In particular, interest expenditure, total expenditure and the overall balance include net streams of interest expenditure resulting from swaps arrangements and forward rate agreements. Government debt is general government consolidated gross debt at nominal value (Council Regulation 479/2009). Information regarding the excessive deficit procedure and its application to different Member States since 2002 can be found at: http://ec.europa.eu/economy_finance/economic_governance/sgp/deficit/index_en.htm.

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

1.2.4. Exchange rate stability

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

Article 3 of the Protocol on the convergence criteria stipulates: "The criterion on participation in the exchange rate mechanism of the European Monetary System (…) shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against the euro on its own initiative for the same period" ([14]). Based on the Council Resolution on the establishment of the ERM II ([15]), the European Monetary System has been replaced by the Exchange Rate Mechanism II upon the introduction of the euro, and the euro has become the centre of the mechanism.

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

A number of Member States have benefited from balance-of-payments assistance programmes since 2008. In order to determine whether international financial assistance constitutes evidence that a country has faced severe tensions in its exchange rate, the Commission examines the role played by official external financing during the assessment period on a case by case basis.

As in previous reports, the assessment of this criterion verifies the participation in ERM II and examines exchange rate behaviour within the mechanism. The relevant period for assessing exchange rate stability in this Technical Annex is 16 May 2012 to 15 May 2014.

1.2.5. Long-term interest rates

The fourth indent of Article 140(1) of the Treaty requires "the durability of convergence achieved by the Member State with a derogation and of its participation in the exchange rate mechanism being reflected in the long-term interest rate levels". Article 4 of the Protocol on the convergence criteria further stipulates that "the criterion on the convergence of interest rates (…) shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than two percentage points that of, at most, the three best performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions" (see Box 1.4).

For the assessment of the criterion on the convergence of interest rates, yields on benchmark 10-year bonds have been taken, using an average rate over the latest 12 months. The reference value for April 2014 is calculated as the simple average of the average long-term interest rates in Latvia (3.3%), Portugal (5.8%) and Ireland (3.5%), plus 2 percentage points, yielding a reference value of 6.2%.

1.2.6. Additional factors

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

The assessment of additional factors gives an important indication of a Member State's ability to integrate into the euro area without difficulties. As regards the balance of payments, the focus is on

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assessment of progress towards the country-specific medium-term budgetary objective.

([14]) 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.

([15]) 97/C 236/03 of 16 June 1997, OJ C 236, 2.8.1997, p.5.

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

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

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

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

For eighteen Member States, the residual maturity of the benchmark bond is above 9.5 years. For eight Member States, the residual maturity of the benchmark bond is around 9 years, while for Croatia the residual maturity is around 6 years. All yields (except for Cyprus) are calculated on the basis of secondary market rates. For Germany and Spain a basket of bonds is used, while a single benchmark bond is used in twenty-five Member States. For Estonia, no appropriate harmonised series or proxy could be identified, primarily reflecting the very low level of Estonian government debt.

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

the situation and development of the external balance ([16]). Market integration is assessed through trade, foreign direct investment and a smooth functioning of the internal market. Finally, progress in financial integration is examined, together with the impact of the financial crisis, the main characteristics, structures and trends of the financial sector and compliance with the acquis of the Union in this area.

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

The section on additional factors makes reference to the surveillance of macroeconomic imbalances under the Macroeconomic Imbalance Procedure, which was adopted in December 2011 as one of the key elements of the legislative package (the "Six-Pack") to enhance the governance structures in EMU, and integrates its results into the assessment ([17]).

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

([17]) To avoid the duplication of surveillance procedures, Member States under EU-IMF financial assistance programmes are not examined under the macroeconomic imbalances procedure and were therefore not covered in the Alert Mechanism Report and in-depth reviews. Among the Member States examined in this report, this concerns Romania.

Box 1.5: The Macroeconomic Imbalance Procedure (MIP)

The Macroeconomic Imbalance Procedure (MIP): key elements

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

A two-step approach with a preventive and a corrective arm

The overall design of the MIP includes a "preventive" arm and a stronger "corrective" arm for more serious cases. For euro area countries, the corrective arm is supplemented by an enforcement mechanism including the possibility of financial sanctions. The procedure relies on a two-step approach where the first step consists of an alert mechanism that aims to identify Member States with potentially emerging macroeconomic imbalances and which require more in-depth investigation. If, on the basis of such an in-depth analysis, the situation is considered unproblematic no further steps are taken. If the Commission however considers that macroeconomic imbalances exist, it may come forward with proposals for policy recommendations for the Member State concerned (which will be – in the preventive arm – part of the integrated package of recommendations under the European Semester). In case the in-depth review points to severe imbalances in a Member State, the Council could declare the existence of an excessive imbalance and adopt a recommendation asking the Member State to present a Corrective Action Plan (CAP). After submission of the CAP by the Member State, the Council would assess the CAP which either can be deemed sufficient or insufficient; if found insufficient, the Member State should present a new CAP. If the new CAP is again found insufficient, a fine can be imposed (0.1% of GDP), though just for euro area Member States. When a sufficient CAP is in place, the Council will assess whether or not the Member State concerned has taken the recommended actions according to the set deadlines. For euro area Member States a first assessment of non-compliance would lead to an interesting-bearing deposit (0.1% of GDP). After a second decision by the Council declaring non-compliance, the Council can take the decision to convert the deposit into an annual fine. If the Council considers that the Member State has taken the recommended corrective action, but imbalances are not yet corrected, the procedure will be placed in abeyance. If the Council considers that the Member State concerned has taken the appropriate action and the Member State is no longer experiencing excessive imbalances, the procedure will be closed.

The alert mechanism scoreboard: design and rationale

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

The 2014 Alert Mechanism Report (AMR) and In-Depth Reviews (IDR)

As the first step of the MIP process of 2014, the Commission published its third Alert Mechanism Report in November 2013. The AMR made an economic reading of the scoreboard as foreseen by the legislation and on this basis 16 Member States were identified for which IDRs on different possible imbalances were warranted. Three of them are Member States covered in this report (Bulgaria, Hungary and Sweden). The IDRs concluded in March 2014 that Hungary and Sweden have imbalances, while Croatia is experiencing excessive imbalances.

2. BULGARIA

2.1. LEGAL COMPATIBILITY

2.1.1. Introduction

The legal basis for the Bulgarska narodna banka (BNB – central bank of Bulgaria), the Law on the Bulgarian National Bank (the BNB Law) of 1997, has not been amended since the 2012 Convergence Report. Therefore, the comments provided in the 2012 Convergence Report are largely repeated in this year's assessment.

2.1.2. Central Bank independence

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

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

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

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

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

Article 14(2) of the BNB Law Bank should be amended. Article 14(2) of the BNB Law Bank stipulates that "where the duties of a Governing Council member cease before the term of office has expired, another person shall be elected/appointed *for the outstanding period of the term of office*". As regards the Governor, this is not in line with Article 14.2 of the ESCB/ECB Statute, pursuant to which the term of office of a Governor shall be no less than five years.

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

2.1.3. Prohibition of monetary financing and privileged access

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

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

Pursuant to Article 45(2) in conjunction with Article 33(2) of the BNB Law, Article 45(1) of the BNB Law does not apply to the extension of credits to state-owned and municipal banks in emergency cases of liquidity risk that may affect the stability of the banking system. The scope of this exemption should be amended to be fully consistent with the wording of Article 123(2) of the TFEU and Article 21.3 of the ESCB/ECB Statute.

2.1.4. Integration in the ESCB

Objectives

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

Tasks

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

- definition of monetary policy and monetary functions, operations and instruments of the ESCB (Articles 2(1), 3, 16(4 and 5), 28, 30, 31, 32, 33, 35, 38, 41 and 61 of the BNB Law);
- conduct of foreign exchange operations and the definition of foreign exchange rate policy (Articles 20(1), 28, 31, 32 of the BNB Law);
- right to authorise the issue of banknotes and the volume of coins (Articles 2(5), 16(9), 24 to 27 of the BNB Law);
- non-recognition of the role of the ECB in the field of international cooperation (Articles 5, 16(12) and 37(4) of the BNB Law);
- ECB's right to impose sanctions (Article 61, 62 of the BNB Law).

There are also numerous imperfections regarding:

- non-recognition of the role of the ECB in the functioning of the payment systems (Articles 2(4) and 40(1) of the BNB Law);
- non-recognition of the role of the ECB and the EU in the collection of statistics (Article 4(1) and 42 of the BNB Law);
- non-recognition of the role of the ECB and of the Council in the appointment of the external auditor (Articles 49(4) of the BNB Law);
- absence of an obligation to comply with the Eurosystem's regime for the financial reporting of NCB operations (Article 16(11), 46 and 49 of the BNB Law).

2.1.5. Assessment of compatibility

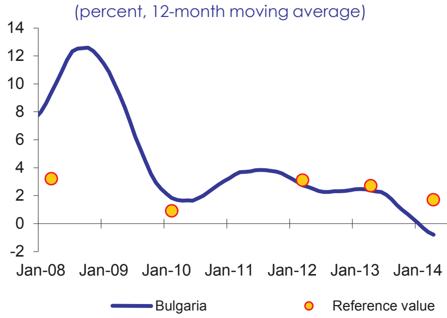
The BNB Law and the Conflict of Interest Prevention and Ascertainment Act are not fully compatible with Article 131 of the TFEU as regards central bank independence, the prohibition of monetary financing and the integration in the ESCB at the time of euro adoption.

2.2. PRICE STABILITY

2.2.1. Respect of the reference value

The 12-month average inflation rate, which is used for the convergence assessment, was below the reference value at the time of the last convergence assessment of Bulgaria in 2012. Average annual inflation hovered around 2.5% between mid-2012 and mid-2013, before declining to 0.4% by end-2013. In April 2014, the reference value was 1.7%, calculated as the average of the 12-month average inflation rates in Latvia, Portugal and Ireland plus 1.5 percentage points. The average inflation rate in Bulgaria during the 12 months to April 2014 was -0.8%, i.e. well below the reference value. It is projected to remain well below the reference value in the months ahead.

Graph 2.1: **Bulgaria - Inflation criterion since 2008**
(percent, 12-month moving average)

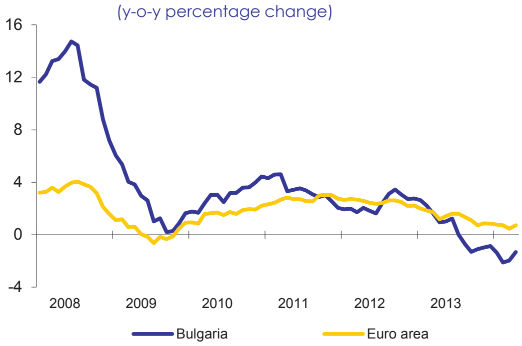


Note: The dots in December 2014 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2014 Forecast.

2.2.2. Recent inflation developments

The inflation rate in Bulgaria has fallen significantly over the past two years, turning negative in the second half of 2013 and first months of 2014. The fall in inflation has been broad-based, but largely driven by declining import prices as well as the appreciation of Bulgaria's euro-fixed currency against its main trading partners in the Balkans, decreases in administratively set energy prices, a good agricultural harvest that led to lower food prices and weak domestic demand. The decline in inflation over the past few years has not followed a smooth trend, as a temporary increase in inflation above the euro area average was recorded in the second half of 2012. This was mainly reflecting the volatility in global commodity prices. However, in addition to import price trends, the sharp fluctuations in energy prices over 2012-13 were amplified by domestic factors. Several administratively set energy price components recorded an increase in 2012, at that time coinciding with an upturn in global energy prices. In contrast, the network charge on electricity was lowered by the government in 2013 in response to public protests against high energy bills. By chance, this measure coincided with a period of global energy price decline.

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



Source: Eurostat.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) declined steadily from somewhat above 1% recorded in 2012 to -0.4% by the end of 2013 and -1.0% in April 2014. Headline inflation was above core inflation till mid-2013, when it abruptly fell due to temporary factors affecting both unprocessed food and energy. The components of core inflation have trended downwards over the past few years, but especially from early 2013. This was likely a reflection of both lower import prices passing through to domestic prices and weak domestic demand, as consumers have remained cautious in spending, in spite of strong growth in real wages over the past years. Inflation of non-energy industrial goods continued to fall, reaching a historically low level of -2.3% in early-2014. Services inflation fell from over 3% in August 2012 to below -1% by early 2014, partly due to the pass-through of lower import prices. Negative producer price inflation confirmed the lack of cost pressures in 2013 and in the first months of 2014.

2.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy-mix and cyclical stance

The economic recovery has so far been weak in Bulgaria, with exports rebounding, but domestic demand still sluggish. GDP growth reached 1.8% in 2011, but has slowed to 0.6% in 2012 before picking up slightly to 0.9% in 2013. According to the Commission services' 2014 Spring Forecast, Bulgaria's GDP growth is expected to be more broad-based over 2014-15, with domestic demand forecast to reinforce the export-driven growth momentum. The purchasing power of households has been buoyed by growth in real wages in a low-inflation environment and consumer confidence

Table 2.1:
Bulgaria - Components of inflation

	2008	2009	2010	2011	2012	2013	Apr-14	weights in total 2014
	(percentage change) 1)							
HICP	12.0	2.5	3.0	3.4	2.4	0.4	-0.8	1000
Non-energy industrial goods	6.0	2.9	0.3	-0.4	-0.8	-1.5	-1.8	231
Energy	12.5	-5.7	9.2	8.9	8.0	-1.7	-4.1	140
Unprocessed food	10.9	1.3	-1.6	1.6	4.4	4.4	0.7	91
Processed food	17.2	2.4	7.5	7.7	1.5	1.3	0.6	208
Services	12.7	5.8	1.5	1.9	2.4	1.1	0.2	329
HICP excl. energy and unproc. food	12.0	4.1	2.5	2.6	1.2	0.3	-0.3	769
HICP at constant taxes	11.3	1.9	2.1	3.2	2.4	0.4	-0.8	1000
Administered prices HICP	10.6	7.2	3.6	2.5	4.9	-1.1	-3.0	156

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

Sources: Eurostat, Commission services.

appears to be gradually firming. GDP growth is forecast to reach 1.7% in 2014 and 2% in 2015. This relatively modest growth momentum would, however, imply a further slight widening of the already negative output gap.

The fiscal stance, as measured by changes in the structural balance, has shifted over recent years, but was overall rather neutral for inflation. Following three years of strong consolidation, the fiscal stance has been slightly expansionary in 2013, with some discretionary expenditure increases after the parliamentary elections. According to the Commission services' 2014 Spring Forecast, the structural balance is projected to weaken slightly further in 2014, but to tighten marginally in 2015.

In the context of its currency board arrangement to the euro, most standard monetary policy instruments are not available to Bulgaria. In response to these limitations, the BNB has taken a conservative approach towards bank regulation. Credit flow to the economy has remained overall slightly positive, with modest growth in corporate credit compensating for a slight decline in household credit. However, the second half of 2013 and the first months of 2014 have been marked by a deceleration of credit growth. Both deposit and lending interest rates have continued on a downward trend, implying a gradual improvement in lending conditions and credit availability. Nevertheless, credit availability may be limited for those sectors most affected by the financial crisis as well as some corporate segments with higher perceived risk, including start-up companies and SMEs. The subdued lending activity and a risk-averse stance of households, confirmed by the rising deposit stock, support the present low-inflation environment.

Wages and labour costs

The economic crisis has led to an extended period of labour market distress, with the first signs of labour market stabilisation visible only in the second half of 2013. Employment fell by about 2.5% in 2012 and was overall broadly flat in 2013. The unemployment rate peaked at around 13% in 2013, while the working-age population has also declined due to ageing and emigration. Despite these factors and wage restraint in the public sector over 2010-12, nominal wage growth in the private sector remained relatively high especially over 2009-2011, but has since then strongly decelerated. The rapid wage growth in the initial crisis years was partly a reflection of composition effects, continued wage convergence pressures, skills shortages in some sectors and administrative increases of sectoral and occupational wage floors.

Labour productivity grew relatively strongly between 2010 and 2012, as large cuts in employment boosted output per employee, while output growth itself was sluggish. This phenomenon ended in 2013 with the stabilization of the labour market. Labour productivity is projected to increase by around 1.5% in 2014 and 2015. The growth in nominal unit labour cost (ULC) declined between 2009-2012, but it picked up again in 2013. ULC growth is projected to stabilise at around 2% in 2014-2015, with upward pressure resulting from expected wage convergence.

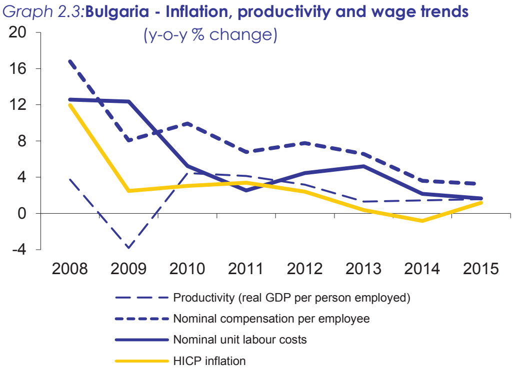
Table 2.2:
Bulgaria - Other inflation and cost indicators **(annual percentage change)**

	2008	2009	2010	2011	2012	2013 1)	2014 2)	2015 2)
HICP inflation								
Bulgaria	12.0	2.5	3.0	3.4	2.4	0.4	-0.8	1.2
Euro area	3.3	0.3	1.6	2.7	2.5	1.3	0.8	1.2
Private consumption deflator								
Bulgaria	7.2	1.5	2.4	4.6	5.4	-1.9	0.0	1.5
Euro area	2.7	-0.4	1.6	2.4	2.1	1.3	0.9	1.3
Nominal compensation per employee								
Bulgaria	16.8	8.1	9.9	6.8	7.8	6.6	3.6	3.3
Euro area	3.5	1.8	2.0	2.2	2.0	1.7	1.6	1.9
Labour productivity								
Bulgaria	3.7	-3.8	4.4	4.1	3.2	1.3	1.4	1.6
Euro area	-0.3	-2.4	2.6	1.4	0.2	0.5	0.9	1.0
Nominal unit labour costs								
Bulgaria	12.6	12.4	5.2	2.5	4.4	5.2	2.2	1.6
Euro area	3.8	4.3	-0.6	0.7	1.8	1.1	0.7	0.8
Imports of goods deflator								
Bulgaria	10.8	-13.7	8.5	9.7	3.5	-4.5	-2.2	1.6
Euro area	4.2	-8.1	5.7	6.6	2.3	-1.9	-1.0	0.8

1) 2013 data (except HICP inflation) are estimates.
2) Commission services' Spring 2014 Forecast.

Source: Eurostat, Commission services.

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



Source: Eurostat, Commission services' Spring 2014 Forecast.

External factors

Given the high openness of the Bulgarian economy, developments in import prices play an important role in domestic price formation. Global energy and food prices are the most relevant for inflation, given their relatively large share in the consumer basket and the high energy intensity of the Bulgarian economy. Import prices (measured by the imports of goods deflator), have been volatile over the past few years. Rebounding from 2009 lows, import prices increased markedly in 2010 and 2011. A somewhat lower increase of about 4% was recorded in 2012, followed by a decline of similar magnitude in 2013, reflecting lower global energy, food and some raw material prices. Import prices are expected to continue declining also in 2014 given i.a. that energy prices are forecast to moderate further over the year. This is also expected to pass through to lower energy-related inflation. It should be noted that Bulgaria depends on a single source of gas supply and negotiates gas prices bilaterally, occasionally diverging from global price trends.

The nominal effective exchange rate of the lev (measured against a group of 36 trading partners) remained relatively stable from early 2009 until late 2012. From November 2012, a noteworthy appreciation trend can be observed, as some currencies of major trading partners depreciated against the euro (Turkish Lira, Russian Rouble, Romanian Leu), which contributed to lower import prices.

Administered prices and taxes

Administered prices ([18]) substantially influenced the consumer price inflation rate in Bulgaria over the past few years, but indirect tax changes less so.

([18]) According to the Eurostat definition, administered prices in Bulgaria include *inter alia* electricity and other regulated utility prices, pharmaceutical products, hospital services, part of public transport and education. For details, see http://epp.eurostat.ec.europa.eu/portal/page/portal/hicp/documents_meth/HICP-AP/HICP_AP_classification_2011_2014_02.pdf

The share of administered prices in the HICP basket is relatively high in Bulgaria at around 17%, compared to 13% in the euro area on average. The annual change of administered prices turned from a 4.9% increase in 2012 to a decline of -1.1% in 2013 on average, with higher decline in the second half of 2013. The increase in administered prices in 2012 was most notably related to electricity prices and to a lesser extent to hospital services. In contrast, responding to public protests in early 2013 against high energy bills, the government strongly lowered the administratively set electricity price in several steps in 2013 and the latest decrease took effect on 1 January 2014. Administratively-set prices of healthcare were lowered, as well. Overall, administered prices raised headline inflation in 2012 by about 0.5 percentage points, but lowered it in 2013 by about 0.3 percentage points, albeit more strongly towards the end of the year.

Indirect tax changes had on aggregate only a minor effect on inflation over 2012-13. In 2012, a rise in excise duties on diesel slightly increased energy prices, but on the other hand changes to VAT legislation applicable to the tourism sector reduced services inflation by about the same amount. In 2013, excise duties on diesel fuels were raised again, but were lowered for natural gas used for heating, resulting in an overall small negative effect on inflation. During the assessment period, annual constant-tax HICP was on average at the same level as headline inflation.

Medium-term prospects

With the fading of base effects from energy and food prices, inflation is forecast to slowly rebound over the second half of 2014 to positive territory. The Commission services' 2014 Spring Forecast expects annual average inflation to reach -0.8% in 2014 and to increase to 1.2% in 2015, in line with the projected recovery in domestic demand and the on-going convergence of prices towards the euro area average.

Risks to the inflation outlook appear broadly balanced, with the most significant risks related to global energy and food price developments, given also their relatively large share in the Bulgarian consumer basket. As a specific inflation risk factor, the administratively lowered electricity network charges might not be sustainable in the longer term. However, presently no change in policy has been announced by the Bulgarian authorities.

The level of consumer prices in Bulgaria was at 47% of the euro area average in 2012. Over the long run, there is significant potential for further price level convergence, in line with the expected catching-up of the Bulgarian economy (Bulgaria's income level was at about 44% of the euro area average in PPS terms in 2012).

Medium-term inflation prospects will depend on wage and productivity developments, as well as on global commodity price trends. A prudent fiscal stance is expected to help contain inflationary pressures. Tax policy is expected to have only a limited impact on inflation, as the harmonisation of excise duties on liquid fuels has been finalised and the excise rate harmonisation for tobacco is scheduled to be spread over several years.

2.3. PUBLIC FINANCES

2.3.1. Recent fiscal developments

On 22 June 2012, the Council decided to abrogate the decision on the existence of an excessive deficit according to Article 126 (12) TFEU, thereby closing the excessive deficit procedure for Bulgaria ([19]). The financial crisis impacted severely on public finances, leading to a budget deficit of 4.3% of GDP in 2009. This was followed by a period of strong fiscal consolidation over 2010-12, when the general government deficit declined from 3.1% of GDP to 0.8% of GDP. The improvement in the fiscal balance was largely due to tight expenditure controls, as reflected in the fall of the expenditure-to-GDP ratio to below 36% of GDP by 2012. In 2013, the deficit has returned to 1.5% of GDP.

This was a weaker outcome than that projected by the Bulgarian authorities in their previous convergence programme submitted in April 2013, which targeted a deficit of 1.3% of GDP. The underperformance was due to a combination of lower-than-expected tax revenues and some expenditure increases. Additional spending was for specific social programmes and for increasing pensions and wages of some public service occupations.

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

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

Outturn and forecast [1]	2008	2009	2010	2011	2012	2013	2014	2015	
General government balance	1.7	-4.3	-3.1	-2.0	-0.8	-1.5	-1.9	-1.8	
- Total revenues	40.1	37.1	34.3	33.6	35.0	37.2	37.5	37.7	
- Total expenditure	38.4	41.4	37.4	35.6	35.8	38.7	39.4	39.5	
of which:									
- Interest expenditure	0.9	0.8	0.7	0.7	0.9	0.8	0.8	0.8	
p.m.: Tax burden	32.3	29.0	27.6	27.3	27.7	28.6	28.7	28.9	
Primary balance	2.6	-3.6	-2.4	-1.2	0.1	-0.7	-1.1	-1.0	
Cyclically-adjusted balance	-0.1	-3.6	-2.4	-1.8	-0.6	-1.1	-1.5	-1.2	
One-off and temporary measures	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	
Structural balance [2]	-0.1	-3.6	-2.3	-1.8	-0.6	-1.1	-1.5	-1.2	
Government gross debt	13.7	14.6	16.2	16.3	18.4	18.9	23.1	22.7	
p.m: Real GDP growth (%)	6.2	-5.5	0.4	1.8	0.6	0.9	1.7	2.0	
p.m: Output gap	5.6	-2.3	-2.2	-0.7	-0.6	-1.2	-1.4	-1.7	
Convergence programme							**2014**	**2015**	**2016**	**2017**
General government balance							-1.8	-1.5	-1.1	-0.9
Structural balance [2) 3)]							-1.1	-0.7	-0.2	0.3
Government gross debt							22.8	22.2	23.3	20.6
p.m. Real GDP growth (%)							2.1	2.6	3.4	3.4

1) Commission services' Spring 2014 Forecast.
2) Cyclically-adjusted balance excluding one-off and other temporary measures.
3) Commission services' calculations on the basis of the information in the programme.
There are no one-off and other temporary measures in the programme.

Previously, pensions and the aggregate public sector wage bill were frozen over several years. The above trends in nominal fiscal deficit are similarly reflected in the estimate of the structural balance. In structural terms, the deficit is estimated to have deteriorated by around 0.5 pp. of GDP in 2013, indicating an expansionary fiscal stance in that year after several years of contraction.

Bulgaria's public debt is one of the lowest among the EU Member States and financing conditions have remained favourable. However, since public finances have been running a deficit since the 2009 economic crisis, the debt-to-GDP ratio has steadily increased from 16.2% in 2010 to 18.9% of GDP in 2013.

2.3.2. Medium-term prospects

The 2014 Budget Law was adopted by Parliament on 9 December 2013. The budget targets a general government deficit of 1.8% of GDP in 2014, which would be higher than the outcome in 2013. There are no major tax rate changes foreseen in the Budget, but the government expects to boost revenue collection through improving tax collection. The increase of the deficit is largely explained by a boost to public investment and some additional expenditure for pensions and social measures.

The Commission services' 2014 Spring Forecast projects the general government deficit at 1.9% of GDP in 2014, improving marginally to 1.8% of GDP in 2015. In structural terms, the deficit is estimated to weaken slightly in 2014, but a consolidation would be under way in 2015, based on a no-policy change assumption. The general government gross debt is forecast to increase from 18.9% in 2013 to about 23% of GDP in 2015.

The 2014 Convergence Programme was submitted on 17 April 2014. The programme aims at reducing the headline general government deficit to 0.9% of GDP by the end of the programme period (2017). The official targets for the general government budget balance have been marginally revised down compared to the previous years' update, now targeting -1.8% of GDP in 2014 and -1.5% of GDP in 2015. The small deviation of the targets for 2014-2015 compared with the Commission services' 2014 Spring Forecast is mainly due and an assumption of much stronger VAT and personal income tax collection in 2014, which is, however, partly balanced by also assuming much stronger investment expenditure growth in the same year.

Further details on the assessment of the 2014 Convergence Programme for Bulgaria can be found in the Commission Staff Working Document, which accompanies the Commission Recommendation for a Council Recommendation on the 2014 National Reform Programme of Bulgaria and delivering a Council Opinion on the 2014 Convergence Programme of Bulgaria.

In March 2012, Bulgaria signed the Treaty on Stability, Coordination and Governance in the EMU and declared its intension to comply with the Title III Fiscal Compact already now. This implies an additional commitment to conduct a stability-oriented and sustainable fiscal policy. The TSCG will apply to Bulgaria in its entirety upon lifting its derogation from participation in the single currency.

2.4. EXCHANGE RATE STABILITY

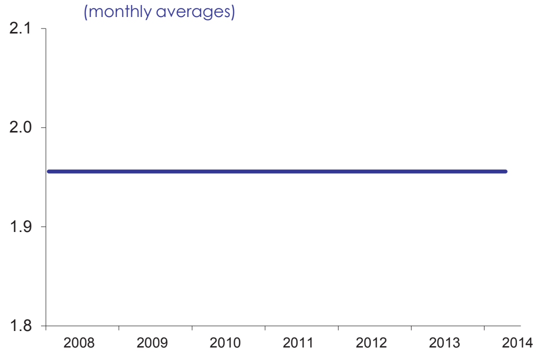
The Bulgarian lev does not participate in ERM II. The BNB pursues its primary objective of price stability through an exchange rate anchor in the context of a currency board arrangement (CBA). Bulgaria introduced its CBA on 1 July 1997, pegging the Bulgarian lev to the German mark and subsequently to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

Over the past two years, the CBA operated in a challenging environment, characterized by weak economic growth, weak credit flow and contagion risks in the banking sector from Greece. However, growing exports, strong public finances, an improving external funding position of the banking sector and sizable reserve buffers have underpinned the resilience of the CBA.

Bulgaria's international reserves (around EUR 14 billion) covered around 163% of the monetary base, about 100% of short-term debt ([20]), 42% of broad money (M3) and about 35% of GDP as of end-2013. A high reserve coverage was deliberately built into the framework for Bulgaria's CBA, to cater for potential financial sector stress following the 1996-97 crisis.

([20]) Based on estimated residual maturity

Graph 2.4:**Exchange rates - BGN/EUR**
(monthly averages)

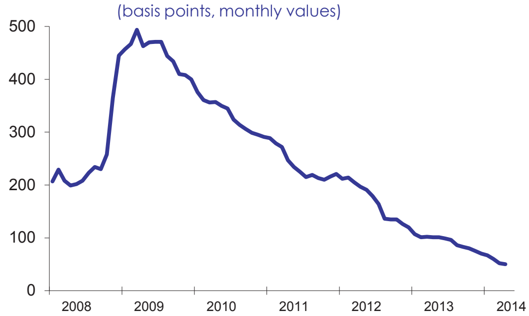


Source: ECB.

The government keeps the bulk of its fiscal reserve deposited in the BNB. International reserves remained rather stable over the past two years and its fluctuation broadly followed the development of the government's fiscal reserves and changes in the price of gold.

The BNB does not set monetary policy interest rates. The domestic interest rate environment is directly affected by the monetary policy of the euro area through the operation of Bulgaria's CBA. Short-term interest rate differentials vis-à-vis the euro area continued to decrease over the past two years. The 3-month spread declined gradually from around 200 basis points in spring 2012 to well below 100 basis points by early 2014. On the other hand, Bulgarian overnight interbank rates were below those of the euro area.

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



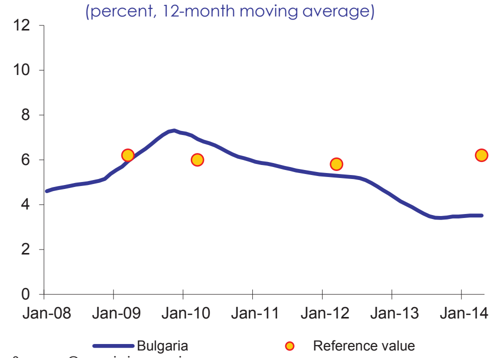
Source: Eurostat.

2.5. LONG-TERM INTEREST RATES

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

The Bulgarian 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion was below the reference value at the 2012 convergence assessment. It declined from above 5% in early 2012 to around 3.5% by mid-2013. In April 2014, the latest month for which data are available, the reference value, given by the average of long-term interest rates in Latvia, Portugal and Ireland plus 2 percentage points, stood at 6.2%. In that month, the twelve-month moving average of the yield on the Bulgarian benchmark bond stood at 3.5%, i.e. about 2.7 percentage points below the reference value.

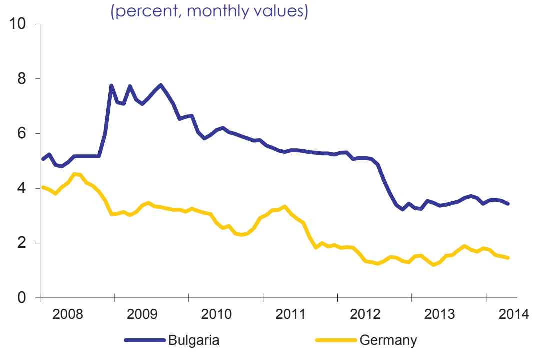
Graph 2.6:**Bulgaria - Long-term interest rate criterion**
(percent, 12-month moving average)



Source: Commission services.

The long-term interest rate of Bulgaria has been on a gradually declining trend since 2009. Bulgarian benchmark bond yields fell significantly in the second half of 2012, with the calming of financial tensions in the euro area, and in Greece in particular. However, 2013 was characterized by some increase in the long-term interest rate, related to political uncertainty around the elections in that year and an expected monetary tightening in the USA.

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



Source: Eurostat.

Spreads to the Bund declined by almost 200 basis points in the second half of 2012 and fluctuated around 190 basis points in 2013, as the rise in Bulgaria's long-term interest rate broadly followed that of Germany. The spread to the German benchmark bond was at around 200 basis points in April 2014 ([21]).

2.6. ADDITIONAL FACTORS

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

In November 2013, the Commission published its third Alert Mechanism Report (AMR 2014) ([22]) under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.5). The AMR 2014 scoreboard showed that Bulgaria exceeded the indicative threshold in two out of eleven indicators, one in the area of external imbalances (i.e. the net international investment position) and one in the area of internal imbalances (i.e. the unemployment rate). In line with the conclusion of the AMR 2014, Bulgaria was subject to an in-depth review, which found that Bulgaria continues to experience macroeconomic imbalances, which require monitoring and policy action.

2.6.1. Developments of the balance of payments

Bulgaria's external balance (i.e. the combined current and capital account) adjusted from high pre-crisis deficits to close to balance by 2010 and reached a surplus of around 3% of GDP in 2013. Both goods and services trade performed well, with the traditionally negative goods balance being partly counterbalanced by the surplus on services. The income account also improved in 2012, reflecting lower profits on FDI, but this slightly reversed in 2013. The strongest improvement relative to 2011 came from current transfers, reflecting an increasing absorption of EU funds and remittances from Bulgarians working abroad.

([21]) The reference to the German benchmark bond is included for illustrative purposes, as a proxy of the euro area long-term AAA yield.
([22]) http://ec.europa.eu/europe2020/pdf/2014/amr2014_en.pdf

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

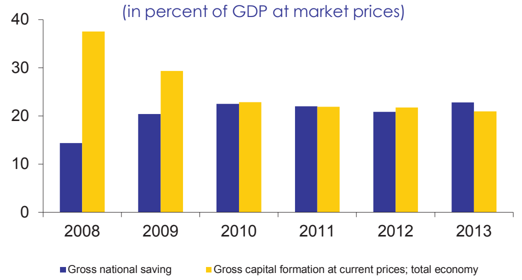
	2008	2009	2010	2011	2012	2013
Current account	-23.1	-8.9	-1.5	0.1	-0.8	1.9
of which: Balance of trade in goods	-24.3	-11.9	-7.7	-5.6	-8.7	-5.9
Balance of trade in services	3.7	3.7	5.2	6.0	6.0	5.3
Income balance	-5.0	-3.4	-3.1	-4.7	-3.3	-3.5
Balance of current transfers	2.4	2.7	4.2	4.4	5.2	6.0
Capital account	0.8	1.4	0.8	1.3	1.4	1.2
External balance 1)	-22.3	-7.6	-0.7	1.4	0.5	3.0
Financial account	30.5	5.2	-0.8	-2.7	-1.7	-2.2
of which: Net FDI	17.5	7.2	2.7	3.1	2.0	2.4
Net portfolio inflows	-2.1	-1.8	-1.8	-0.9	-2.2	-0.3
Net other inflows 2)	16.9	-2.1	-2.8	-4.5	3.9	-5.7
Change in reserves (+ is a decrease)	-1.9	1.9	1.1	-0.4	-5.4	1.5
Financial account without reserves	32.4	3.3	-1.9	-2.3	3.7	-3.7
Errors and omissions	-8.1	2.4	1.5	1.3	1.2	-0.9
Gross capital formation	37.5	29.4	22.9	21.9	21.7	20.9
Gross saving	14.4	20.4	22.5	22.0	20.9	22.8
External debt	105.1	108.3	102.7	94.3	94.6	93.5
International investment position	-98.4	-101.8	-95.4	-85.9	-79.1	-78.1

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

Sources: Eurostat, Commission services, Bulgarian National Bank.

Mirroring the trends of the current account, the savings-investment gap hovered close to balance from 2010 and rose to about 2% of GDP in 2013. Gross national savings remained high by historical standards, as companies continued to undergo balance-sheet adjustments and households remained cautious in their spending, in spite of increasing incomes. At the same time, gross fixed capital formation remained subdued as firms and households have not recovered confidence amid a weak economic recovery. Capacity utilisation in industry remains below the pre-crisis peak levels.

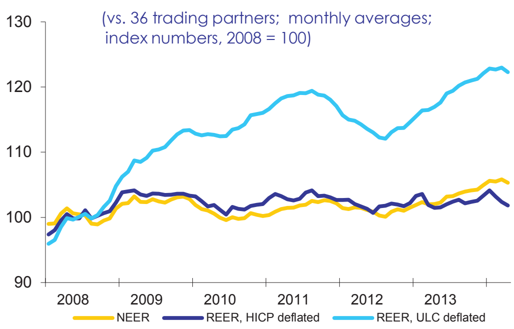
Graph 2.8: **Bulgaria - Saving and investment**
(in percent of GDP at market prices)



Source: Eurostat, Commission services.

Competitiveness indicators showed a mixed picture in the past two years. The ULC-deflated real-effective exchange rate has appreciated significantly since mid-2012, largely due to the rising NEER. On the other hand, HICP- and manufacturing sector ULC-based REERs remained more stable (given that manufacturing sector records lower wage growth than in the services sector while productivity growth is higher). Bulgaria has had an improving market performance since the 2008 crisis. After a temporary dip in 2012, this trend resumed in 2013.

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



Source: Commission services.

Moderate financial account outflows have continued since 2010. Net FDI inflows have remained positive, but rather subdued by historical standards since 2009. New investments went mainly to productive sectors, including automotive and metals manufacturing and energy. The slump in real estate activity was reflected by a sharp drop in FDI in this sector. The banking sector has continued to reduce its foreign liabilities and increased its assets abroad. Net portfolio outflows declined to close to zero in 2013. Gross external debt declined significantly from around 108% of GDP at end-2009 to about 94% by end-2013, supported by repayment of foreign debt by the banking sector and non-financial corporate deleveraging. Similarly, the improvement in the international investment position was reflected in a reduction in net external debt, while the FDI stock has remained relatively stable.

According to the Commission services' 2014 Spring Forecast, the external surplus is projected to abate to around 2% of GDP in 2014 and 2015, as a pick-up in domestic demand is expected to drive imports while export growth remains overall robust.

2.6.2. Market integration

The Bulgarian economy is well integrated to the euro area through trade and investment linkages. As a small open economy, Bulgaria is characterised by a high ratio of trade openness. During the global crisis, however, Bulgaria recorded a contraction of trade openness, as external demand faltered, and both imports and exports contracted in real terms. In recent years, due to the rebound of global trade, the declining trend in openness to trade reversed, increasing from a low of 52% in 2009 to some 68% in 2012.

Bulgaria's export specialisation is focused on intermediate technology products. A breakdown of exported goods by product category shows a predominance of labour and raw-material-intensive, low- and medium-technology goods over high-technology goods. Mineral products (19%), base metals (18%), and machinery and electrical equipment (14%) are the largest export sectors in Bulgaria. Despite an increase in the share of high technology products in exports until 2009 (reaching 4.6% of GDP), the trend seems to have reversed in recent years, contributing to a high-tech trade deficit (i.e. trade deficit in high-tech) of -3.8% in 2012.

Bulgaria experienced significant FDI inflows during the pre-crisis period on account of low labour costs, an excellent tourism potential and a lower risk perception associated with the perspective of the country's EU accession. The main recipient sectors of FDI were services (real estate and business activities, and financial intermediation), construction and to a lesser extent manufacturing. FDI inflows reached a high of 29% of GDP in 2007, but dried up considerably during the global economic downturn, with just 3.7 % of GDP in 2012. However, in particular due to the high accumulation rate experienced in the years before the crisis, the FDI stock in Bulgaria is higher than the average for the other non-euro area Member States.

After the pre-crisis boom that ended in 2008, house prices in Bulgaria have been declining. The cumulated correction between 2008 and 2012 reached 42% but the speed of the adjustment has declined over time. In 2012, the real house price index fell by 7% (compared to 10% in 2011). Building permits fell sharply from 2007 to 2012, accumulating a huge 83% decline. The latest available figures signal a trend reversal and the number of authorisations to start building projects increased by 16% in 2013. Employment and value added in the construction sector have decreased steadily since 2009.

Concerning the business environment, Bulgaria performs in general worse than most euro area Member States in international rankings ([23]). Based on the World Bank Doing Business indicators, the performance of Bulgaria deteriorated in 2013 in the areas of starting a business, dealing with construction permits and registering property, accessing electricity and protecting investors and managing insolvency. On the other hand, there was a marked improvement in the indicator related to trading across borders. Public administration as a whole scores relatively poorly according to the World Bank's Worldwide Governance Indicators ([24]). According to the November 2013 Internal Market Scoreboard, Bulgaria had a transposition deficit (0.6%) close to the 0.5 % target as proposed by the European Commission in the Single Market Act (2011).

([23]) For instance, Bulgaria ranks 58th (out of 189 economies) on the World Bank's 2014 Ease of Doing Business Index and 57th (out of 148 economies) on the World Economic Forum's 2013-2014 Global Competitiveness Index.

([24]) http://info.worldbank.org/governance/wgi/index.aspx#home

Table 2.5:
Bulgaria - Product market integration

	2007	2008	2009	2010	2011	2012
Trade openness 1) (%)	69.4	68.5	51.9	58.4	66.5	68.2
Intra-EA trade in goods GDP ratio 2) (%)	26.3	24.5	18.7	20.8	25.0	24.8
Intra-EA trade in services GDP ratio 3) (%)	n.a.	5.8	5.6	4.9	4.6	5.0
Extra-EA trade in goods GDP ratio 4) (%)	31.2	32.4	22.2	27.5	31.7	33.1
Export in high technology 5) (%)	3.5	3.6	4.6	4.1	3.7	3.8
High-tech trade balance 6) (%)	-3.2	-2.9	-2.0	-2.2	-2.8	-3.8
Total FDI inflows GDP ratio 7) (%)	29.4	19.0	7.0	3.2	3.5	3.7
Intra-EA FDI inflows GDP ratio 8) (%)	20.3	12.3	4.3	3.0	2.7	2.0
FDI intensity 9)	15.0	10.2	3.4	1.8	1.9	2.2
Internal Market Directives 10) (%)	0.8	0.4	0.3	0.4	0.9	0.6
Time to start up a new company 11)	32.0	49.0	18.0	18.0	18.0	18.0
Real house price index 12)	n.a.	145.5	114.1	100.0	90.3	84.1
Residential investment 13) (%)	5.3	6.1	5.3	2.8	2.4	n.a.
Building permits index 14)	500.8	385.2	157.0	100.0	85.5	82.8

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

2) (Intra-EA-18 Imports + Exports of goods / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).

3) Intra-EA-17 trade in services (average credit and debit in % of GDP at current prices) (Balance of Payments).

4) (Extra-EA-18 Imports + Exports of goods / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).

5) Taken directly from Eurostat's databases: Exports of high technology products as a share of total exports.

6) (Exports - imports in high tech) / GDP at current prices x 100, since 2007 the data based upon SITC Rev. 4 (earlier SITC Rev. 3).

7) Total FDI inflows (in % of GDP at current prices).

8) Intra-EA-17 FDI inflows (in % of GDP at current prices).

9) FDI intensity (average intra-EU-27 inflows and outflows in % of GDP at current prices).

10) Percentage of internal market directives not yet communicated as having been transposed, in relation to the total number.

11) Time to start a new company (in days), Doing Business World Bank.

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

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

14) Number of new residential building permits (2010=100), Eurostat.

Sources: Eurostat, Sectoral Performance Indicators Database (SPI), Commission services.

The experience of 2008-13 shows that the Bulgarian labour market adjusts to economic shocks by shedding labour rather than by lowering wages ([25]). This tendency is not entirely explained by institutional factors. Wage setting appears relatively flexible in Bulgaria according to most labour market institutional features (wage bargaining largely at firm level, relatively low coverage of collective wage agreements, low union density, short duration of wage bargaining contracts, limited wage indexation). While most institutional features do not therefore seem to significantly limit labour market adjustment, an exception appears to be a unique Bulgarian system of minimum social security thresholds, which set a multitude of wage floors by industry and occupation, potentially limiting downward wage flexibility in a crisis.

While the Bulgarian labour market demonstrated some flexibility during the downturn through shedding labour, it appears less efficient in post-crisis reallocation and re-employment of labour. In Bulgaria, active labour market and retraining policies to facilitate the upgrading of the skills of the unemployed and their transition to new employment are less developed. The Bulgarian labour market is also characterised by persistent emigration. According to the National Statistics Office data, net emigration was especially high during 2009-10, coinciding with the period of the labour market crisis. However, while emigration was less pronounced in other periods, it exceeded immigration flows also during the boom years 2007-08 and since 2011 (last data is available from 2012). This suggests that emigration is fundamentally driven by the large income gap with

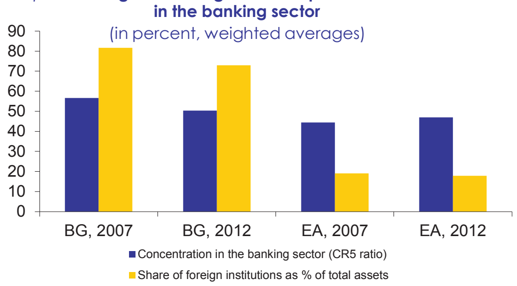
([25]) Maiväli, M. and M. Stierle, 'The Bulgarian labour market puzzle: Strong wage growth amidst rising unemployment', Country Focus, Directorate-General for Economic and Financial Affairs, European Commission, 2013.

the other EU Member States and domestic labour market cycles only affect the strength of net emigration. Therefore, it cannot be expected that in Bulgaria cross-border labour movements would symmetrically facilitate labour market adjustments both over up- and downturns of the economic cycle.

2.6.3. Financial market integration

Bulgaria's financial sector is well integrated with the EU financial sector, in particular through a high level of foreign ownership in its banking system. The share of foreign-owned institutions in total bank assets has, however, declined during the crisis, reaching 73% in 2012, as local banks were more active in the new environment. Bank concentration, as measured by the market share of the five largest credit institutions in total assets, has converged to the euro area average since EU accession.

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

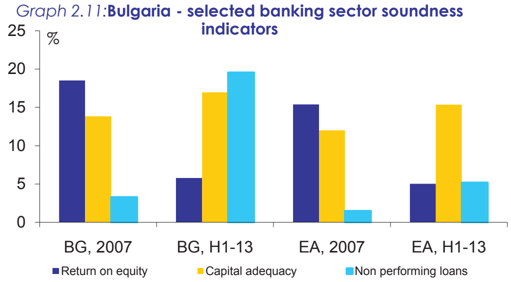


Source: ECB, Structural financial indicators.

Financial intermediation in Bulgaria is mainly indirect, with domestic bank credit steadily around 70% of GDP since 2011. Rapid credit expansion ended by 2009 as changes in the international financial environment constrained access to foreign funding and the economy started to deleverage. The attractiveness of domestic deposit collection increased and competition among banks led to high deposit rates in some periods. The banking sector managed to substantially reduce its reliance on external funding. Credit to the economy by the domestic banking sector has been flat since mid-2012. The share of foreign-currency loans (predominantly in euro) in total declined somewhat during the past two years and stood around 72% for non-financial corporations and 39% for households at the end of 2013. Private sector debt of 132% of GDP in 2012 is somewhat below the euro area average (145% of GDP) ([26]).

The Bulgarian financial system has proved resilient to the international financial crisis. No banking system rescue measure had to be taken by the government. Confidence in the currency board arrangement is strong and international reserves remained at high level. The banking system is fairly liquid and well capitalized, with a capital adequacy ratio of 16.9% at the end of 2013. The quality of the loan portfolio is, however, still deteriorating, with the share of non-performing loans reaching 16.9% at end-2013, as domestic recovery has been weak. Profitability of the domestic banking sector has remained positive since EU accession.

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

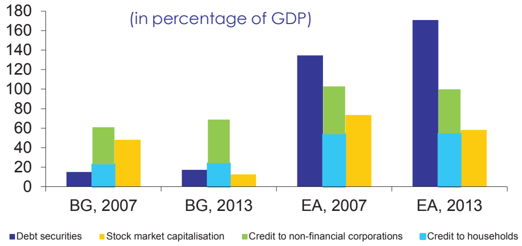


Note: For 2007 EU-27 non performing loans are a proxy for EA.
For 2007, EA RoE and CAR averages are unweighted.
Source: ECB, EC calculations.

The non-banking financial sector remains underdeveloped relative to the euro area with a relatively small insurance sector. The financial deepening of capital markets, which progressed considerably during the economic boom, came to a halt since the financial crisis. The capitalization of the stock market declined markedly since its highs of 2007 and was down to less than 13% of GDP in 2013. The debt securities market remains small in comparison with the euro area average and is mainly used for financing a part of Bulgaria's relatively low public debt.

([26]) Data on private sector debt are based on consolidated ESA 95 data of non-financial corporations and households (and non-profit institutions serving households) sectors' liabilities related to loans and securities other than shares.

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



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

Regulation and supervision of monetary financial institutions is conducted by the BNB. Since 1 March 2003, all players in the non-banking financial sector and the capital markets are under the supervision of a single regulator, the Financial Supervision Commission (FSC). The FSC cooperates strongly with the BNB, as well as with international partners, especially from the neighbouring countries. Bulgaria has a good track record of implementing EU financial services directives.

3. CZECH REPUBLIC

3.1. LEGAL COMPATIBILITY

3.1.1. Introduction

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

Following the Convergence Report 2012, the ČNB Law was amended by Law No. 227/2013 Coll. which was adopted on 20 June 2013. However, since there have been only limited amendments as regards the incompatibilities highlighted in the Commission's 2012 Convergence Report, the comments made in the latter are largely repeated in this year's assessment.

3.1.2. Independence

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

However, according to Article 3 of the ČNB Law, the ČNB shall submit a report on monetary developments to the Chamber of Deputies of the Parliament for review at least twice per year. The Chamber of Deputies may ask for a revised report and in this case, the ČNB will have to submit a revised version complying with the Chamber of Deputies' requirements. This power of the Parliament to ask for amendments and, thus, to influence the content of the ČNB's report on monetary developments can affect the ČNB's institutional independence. For this reason, Article 3 contradicts Article 9(1) and is considered as incompatible with Article 130 of the TFEU and Article 7 of the ESCB/ECB Statute.

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

The power for the Chamber of Deputies of the Parliament to request modifications to the submitted earlier annual financial report (Article 47(5) of the ČNB Law), could also hamper the ČNB’s institutional (and possibly financial) independence. Thus, Article 47(5) of the ČNB Law constitutes an additional incompatibility which should be removed from the Act.

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

3.1.3. Prohibition of monetary financing

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

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

3.1.4. Integration in the ESCB

Objectives

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

Tasks

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

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

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

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

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

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

There are also some imperfections regarding:

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

- non-recognition of the role of the ECB in the functioning of the payment systems (Article 38 and 38a of the ČNB Law);

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

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

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

3.1.5. Assessment of compatibility

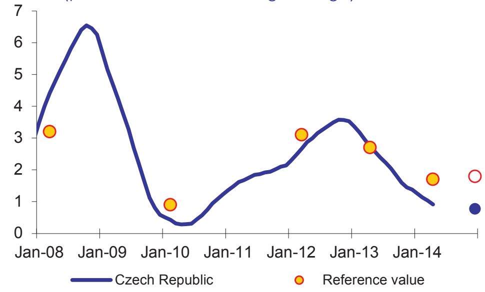
As regards the independence of the central bank, the prohibition of monetary financing and the integration of the central bank in the ESCB at the time of euro adoption, the ČNB Law is not fully compatible with the compliance duty under Article 131 of the TFEU.

3.2. PRICE STABILITY

3.2.1. Respect of the reference value

The 12-month average inflation rate, which is used for the convergence evaluation, was below the reference value at the time of the last convergence assessment of the Czech Republic in 2012. Following an upward trend since mid-2010, it peaked at above 3.5% in late 2012, before declining gradually close to 1% in early 2014. In April 2014, the reference value was 1.7%, calculated as the average of the 12-month average inflation rates in Latvia, Portugal and Ireland plus 1.5 percentage points. The corresponding inflation rate in the Czech Republic was 0.9%, i.e. 0.8 percentage points below the reference value. The 12-month average inflation rate is projected to fall well below the reference value in the months ahead.

Graph 3.1: **Czech Republic - Inflation criterion since 2008**
(percent, 12-month moving average)



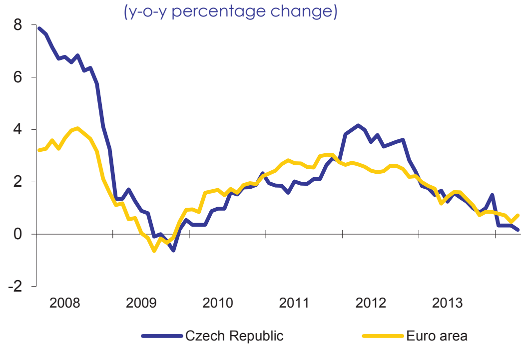
Note: The dots in December 2014 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2014 Forecast.

3.2.2. Recent inflation developments

Annual HICP inflation in the Czech Republic moved broadly in line with the euro-area average in the period between 2009 and 2011. It increased above the euro-area inflation in 2012, largely due to an increase in the lower VAT rate while higher energy and food prices in global commodity markets were also passed through into consumer prices. Despite another VAT increase in January 2013, price growth significantly moderated throughout 2013 as pressures stemming from energy prices gradually eased off and growth in prices of services became subdued. Price developments in the services sector reflected a sharp fall in prices of communication services and lower increases in administered prices as compared to previous years. Lack of demand pressures, reflecting the economic downturn, also contributed to the moderate price growth. Annual HICP inflation hovered close to 0.3% in early 2014.

Core inflation (measured as HICP inflation excluding energy and unprocessed food), averaged 1.7% in 2012-2013, reflecting weak underlying price pressures in the real economy. Higher costs of key intermediate inputs – energy and food commodities – together with changes in VAT were the main drivers of price growth in processed food, and in 2012 also in services. Prices of non-energy industrial goods have followed a declining trend since 2002 on the back of intensifying competition on final markets and sustained effectiveness gains on the part of producers of imported goods. In 2012-2013, their negative contribution to core inflation was mitigated by the above-mentioned increases in indirect taxes and a weaker koruna. In 2012, headline inflation exceeded core inflation by a wide margin as the hikes in imported food and energy prices were not fully passed through into core inflation. Producer price inflation for total industry decreased to 0.8% in 2013, confirming the moderation of cost pressures on the supply side.

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



Source: Eurostat.

3.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy-mix and cyclical stance

Following a moderate recovery in 2010-2011, real GDP declined again in both 2012 and 2013 largely on account of falling domestic demand. While private consumption expenditure was negatively affected by declines in real disposable income of households, gross capital formation fell due to recurrent cuts in public investment and decreased risk tolerance on the part of businesses. As these factors gradually eased off, economic growth resumed in the second quarter of 2013, albeit initially at a modest pace. According to the Commission services' 2014 Spring Forecast, economic activity, supported by a brightening outlook for the global economy, is expected to strengthen, resulting in real GDP growth of 2% in 2014 and 2.4% in 2015. The Czech economy is estimated to have operated well below its potential since 2009 and the output gap is projected to remain negative even in 2015.

The fiscal stance, as measured by changes in the structural balance, has been restrictive since 2010. The headline deficit decreased in 2010 and 2011 on account of improvements in both the cyclical and structural components. The structural balance continued to improve in 2012 as further consolidation was pursued, although the headline deficit was temporarily pushed up by sizeable one-off expenditure measures (in particular related to the adoption of the law on financial compensations to churches). Fiscal adjustment in both 2012 and 2013 relied heavily on cuts in public investment

Table 3.1:
Czech Republic - Components of inflation

	2008	2009	2010	2011	2012	2013	Apr-14	weights in total 2014
						(percentage change)[1]		
HICP	6.3	0.6	1.2	2.1	3.5	1.4	0.9	1000
Non-energy industrial goods	-0.2	-2.4	-2.4	-1.8	-0.5	-0.5	-0.3	238
Energy	11.0	2.7	4.3	7.2	7.7	0.6	-1.8	144
Unprocessed food	2.1	-1.8	3.5	0.7	7.7	7.2	5.4	76
Processed food	11.0	0.7	2.1	5.9	5.0	3.0	3.2	208
Services	7.6	2.5	1.9	1.1	3.1	1.0	0.5	334
HICP excl. energy and unproc. food	5.8	0.5	0.5	1.4	2.4	1.0	1.0	780
HICP at constant taxes	4.3	0.6	-0.1	2.1	2.2	0.5	0.2	1000
Administered prices HICP	13.6	6.9	5.0	2.9	8.3	3.5	2.2	107

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

Sources: Eurostat, Commission services.

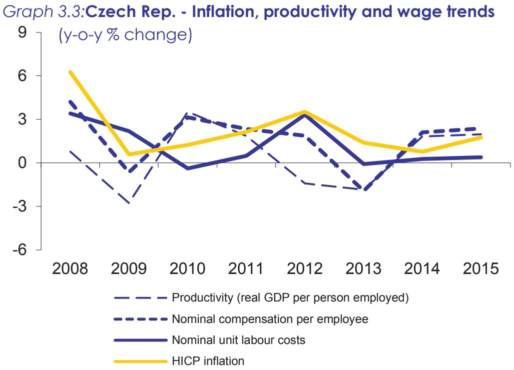
and increases in indirect taxes, which is likely to have accentuated the economic downturn. Looking ahead, the fiscal stance is expected to loosen in both 2014 and 2015.

Monetary policy, conducted within an inflation targeting framework ([27]), was further loosened in 2012 in view of the subdued inflation outlook and faltering recovery. The ČNB cut its main policy rate (the 2-week repo rate) by a cumulative 70 basis points to its technical 'zero bound' (0.05%) between June and November 2012. Despite the accommodative monetary policy stance, credit growth and the inflation outlook remained subdued. Having fully exploited the interest rate channel, the ČNB began using the exchange rate as an additional instrument for easing monetary conditions in November 2013, which is likely to stoke up inflation in 2014.

Wages and labour costs

The labour market showed substantial flexibility in accommodating lower labour demand during the economic downturn of 2012 and 2013. Specifically, the rise in unemployment was limited by the willingness of firms to cut working hours rather than jobs and by a persistent shift from regular to self-employment. The unemployment rate peaked at 7% in 2012 and started to decline (in seasonally adjusted terms) in the second half of 2013. Despite the unfavourable economic situation, the number of employed persons continued to expand at a modest pace, supported by a growing supply of part-time jobs and rising participation of older workers. Real wages fell in both 2012 and 2013 as a consequence of modest nominal wage increases in this period. The Czech population of working age is projected to continue shrinking in coming years, which is set to weigh on employment growth going forward.

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



Source: Eurostat, Commission services' Spring 2014 Forecast.

The labour hoarding behaviour on the part of employers contributed to negative growth in productivity per worker in 2012 and 2013. As nominal compensation per employee continued to rise in 2012, nominal unit labour costs (ULC) increased. ULC broadly stabilised in 2013 due to the decline in nominal compensation per employee. This was to a large extent related to the introduction of a second personal income tax bracket, in anticipation of which part of compensations was paid out in the fourth quarter of 2012, before the tax became effective. Labour productivity is expected to increase again along with the firming economic recovery, thus dampening nominal ULC growth in 2014 and 2015.

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

Table 3.2:

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

	2008	2009	2010	2011	2012	2013 1)	2014 2)	2015 2)
HICP inflation								
Czech Republic	6.3	0.6	1.2	2.1	3.5	1.4	0.8	1.8
Euro area	3.3	0.3	1.6	2.7	2.5	1.3	0.8	1.2
Private consumption deflator								
Czech Republic	4.8	0.8	-0.2	0.5	2.7	1.1	1.0	1.8
Euro area	2.7	-0.4	1.6	2.4	2.1	1.3	0.9	1.3
Nominal compensation per employee								
Czech Republic	4.2	-0.6	3.1	2.3	1.9	-1.9	2.1	2.4
Euro area	3.5	1.8	2.0	2.2	2.0	1.7	1.6	1.9
Labour productivity								
Czech Republic	0.8	-2.8	3.5	1.9	-1.4	-1.8	1.8	2.0
Euro area	-0.3	-2.4	2.6	1.4	0.2	0.5	0.9	1.0
Nominal unit labour costs								
Czech Republic	3.4	2.2	-0.4	0.5	3.3	-0.1	0.3	0.4
Euro area	3.8	4.3	-0.6	0.7	1.8	1.1	0.7	0.8
Imports of goods deflator								
Czech Republic	-3.0	-2.9	1.0	3.1	3.7	-0.3	3.2	1.0
Euro area	4.2	-8.1	5.7	6.6	2.3	-1.9	-1.0	0.8

1) 2013 data (except HICP inflation) are estimates.
2) Commission services' Spring 2014 Forecast.

Source: Eurostat, Commission services.

External factors

Given the size and openness of the Czech economy, import prices have a sizeable effect on domestic price formation. Import prices (measured by the imports of goods deflator) increased considerably in 2012, largely on account of higher prices of internationally-traded commodities, but their growth significantly decelerated in 2013. As a result, energy and food prices increased significantly in 2012 before moderating by late 2013. The joint contribution of energy prices and unprocessed food prices to HICP inflation averaged 1.2 percentage points in 2012 and 2013, accounting for about half of the average HICP increase in this period. The key factor behind the projected increase in import prices in 2014 is a weaker nominal effective exchange rate of the koruna.

Inflationary impulses from the exchange rate have been moderate up to late 2013. The koruna's nominal effective exchange rate (measured against a group of 36 trading partners) depreciated by less than 2% between the first quarter of 2012 and the third quarter of 2013. However, following the ČNB's decision to intervene on the foreign exchange market, the NEER dropped by about 6% in late 2013 and then remained broadly stable in early 2014.

Administered prices and taxes

Changes in administered prices and indirect taxes have played a significant role in determining headline inflation in recent years. At the same time, the share of administered prices in the HICP basket has declined in recent years to below 11% by 2014 ([28]), compared to 13% in the euro area.

Changes in administered prices were a sizeable driver of inflation in 2012, but their growth moderated in 2013. Developments in 2012 were affected by the ongoing deregulation of rents, hikes in heat energy prices and changes in most administrative charges – in particular in health care – on account of the increase in the lower VAT rate (see below) and higher input prices of materials.

Similarly, the contribution of indirect taxes to headline inflation was stronger in 2012 than in 2013 as it was significantly influenced by changes in the value added tax in both years. While the lower VAT rate was increased from 10% to 14% in 2012, affecting about a third of the consumption

([28]) According to the Eurostat definition, administered prices in the Czech Republic include *inter alia* regulated utility prices, heat energy, public transport, pharmaceuticals, medical and social services. For details, see http://epp.eurostat.ec.europa.eu/portal/page/portal/hicp/documents_meth/HICP-AP/HICP_AP_classification_2011_2014 _02.pdf basket, both VAT rates were raised by 1 pp. to 15% (the reduced rate) and 21% (the basic rate) respectively in 2013. Another significant tax change that affected both years concerned the excise duty on tobacco, the rates of which were harmonised with the minimum rates imposed by the EU Single Market rules. Constant tax inflation was thus substantially lower than headline inflation in 2012 and 2013. HICP inflation is not expected to be significantly affected by further changes in indirect taxes in 2014.

Medium-term prospects

The fading out of past increases in indirect taxes together with the large fall in regulated prices of electricity are expected to keep inflation subdued in 2014. However, inflation is projected to pick up in the second half of 2014 on account of the significant weakening of the koruna in late 2013. Stronger domestic demand is then expected to stoke up inflation in 2015. On this basis, the Commission services' 2014 Spring forecast projects annual HICP inflation to average 0.8% in 2014 and 1.8% in 2015.

Risks to this inflation outlook are broadly balanced. The main downside risk stems from weaker-than-expected economic activity on account of a slower recovery in the euro area and other key trading partners. On the upside, a stronger-than-expected recovery in domestic demand would bolster nominal wages, and re-ignite demand pressures.

The level of consumer prices in the Czech Republic was at some 71% of the euro-area average in 2012, with the relative price gap widest for services. This suggests potential for further price level convergence in the long term. Income convergence has effectively stalled in the post-crisis period as the income level reached 75% of the euro-area average in PPS in 2012, compared to 76% in 2007.

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

3.3. PUBLIC FINANCES

3.3.1. The excessive deficit procedure for the Czech Republic

On 2 December 2009, the Council decided that an excessive deficit existed in the Czech Republic in accordance with Article 126(6) of the Treaty on the Functioning of the European Union (TFEU) and addressed recommendations to the Czech Republic in accordance with Article 126(7) with a view to bringing an end to the situation of an excessive government deficit by 2013. In its recommendations, the Council invited the Czech Republic to ensure an average annual fiscal effort of 1% of GDP over the period 2010-2013. The Council established the deadline of 2 June 2010 for the Czech government to take effective action to implement the deficit reducing measures in 2010 as planned in the draft budget law for 2010 and to outline in some detail the consolidation strategy that will be necessary to progress towards the correction of the excessive deficit. On 13 July 2010, the Council concluded that the Czech authorities had taken effective action to correct the excessive deficit and that no additional steps in the excessive deficit procedure were necessary at that stage ([29]). As the headline general government deficit was well below the 3% of GDP threshold in 2013 and the Commission services' 2014 Spring Forecast confirmed the durability of the correction, the European Commission is recommending that the Council abrogate the decision on the existence of an excessive deficit in the Czech Republic.

3.3.2. Recent fiscal developments

The severe economic downturn experienced by the country in 2009 had a negative effect on public finances and caused the general government deficit to widen from 2.2% of GDP in 2008 to 5.8% of GDP in 2009. The subsequent period has been marked by continuous efforts to correct the excessive deficit and to bring public finances back on a more sustainable path. The cumulative fiscal effort (measured by the change in the structural balance) in the period from 2010 until 2013 amounted to about 5.5% of GDP.

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

Table 3.3:

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

Outturn and forecast [1]	2008	2009	2010	2011	2012	2013	2014	2015		
General government balance	-2.2	-5.8	-4.7	-3.2	-4.2	-1.5	-1.9	-2.4		
- Total revenues	38.9	38.9	39.1	40.0	40.3	40.9	40.6	40.2		
- Total expenditure	41.2	44.7	43.8	43.2	44.5	42.4	42.5	42.6		
of which:										
- Interest expenditure	1.1	1.3	1.4	1.4	1.5	1.4	1.4	1.3		
p.m.: Tax burden	34.5	33.4	33.6	34.6	35.0	35.6	35.2	34.5		
Primary balance	-1.2	-4.5	-3.3	-1.8	-2.7	-0.1	-0.5	-1.1		
Cyclically-adjusted balance	-4.1	-5.2	-4.4	-3.0	-3.5	-0.2	-0.9	-1.9		
One-off and temporary measures	0.0	0.3	0.2	0.0	-1.8	-0.1	0.2	0.0		
Structural balance [2]	-4.1	-5.6	-4.6	-3.0	-1.6	-0.1	-1.1	-1.9		
Government gross debt	28.7	34.6	38.4	41.4	46.2	46.0	44.4	45.8		
p.m: Real GDP growth (%)	3.1	-4.5	2.5	1.8	-1.0	-0.9	2.0	2.4		
p.m: Output gap	4.7	-1.5	-0.8	-0.5	-1.9	-3.3	-2.4	-1.3		
Convergence programme							**2014**	**2015**	**2016**	**2017**
General government balance							-1.8	-2.3	-2.0	-1.7
Structural balance [2] [3]							-1.0	-1.6	-1.6	-1.9
Government gross debt							44.9	46.0	47.1	47.1
p.m. Real GDP (% change)							1.7	2.0	2.1	2.5

1) Commission services' Spring 2014 Forecast.

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

3) Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures in the convergence programme of April 2014 are 0.1% of GDP in 2014, deficit-decreasing; and 0.1% of GDP in both 2015 and 2016, deficit-increasing.

Sources: Commission services, the 2014 Convergence Programme of Czech Republic.

While the composition of the consolidation packages varied from one year to another, two main budgetary items appear to have driven the overall budgetary adjustment, namely indirect taxes and public investment. Within the category of indirect taxes, both excise duties and VAT were increased several times with an estimated cumulative fiscal impact of almost 1.8% of GDP in the period 2010-2013. VAT rates increased from 5% and 19% in 2010 to the current 15% and 21%. The sharp drop in public investment averaged more than 13% annually over the period 2010-2013. The consolidation effort affected also other expenditure and revenue categories, such as social benefits, the public sector wage bill, intermediate consumption and the social security contributions, albeit to a lesser degree.

The general government deficit in 2013 reached 1.5% of GDP. This outcome was underpinned by consolidation measures of 0.7 pp. of GDP, of which about two thirds fall on the revenue side. The main measures included increases in both the reduced and standard VAT rate by 1 pp. and a lower indexation of pensions. A public investment retrenchment of 12% year-on-year as well as higher property income reflecting strong performance of some state-controlled companies were also important factors contributing to the reduction of the headline deficit. The revenue-to-GDP ratio increased by 0.6 pp. to 40.9% of GDP while the expenditure-to-GDP ratio fell by 2.1 pp. to 42.4 % of GDP.

While still well below the 60% of GDP threshold, the debt ratio increased from 38.4% of GDP in 2010 to 46% of GDP in 2013, mainly on account of high government deficits.

3.3.3. Medium-term prospects

The budget for 2014 was adopted by the Parliament on 19 December 2013. According to the Commission services' 2014 Spring Forecast, the general government deficit is expected to increase to 1.9% of GDP in 2014 in an environment of improving macroeconomic conditions. Government consumption is set to exhibit a relatively strong growth on account of the planned increase in the public sector wage bill and in intermediate consumption (total fiscal impact of approximately 0.2% of GDP). The forecast also factors in a sharp increase in public investment as a strong rebound is expected in EU-financed investment projects. The main deficit-reducing measures include an increase in excise duties and one-off revenue from the sale of newly released frequency ranges. Overall, total government expenditure will remain broadly in line with nominal GDP growth. The revenue-to-GDP ratio is projected to drop by 0.3 pp. to 40.6%. The structural balance is forecast to deteriorate by about 1.1 pp. of GDP in the context of a narrowing output gap.

On unchanged policies, the headline deficit is expected to widen to 2.4% of GDP in 2015 and the structural deficit is forecast to deteriorate further to 1.9% of GDP. The debt-to-GDP ratio is projected to remain broadly stable over the forecast horizon reaching 45.8% in 2015.

The 2014 Convergence Programme, covering the period 2014-2017, was submitted by the Czech authorities on 28 April 2014. The main goal of the programme´s budgetary strategy is to keep the general government deficit below the 3% of GDP reference value in 2014-2017. The recalculated structural balance is expected to reach -1% of GDP in 2014 according to the programme, implying that the Czech Republic should reach its MTO this year. Following an overall assessment of the Czech Republic's budgetary plans, with the structural balance as a reference, including an analysis of expenditure net of discretionary revenue measures, there is a risk that the structural deficit will exceed the MTO in 2015.

Further details on the assessment of the 2014 Convergence Programme for the Czech Republic can be found in the Commission Staff Working Document, which accompanies the Commission Recommendation for a Council Recommendation on the 2014 National Reform Programme of the Czech Republic and delivering a Council Opinion on the 2014 Convergence Programme of the Czech Republic.

The Czech Republic has not signed the Treaty on Stability, Coordination and Governance in the EMU by the time of this assessment.

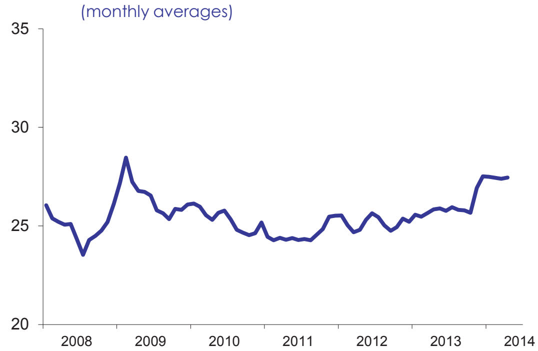
3.4. EXCHANGE RATE STABILITY

The Czech koruna does not participate in ERM II. Since the late 1990's, the ČNB has been operating under an explicit inflation targeting framework combined with a floating exchange rate regime, allowing for foreign exchange market interventions by the central bank.

The exchange rate of the koruna against the euro experienced a prolonged nominal appreciation in the period following EU accession, amid significant capital inflows that supported a sustained economic catching-up. After reaching an all-time-high against the euro in mid-2008, the koruna's exchange rate weakened considerably during the global financial crisis in late 2008 and early 2009. The koruna recovered partly during 2009 and then remained broadly stable, predominantly trading between 24 and 26 CZK/EUR from early 2010 until late 2013.

On 7 November 2013, the ČNB began using the exchange rate as an additional instrument for easing monetary conditions in view of projected price developments indicating an undershooting of the inflation target for a protracted period of time. The ČNB announced that it would intervene on the foreign exchange market to weaken the koruna, so that its exchange rate against the euro was close to 27, and clarified that it regarded this commitment as one-sided, allowing the exchange rate to float freely on the weaker side of this level. The announcement and initial market interventions proved to be effective as the koruna swiftly weakened from below 26 CZK/EUR to above 27 CZK/EUR and then continued to trade close to 27.4 CZK/EUR in early 2014. During the two years before this assessment, the koruna depreciated against the euro by almost 11%.

Graph 3.4: **Exchange rates - CZK/EUR**
(monthly averages)

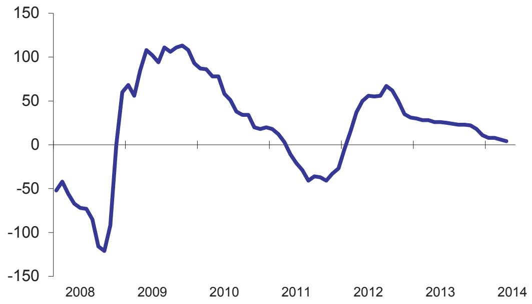


Source: ECB.

International reserves increased to about EUR 34 billion in the fourth quarter of 2012 and then remained broadly stable for three quarters. The reserve level jumped up to above EUR 40 billion (27% of GDP) in late 2013, largely as a result of the ČNB's foreign exchange market interventions.

After having increased during the global financial crisis, the 3-month interest rate differential against the euro declined gradually in late 2009 and throughout 2010, partly reflecting the cuts in policy rates of the ČNB. Short-term interest rate spreads vis-à-vis the euro area turned negative in 2011 as the ECB temporarily tightened its policy stance, but returned to positive territory in 2012 following rate cuts and massive liquidity injections through 3-year long-term refinancing operations in the euro area. The 3-month interest rate differential declined to below 50 basis points in late 2012 as the ČNB cut its key policy rate to 0.05% in November 2012 and then continued to further converge to zero during 2013 and in early 2014. At the cut-off date of this report, the 3-month spread vis-à-vis the euro area was just some 4 basis points.

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



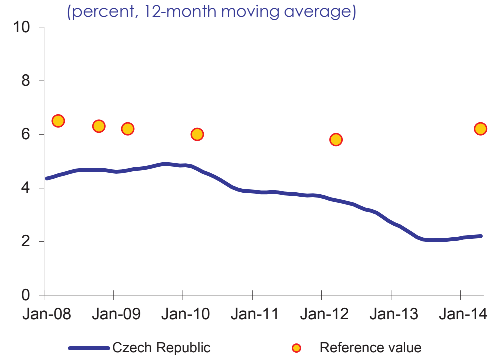
Source: Eurostat.

3.5. LONG-TERM INTEREST RATES

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

The Czech 12-month average long-term interest rate relevant for the assessment of the Treaty criterion was below the reference value at the time of the last convergence assessment of the Czech Republic in 2012. It peaked in the aftermath of the global financial crisis at 4.9% in late 2009 and then declined gradually to 2.1% by mid-2013. It increased somewhat in early 2014. In April 2014, the latest month for which data are available, the reference value, given by the average of long-term interest rates in Latvia, Portugal and Ireland plus 2 percentage points, stood at 6.2%. In that month, the 12-month moving average of the yield on the Czech benchmark bonds stood at 2.2%, i.e. 4 percentage points below the reference value.

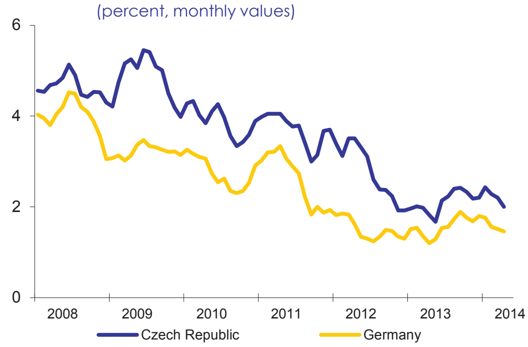
Graph 3.6: **Czech Republic - Long-term interest rate criterion**
(percent, 12-month moving average)



Source: Commission services.

After the global financial crisis, long-term interest rates in the Czech Republic followed a protracted downward trend, declining from above 5% in mid-2009 to below to below 2% in late 2012. At the same time, the spread against the German long-term benchmark bond narrowed to below 100 basis points, reflecting the ČNB's policy rate cuts as well as the gradual stabilisation in euro-area financial markets. Long-term spreads remained broadly stable in 2013, oscillating around 50 basis points, as yields increased somewhat in both the Czech Republic and Germany. The spread against the German benchmark bond widened to about 70 basis points in early 2014 ([30]).

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



Source: Eurostat.

3.6. ADDITIONAL FACTORS

The Treaty (Article 140 TFEU) calls for an examination of other factors relevant to economic integration and convergence to be taken into account in the assessment. The assessment of the additional factors – including balance of payments developments, product and financial market

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

integration – gives an important indication of a Member State's ability to integrate into the euro area without difficulties.

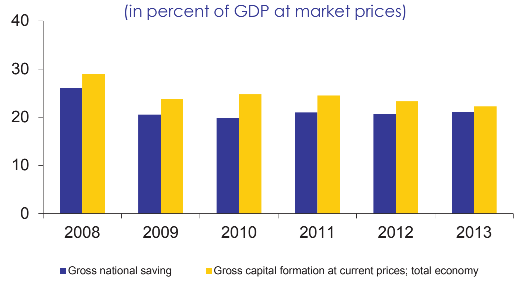
In November 2013, the Commission published its third Alert Mechanism Report (AMR 2014) ([31]) under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.5). The AMR 2014 scoreboard showed that that the Czech Republic exceeded the indicative threshold in one out of eleven indicators, i.e. the net international investment position. In line with the conclusions of the AMRs 2012-14, the Czech Republic has not been subject to in-depth reviews in the context of the MIP.

3.6.1. Developments of the balance of payments

The Czech Republic's external balance (i.e. the combined current and capital account) gradually improved from a deficit of above 3% of GDP in 2010 to a surplus of 0.5% of GDP in 2013. The adjustment was mostly on account of growing surpluses in the merchandise trade balance as imports (dampened by weak domestic demand) slowed down faster than exports. In contrast, trade in services recorded only a moderate surplus of around 1.5% of GDP on average in 2011-2013, falling short of the levels reached in previous years. Favourable developments in the trade balance were partly offset by deficits in the income balance, which continued to burden the current account as net income transfers reached a new low of -8% of GDP in 2013. The external balance was also supported by the increased capital account surplus.

In terms of the savings-investment balance, the improvement in the external account over 2012-2013 was aligned with lower borrowing needs of the general government. Overall, gross capital formation declined from almost 25% of GDP in 2010 to some 22% of GDP in 2013, while savings hovered around 21% of GDP over 2011-13. The saving-investment gap of the private sector remained broadly unchanged (as a percentage of GDP), but its structure was impacted by the 2012-2013 economic downturn. Households, facing reductions in their real spending power, reduced investment purchases while savings of non-financial corporations were constrained by their falling gross operating surplus.

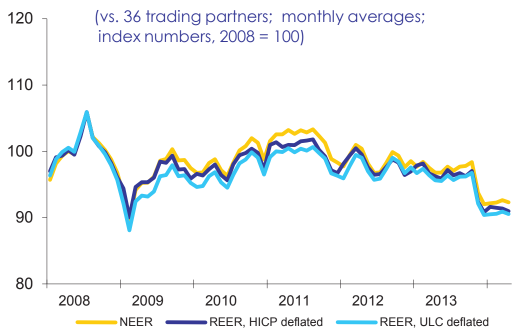
Graph 3.8:Czech Republic - Saving and investment
(in percent of GDP at market prices)



Source: Eurostat, Commission services.

Export performance deteriorated somewhat in 2013 after having improved for more than a decade. This was partly due to one-off factors such as a sizeable fall in revenue from tourism and in exports of computers and electronics, while the pace of exports to non-EU markets slowed down considerably as well. External price and cost competitiveness, as measured by the ULC- and HICP-deflated real effective exchange rates, improved considerably in late 2013, reflecting a substantial NEER depreciation.

Graph 3.9:Czech Republic - Effective exchange rates



Source: Commission services.

Mirroring the improvement in the external balance, the financial account balance turned negative in 2012 and then remained broadly stable in 2013. The net inflow of FDI remained positive, but diminished in 2013 largely on account of outflows of foreign funds from domestic non-financial corporations. The net portfolio inflows, which turned into a surplus in the aftermath of the 2008 crisis, also remained positive, increasing to almost 2.5% of GDP in 2013. The largest adjustment was recorded in other investment flows and international reserves, which mainly reflected foreign exchange operations of the ČNB in late 2013. Gross external debt increased gradually to 54% of GDP in 2013. Nevertheless, the net international investment position improved somewhat in 2013.

([31]) http://ec.europa.eu/europe2020/pdf/2014/amr2014_en.pdf

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

	2008	2009	2010	2011	2012	2013
Current account	-2.1	-2.4	-3.9	-2.7	-1.3	-1.4
of which: Balance of trade in goods	0.7	2.3	1.4	2.4	3.9	4.9
Balance of trade in services	1.9	2.0	2.0	1.5	1.6	1.4
Income balance	-4.6	-6.7	-7.5	-6.7	-6.8	-8.0
Balance of current transfers	-0.2	0.0	0.2	0.1	-0.1	0.4
Capital account	0.7	1.4	0.9	0.4	1.3	1.9
External balance [1]	-1.4	-1.0	-3.1	-2.4	0.0	0.5
Financial account	1.4	2.3	3.6	2.0	-0.2	-0.1
of which: Net FDI	1.0	1.0	2.5	1.2	3.1	0.9
Net portfolio inflows	-0.2	4.3	4.0	0.1	1.4	2.4
Net other inflows [2]	1.7	-1.4	-1.8	0.2	-2.6	1.5
Change in reserves (+ is a decrease)	-1.0	-1.6	-1.1	0.5	-2.1	-4.8
Financial account without reserves	2.5	3.9	4.7	1.6	1.9	4.7
Errors and omissions	0.0	-1.2	-0.5	0.3	0.1	-0.4
Gross capital formation	28.9	23.8	24.8	24.5	23.3	22.3
Gross saving	26.0	20.6	19.8	21.0	20.7	21.1
External debt	39.2	43.6	47.0	46.8	50.8	54.0
International investment position	-40.1	-46.0	-48.3	-47.5	-48.8	-45.6

1) The combined current and capital account.
2) Including financial derivatives.
Note: Loans for direct investment that are included in the gross external debt are currently reported in net terms by the CNB.
Sources: Eurostat, Commission services, Czech National Bank.

According to the Commission services' 2014 Spring Forecast, the external balance is expected to continue increasing in 2014-2015 as the export performance should be supported by favourable external environment.

3.6.2. Market integration

The Czech economy is highly integrated into the euro-area through trade and investment linkages. Trade openness of the Czech Republic remains very high. Although it declined markedly during the global crisis, it rebounded in recent years to reach 75% of GDP in 2012.

Trade is predominantly conducted with the neighbouring euro-area Member States, also in relation to their significant foreign direct investment presence. The share of intra-euro-area trade in goods expressed in percentage of GDP is high and has been further increasing in recent years, reaching almost 48% in 2013. The evolution of Czech exports was mainly driven by a few sectors over the past years, namely machinery and electrical equipment (37% of overall exports), vehicles, aircraft, vessels (18%) and metals (10%). A rising share of high-technology products in total exports, combined with a high-tech trade deficit that closes only gradually, points to the significance of outward processing trade. Exports of high-technology products have increased over the past years (e.g. computers), but the technologically more advanced components are produced abroad.

The Czech Republic has attracted a high share of FDI in the tradable sector thanks to its geographical proximity to EU core markets, relatively good infrastructure and highly educated labour force. FDI inflows mainly originate in the EU, with the Netherlands, Germany, and Austria accounting for more than two thirds of the total stock. From a sectoral perspective, FDI was directed mainly to a few sectors, namely automotive, real estate, finance and insurance (accounting for more than 50% of the total stock). Recently, an increase of FDI in the renewable energy sector has been evident.

Since 2008, house prices in the Czech Republic have followed a declining trend, with the cumulated fall in the 2008-2012 period amounting to 10%. In 2012, the deflated house price index decreased by 4%. Between 2008 and 2012, the number of authorisations to start work on building projects declined by 47%, which was nonetheless

Table 3.5:
Czech Republic - Product market integration

	2007	2008	2009	2010	2011	2012
Trade openness 1) (%)	66.9	63.3	57.0	64.9	70.8	75.2
Intra-EA trade in goods GDP ratio 2) (%)	43.9	40.8	35.9	41.4	45.7	46.8
Intra-EA trade in services GDP ratio 3) (%)	4.9	5.2	5.0	5.4	5.7	5.9
Extra-EA trade in goods GDP ratio 4) (%)	22.7	22.9	19.0	23.9	27.1	29.1
Export in high technology 5) (%)	14.1	14.1	15.2	16.1	16.4	16.2
High-tech trade balance 6) (%)	-0.5	-0.3	-0.5	-1.4	0.1	0.7
Total FDI inflows GDP ratio 7) (%)	5.8	2.9	1.5	3.1	1.1	5.4
Intra-EA FDI inflows GDP ratio 8) (%)	n.a.	n.a.	1.2	2.0	0.1	4.5
FDI intensity 9)	3.3	2.4	1.0	1.8	0.5	3.0
Internal Market Directives 10) (%)	3.4	1.4	1.2	1.2	1.9	0.2
Time to start up a new company 11)	17.0	20.0	20.0	20.0	19.5	19.5
Real house price index 12)	n.a.	106.5	101.7	100.0	99.6	95.6
Residential investment 13) (%)	4.1	4.3	3.9	4.2	3.9	3.7
Building permits index 14)	157.6	157.9	130.7	100.0	98.8	83.4

1) (Imports + Exports of goods and services / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics, Balance of Payments).
2) (Intra-EA-18 Imports + Exports of goods / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).
3) Intra-EA-17 trade in services (average credit and debit in % of GDP at current prices) (Balance of Payments).
4) (Extra-EA-18 Imports + Exports of goods / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).
5) Taken directly from Eurostat's databases: Exports of high technology products as a share of total exports.
6) (Exports - imports in high tech) / GDP at current prices x 100, since 2007 the data based upon SITC Rev. 4 (earlier SITC Rev. 3).
7) Total FDI inflows (in % of GDP at current prices).
8) Intra-EA-17 FDI inflows (in % of GDP at current prices).
9) FDI intensity (average intra-EU-27 inflows and outflows in % of GDP at current prices).
10) Percentage of internal market directives not yet communicated as having been transposed, in relation to the total number.
11) Time to start a new company (in days), Doing Business World Bank.
12) Deflated house price index (2010=100), Eurostat.
13) Gross capital formation in residential buildings (in % of GDP), Eurostat.
14) Number of new residential building permits (2010=100), Eurostat.

Sources: Eurostat, Sectoral Performance Indicators Database (SPI), Commission services.

lower than the fall experienced at EU-28 level. Despite the evolution of building licenses, residential investment has remained broadly stable at around 4% of GDP in the past years. The share of employment in the construction sector has also remained unchanged at around 9%. On the other hand, value added in the construction sector has fallen by 11% since 2009 (in real terms).

As far as the business environment is concerned, the Czech Republic has experienced a deterioration of the scores received in international rankings in recent years which thus remain in general worse than for most euro-area Member States ([32]). In particular, the Czech Republic performs poorly on protecting investors, suffers from high tax compliance costs and there is also a scope for improvement in obtaining construction permits.

According to the 2013 Internal Market Scoreboard, the Czech Republic reduced its deficit in the transposition of EU directives to a record low of 0.2% in 2012. An amendment to the Public Procurement Act was adopted in late 2013. The new amendment appears to go against the changes adopted in 2012 by removing some of the transparency safeguards and loosening the public procurement rules.

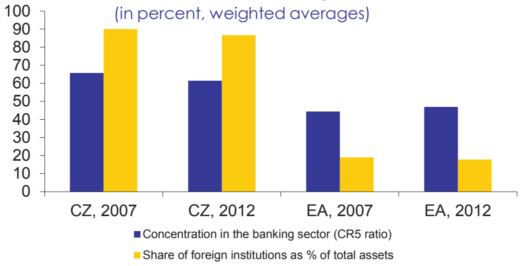
Since protection of permanent employees against collective and individual dismissals is relatively strict (above the euro-area-OECD countries' average according to the 2013 OECD employment protection indicator), companies prefer adjusting wages and working hours to downsizing in case of a moderate distress. Net migration flows have not been significant in recent years, with the exception of pre-crisis years 2007-08, when considerable net immigration was registered.

([32]) For instance, the Czech Republic ranks 75th (out of 189 economies) on the World Bank's 2014 Ease of Doing Business Index and 46th (out of 148 economies) on the World Economic Forum's 2013-2014 Global Competitiveness Index.

3.6.3. Financial market integration

The Czech financial sector remains highly integrated into the EU financial sector. The main channel of integration is through a high degree of foreign ownership of financial intermediaries. The Czech banks, of which around 90% belong to foreign groups, operate a conservative retail-orientated business model. Bank concentration, as measured by the market share of the largest five credit institutions in total assets, remained above the euro-area average over the past years, but it has fallen by 4 percentage points since 2010.

Graph 3.10:**Czech Republic - Foreign ownership and concentration in the banking sector**
(in percent, weighted averages)

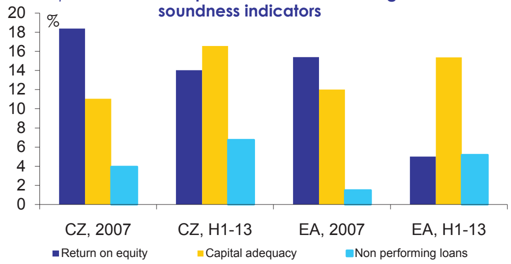


Source: ECB, Structural financial indicators.

By end-2013, the total assets held by the banking sector accounted for almost 128% of GDP. Loans constitute about 60% of total bank assets. While credit to non-financial companies remained just above 21% of GDP between 2007 and 2013, loans to households grew from 20% to 30% of GDP over the same time period. As a result, the level of private sector debt ([33]) increased from 61% of GDP in 2007 to 72% of GDP in 2012, remaining significantly below the euro-area average of 145%. On the other hand, deposits account for some 69% of banking sector liabilities. Czech banks thus act as net creditors to their foreign parents, a distinguishing feature within the region.

The capital adequacy of banks measured by standard regulatory ratios is somewhat higher than in the euro area. The average capital adequacy ratio stood at 16.6% in June 2013. Non-performing loans (6.7% in June 2013) are some 1.5 percentage points above the euro-area average. Profitability has held up remarkably well during the financial crisis. In June 2013, the average return on equity (RoE) amounted to 15.4%, more than three times the euro-area average and only 3 percentage points below the end-2007 RoE. A conservative business model and low funding costs have helped to preserve the high profitability of Czech banks.

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

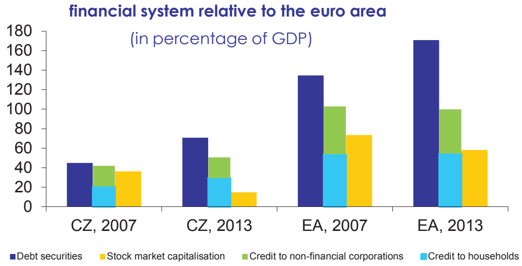


Note: For 2007 EU-27 non performing loans are a proxy for EA.
For 2007, EA RoE and CAR averages are unweighted.
Source: ECB, EC calculations.

Similarly to most regional peers, the Czech financial system remains heavily bank-based, with banks holding about three quarters of its total assets under their management. The remaining quarter is equally shared between the insurance sector, including the pension schemes, and other financial intermediaries, including auxiliaries.

The Prague Stock exchange enjoys strong ties with the Vienna, Budapest and Ljubljana stock exchanges as the CEE Stock Exchange Group holds a controlling stake in all four of these stock exchanges. Prague's stock market capitalisation stood at 15% of GDP by end-2013, which was about half of its 2007 level and far below the euro-area average of 74%. The total amount of outstanding debt securities increased by about 50% between 2007 and 2013 and amounted to some two thirds of Czech GDP by end-2013. As far as its composition is concerned, some 63% was issued by government institutions, 22% by banks, 13% by non-financial corporations and 2% by insurance companies.

Graph 3.12:**Czech Republic - Recent development of the financial system relative to the euro area**
(in percentage of GDP)



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

Since 1993 the Czech National Bank supervises the financial market in the Czech Republic. It regulates and enforces the rules for the banking

([33]) Data on private sector debt are based on consolidated ESA 95 data of non-financial corporations and households (and non-profit institutions serving households) sectors' liabilities related to loans and securities other than shares.

sector including credit unions, the capital market, the insurance and pension-savings industry. The Czech Republic has implemented all EU financial services directives. The implementation of the last two, the prospectus directive and the alternative investment fund managers directive (AIFMD), is currently being examined by the Commission services.

4. CROATIA

4.1. LEGAL COMPATIBILITY

4.1.1. Introduction

The main legal rules governing the Croatian National Bank (Hrvatska Narodna Bank – HNB) are laid down in Article 53 of the Constitution of the Republic of Croatia ([34]) and the Act on the Croatian National Bank ([35]). The Act was amended in 2013 with a view to Croatia entering the European Union on 1 July 2013. The Act provides for specific rules applying to the HNB as of EU accession of Croatia and a specific chapter for rules applying to the HNB as of the moment the euro becomes the official currency of the Republic.

4.1.2. Central bank independence

The principle of independence of the HNB is laid down in Article 53 of the Constitution and in Articles 2 (2) and 71 of the Act. Article 71 of the Act contains a specific reference to the principle of Central Bank independence as enshrined in the Treaty, stating that the HNB shall be independent in achieving its objective and carrying out its tasks under the Act in accordance with Article 130 of the TFEU. As regards the rules on a possible removal of the HNB Governor from office, Article 81 of the Act makes a specific reference to the relevant wording of Article 14 (2) of the Statute.

No incompatibilities and imperfections exist in this area.

4.1.3. Prohibition of monetary financing and privileged access

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

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

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

4.1.4. Integration in the ESCB

Objectives

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

Tasks

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

4.1.5. Assessment of compatibility

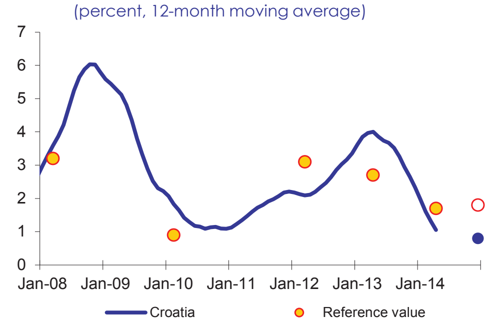
The Constitution and the Act on the Croatian National Bank are fully compatible with Articles 130 and 131 of the TFEU.

4.2. PRICE STABILITY

4.2.1. Respect of the reference value

The 12-month average inflation rate, which is used for the convergence assessment, increased from slightly above 2% in early 2012 to 4% in April 2013, but has declined strongly thereafter. In April 2014, the reference value was 1.7%, calculated as the average of the 12-month average inflation rates in Latvia, Portugal and Ireland plus 1.5 percentage points. The average inflation rate in Croatia during the 12 months to April 2014 was 1.1%, i.e. 0.6 percentage point below the reference value. It is projected to remain below the reference value in the months ahead.

Graph 4.1: **Croatia - Inflation criterion since 2008**
(percent, 12-month moving average)

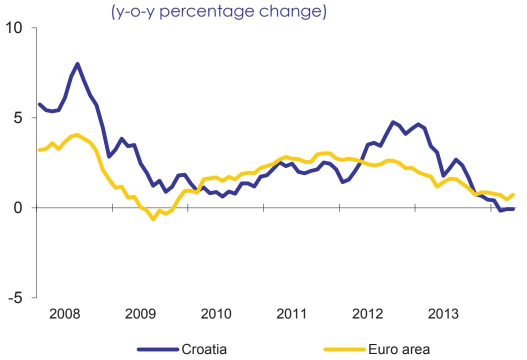


Note: The dots in December 2014 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2014 Forecast.

4.2.2. Recent inflation developments

Inflation in Croatia has fluctuated over the past two years, reflecting mainly cost pressures, such as volatile energy and food prices, combined with increases in administered prices and indirect taxes, while demand-side pressures have remained low. With energy and food products accounting for close to half of the consumption basket, annual inflation exceeded 4% during the second half of 2012 and remained relatively high until early 2013. Inflation slowed down significantly from spring 2013 as global energy price pressures and the impact of earlier hikes in administered prices gradually faded and disinflationary effects from the protracted recession more than offset increases in indirect taxes. From October 2013, declining electricity prices due to market liberalisation further contributed to the slowdown in inflation. Annual inflation turned slightly negative in spring 2014.

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



Source: Eurostat.

After following a gradual upward trend from mid-2012 to early 2013, core inflation (measured as HICP inflation excluding energy and unprocessed food) declined from autumn 2013, falling about 2 percentage points to below 1% by early 2014. The increase in core inflation until early 2013 was mainly driven by processed food prices, but mitigated to some extent by the slowdown of inflation of non-energy industrial goods. From autumn 2013, pressures from processed food and services prices receded, driving down core inflation to 0.5% in April 2014. Over the past two years, core inflation was on average 1 percentage point below headline inflation, reflecting the impact of global energy prices, combined with changes in administered prices and taxes. By contrast, headline inflation fell below core inflation from the second half of 2013. Producer price inflation (total industry) dropped significantly, to -3% at year-end 2013 from 7% a year earlier, confirming the decrease in price pressures.

4.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy-mix and cyclical stance

The global financial crisis halted Croatia's credit-driven growth model and exposed deep-rooted structural problems, including an uncompetitive tradable sector and a significant private debt overhang. Economic activity contracted during 2012-2013, extending the recession to five years and the cumulative decline in output to 12%. The latter is mostly attributable to a contraction in domestic demand. Net exports contributed positively to GDP growth, reflecting ongoing compression of imports. The Commission services' 2014 Spring Forecast projects real GDP to decline by 0.6% in 2014, also reflecting the impact of fiscal consolidation, before expanding by 0.7% in 2015. Croatia's economy is estimated to have operated well below potential since 2009.

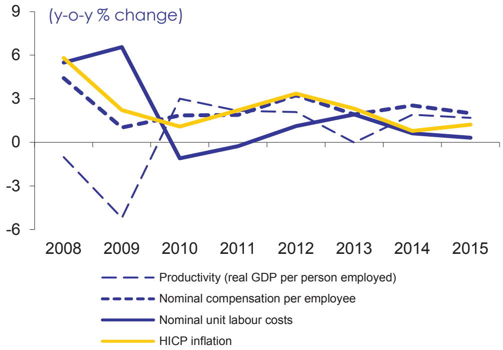
The fiscal stance, as measured by changes in the structural balance, appears to have been restrictive in 2012 and 2013. However, given the protracted recession, estimates of the structural balance are surrounded by substantial uncertainties. In addition, specific transactions such as the assumption of debt of some public and state-owned enterprises (e.g. shipyards) affected the structural deficit in 2010 and 2011, since, although exceptional, they were not considered as one-offs. Nevertheless, the estimations suggest that the structural deficit remained large, at 3.5% in 2013. Fiscal consolidation measures, as defined in the March revision of the 2014 budget, and an additional package of measures in April, are expected to contribute to its gradual narrowing to 2.3% by 2015.

The HNB maintains an accommodative monetary policy stance, with continued high liquidity provision to the banking sector. Tight macro-prudential policies in the past have built high reserve and liquidity buffers in the financial system, some of which were gradually released in the course of the crisis. However, the high degree of financial euroisation constrains the scope of domestic monetary policy, while its effectiveness is limited by the shallow domestic money market and relatively high concentration in the banking sector. The transmission of the historically low short-term rates to lending rates has been limited so far, in particular for longer-term loans. Nevertheless, supply does not appear to be the main constraint to credit, as the largest banks have comfortable levels of capital and liquidity. Demand for loans is weak because of high indebtedness and deleveraging needs of the private sector. This has resulted in a slight contraction of credit to the private sector since mid-2012.

Wages and labour costs

The protracted recession has taken a toll on the labour market. Employment dropped by 13% in the period 2008-2013 and the unemployment rate doubled to above 17%. Job losses were most pronounced in the manufacturing sector, construction and trade, while the lack of adjustment in the public sector and the slow process of restructuring of state-owned companies may have dampened the decrease in employment. Growth in nominal gross wages decreased with the onset of the crisis to 2.3% on average since 2009. Real wages stagnated during five consecutive years.

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



Source: Eurostat, Commission services' Spring 2014 Forecast.

Labour productivity grew on average close to 2% annually during 2010-2013 as a result of the decrease in employment. Nominal unit labour costs (ULC) increased moderately at 0.4% on average over the same period. Looking ahead, ULC growth is expected to remain contained.

External factors

Inflation developments in Croatia are sensitive to external price developments, due to the small size of the economy with limited diversity in domestic production and a strong dependency on imports. The high share of energy and food products in the consumption basket implies a particularly high vulnerability to fluctuations in global commodity prices. Import prices (measured by the imports of goods deflator), rose markedly in 2012, but grew at a much slower pace during 2013, contributing to the disinflationary trend. Import prices developed broadly in line with inflation in the euro area, which supplies the bulk of imported goods.

The nominal-effective exchange rate (NEER) of the kuna (measured against a group of 36 trading partners) has appreciated by about 1% during the past two years. A marginal nominal depreciation against the euro was counterbalanced by a strengthening against the US dollar, the Russian rouble and the Chinese yuan – the currencies of Croatia's most important non-euro-area trading partners. The temporary increase of the NEER during summer 2013 was related to the strong tourism season. Exchange rate fluctuations over the past two years appear to have been too small to have exerted a significant impact on prices. However, the temporary depreciation of the kuna against the US dollar in mid-2012 contributed to the increase in energy prices at that time.

Administered prices and taxes

Eurostat has not yet published a list of administered prices in Croatia according to the common EU methodology. However, in 2012 and 2013, there were changes in some prices of goods and services that could be considered as administered. During the first half of 2012, prices were raised for utilities such as electricity, gas and water supply and some other communal services, notably public transportation and heating. The fading out of the impact of these changes contributed to lower inflation in 2013.

Table 4.1:
Croatia - Components of inflation

(percentage change)[1]	2008	2009	2010	2011	2012	2013	Apr-14	weights in total 2014
HICP	5.8	2.2	1.1	2.2	3.4	2.3	1.1	1000
Non-energy industrial goods	2.9	1.3	-0.6	-0.2	1.2	-0.1	-0.7	227
Energy	8.0	-2.8	9.9	7.0	10.8	1.8	-1.0	165
Unprocessed food	7.0	2.5	-2.2	1.5	5.5	4.5	0.8	93
Processed food	10.0	4.1	0.1	5.6	2.7	5.3	4.6	210
Services	4.2	4.2	1.6	-0.1	0.5	1.6	1.0	305
HICP excl. energy and unproc. food	5.2	3.0	0.3	1.5	1.5	2.1	1.5	742
HICP at constant taxes	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1000
Administered prices HICP	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

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

Sources: Eurostat, Commission services.

The most important change to indirect taxes was the increase in the standard VAT rate from 23% to 25% in March 2013. Further changes were introduced from January 2014, when the intermediate rate was increased from 10% to 13%. In line with tax harmonisation requirements within the EU, but also due to the need to increase budget revenues, there were some changes in excise taxes. The tax on tobacco was raised in November 2012 and in June 2013. Excises on motor fuels were gradually increased in 2012-2014, while excises on motor vehicles were lowered for the more environmentally-friendly cars in 2013. Eurostat's constant-tax inflation measure (HICP-CT) is not yet available for Croatia.

Medium-term prospects

HICP inflation is expected to remain low in the context of weak domestic demand, unfavourable labour market developments and high deleveraging needs of the private and the public sector. Wage growth will likely remain subdued in view of the need to increase export competitiveness, further reducing cost price pressures. The Commission services' 2014 Spring Forecast projects the average HICP inflation rate to fall to 0.8% in 2014, before increasing slightly to 1.2% in 2015.

Risks to the inflation outlook are slightly on the downside. Disinflationary pressures could emerge from protracted weak labour market developments if the recovery turns out weaker than expected. Private sector deleveraging could also remain a stronger drag. The main upside risk is a shock to global commodity prices, to which Croatia is particularly exposed. The impact of the expected fiscal consolidation is ambiguous: while further increases in indirect taxes and administrative prices imply upside risks, expenditure cuts may have disinflationary effects through further reducing private demand.

In Croatia, the level of consumer prices stood at 69% of the euro-area average in 2012. This suggests potential for further price level convergence in the long term, as income levels (around 57% of the euro-area average in PPS in 2012) rise towards the euro-area average.

Medium-term inflation prospects will depend on wage cost and import price dynamics, also in relation to the extent of spare capacity in the economy. Efforts to increase productivity and employment in the tradable sector will be important in determining the outcome. Failure to improve competitiveness and engineer a rebalancing of the economy towards more export-driven growth, while reducing the overall level of indebtedness, may imply weak economic prospects and subdued inflation in the medium-term. High foreign exchange exposure of the public and the private sector and the commitment to avoid excessive exchange rate volatility determine the central bank's room for manoeuvre.

4.3. PUBLIC FINANCES

4.3.1. The excessive deficit procedure for Croatia

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

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

	2008	2009	2010	2011	2012	2013 1)	2014 2)	2015 2)
HICP inflation								
Croatia	5.8	2.2	1.1	2.2	3.4	2.3	0.8	1.2
Euro area	3.3	0.3	1.6	2.7	2.5	1.3	0.8	1.2
Private consumption deflator								
Croatia	5.6	3.2	1.5	2.4	3.5	1.9	1.0	1.4
Euro area	2.7	-0.4	1.6	2.4	2.1	1.3	0.9	1.3
Nominal compensation per employee								
Croatia	4.4	1.0	1.9	1.9	3.2	1.9	2.5	2.0
Euro area	3.5	1.8	2.0	2.2	2.0	1.7	1.6	1.9
Labour productivity								
Croatia	-1.0	-5.2	3.0	2.2	2.1	0.0	1.9	1.7
Euro area	-0.3	-2.4	2.6	1.4	0.2	0.5	0.9	1.0
Nominal unit labour costs								
Croatia	5.5	6.6	-1.1	-0.3	1.1	1.9	0.6	0.3
Euro area	3.8	4.3	-0.6	0.7	1.8	1.1	0.7	0.8
Imports of goods deflator								
Croatia	4.1	-2.4	1.5	6.3	3.0	-0.3	0.5	1.5
Euro area	4.2	-8.1	5.7	6.6	2.3	-1.9	-1.0	0.8

1) 2013 data (except HICP inflation) are estimates.
2) Commission services' Spring 2014 Forecast.
Source: Eurostat, Commission services.

Council invited the Croatian authorities to gradually reduce the general government deficit to 4.6%, 3.5% and 2.7% of GDP in 2014, 2015, and 2016, respectively, consistent with an annual improvement in the structural balance of 0.5%, 0.9% and 0.7% of GDP, respectively, in the three years. The Council established the deadline of 30 April 2014 for effective action to be taken.

To limit risks to the adjustment, Croatia was recommended to (i) carry out a thorough expenditure review with the objective to rationalise wage, social security and subsidy outlays and to provide sufficient fiscal space for the implementation of growth-enhancing expenditure, including co-financing of EU-funded projects; (ii) further improve tax compliance and increase the efficiency of tax administration; and (iii) improve the institutional framework for public finances, including through enhancing multi-annual budgetary programming, strengthening the role and independence of the Fiscal Policy Committee, and ensuring compliance with fiscal rules. In addition, the Council invited the Croatian authorities to implement structural reforms, notably addressing labour market rigidities and an unfavourable business environment and improving the quality of public administration, with a view to raising potential GDP growth.

4.3.2. Recent fiscal developments

Croatia's fiscal situation deteriorated rapidly with the onset of the global financial crisis, as cyclical factors interacted with entrenched structural weaknesses. Declining revenues and the lack of more decisive corrective reaction by the authorities determined subsequent adverse trends in the public deficit and debt. Recurrent assumptions by the government of debt of SOEs, such as the now privatised shipyards, also added to the general government deficit and debt. The deficit peaked at 7.8% of GDP in 2011, came down to 5% of GDP in 2012 and remained at that level in 2013.

In 2013 the government revised the budget twice, in April and December, responding to higher expenditures relative to plan and unexpected revenue shortfalls. In particular, corporate income tax receipts came in weaker than expected after the introduction of a tax break on reinvested profits. Revenues were also adversely impacted by the change in the VAT collection system, in the context of entering the customs union. Meanwhile, total expenditures increased, chiefly due to higher social expenditures, including a 1%-of-GDP clearance of arrears of the health sector, and growing interest expenditures.

Table 4.3:
Croatia - Budgetary developments and projections **(as % of GDP unless indicated otherwise)**

Outturn and forecast [1]	2008	2009	2010	2011	2012	2013	2014	2015	
General government balance	-1.9	-5.4	-6.4	-7.8	-5.0	-4.9	-3.8	-3.1	
- Total revenues	41.5	40.8	40.5	40.3	40.8	41.0	43.0	43.5	
- Total expenditure	43.4	46.2	46.9	48.1	45.7	45.9	46.8	46.6	
of which:									
- Interest expenditure	1.5	2.0	2.2	2.6	3.0	3.1	3.4	3.6	
p.m.: Tax burden	36.7	36.6	36.1	n.a.	n.a.	n.a.	n.a.	n.a.	
Primary balance	-0.4	-3.5	-4.1	-5.2	-2.0	-1.9	-0.4	0.4	
Cyclically-adjusted balance	-4.5	-5.0	-5.4	-7.2	-4.1	-3.7	-2.2	-1.6	
One-off and temporary measures	0.0	0.0	0.0	0.0	0.0	-0.2	0.9	0.7	
Structural balance [2]	-4.5	-5.0	-5.4	-7.2	-4.1	-3.5	-3.1	-2.3	
Government gross debt	n.a.	36.8	45.0	52.0	55.9	67.1	69.0	69.2	
p.m: Real GDP growth (%)	2.1	-6.9	-2.3	-0.2	-1.9	-1.0	-0.6	0.7	
p.m: Output gap	6.6	-0.9	-2.4	-1.7	-2.2	-2.9	-3.8	-3.7	
Convergence programme [4]							**2014**	**2015**	**2016**	**2017**
General government balance							-4.4	-3.5	-2.7	-2.5
Structural balance [2] [3]							-4.1	-3.3	-2.1	-2.1
Government gross debt							71.7	71.0	71.2	71.2
p.m. Real GDP (% change)							0.0	1.2	1.3	1.5

1) Commission services' Spring 2014 Forecast.
2) Cyclically-adjusted balance excluding one-off and other temporary measures.
3) Commission services' calculations on the basis of the information in the programme.
There are no one-off and other temporary measures in the programme.
4) Government budgetary figures are not fully aligned with ESA standards and cannot directly be compared with the figures provided by the Commission.
Sources: Commission services, the 2014 Convergence Programme of Croatia.

The expenditure-to-GDP ratio peaked at above 48% in 2011, before declining to below 46% in 2012-2013. The revenue-to-GDP ratio increased slightly during the past two years, from above 40% in 2011 to 41% in 2013.

Public debt surpassed 67% of GDP in 2013, up from 56% of GDP 2012 and 37% of GDP in 2009. Debt dynamics reflected persistently high budget deficits, coupled with weak economic activity and some calling of guarantees. In 2013, the debt level was also affected by the bond issuance in the U.S. market in November to pre-finance debt roll-over needs in early 2014.

4.3.3. Medium-term prospects

The 2014 Budget Law was adopted by Parliament on 4 December 2013, targeting a general government deficit of 5.5% of GDP according to the national methodology ([36]). The main measures on the revenue side were an increase in the intermediate VAT rate from 10% to 13% and a further alignment of the tobacco excise tax. In response to the recommendations by the Council with a view to correcting the excessive deficit, the Parliament passed a budget amendment in March 2014, with consolidation measures totalling close to 2% of GDP, at face value, in 2014. The measures are distributed roughly half-half between the revenue and expenditure sides. An additional set of measures amounting to 0.4% of GDP was endorsed in April 2014.

The Commission services' 2014 Spring Forecast, which takes into account the amended budget and additional measures, projects the general government deficit to decline to 3.8% of GDP in 2014 and 3.1% of GDP in 2015 (according to ESA 95 standards). The cumulative change in the structural balance in 2014 and 2015, as compared to 2013, is estimated at 1.2 percentage points. General government gross debt is forecast to increase from about 67% of GDP in 2013 to above 69% of GDP in 2015.

The 2014 Convergence Programme was submitted on 24 April 2014. It confirms the government's commitment to reduce the deficit to below 3% of GDP by 2016, as recommended by the Council. In

([36]) Government budgetary figures are not fully aligned with ESA standards and cannot directly be compared with the figures provided by the Commission.

particular, the general government deficit is targeted to gradually decline from 4.9% of GDP in 2013 to 2.5% of GDP in 2017. The deviation of the targets for 2014-2015 compared to the projections in the Commission services' 2014 Spring Forecast is mainly a consequence of the more favourable macroeconomic scenario underlying the Programme and a different assessment of the envisaged measures and their estimated impact.

Further details on the assessment of the 2014 Convergence Programme for Croatia can be found in the Commission Staff Working Document, which accompanies the Commission Recommendation for a Council Recommendation on the 2014 National Reform Programme of Croatia and delivering a Council Opinion on the 2014 Convergence Programme of Croatia.

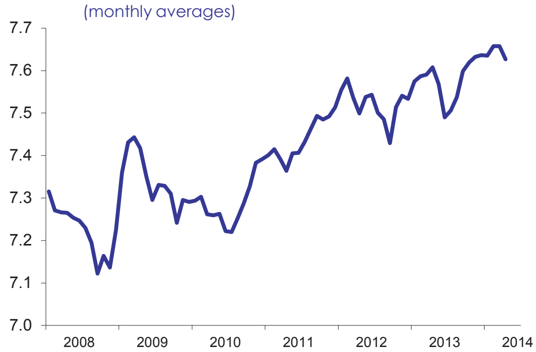
Croatia has not signed the Treaty on Stability, Coordination and Governance in the EMU by the time of this assessment.

4.4. EXCHANGE RATE STABILITY

The Croatian kuna does not participate in ERM II. The HNB conducts its monetary policy within a flexible inflation targeting regime with the exchange rate as the main nominal anchor to achieve the price stability objective. Maintaining a broadly stable exchange rate of the kuna against the euro is also important from a financial stability perspective, given the high degree of balance sheet euroisation of both the public and private sectors. The exchange rate regime can be characterised as a tightly-managed float. The HNB does not defend a target rate or band for the kuna's exchange rate against the euro, but aims to counter excess volatility. The HNB has also not announced a numerical inflation target, which allows a higher degree of discretion in conducting monetary policy, including with a view to maintaining the overall stability of the financial system.

The kuna's exchange has remained broadly stable over the past two years, with movements between 7.4 and 7.7 against the euro. The marginally weaker trend path has reflected weak domestic economic developments and unfavourable external conditions. Subdued growth, a slowdown in capital inflows and monetary policy easing by the HNB were compounded by the fluctuations of the euro against other major currencies and financial market tensions affecting the CEE region and emerging markets more generally. The latter were particularly pronounced during late 2011 and early 2012, as deleveraging pressures mounted on euro area parent banks, and during summer/autumn 2013, amid the prospect of an earlier end to the Federal Reserve's asset purchase programme. Notwithstanding the medium-term trend, the kuna experienced some intra-year volatility, mainly related to developments in the tourism sector. The currency tended to strengthen during the summer months and weakened during the low season.

Graph 4.4: **Exchange rates - HRK/EUR**
(monthly averages)



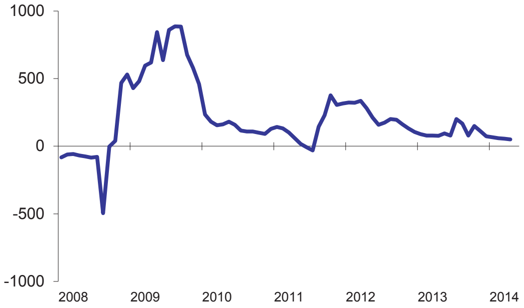
Source: ECB.

Croatia's international reserves stood at EUR 12.9bn at year-end 2013, equivalent to around 29% of GDP and covering about 100% of short-term external debt ([37]). In terms of monetary aggregates, international reserves covered around 173% of the monetary base. Croatia continued to accumulate international reserves during the past few years, although at a slower pace compared to the pre-crisis period. Continued growth in reserves partly reflects international issuances of sovereign bonds.

The HNB does not actively use interest rates as a monetary policy tool, given the weak transmission channel in a shallow domestic money market. However, the HNB uses liquidity and reserve requirements to steer short-term rates. From early 2010, money market liquidity remained abundant, which was reflected in a decline in short-term interest rates. The domestic benchmark rate Zibor remained on average about 130 basis points above the 3-month Euribor during the past two years. Higher rates between mid-2011 and early 2012 were related to the winding-up of a smaller bank in November 2011, a temporary increase in the reserve requirement rate, and interventions by the HNB on the foreign exchange market. At the cut-

([37]) Based on estimated residual maturity off date of this report, the 3-months spread vis-à-vis the euro area stood at 50 basis points.

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

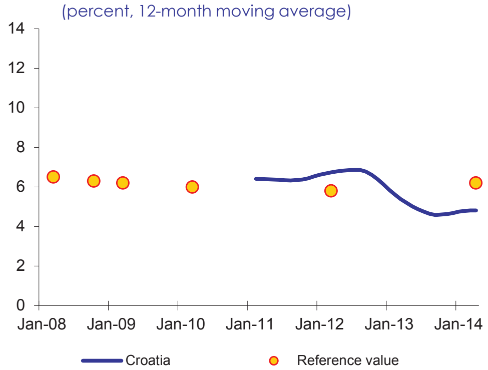


Source: Eurostat.

4.5. LONG-TERM INTEREST RATES

The long-term interest rate in Croatia used for the convergence examination reflects the secondary market yield on a single benchmark government bond with a residual maturity of about six years. In the absence of a kuna-denominated sovereign bond with longer maturity, yield developments have to be interpreted with great caution.

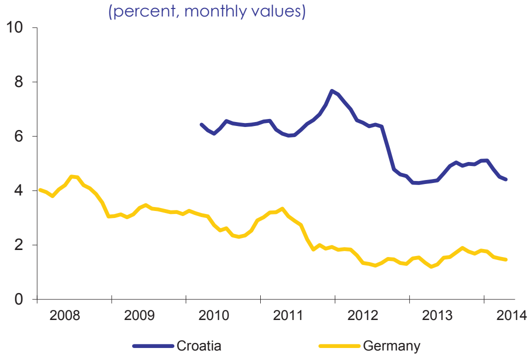
Graph 4.6:**Croatia - Long-term interest rate criterion**
(percent, 12-month moving average)



Source: Commission services.

The Croatian 12-month moving average long-term interest rate used for the assessment of the Treaty criterion gradually declined from a peak of 6.9% in July 2012 to around 4.6% in late 2013, before increasing slightly from early 2014. In April 2014, the last month for which data are available, the reference value, given by the average of long-term interest rates in Latvia, Portugal and Ireland plus 2 percentage points, stood at 6.2%. In that month, the 12-month moving average of the yield on the Croatian benchmark bond stood at 4.8%, i.e. 1.4 percentage points below the reference value. However, the comparability of the benchmark rate with the reference value is constrained by the relatively short residual maturity of the bond.

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



Source: Eurostat.

The monthly long-term interest rate remained above 7% in early 2012, following a sharp increase in late 2011 amid heightened risk perception towards the CEE region. It fell rapidly during the second half of 2012 and the beginning of 2013 to around 4.3%, as financial market confidence improved and investors searched for yield, amid ample liquidity in the banking system. Between June 2013 and January 2014, the long-term interest rate increased to around 5%, driven by growing risk aversion towards emerging markets, the deterioration of the fiscal outlook, and subsequent downgrades of Croatia's long-term sovereign rating to sub-investment grade by the three major credit rating agencies. In April 2014, the long-term interest rate (6-year maturity) stood at 4.4% and the spread vis-à-vis the German benchmark bond (10-year maturity) at 300 basis points. The six-year interest rate spread vis-à-vis the similar-maturity German benchmark bond stood at 370 basis points in April 2014.

On the basis of additional indicators, such as CDS spreads or the long-term ratings of the sovereign, there appears to be room for further convergence of Croatia's credit status. In particular, Croatia's sovereign rating is low compared to the euro area, and the negative outlook assigned by two rating agencies indicates the possibility of further downgrades. The cost of insuring sovereign debt against non-payment remained elevated, including in relation to countries with comparable ratings. Five-year CDS spreads stood above 300 basis points in early 2014, the highest among the CEE countries.

4.6. ADDITIONAL FACTORS

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

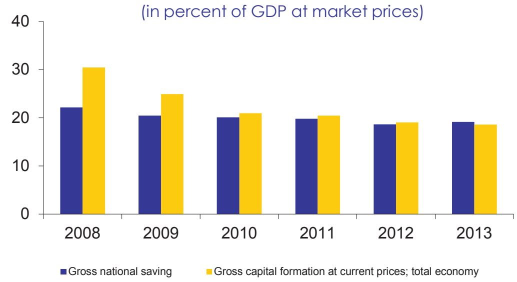
In November 2013, the Commission published its third Alert Mechanism Report (AMR 2014) ([38]) under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.5). The AMR 2014 scoreboard showed that Croatia exceeded the indicative threshold for three out of eleven indicators, two in the area of external imbalances (i.e. the net international investment position and export market shares) and one in the area of internal imbalances (i.e. unemployment). In line with the conclusion of the AMR 2014, Croatia was subject to an in-depth review, which found that Croatia is experiencing excessive imbalances, which require specific monitoring and strong policy action. In particular, policy action is required in view of the vulnerabilities arising from sizeable external liabilities, declining export performance, highly leveraged firms and fast-increasing general government debt, all within a context of low growth and poor adjustment capacity.

4.6.1. Developments of the balance of payments

Croatia's external balance (i.e. the combined current and capital account) adjusted from very large and rising deficits until 2008 to near balance in 2012 and reached a surplus of 1.2% of GDP in 2013. The improvement was mostly on account of merchandise trade, as imports dropped with the contraction in domestic demand. Strong surpluses in the services account, due to the importance of the tourism industry, have pushed the overall external balance into a surplus. The income account deficit remained broadly unchanged until 2012, reflecting a comparable contraction of outflows and inflows, but declined significantly in 2013 as a result of lower profitability of direct equity investments.

The large and increasing savings-investment gap during 2006-2008 (about -7% of GDP on average) was eliminated by 2013, against the backdrop of the protracted recession and the slowdown of capital inflows. Gross national savings dropped from above 22% of GDP in 2008 to 19% in 2013, reflecting rising borrowing needs by the public sector, while the private sector adjusted its balance sheets after strong credit expansion in the pre-crisis period. Gross fixed capital formation collapsed during 2009-2010 and has not recovered since then. In 2013, it stood at below 19% of GDP.

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



Source: Eurostat, Commission services.

Competitiveness indicators for Croatia reveal a mixed picture in the past years. After deteriorating during the pre-crisis period, some improvement has taken place in the past few years. The ULC-deflated real-effective exchange rate (REER) depreciated by about 7% in the period 2010 to early 2014, although from a high level, supported by both NEER and ULC developments. The improvement in the ULC-deflated REER masks important divergences between sectors. In the manufacturing sector, the ULC-deflated REER appreciated by about 10% in 2009-2010 and only started to improve gradually from mid-2011, depreciating by about 5% through to early 2014. The HICP-deflated REER depreciated during 2010 and 2011, but appreciated thereafter, partly due to increases in indirect taxes and administered prices. Croatia's export performance has deteriorated during the past years, reflecting low competitiveness, in particular in the manufacturing sector.

([38]) http://ec.europa.eu/europe2020/pdf/2014/amr2014_en.pdf

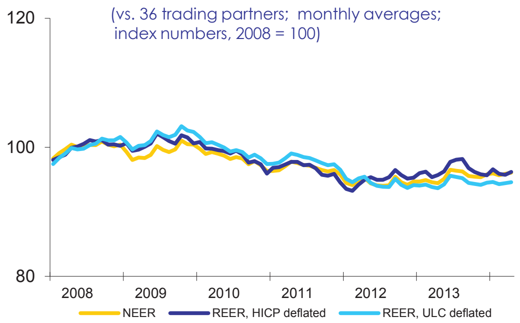
Table 4.4:
Croatia - Balance of payments **(percentage of GDP)**

	2008	2009	2010	2011	2012	2013
Current account	-8.7	-4.9	-0.8	-0.8	0.1	1.2
of which: Balance of trade in goods	-22.8	-16.6	-13.5	-14.4	-13.8	-14.4
Balance of trade in services	15.1	13.4	13.7	14.6	14.8	15.7
Income balance	-3.3	-4.0	-3.5	-3.6	-3.5	-2.6
Balance of current transfers	2.3	2.3	2.4	2.5	2.6	2.5
Capital account	0.0	0.1	0.1	0.0	0.1	0.1
External balance [1]	-8.7	-4.8	-0.7	-0.8	0.2	1.3
Financial account	12.0	7.7	2.9	3.0	1.1	0.8
of which: Net FDI	6.7	3.4	0.9	2.3	2.6	1.2
Net portfolio inflows	-1.7	0.9	1.1	1.4	3.9	4.4
Net other inflows [2]	6.3	5.3	1.1	0.2	-5.3	-0.5
Change in reserves (+ is a decrease)	0.7	-2.0	-0.2	-0.9	-0.1	-4.3
Financial account without reserves	11.3	9.7	3.1	3.9	1.2	5.1
Errors and omissions	-3.3	-2.9	-2.2	-2.2	-1.3	-2.1
Gross capital formation	30.4	24.9	20.9	20.5	19.1	18.6
Gross saving	22.2	20.5	20.1	19.8	18.7	19.1
External debt	86.2	101.1	104.7	103.9	102.7	105.4
International investment position	-75.3	-87.4	-95.9	-92.0	-89.5	-88.4

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

Sources: Eurostat, Commission services, Croatian National Bank.

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



Source: Commission services.

Mirroring the improvement in the external balance, the surplus in the financial account declined strongly from 2008, to below 1% in 2013. The net FDI balance recovered somewhat in 2011 and 2012, but fell again in 2013. Net inflows of portfolio investment continued to increase towards the end of the observed period, as the government financed part of its debt on external markets. On the other hand, net other inflows turned negative from 2012 due to deleveraging of the private sector, in particular the financial sector. Gross external debt has been hovering at slightly above 100% of GDP since 2009, peaking at 105% of GDP in 2013. The relative stability hides diverging trends in the public and the private sector. While the former increased its external indebtedness since the onset of the crisis, the latter reduced it. The decline in the private sector's foreign exposure was most pronounced in the banking sector. Private sector deleveraging has been supportive for rebalancing of the net international investment position, which improved moderately since 2010, although the negative balance remains substantial.

According to the Commission services' 2014 Spring Forecast, the external account is projected to remain in surplus in 2014 and 2015, as domestic demand remains subdued while exports benefit from improving demand in the EU, Croatia's key export market.

4.6.2. Market integration

The Croatian economy is integrated into the euro area through trade and investment linkages. The degree of trade openness stood at 43.4% of GDP in 2012, which is low given the small size of the Croatian economy. It is also lower than in the pre-crisis years as a result of import compression and poor export performance. Intra-euro-area trade in goods accounted for slightly over half of total trade in goods or 14.9% of GDP in 2012. There remains

Table 4.5:
Croatia - Product market integration

	2007	2008	2009	2010	2011	2012
Trade openness [1] (%)	45.9	46.0	38.4	40.0	42.6	43.4
Intra-EA trade in goods GDP ratio [2] (%)	16.8	16.6	13.1	13.7	14.9	14.9
Intra-EA trade in services GDP ratio [3] (%)	n.a.	8.6	7.5	7.7	8.4	8.5
Extra-EA trade in goods GDP ratio [4] (%)	15.3	15.4	12.3	13.4	14.4	14.6
Export in high technology [5] (%)	6.5	7.1	7.6	7.0	5.8	7.4
High-tech trade balance [6] (%)	-2.2	-2.1	-1.8	-1.5	-1.5	-1.4
Total FDI inflows GDP ratio [7] (%)	8.4	6.8	5.4	0.6	2.4	2.4
Intra-EA FDI inflows GDP ratio [8] (%)	7.6	4.7	6.3	0.6	2.4	2.4
FDI intensity [9]	4.4	3.6	3.7	0.2	1.2	1.1
Internal Market Directives [10] (%)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Time to start up a new company [11]	21.5	21.5	21.5	8.5	8.0	8.0
Real house price index [12]	120.9	118.4	110.4	100.0	94.1	91.9
Residential investment [13] (%)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Building permits index [14]	186.5	185.2	126.3	100.0	101.0	73.4

1) (Imports + Exports of goods and services / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics, Balance of Payments).
2) (Intra-EA-18 Imports + Exports of goods / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).
3) Intra-EA-17 trade in services (average credit and debit in % of GDP at current prices) (Balance of Payments).
4) (Extra-EA-18 Imports + Exports of goods / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).
5) Taken directly from Eurostat's databases: Exports of high technology products as a share of total exports.
6) (Exports - imports in high tech) / GDP at current prices x 100, since 2007 the data based upon SITC Rev. 4 (earlier SITC Rev. 3).
7) Total FDI inflows (in % of GDP at current prices).
8) Intra-EA-17 FDI inflows (in % of GDP at current prices).
9) FDI intensity (average intra-EU-27 inflows and outflows in % of GDP at current prices).
10) Percentage of internal market directives not yet communicated as having been transposed, in relation to the total number.
11) Time to start a new company (in days), Doing Business World Bank.
12) Deflated house price index (2010=100), Eurostat.
13) Gross capital formation in residential buildings (in % of GDP), Eurostat.
14) Number of new residential building permits (2010=100), Eurostat.

Sources: Eurostat, Sectoral Performance Indicators Database (SPI), Commission services.

significant room for deepening trade integration with the euro area.

The poor export performance is mainly due to the depressed state of goods exports. During the past decade, they stagnated at 22% of GDP, whereas in the CEE EU Member States, goods exports expanded from 46% to 62% of GDP in 2000-2012. Goods exports account for about half of total exports, with sizeable shares for machinery, electrical, chemical and mineral products. Services exports have fared slightly better, mainly due to strong growth in the tourism sector. In 2012, tourism accounted for two thirds of services exports and one third of total exports. Maintaining high growth in the tourism sector may become gradually more challenging, as the potential to expand beyond summer tourism seems limited. The share of high-technology exports stood at 7.4% of total exports in 2012, a slight expansion from 2007-08. The high-tech trade balance remains in negative territory, but has improved slightly during the past few years.

Total FDI inflows to Croatia in percent of GDP slowed down significantly in 2010 and have recovered moderately to 2.4% in 2011 and 2012. During the past decade, FDI was mainly directed into the banking, real estate and retail sectors, which may not attract similar levels of investment in the near term, as the credit-driven growth model seems to have run its course. Croatia has failed to attract FDI in the tradable sector and is weakly integrated into global supply chains. Relatively high costs and an unfavourable business environment appear to be the main obstacles to attracting FDI.

From the early 2000s to the peak of 2007, house prices followed an upward trend, increasing by 47% in real terms. The correction between 2007 and 2012 reached 24%. The real house price index showed a 2% decrease in 2012, which accelerated to 18% in 2013. In the past six years, the number of building permits granted fell substantially, by 27% in 2012 and by 20% in 2013. Furthermore, real value added in the construction sector has decreased substantially, at an annual average rate of 12% between 2009 and 2012. The share of construction in total value added was 5% in 2012, down from 9% in 2008.

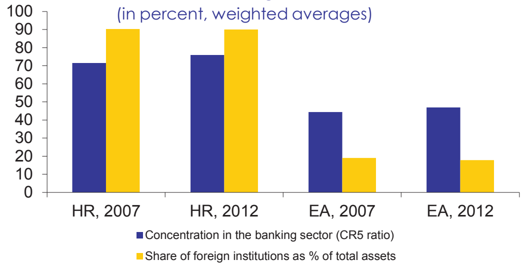
With regard to the business environment, Croatia performs worse than most euro area Member States in international rankings ([39]). The business environment is marked by multiple shortcomings, notably a high regulatory burden, inefficiencies in the administration of construction permits and property registration, an inefficient justice system, prolonged litigation and bankruptcy procedures and weak protection of investments. Public administration as a whole also performs relatively poorly according to the World Bank's Worldwide Governance Indicators ([40]).

Activity and employment rates are low compared to the euro-area average, which is partly related to underlying institutions and policies such as early retirement schemes, pension eligibility criteria, and the tax-benefit system. Furthermore, a comparatively high share of workers is employed in the non-tradable sector, including the government sector and SOEs, which may slow down the necessary employment reallocation. At the same time, high long-term unemployment risks reducing the potential employability of the labour force once the economy recovers. Anecdotal evidence suggests that brain-drain pressures may become an issue as a consequence of joining the Single Market.

4.6.3. Financial market integration

The financial sector in Croatia is highly integrated with the EU financial sector, with foreign ownership of financial institutions exceeding 90% of total assets. Market concentration is high, as the largest five banking institutions account for 76% of banking sector assets, slightly higher than in 2007.

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



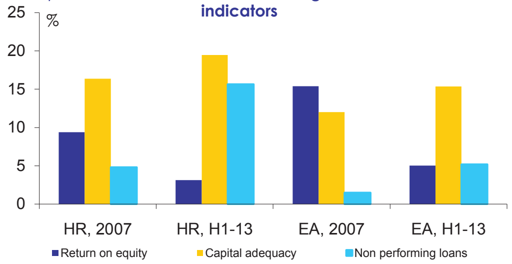
Source: ECB, Structural financial indicators and HNB Banks Bulletin.

Financial intermediation in Croatia is mainly indirect, with domestic bank credit just above 70% of GDP, out of total lending of 100% of GDP at end-2013. Strong credit expansion during the boom years has given way, during the current recessionary period, to rapid deleveraging, especially in the corporate sector. With increased risk aversion by the private sector, deposit volumes have increased and deposit funding has become cheaper for Croatian banks. This has led to an improvement in the loan-to-deposit ratio and has also enabled the large banks to reduce their reliance on parent bank funding. Outstanding credit to non-financial corporations and households was lower than in the euro area, at 33% and 38% of GDP, respectively, in 2012. The share of foreign-currency-denominated loans stood at 73% of total loans at end-2013, with the majority denominated in euro (64% of total loans) and a smaller share in Swiss franc (9% of total loans, mostly housing loans). Private sector debt stood at 132% of GDP in 2012, somewhat below the euro area average. Cross-border loans by foreign parent banks to the corporate sector have played a significant role in the expansion of private sector debt between 2005 and 2010.

The banking system appears to have adequate levels of liquidity and is highly capitalized. The overall capital adequacy ratio stood at 21% at the end of 2013, significantly above the euro-area average. Profitability has been high and remained positive until end-2013, but rising non-performing loans and increasing provisioning reduced it by 70% year-on-year in 2013. The quality of the loan portfolio is deteriorating rapidly, with the share of NPLs reaching 15.6% at end-2013. A particular concern has been the rapid rise in NPLs in the corporate sector, which reached 27% at end-2013. The coverage ratio increased slightly during 2013 to 46%, but remains below historical levels and below the average of the CEE region.

([39]) For instance, Croatia ranks on 89th (out of 189 economies) on the World Bank's 2014 Ease of Doing Business Index and 75th (out of 148 economies) on the World Economic Forum's 2013-2014 Global Competitiveness Index.
([40]) http://info.worldbank.org/governance/wgi/index.aspx#home

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

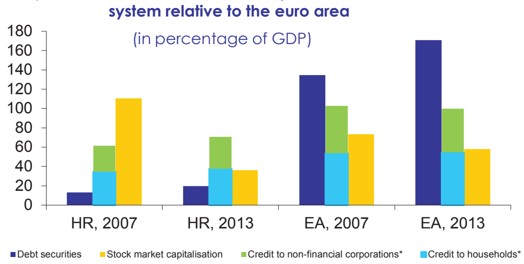


Note: For 2007 EU-27 non performing loans are a proxy for EA.
For 2007, EA RoE and CAR averages are unweighted.
Source: ECB, HNB, EC calculations.

The non-banking financial sector is well developed relative to other CEE countries, and non-banking institutions play a fairly important role in financial intermediation. In 2012, they accounted for roughly 40% of GDP or one fourth of financial institutions' assets. Pension funds, with total assets of about 16% of GDP, are the biggest players, and their size has more than doubled since 2008. The insurance sector has also been growing, but its size, measured by total premium to GDP of about 10% in 2012, is comparable to the euro-area average. Investment funds have also increased their assets, since 2008 by 40%, and their total assets account for about 5% of GDP. Leasing and factoring are another important group in the non-banking financial sector with total assets fairly high (almost 9% of GDP), despite their modest reduction in business since 2008.

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

(in percentage of GDP)



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

Capital markets in Croatia are less developed than in the euro area, but among the most developed in the CEE region. In 2007 the Zagreb Stock Exchange (ZSE) merged with Varaždin Stock Exchange, resulting in a single Croatian capital market, leading in the region by market capitalization and trading volume. Initially, trading volumes were very high at 111% of GDP, but have shrunk in the course of the crisis and are now more in line with those of other CEE countries. Currently, the ZSE includes stocks of 378 companies, with market capitalization of around HRK 180 billion, corresponding to 55% of GDP. Conversely, debt markets are not very developed.

The Croatian National Bank (HNB) is the supervisory authority for credit institutions while HANFA, the Croatian Financial Services Supervisory Agency, is in charge of the supervision of non-bank financial institutions, including insurance and leasing companies, investment firms, and asset and pension fund management companies. During 2013 the Council for Financial Stability was established with members from HNB, HANFA, the Ministry of Finance and the State Agency for Deposit Insurance and Bank Rehabilitation for the implementation of macro-prudential policy. In principle, the transposition of all directives related to financial services should have taken place before the accession of Croatia to the European Union. The relevant legislation is currently under examination by the Commission services, including the Alternative Investment Fund Managers Directive (AIFMD), for which the transposition date was July 2013.

5. LITHUANIA

5.1. LEGAL COMPATIBILITY

5.1.1. Introduction

The Bank of Lithuania was established originally in 1922 and was re-established in March 1990. Its legal status is defined in Article 125 of the Lithuanian Constitution of 1992. The Law on the Bank of Lithuania (hereinafter 'the BoL Law') lays down the tasks and functions of the Bank of Lithuania ([41]). The BoL Law was amended several times and most recently through Law No XII-765 of 23 January 2014 ([42]).

5.1.2. Central bank independence

Pursuant to a recent amendment ([43]) to the Law on the National Audit Office, now clearly defines the scope of control conducted by the National Audit Office without prejudice to the activities of the Bank of Lithuania's independent external auditor competences as provided in Article 27.1 of the Statute of the ESCB and of the ECB. According to the amended law, the National Audit Office may perform an audit of the activities of the Bank of Lithuania, with the exception of the execution of tasks of the European System of Central Banks and the Eurosystem. The law foresees that the National Audit Office shall take into account the independence of the Bank of Lithuania and shall not give instructions to the Bank of Lithuania, Board of the Bank of Lithuania or its members in carrying out its functions related to the performance of the tasks of the European System of Central Banks and the Eurosystem.

On 24 January 2014, the Lithuanian Constitutional Court declared that the amendments from 2006 to Article 125 of the Constitution were unconstitutional given that the amendments were not carried out in line with the appropriate legislative procedure applying to amendments to the Constitution. The amendments of 2006 brought the Constitution in line with the principle of central bank independence as they revoked the BoL's exclusive right to issue currency and clarified the legal basis for the right to dismiss the BoL governor in line with Article 130 of the TFEU and Article 14.2 of the Statute.

The Constitutional Court clarified in its ruling that the declaration of unconstitutionality of the amendments does not mean that the previous version of Article 125 of the Constitution re-enters into force. Therefore, the Constitution does not provide for the exclusive right of the BoL to issue the currency. Furthermore, the Court stated that the constitutional commitment of Lithuania to eventual full participation in the Economic and Monetary Union implies the application of the independence guarantee to the BoL set by the law of the European Union. Against this background, the Commission understands that the Seimas' vote of non-confidence against state officials appointed by the latter as enshrined in Articles 75 and 84 (13) of the Constitution cannot constitute a ground for dismissal of the BoL governor in addition to the grounds for dismissal provided by Article 14.2 of the Statute and as replicated in Article 12 of the BoL Law. The Commission understands that the Court's jurisprudence forms the official constitutional doctrine which has the same legal value as the Constitution itself. On the basis of this understanding, the Constitution is compatible with the principle of central bank independence as enshrined in the TFEU and the Statute.

5.1.3. Prohibition of monetary financing and privileged access

There are no incompatibilities and imperfections in the Lithuanian laws with regard to the prohibition of monetary financing and privileged access as enshrined in Article 123 and 124 of the TFEU.

5.1.4. Integration in the ESCB

Objectives

The objectives of the Bank of Lithuania are compatible with the TFEU.

Tasks

There are no incompatibilities and imperfections in the Lithuanian legislation with regard to the tasks

([41]) Law No I-678 of 1 December 1994.
([42]) Register of Legal Acts 2014-01-30, No. 2014-716, effective as of 31 January 2014.
([43]) Law No XII-766 of 23 January 2014, Register of Legal Acts 2014-01-30, No 2014-712, entering into force on the day the Council abrogates the derogation of Lithuania pursuant to Article 140 of the TFEU.

Table 5.1:
Lithuania - Components of inflation

	(percentage change)[1]							weights in total
	2008	**2009**	**2010**	**2011**	**2012**	**2013**	**Apr-14**	**2014**
HICP	11.1	4.2	1.2	4.1	3.2	1.2	0.6	1000
Non-energy industrial goods	1.8	0.2	-2.9	-0.7	1.1	1.0	0.5	301
Energy	17.9	8.2	10.4	12.0	6.7	-1.2	-2.5	143
Unprocessed food	15.3	3.1	-2.3	5.0	3.3	3.2	1.9	103
Processed food	15.8	5.8	5.3	7.0	3.2	1.4	1.5	220
Services	12.2	5.8	-1.5	1.3	2.9	1.8	1.5	234
HICP excl. energy and unproc. food	9.3	3.7	0.0	2.4	2.4	1.4	1.1	755
HICP at constant taxes	10.1	0.2	-0.3	4.2	3.0	1.2	0.6	1000
Administered prices HICP	17.0	15.8	6.6	5.0	6.8	1.1	-0.7	130

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

Sources: Eurostat, Commission services.

of the ESCB and the ECB and the correct spelling of the euro.

5.1.5. Assessment of compatibility

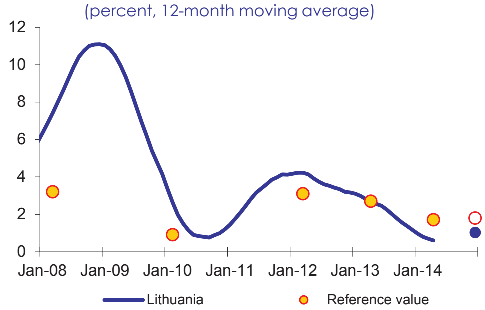
The Lithuanian Constitution, the BoL Law and the Law on the National Audit Office, as amended, are fully compatible with Articles 130 and 131 of the TFEU.

5.2. PRICE STABILITY

5.2.1. Respect of the reference value

The 12-month average inflation rate for Lithuania, which is used for the convergence evaluation, was above the reference value at the time of the last convergence assessment in 2012. Since early 2012, average inflation has been on a steady downward trend, dropping from 4.2% in February 2012 to below 1% at the beginning of 2014. In April 2014, the reference value was 1.7%, calculated as the average of the 12-month average inflation rates in Latvia, Portugal and Ireland plus 1.5 percentage points. The corresponding inflation rate in Lithuania was 0.6%, i.e. 1.1 percentage points below the reference value. The 12-month average inflation is projected to remain below the reference value in the months ahead.

Graph 5.1: **Lithuania - Inflation criterion since 2008**
(percent, 12-month moving average)

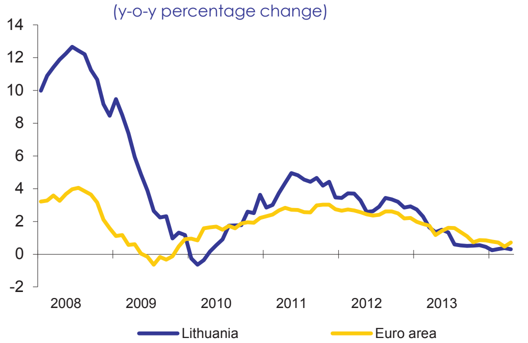


Note: The dots in December 2014 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2014 Forecast.

5.2.2. Recent inflation developments

In previous years, Lithuania's inflation rate moved within a broad range, reflecting in particular large variations in the inflation contributions of services, food and energy, which together represent around 75% of the HICP basket. Changes in administered prices and taxation further amplified inflation volatility. Annual HICP inflation peaked at above 12% in mid-2008 and then decreased rapidly throughout 2009 as the economy moved into recession. Following a marginal year-on-year decline in the price level in early 2010, annual inflation increased on the back of higher commodity prices to 5% in May 2011. Annual inflation has thereafter broadly followed a declining trend, induced by lower inflation of energy and processed food prices, which was also supported by continuing wage restraint in the economy. After having stabilised at around 0.5% in the second half of 2013, annual inflation dropped to some 0.3% in early 2014.

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



Source: Eurostat.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) has been less volatile than headline inflation in recent years, highlighting the strong effect of rising commodity prices on inflation. Core inflation peaked at above 2.5% in late 2012 and then declined during the first half of 2013 to 1.1% in July 2013. At the same time, the gap between core and headline inflation narrowed due to particularly low inflation of energy prices. In fact, energy inflation has steadily decelerated since 2011 and turned negative in 2013. It stood at -2.5% in early 2014. Since June 2013 the core inflation rate has exceeded headline inflation levels as it remained slightly above 1% in early 2014. Inflation of service prices mirrored the overall declining trend albeit at a slower pace. It has fallen since 2012 to reach 1.5% in April 2014. Non-energy industrial goods inflation was already relatively low and has remained so in recent years with 1.1% in 2012, 1.0% in 2013 and 0.6% in early 2014. Annual average producer price inflation for total industry decreased from 5.1% in 2012 to -2.3% in 2013 and stood at -4.2% in March 2014, suggesting that pipeline price pressures remain subdued.

5.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy-mix and cyclical stance

Real GDP growth was around 7% on average between 2005 and 2008, but a sharp contraction of almost 15% followed in 2009. GDP growth turned positive in 2010 before reaching 6% in 2011 and 3.7% in 2012. Initially driven by rapid export growth, the recovery has increasingly relied on domestic demand through growth in both private consumption and investment. In the second half of 2013, the contribution of net exports turned negative and domestic consumption became the main growth driver, leading to a GDP growth rate of 3.3% for 2013. The output gap, which turned negative in 2009, is estimated to close in 2016. According to the Commission services' 2014 Spring Forecast, real GDP growth is projected to remain 3.3% in 2014 and to accelerate to 3.7% in 2015.

The fiscal stance, as measured by changes in the structural balance, was tightened over 2012 and 2013 in line with the gradual recovery in domestic demand. The structural deficit is estimated to have remained just above 2% of GDP in 2013. A further gradual tightening of the fiscal stance is foreseen for 2014 and 2015.

Monetary conditions have been accommodative in recent years in the framework of the currency board arrangement within ERM II. Short-term interest rates have remained close to levels observed in the euro area since end-2010. Credit conditions stabilised in the aftermath of the global financial crisis and banks have sufficient liquidity. However, lending conditions, in particular to SMEs, construction and the real estate sector, remain tight, while private sector demand for credit is still weak as deleveraging pressures persist.

Wages and labour costs

The Lithuanian labour market demonstrated a high degree of flexibility during the crisis, supported by a decentralised wage bargaining process. Unemployment has gradually declined from its post-crisis peak of almost 18% in 2010 to below 12% in 2013. Employment started to grow again in the second quarter of 2010 and has been on a modest upward trend since then.

Nominal compensation per employee declined in 2009 but recovered strongly in the following years. The public sector wage freeze, which was implemented during the crisis, was partially reversed in 2013 and the minimum wage was raised by 25% to LTL 1,000 in January 2013, inducing a pick-up in growth of compensation per employee. As a result, nominal unit labour cost growth, which turned positive in 2011, increased to 3.8% in 2013 as productivity growth declined gradually between 2010 and 2013.

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

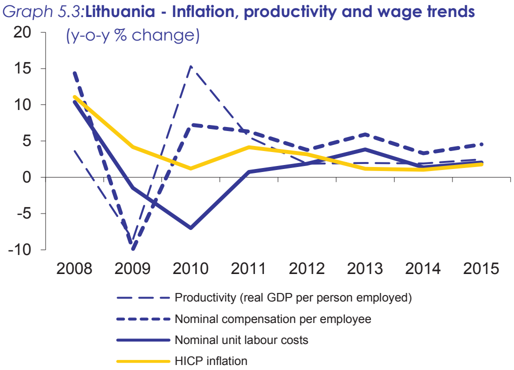
	2008	2009	2010	2011	2012	2013[1)]	2014[2)]	2015[2)]
HICP inflation								
Lithuania	11.1	4.2	1.2	4.1	3.2	1.2	1.0	1.8
Euro area	3.3	0.3	1.6	2.7	2.5	1.3	0.8	1.2
Private consumption deflator								
Lithuania	10.9	4.5	1.3	4.1	3.1	1.0	1.0	1.8
Euro area	2.7	-0.4	1.6	2.4	2.1	1.3	0.9	1.3
Nominal compensation per employee								
Lithuania	14.3	-9.9	7.2	6.3	3.8	5.9	3.3	4.6
Euro area	3.5	1.8	2.0	2.2	2.0	1.7	1.6	1.9
Labour productivity								
Lithuania	3.6	-8.6	15.3	5.5	1.9	2.0	1.9	2.5
Euro area	-0.3	-2.4	2.6	1.4	0.2	0.5	0.9	1.0
Nominal unit labour costs								
Lithuania	10.4	-1.5	-7.0	0.7	1.9	3.8	1.4	2.0
Euro area	3.8	4.3	-0.6	0.7	1.8	1.1	0.7	0.8
Imports of goods deflator								
Lithuania	9.3	-11.5	10.9	14.2	4.6	-1.9	-2.5	1.8
Euro area	4.2	-8.1	5.7	6.6	2.3	-1.9	-1.0	0.8

1) 2013 data (except HICP inflation) are estimates.
2) Commission services' Spring 2014 Forecast.

Source: Eurostat, Commission services.

According to the Commission services' 2014 Spring Forecast, growth of nominal unit labour costs should decline again to below 2% in 2014 and to 2% in 2015, reflecting a pick-up in labour productivity growth. Nevertheless, high structural unemployment and emerging skill mismatches in some labour market segments could lead to emerging wage pressures.

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



Source: Eurostat, Commission services' Spring 2014 Forecast.

External factors

As a small and open economy, Lithuania is highly sensitive to external developments, a factor further exacerbated by the large weight of energy and food prices in the HICP basket. Mirroring trends in world energy and food prices, import prices (measured by the imports of goods deflator) surged in 2010 and 2011. Import price growth moderated in 2012 and turned negative in 2013, largely caused by a stabilisation and subsequent drop in world oil and food prices. Accordingly, the contribution of energy prices to HICP inflation became negative (0.2pps) in 2013 while unprocessed and processed food contributed 0.4pps and 0.3pps respectively. The nominal effective exchange rate of the litas (measured against a group of 36 trading partners) has followed a mild appreciation trend since mid-2012. As a result, it had a slightly dampening impact on domestic price developments.

Administered prices and taxes

Adjustments in administered prices ([44]) and indirect taxes have been important determinants of inflation in Lithuania in recent years. Increases in administered prices, with a weight of around 17% in the HICP basket (compared to 13% in the euro area) significantly exceeded HICP inflation in the past. The average annual increase in administered

([44]) According to the Eurostat definition, administered prices in Lithuania *inter alia* include water supply, refuse and sewerage collection, electricity, gas, heat energy, medical products and certain categories of passenger transport. For details, see http://epp.eurostat.ec.europa.eu/portal/page/portal/hicp/documents_meth/HICP-AP/HICP_AP_classification_2011_2014_02.pdf prices declined from almost 16% in 2009 to below 7% in 2010 and some 6.8% in 2012, when it was mainly driven by rising prices of gas, heat energy and passenger rail transport. In 2013, administered prices grew at 1.1%, i.e. below headline inflation. This trend is forecast to continue in 2014, with negative growth of administered prices and a stabilisation thereafter. Notably, decisions to reduce heating prices were taken in 2012 and 2013 with a considerable downward impact on inflation in 2013 and 2014.

The standard VAT rate has not been raised since September 2009 and stands at 21%. Excise duties on cigarettes, alcoholic beverages and diesel fuel have been repeatedly increased since 2009, but are estimated to have had only a marginal impact on average annual inflation in the respective years. Further increases in excise duties were introduced at the beginning of 2014, in line with applicable EU regulations. Reduced VAT rates for periodicals and for some passenger transportation services were introduced in 2013, while reduced VAT rates for residential heating and some medicines were extended. In the absence of major tax revisions, the HICP at constant tax rates has developed very much in line with actual inflation rates, dropping from slightly above 4% in 2011 to 1.2% in 2013 and further to 0.6% in spring 2014. No further VAT rate revision has been announced for the immediate future.

Medium-term prospects

The favourable outlook for primary commodity price developments suggests that the inflation contributions of energy and food products could continue to be low or even negative in 2014. At the same time, domestic price increases should remain modest. Inflation expectations remain well anchored. According to the Commission services' 2014 Spring Forecast, average annual inflation is thus projected to remain broadly stable in 2014 at about 1.0% and increase moderately to 1.8% in 2015.

Risks to the inflation outlook appear to be broadly balanced. Upside risks are mainly related to a possible rise of global commodity prices, with the overall impact amplified by the relatively large weight of commodities in the consumption basket, as well as increasing wage pressure resulting from a tightening labour market. The output gap is set to close in 2016 and the unemployment rate is at its estimated natural level. Additionally, skill mismatches can be observed in some sectors of the economy, possibly contributing to an acceleration of wages going forward. Downside risks to inflation could emerge from a delayed economic recovery of Lithuania's main trading partners leading to a protracted period of low commodity prices and weaker-than-expected growth in Lithuania.

5.3. PUBLIC FINANCES

5.3.1. Recent fiscal developments

On 21 July 2013, the Council decided to abrogate the decision on the existence of an excessive deficit according to Article 126 (12) TFEU, thereby closing the excessive deficit procedure for Lithuania ([45]).

The economic crisis had severe repercussions on Lithuania's public finances, as the headline general government deficit rose from 1.0% of GDP in 2007 to 9.4% of GDP in 2009, despite substantial consolidation measures of around 8% of GDP adopted during 2009. Due to further consolidation measures adopted in subsequent years, the general government deficit declined to 7.2% of GDP in 2010 and 5.5% of GDP in 2011. The consolidation measures were taken mostly on the expenditure side, including cuts in public sector wages followed by a wage freeze, temporary cuts in pensions as well as a reduction of selected social benefits. In addition, transfers to the second pillar pension funds were lowered. On the revenue side the government increased the standard VAT rate by 3pp and eliminated some tax exemptions.

In 2012 Lithuania’s general government deficit narrowed to 3.2% of GDP. Progress was in large part due to expenditure restraint and improvements in tax compliance, supported by solid economic growth. However, the outcome fell short of reaching the target of 3.0% of GDP set in the 2012 convergence programme, mainly because state-owned enterprises only paid half of the expected dividends to the budget, sales of carbon rights fell considerably short of plan and local governments encountered a deficit higher than expected.

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

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

Outturn and forecast [1]	2008	2009	2010	2011	2012	2013	2014	2015
General government balance	-3.3	-9.4	-7.2	-5.5	-3.2	-2.1	-2.1	-1.6
- Total revenues	34.6	35.5	35.0	33.2	32.7	32.2	32.0	31.7
- Total expenditure	37.9	44.9	42.2	38.7	36.0	34.4	34.2	33.3
of which:								
- Interest expenditure	0.7	1.3	1.8	1.8	1.8	1.7	1.6	1.5
p.m.: Tax burden	31.1	30.8	28.8	27.7	27.5	27.5	27.4	27.2
Primary balance	-2.6	-8.2	-5.4	-3.7	-1.4	-0.5	-0.6	-0.1
Cyclically-adjusted balance	-5.4	-6.5	-4.7	-4.4	-2.9	-1.9	-2.0	-1.5
One-off and temporary measures	-0.1	0.4	0.0	0.0	0.1	0.2	-0.1	-0.2
Structural balance [2]	-5.3	-6.9	-4.7	-4.4	-2.9	-2.1	-1.9	-1.3
Government gross debt	15.5	29.3	37.8	38.3	40.5	39.4	41.8	41.4
p.m: Real GDP growth (%)	2.9	-14.8	1.6	6.0	3.7	3.3	3.3	3.7
p.m: Output gap	6.8	-9.7	-8.2	-3.5	-1.3	-0.7	-0.5	-0.4

Convergence programme	2014	2015	2016	2017
General government balance	-1.9	-0.9	0.1	1.1
Structural balance [2][3]	-1.2	-0.6	0.2	0.9
Government gross debt	41.6	40.7	35.3	34.8
p.m. Real GDP (% change)	3.4	4.3	4.0	4.3

1) Commission services' Spring 2014 Forecast.
2) Cyclically-adjusted balance excluding one-off and other temporary measures.
3) Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures taken from the programme , while they do not meet the criteria applied by the Commission.
Sources: Commission services, the 2014 Convergence Programme of Lithuania .

In 2013, fiscal consolidation was supported by a healthy collection of direct taxes, in particular corporate income tax, which compensated for a shortfall in indirect tax collection, while expenditure growth at central government level was contained. In addition, fiscal results of local governments turned out to be better than expected. Overall, the general government deficit reached 2.1% of GDP in 2013, i.e. 0.4pps less than targeted in the 2013 Convergence Programme.

The structural deficit (the cyclically-adjusted balance net of one-offs and other temporary measures) as calculated by the Commission decreased gradually from some 7.2% of GDP in 2009 to around 2.1% in 2013.

The expenditure-to-GDP ratio has declined steadily over the last years due to lower spending on personnel, goods and services and social transfers. It decreased from 42.2% in 2010, to 34.4% in 2013. The revenue-to-GDP ratio declined as well, falling from 35% in 2010 to 32.2% in 2013, mainly due to slow nominal growth in indirect tax revenue, despite the recovery of domestic demand and government's efforts to improve tax compliance.

While remaining well below 60% of GDP, the debt-to-GDP ratio deteriorated to 39.4% in 2013 from only 15.5% in 2008 as a result of high government deficits and high interest on new debt incurred during the crisis.

5.3.2. Medium-term prospects

The Lithuanian Parliament adopted the 2014 budget on 12 December 2013 targeting a general government deficit of 1.9% of GDP along with a medium-term budgetary framework for 2014-2016. The general government budget deficit is planned at 0.9% of GDP in 2015 and a surplus of 0.1% of GDP is foreseen for 2016. Consolidation in the 2014 budget is based on further expenditure restraint, in particular maintaining the partial public sector wage freeze for the fifth year. In October 2013 the government had to partially reverse public wage cuts following a judgement of the Constitutional Court. In 2014, cuts of state and other specific pensions have been reverted. On the revenue side, excise taxes on tobacco and alcohol increased as of spring 2014. The government also plans to collect more revenues by stepping up tax collection efforts, especially for VAT.

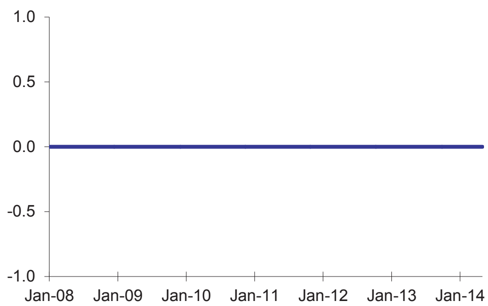
Taking into account these measures and robust growth in domestic demand, the Commission services' 2014 Spring Forecast projects a deficit of 2.1% of GDP in 2014. In 2015, the state budget expenditure rule is expected to contain the increase in total expenditure. The government deficit is therefore forecast to fall to 1.6% of GDP in 2015. The overall fiscal stance in 2014, as measured by the change in the structural balance, is expected to result in a moderate consolidation of 0.2pps and is expected to become more restrictive in 2015. The general government debt is expected to increase from 39.4% of GDP in 2013 to around 41.4% of GDP in 2015, due to foreseen pre-financing for the redemption of a Eurobond in February 2016.

In March 2012, Lithuania signed the Treaty on Stability, Coordination and Governance in the EMU. This implies an additional commitment to conduct a stability-oriented and sustainable fiscal policy. The TSCG will apply to Lithuania in its entirety upon lifting its derogation from participation in the single currency.

5.4. EXCHANGE RATE STABILITY

Lithuania entered ERM II on 28 June 2004 and has thus been participating in the mechanism for almost ten years at the time of the adoption of this report. The ERM II central rate was set at the parity rate prevailing under the existing currency board arrangement, with a standard fluctuation band of ±15%. Upon ERM II entry, the authorities unilaterally committed to maintain the currency board within the mechanism. Since then, and in line with this commitment, there has been no deviation from the central rate.

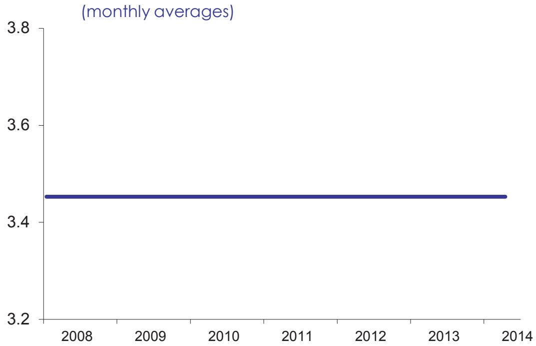
Graph 5.4: **LTL - Spread vs central rate**
(as percent, daily values)



Source: Commission services, ECB.

The Bank of Lithuania began operating under a currency board in April 1994, with the litas initially pegged to the US dollar at 4 LTL/USD. The litas peg was changed to the euro in February 2002 at the prevailing market rate of 3.4528 LTL/EUR. The litas exchange rate did not experience tensions during the reference period.

Graph 5.5: **Exchange rates - LTL/EUR**
(monthly averages)



Source: ECB.

Under the currency board arrangement all domestic liabilities of the Bank of Lithuania have to be backed by foreign exchange reserves or gold. International reserves increased from below EUR 5bn at the beginning of 2011 to above EUR 6bn at the end of 2011 thanks to strong FDI inflows and successful international sovereign bond issuance. They remained close to this level throughout 2012 and 2013, with relatively small fluctuations mainly reflecting short-term changes in government deposits. International reserves covered on average around 130% of the monetary base during 2012-2013, well above the required 100% statutory minimum. The ratio of international reserves to GDP stood at 17.6% and they covered around 80% of short-term debt by the end of 2013([46]).

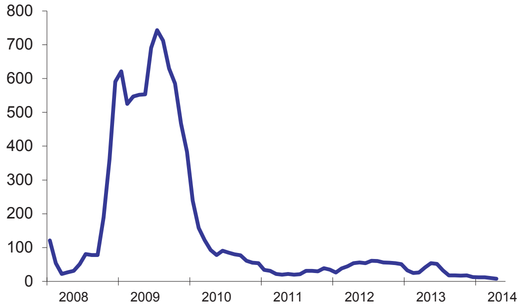
The Bank of Lithuania does not set monetary policy interest rates. The domestic interest rate environment is directly affected by monetary conditions in the euro area through the operations of Lithuania's currency board arrangement.

The 3-month interest rate differential against the euro peaked in mid-2009, reflecting elevated risk premia during the period of heightened financial market tensions. After dropping sharply during the second half of 2009 and in early 2010, short-term interest differentials vis-à-vis the euro area remained below 50 basis points in 2011. Short-term spreads widened again to above 50 basis points in 2012 as monetary policy loosening in the euro area was not fully reflected in local interbank rates. Spreads narrowed considerably by mid-

([46]) Based on estimated residual maturity.

2013, falling to below 20 basis points in August 2013 as local money market conditions further improved. At the cut-off date of this report, the 3-month spread vis-à-vis the euro area amounted to about 10 basis points.

Graph 5.6: **Lithuania - 3-M Vilibor spread to 3-M Euribor**
(basis points, monthly values)



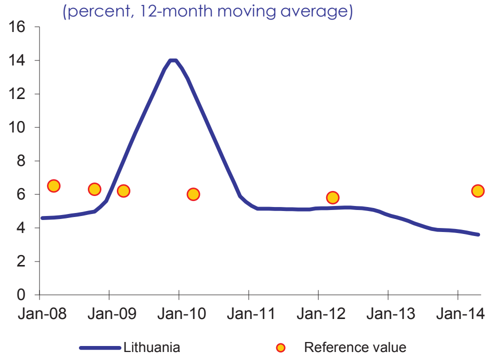
Source: Eurostat.

5.5. LONG-TERM INTEREST RATES

The long-term interest rate in Lithuania used for the convergence examination reflects the secondary market yield on a single benchmark government bond with a residual maturity of around 9 years.

The Lithuanian 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion peaked at some 14% at the end of 2009. It declined to around 5.2% in early 2011 and remained rather stable until the beginning of 2012. It was below the reference value at the time of the last convergence assessment in 2012. Since then it declined further during 2012 and 2013. In April 2014, the latest month for which data are available, the reference value, given by the average of long-term interest rates in Latvia, Portugal and Ireland plus 2 percentage points, stood at 6.2%. In that month, the 12-month moving average of the Lithuanian benchmark bond stood at 3.6%, i.e. 2.6 percentage points below the reference value.

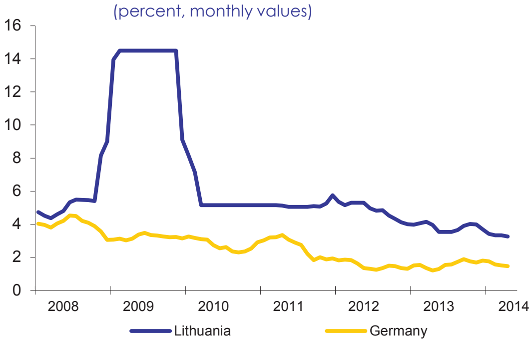
Graph 5.7: **Lithuania - Long-term interest rate criterion**
(percent, 12-month moving average)



Source: Commission services.

Long-term interest rates remained fairly stable at just above 5% from March 2010 until the beginning of 2012. Afterwards they gradually declined to below 4% by mid-2013, reflecting improved investor sentiment towards the country supported by increased sovereign credit ratings as well as a relatively low domestic inflation. Although the long-term litas-denominated government bond market is relatively shallow, the government issued debt securities with original maturity of up to 10 years in 2012 and 2013. The Lithuanian long-term interest spread vis-à-vis the German benchmark bond ([47]) stood at around 180 basis points in early 2014.

Graph 5.8: **Lithuania - Long-term interest rates**
(percent, monthly values)



Source: Eurostat.

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

5.6. ADDITIONAL FACTORS

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

In November 2013, the Commission published its third Alert Mechanism Report (AMR 2014) ([48]) under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.5). The AMR 2014 scoreboard showed that Lithuania exceeded the indicative threshold for two out of eleven indicators, one in the area of external imbalances (i.e. the net international investment position) and one in the area of internal imbalances (i.e. the unemployment rate). In line with the conclusions of the AMRs 2012-14, Lithuania has not been subject to in-depth reviews in the context of the MIP.

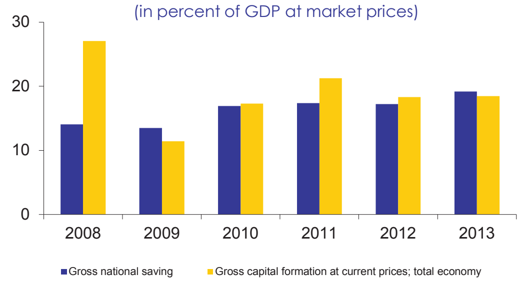
5.6.1. Developments of the balance of payments

After recording a substantial surplus in 2009, Lithuania's external balance (i.e. the combined current and capital account) deteriorated again in 2010, reaching a deficit of 1.2% of GDP in 2011, despite strong export growth combined with solid gains in market shares, as the parallel recovery in domestic demand boosted imports. After reaching surpluses in 2010-2011, the current account moved to a deficit of 3.7% of GDP again in 2011 as domestic demand rebounded, although it improved again and was close to balance in 2012 and moved to surplus in 2013. The current account is set to post moderate deficits in 2014 and 2015.

Lithuania's deficit in international trade of goods fell by almost 10pp to 3.3% of GDP in 2009 as the sharp recession suppressed demand for imports. Subsequently, a slow recovery of imports combined with a good export performance kept the balance of trade in goods at significantly lower levels compared to pre-crisis years (-4.8% of GDP in 2010 and -5.8% of GDP in 2011). In 2012, the deficit was at 2.8% of GDP and widened only slightly in 2013. Lithuania's surplus in services increased from 1.6% of GDP in 2009 to 3.7% of GDP in 2013. The income account moved to surplus in 2009, reflecting mainly loan-loss provisions made by foreign-owned banks, and returned to deficit from 2010 onwards when foreign-owned banks regained profitability. Current transfers and the capital account have consistently recorded significant surpluses reflecting positive net inflows from EU funds and migrant remittances.

The saving-investment gap has narrowed since 2011 and in 2013 savings exceeded the investment. Gross national savings increased in 2010 amid the uncertainty regarding the prospects of the economy and has been on a gradual upward trend since then. While the household savings rate fell somewhat in 2012 and 2013, after a peak in 2010, the evolution in the government savings rate was less negative as reflected in an improving fiscal balance, while corporate savings increased substantially. Following a steep fall in 2008-2009, investment activity rebounded in 2010 and very strongly in 2011 but declined again in 2012. It started to recover in 2013. Investment as share of GDP declined significantly in 2009 and has remained at much lower levels than before the crisis.

Graph 5.9: **Lithuania - Saving and investment**
(in percent of GDP at market prices)



Source: Eurostat, Commission services.

A significant decline in the real-effective exchange rate in 2009-2011, in particular when deflated by ULC, gave a strong boost to Lithuania's cost competitiveness. Since 2012 labour costs started to rise and the REER began to increase. Nevertheless, Lithuania continued substantially improving its export performance since 2010. Following a mild upward trend, the ULC-deflated REER appreciated by about 6% and HICP-deflated by about 3% between mid-2012 and April 2014, while NEER appreciated by about 4%.

([48]) http://ec.europa.eu/europe2020/pdf/2014/amr2014_en.pdf

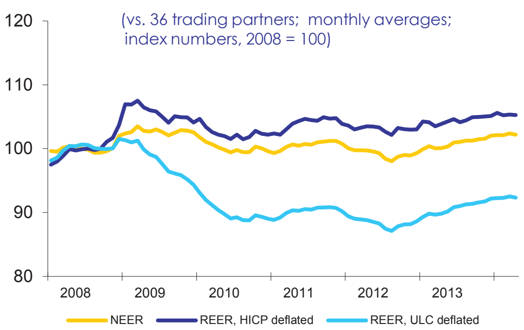
Table 5.4:
Lithuania - Balance of payments **(percentage of GDP)**

	2008	2009	2010	2011	2012	2013
Current account	-12.9	3.7	0.1	-3.7	-0.2	1.5
of which: Balance of trade in goods	-13.0	-3.3	-4.8	-5.8	-2.8	-3.5
Balance of trade in services	1.2	1.6	2.9	3.2	3.7	4.6
Income balance	-3.4	1.1	-2.8	-4.6	-4.1	-3.9
Balance of current transfers	2.2	4.4	4.8	3.5	3.0	4.2
Capital account	1.8	3.4	2.7	2.5	2.2	2.2
External balance [1]	-11.1	7.1	2.7	-1.2	2.0	3.7
Financial account	11.1	-7.2	-2.7	1.3	-1.9	-3.7
of which: Net FDI	3.4	-0.6	2.2	3.2	0.7	0.9
Net portfolio inflows	-0.5	3.3	5.8	3.9	2.8	-4.1
Net other inflows [2]	5.8	-10.2	-9.4	-1.5	-5.1	-1.9
Change in reserves (+ is a decrease)	2.4	0.3	-1.3	-4.4	-0.4	1.3
Financial account without reserves	8.7	-7.5	-1.4	5.7	-1.6	-5.0
Errors and omissions	0.0	0.0	0.0	0.0	-0.1	0.0
Gross capital formation	27.1	11.4	17.3	21.3	18.3	18.5
Gross saving	14.0	13.5	16.9	17.4	17.2	19.2
External debt	71.0	83.9	82.9	77.4	75.4	67.1
International investment position	-51.6	-57.3	-55.2	-52.3	-52.8	-45.7

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

Sources: Eurostat, Commission services, Bank of Lithuania.

Graph 5.10: **Lithuania - Effective exchange rates**



Source: Commission services.

Mirroring the improvement in the external balance, the financial account moved closer to balance by 2011. Lithuania has attracted positive net inflows of foreign direct investment since 2010, albeit at an uneven pace in 2011-2013, while also recording substantial net portfolio investment, mainly thanks to successful sovereign external debt issuance. Net outflows of other investment were particular high in 2009 and 2010 when foreign banks started to deleverage and external loan liabilities in the banking sector shrank significantly. Since then net outflows continued at a slower pace in line with deleveraging.

Net FDI inflows recovered after a collapse in 2009 and peaked at 3.2% of GDP in 2011, helped by better financial results in the banking sector. However, net FDI subsided to 0.7% in 2012 and recovered only somewhat in 2013. The net international investment position improved from its lowest level in 2009 (-57.3% of GDP) to -45.7% of GDP by end-2013. Total gross external debt declined to about 67% of GDP at the end of 2013 after peaking at around 84% in 2009.

According to the Commission services' 2014 Spring Forecast, the external surplus is expected to shrink gradually in 2014 and 2015 as the positive impact of stronger external demand is foreseen to be offset by a parallel increase in the impact of domestic demand growth.

5.6.2. Market integration

The Lithuanian economy is well integrated into the euro area through trade and investment linkages. Trade openness of Lithuania remains very high, almost 84% in 2012, and is substantially above the euro-area average. The economic crisis affected Lithuania's trade openness negatively, but the ratio quickly recovered in recent years.

Table 5.5:
Lithuania - Product market integration

	2007	2008	2009	2010	2011	2012
Trade openness [1] (%)	60.5	65.6	55.1	68.7	78.6	83.5
Intra-EA trade in goods GDP ratio [2] (%)	23.8	22.4	19.4	23.6	28.3	28.9
Intra-EA trade in services GDP ratio [3] (%)	n.a.	2.7	2.8	3.0	3.1	3.6
Extra-EA trade in goods GDP ratio [4] (%)	29.0	35.0	27.4	36.5	41.1	43.9
Export in high technology [5] (%)	7.3	6.5	5.8	6.0	5.6	5.8
High-tech trade balance [6] (%)	-1.0	0.0	-0.1	0.2	0.1	0.3
Total FDI inflows GDP ratio [7] (%)	5.1	4.1	0.0	2.2	3.4	1.7
Intra-EA FDI inflows GDP ratio [8] (%)	1.7	1.9	-0.2	1.2	-1.2	1.2
FDI intensity [9]	3.3	2.4	0.2	1.1	1.7	1.3
Internal Market Directives [10] (%)	0.6	0.6	0.2	0.5	0.9	0.6
Time to start up a new company [11]	26.0	26.0	26.0	22.0	22.0	19.5
Real house price index [12]	166.0	163.1	109.4	100.0	102.4	99.1
Residential investment [13] (%)	2.8	3.4	3.3	1.8	1.8	1.8
Building permits index [14]	231.4	191.4	90.8	100.2	87.8	121.1

1) (Imports + Exports of goods and services / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics, Balance of Payments).
2) (Intra-EA-18 Imports + Exports of goods / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).
3) Intra-EA-17 trade in services (average credit and debit in % of GDP at current prices) (Balance of Payments).
4) (Extra-EA-18 Imports + Exports of goods / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).
5) Taken directly from Eurostat's databases: Exports of high technology products as a share of total exports.
6) (Exports - imports in high tech) / GDP at current prices x 100, since 2007 the data based upon SITC Rev. 4 (earlier SITC Rev. 3).
7) Total FDI inflows (in % of GDP at current prices).
8) Intra-EA-17 FDI inflows (in % of GDP at current prices).
9) FDI intensity (average intra-EU-27 inflows and outflows in % of GDP at current prices).
10) Percentage of internal market directives not yet communicated as having been transposed, in relation to the total number.
11) Time to start a new company (in days), Doing Business World Bank.
12) Deflated house price index (2010=100), Eurostat.
13) Gross capital formation in residential buildings (in % of GDP), Eurostat.
14) Number of new residential building permits (2010=100), Eurostat.

Sources: Eurostat, Sectoral Performance Indicators Database (SPI), Commission services.

Around 40% of Lithuania's trade was with the euro area countries in 2012 ([49]). Lithuania's main euro area trading partners were Germany, Latvia, Estonia and the Netherlands, while Russia, Poland, the United Kingdom and Belarus remained important non-euro-area export markets.

Low-to-medium-technology goods continue to predominate in Lithuania's exported goods. While before the economic crisis a gradual shift to exports of high-technology products could be observed, accounting for 7.3% of total exports in 2007, this share declined to a low of 5.8% in 2012. The highest share in total exports of goods was that of mineral products with 24%, while the share of machinery and electrical equipment was only 11%, significantly below the levels recorded in other non-euro area Member States.

The stock of inward FDI amounted to some 36% of GDP in 2012, up from 34% in 2009, with the main FDI inflows originating in Sweden, Poland, Germany and the Netherlands. Despite a relatively favourable business environment and moderate taxes, Lithuania has been struggling to attract higher FDI inflows. Following the crisis, total FDI inflows in percent of GDP fell in 2009 and have been recovering in recent years.

House prices declined sharply between 2007 and 2009 (by 34% in real terms) and remained broadly stable thereafter. The real house price index decreased by 3.2 % in 2012. Investment in dwellings followed the same evolution. After a 47% fall between the 2008 peak and 2010, residential investment has remained unchanged at 1.8% of GDP for the last three years. The share of construction in total value added almost halved between 2008 and 2010 and has remained at just over 6% since then. Consistent with the above developments, employment in construction experienced a sharp fall in 2009 and 2010 (of 26%

([49]) Latvia – an important trading partner of Lithuania - joined the euro area in 2014, which led to a further increase in this ratio.

and 29%, respectively). The situation improved in 2012, with an increase in employment of 5% (construction making up 7% of total employment). Construction activities are expected to revitalize, as building permits picked up in 2012 after a sharp fall of 61% between 2007 and 2009. The number of building licenses granted increased by 38% in 2012 and by 19% in 2013.

Concerning the business environment, Lithuania performs broadly in line with the average of euro area Member States in international rankings ([50]). The government has taken actions to cut administrative burden, and some progress was made on the time necessary to start a new company. According to the November 2013 Internal Market Scoreboard, Lithuania had a transposition deficit (0.6%), close to the 0.5 % target as proposed by the European Commission in the Single Market Act (2011).

The Lithuanian labour market has proved to be highly flexible as demonstrated by nominal wage adjustment during the economic cycle. While the decentralised wage-setting system supported a rapid wage increase during the boom years, it also allowed a considerable downward wage adjustment during the subsequent recession in 2009 and 2010. Since then, wages have moved broadly in line with productivity.

Since joining the EU, Lithuania has experienced a net outflow of workers demonstrating a high degree of mobility within the EU. Emigration has tended to flow to EU countries with strong cyclical demand for additional labour. As the post-crisis recovery of Lithuania's economy has so far been stronger than in most EU Member States, net emigration has come down significantly, reflecting both decreasing gross emigration and a rise of re-immigration.

5.6.3. Financial market integration

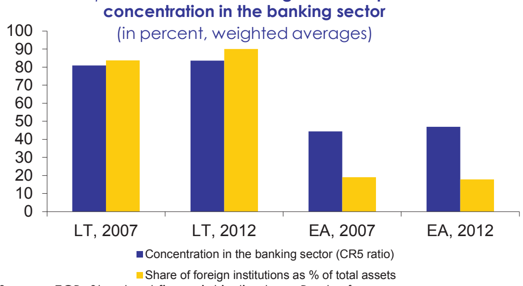
Lithuania's financial sector is highly integrated into the EU financial system. Foreign ownership amounted to about 90% of total assets at the end of 2012, held mainly by a few large subsidiaries and branches of Nordic banking groups. It increased compared to 2007, primarily due to the liquidation of the domestic Snoras bank in December 2011.

([50]) Lithuania ranks 17th (out of 189 economies) on the World Bank's 2014 Ease of Doing Business Index and 48th (out of 148 economies) on the World Economic Forum's 2013-2014 Global Competitiveness Index.

The banking sector is highly concentrated, with the five largest institutions accounting for almost 84% of total assets.

The size of Lithuania's financial sector is small compared to the euro-area average, with banks constituting the largest segment. Deleveraging triggered by the financial crisis has reduced the loan portfolio: credit to corporations fell from 31% of GDP in 2007 to 22% of GDP in 2013 while credit to households declined from 25% to 21% of GDP, respectively. Consolidated private sector debt fell from 85% of GDP in 2009 to 63% of GDP in 2012 and is significantly below the euro-area average. Facilitated by the litas' peg to the euro, euro-denominated lending is prevalent for both households and corporations. The share of foreign-currency loans amounts to 74% in the corporate, 76% in the residential and 41% in the consumer portfolio ([51]). The gradual reduction of foreign-currency loans after the crisis has not fundamentally altered the exchange rate risk of the private sector.

Graph 5.11: **Lithuania - Foreign ownership and concentration in the banking sector**
(in percent, weighted averages)

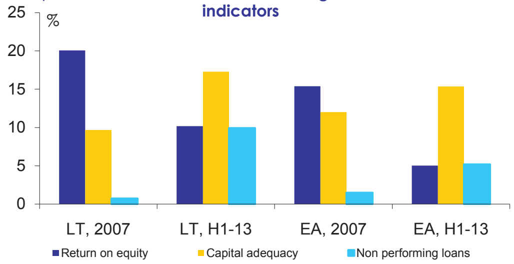


Source: ECB, Structural financial indicators , Bank of Lithuania.

The capital adequacy ratio (CAR) of the banking sector improved substantially from around 10% in 2007 to 17% in 2013. At the same time, Lithuania made significant progress in resolving the stock of non-performing loans that peaked above 20% following the 2009 recession. The NPL ratio has decreased to 10% in mid-2013, helped by prudent bank provisioning policies and some adjustments to the regulatory framework. Apart from write-offs of defaulted loans, the improvement in asset quality resulted also from a return to debt servicing by borrowers as their financial standing improved. After losses in 2009 and 2010, Lithuanian banks have posted annual profits since 2011. Although return on equity has not come back to its pre-crisis level, at 10% in 2013 it was above the euro-area average.

([51]) Bank of Lithuania supervisory data, end 2013.

Graph 5.12: **Lithuania - selected banking sector soundness indicators**



Note: For 2007 EU-27 non performing loans are a proxy for EA.
For 2007, EA RoE and CAR averages are unweighted.
Source: ECB, EC calculations.

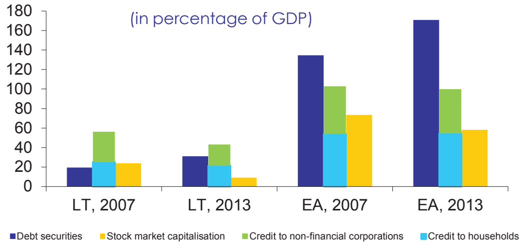
Following the financial crisis, banks in Lithuania have become increasingly self-funded, accumulating local deposits and decreasing liabilities towards their foreign parent banks. This is a common trend for many banking markets in Central, Eastern and South-Eastern Europe, including those in the euro area. The change in funding structure is illustrated by the fall in the loan-to-deposit ratio from 210% in 2009 to 120% in 2013. The share of non-resident deposits in banking sector liabilities is low (below 3%) and these deposits are well-diversified in terms of country of origin ([52]).

Non-bank financial intermediaries play a relatively minor role in Lithuania's financial system. In 2012, total assets of eleven insurance companies amounted to less than 3% of GDP while ten leasing companies held assets worth about 5% of GDP. Assets of pension funds, in particular the 2nd pillar funds, were growing continuously in recent years, reaching 4.3% of GDP. Recent amendments of the legal framework may facilitate development of investment funds, whose assets correspond to 1.6% of GDP. Credit unions have expanded, featuring double digit annual growth rates even during the crisis, but despite their number ([53]) they have remained relatively small players in the market with assets corresponding to about 2% of GDP ([54]).

The Vilnius Stock Exchange (VSE) belongs to the NASDAQ OMX group and uses a single trading platform together with other exchanges in the Baltic-Nordic region. Stock market capitalisation fell from 24% of GDP in 2007 to 9% of GDP in 2013, reflecting both limited stock supply by domestic companies and feeble investor demand. Overcoming these constraints is challenging in a relatively small capital market. Due to an increasing level of central government debt, the outstanding stock of debt securities reached 31% of GDP in 2013.

Graph 5.13: **Lithuania - Recent development of the financial system relative to the euro area**

(in percentage of GDP)



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

Since 2012, the Bank of Lithuania (BoL) is the single authority exercising micro-prudential supervision. It has been proactive in identifying and addressing risks in the financial sector. After the liquidation of Snoras bank, launched at the end of 2011, in January 2013 the BoL revoked licences of two credit unions in the framework of tightening oversight of this market segment. In February 2013, it resolved ailing Ukio bank on concerns about asset quality and risk management practices. Ukio bank's good assets were transferred to another domestic bank, Siauliu bank, supported by an equity participation of the EBRD. The BoL interventions contributed to protecting financial stability in the long term while preserving depositor confidence in the short term. According to a draft law proposed in 2013, the Bank of Lithuania will also assume responsibility for development and implementation of macro-prudential policy. Lithuania has a good track record in implementing EU financial services directives.

5.7. SUSTAINABILITY OF CONVERGENCE

This concluding section draws together elements that are key for gauging the sustainability of Lithuania’s convergence vis-à-vis the euro area. The analysis reviews sustainability from a number of angles:

First, the sustainability dimension is inherent in the individual convergence criteria themselves. This holds most explicitly for the price stability criterion, which includes the requirement of a “sustainable price performance”. The fiscal

([52]) Bank of Lithuania (2013) Financial Stability Review 2013
([53]) In 2012, there were 77 credit unions with assets corresponding to 1.8% of GDP and one central credit union with assets corresponding to 0.3 GDP.
([54]) Bank of Lithuania (2013) Financial Stability Review 2013

criterion (EDP) also involves a forward-looking aspect, providing a view on the durability of the correction of fiscal imbalances. While the exchange and interest rate criteria are, by construction, backward-looking, they aim at capturing an economy's ability to operate durably under conditions of macroeconomic stability, hence indicating whether the conditions for sustainable convergence following euro adoption are in place.

Second, the assessment of additional factors (balance of payments, product and financial market integration) required by the Treaty broadens the view on sustainability of convergence and allows for a more complete picture, complementing the quantitative criteria. In particular, a sound external competitiveness position, effectively functioning markets for goods and services and a robust financial system are key ingredients to ensure that the convergence process remains smooth and sustainable.

Third, the convergence assessment should be informed by the results and findings of enhanced policy co-ordination and surveillance procedures (MIP, fiscal governance). The aim of these new governance instruments is not to add to the existing requirements for euro adoption, but to make full use of the more comprehensive analysis undertaken under the new surveillance tools in assessing sustainability of convergence. While individual elements drawn from the new governance framework (e.g. related to AMR scoreboard indicators) are included in the relevant chapters on convergence above, this section uses the new framework to provide a more integrated view of the sustainability dimension.

Any assessment of the sustainability of convergence has limits and must be based on a judgement of the likely future evolution of the economy. In particular, as experience has shown, the sustainability and robustness of the convergence process after euro adoption is to a significant extent endogenous, i.e. it depends on a Member State's domestic policy orientations after it has joined the euro area. Therefore, while the assessment of sustainability is an essential element in determining a Member State's readiness to adopt the euro based on initial conditions and existing policy frameworks, the outcome of such a sustainability assessment must ultimately be conditional and can only be validated by the adoption of appropriate policies over time. In this respect, the on-going strengthening of governance mechanisms in EMU will have a major part to play in ensuring that such policies are implemented by the Member State after euro adoption.

The analysis below looks at sustainability from five different perspectives: price stability; fiscal performance and governance; macroeconomic imbalances; competitiveness and market functioning; and financial stability.

Price stability

Lithuania's present inflation rate is below the reference value, and while the inflation rate is projected to rise from the current levels, it is expected to remain moderate over the forecast horizon. Going beyond the headline view, a sustainable price performance implies that the respect of the reference value reflects underlying fundamentals rather than temporary factors. The analysis of underlying fundamentals (e.g. cyclical conditions and policy stance, wage and productivity developments, imported inflation, administered prices – see section 2.2) and the fact that the reference value has been met by a comfortable margin support a positive assessment on the fulfilment of the price stability criterion.

In Lithuania, the level of final consumption prices of private households stood at around 63% of the euro-area average in 2012. This suggests a potential for further price level convergence in the long term, as income levels (around 67% of the euro-area average in PPS in 2012) rise towards the euro-area average. To the extent that this is an equilibrium phenomenon, it does not imply a loss of price and cost competitiveness, but the process needs to be managed carefully so as to detect and counteract the emergence of excessive price pressures at an early stage.

Longer-term inflation prospects will hinge in particular on wages growing in line with productivity. As Lithuania is still a catching-up economy, wages are expected to grow at a faster rate than in most advanced euro area members. However, risks to price stability from catching-up related price adjustment are limited by the recently demonstrated flexibility of the labour market and wage-setting mechanisms which should ensure that labour costs are aligned with productivity. They are also contained by the country's significant progress in implementing the EU services directive and low market entry costs, which keep competitive pressures high, as witnessed by the recent new entries in the retail market. A shortage of well-qualified labour in the medium term could drive up wages relative to productivity. Addressing the remaining bottlenecks will be important in limiting any tightening of the labour market. Diversification of supplies and more competitive markets would also support favourable price developments in the energy sector.

The productivity growth required to ensure a smooth catching-up in the price level will largely depend on improvements in the business environment and progress in attracting new investment. Increased market competition should also support favourable price developments (and there is no evidence that Lithuania would fare worse in this respect than the euro area average). Price developments will also depend on maintaining a prudent fiscal policy stance, including cautious wage setting in the public sector, to keep domestic demand in line with fundamentals and help anchor inflation expectations. Finally, if commodity prices rise again in the medium term, Lithuania would be particularly affected due to the composition of its consumer basket, low energy efficiency and high material input share in production. In this context, efforts to improve the energy efficiency of the economy, in particular for buildings and in the transport sector, should be further prioritised, as also indicated in the annual European Semester exercise.

Fiscal performance and governance

The 2014 Convergence Programme covering the period of 2014-2017 was submitted on 23 April 2014. The budgetary strategy outlined in the programme is to adjust the structural budgetary position towards achieving the medium-term budgetary objective (MTO) in 2015. The MTO itself is set at the level of minus 1% of GDP. In terms of nominal targets, this strategy implies a headline deficit of 1.9% of GDP in 2014, with the deficit declining further to 0.9% in 2015 and the budget turning to a surplus in 2016-2017. The headline budgetary deficit targets for 2014 and 2015 are below the projections in the Commission services' 2014 Spring Forecast, with deficits of 2.1% of GDP in 2014 and 1.6% of GDP in 2015, respectively.

Further details on the assessment of the 2014 Convergence Programme for Lithuania, including the assessment of the long-term budgetary impact of ageing, can be found in the Commission Staff Working Document, which accompanies the Commission Recommendation for a Council Recommendation on the 2014 National Reform Programme of Lithuania and delivering a Council Opinion on the 2014 Convergence Programme of Lithuania.

Lithuania has put in place a number of fiscal governance measures, which should support the longer-term commitment to sound public finances. In March 2012, Lithuania signed the Treaty on Stability, Coordination and Governance in EMU (TSCG) and the respective ratification law was approved by Parliament in September 2012. This implies an additional commitment to conduct stability-oriented and sustainable fiscal policies. This development is important to ensure that Lithuania’s medium-term budgetary framework, which specifies revenues and expenditure of the national budget for three years, is complemented with binding targets and a clear connection between the medium-term targets and the annual budgets. Currently, a draft legislative package including a constitutional law on the sustainability of general government sector finances in accordance with the Fiscal Compact is being discussed by Parliament. These laws should enforce multi-year fiscal discipline in accordance with the requirements of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union. It is anticipated that the National Audit Office would be charged with the functions of an independent Fiscal Council and its legal independence would be strengthened.

The transposition of the TSCG into national law would furthermore support existing legislation, in particular the Law on Fiscal Discipline, adopted in 2007 and applied since 2013. It is based on provisions of the Stability and Growth Pact, links an expenditure ceiling to revenues and sets as an objective a balanced budget in the medium term as well as long-term sustainability. However, it lacks a binding medium-term expenditure framework.

In addition, amendments of the National Budget law to implement Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States targeting a balanced or surplus position over the cycle are coming into full force for the 2014 budget planning and execution process. These amendments increase the government's accountability for the implementation of the multiannual fiscal targets; however, the new law is not yet tested.

Overall, existing legal commitments as well as legal acts currently under preparation to strengthen Lithuania's fiscal framework are important elements to ensure that the commitment to fiscal discipline will be sustained over time. In addition, the fiscal framework will also benefit from continuous efforts to strengthen governance mechanisms in EMU, which should ensure appropriate implementation by the Member State after euro adoption.

Macroeconomic imbalances

The assessment of convergence also draws on the surveillance of macroeconomic imbalances under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.5), embedded in the broader "European Semester" approach to enhance the governance structures in EMU, and integrates the MIP results into the analysis. The Commission published its third Alert Mechanism Report (under the cycle for 2014) in November 2013.

The related scoreboard update shows that Lithuania breaches the indicative threshold in two out of eleven indicators, one in the area of external imbalances (i.e. net international investment position) and one in the area of internal imbalances (i.e. unemployment). Both indicators are moving towards the indicative thresholds. Based on the conclusions of the last three reports, Lithuania was not subject to an in-depth review in the context of the MIP.

The AMR from November 2013 notes that after accumulation of imbalances prior to the crisis in 2009 Lithuania's external competiveness has improved substantially. The process of internal adjustment included wage and employment cuts, fiscal consolidation, deleveraging in the private sector, and growth-enhancing structural reforms.

Competitiveness, labour and product market functioning

Standard indicators of cost competitiveness, such as real effective exchange rates (REER) and relative unit labour costs, are now below the indicative thresholds set under the scoreboard for monitoring external imbalances under the MIP. From 2008 to mid-2012, the REER deflated by unit labour costs depreciated by about 20%, but it started to appreciate slowly since then as wage growth picked up in 2013. The current level of the REER is considered sustainable, as the country has steadily gained market shares over the past years. However, the REER estimates do not include Russia, which is one of the major trade partners of Lithuania. The latest projections suggest that the Lithuania's current account will remain slightly in deficit in 2014-2015 while the overall external balance (current and capital accounts) will be slightly positive for the same period.

The Lithuanian labour market demonstrated a high degree of flexibility during the crisis. Job seekers also showed high mobility within the EU as emigration increased substantially in the process of structural adjustment flowing to EU countries with high demand for additional labour. More recently, the robust post-crisis recovery and steady pace of job creation have not only reduced emigration but raised significantly the number of (re-)immigrants in Lithuania.

Underpinned by a decentralised wage-setting system, considerable wage adjustment took place in Lithuania over 2009 and 2010 and wages moved broadly in line with productivity afterwards. In 2014-2015, wages are projected by the Commission services' 2014 Spring Forecast to remain consistent with productivity. Vacancy rates remain among the lowest in the EU, indicating that at the aggregate level labour supply is adequate. Nevertheless, regional differences and skills mismatches on specific labour market segments keep structural unemployment relatively high. The latest statistics show that youth unemployment, though still high, has moved slightly below the EU average. Long-term unemployment declines in line with total unemployment rate, while still remaining a major challenge. All these structural deficiencies on the labour market amount to a significant loss in potential output and pose risks of excessive wage adjustments; they need to be properly addressed by active labour market policies and education reforms, as stipulated in the Commission and Council country-specific recommendations.

Lithuania has achieved significant progress in liberalising its markets and integrating its trade of goods and services within the Single Market. Much of the structural adjustment related to this process has been already completed. However, challenges still remain and are being addressed in the context of the country-specific recommendations issued by the Commission and the Council. The recommendations emphasise the importance of enhancing energy efficiency and energy interconnections with other EU Member States and furthering a reform of state-owned enterprises.

The process of further structural adjustment needs to be supported by flexible resource allocation and well-functioning markets. Moreover, some social policy indicators are still significantly below the euro area average, which poses additional risks to the full completion of the convergence process. However, on balance, the size of the economic restructuring and convergence progress in the past several years suggest that the country's institutional capacity and market maturity are already sufficient to address remaining challenges.

On balance, there is sufficient ground for a positive assessment of Lithuania's competitiveness prospects going forward. The relative flexibility of the labour market and the advanced integration and liberalisation of product markets create favourable conditions for the economy, while remaining weaknesses should be addressed to further reduce the risk of imbalances.

Financial stability

The integration of the domestic financial sector into the EU financial system is substantial, mainly thanks to a high level of foreign ownership of the banking system. The relative size of Lithuania's financial system is small compared to the euro area average, not least due to the post-crisis private sector deleveraging process, which is just coming to an end. The foreign-owned segment of the financial sector proved resilient to the economic and financial crisis, benefitting from substantial support from parent banks, while two domestic banks and several domestic credit unions were closed in an orderly fashion. Financial supervision has been tightened in line with international supervisory regulations; prudential indicators of the banking system are met with a significant margin.

Looking ahead, it is essential to ensure that credit is used to finance sound and productive investments by enterprises, including SMEs. The prospects of a re-emerging lending boom are reduced as Lithuania's financial supervision has responded to the experience of the past crisis and tightened banking sector regulation, while closing overexposed domestic credit institutions (see section 5.6.3). Nevertheless, in view of the expected price level convergence, real interest rates may *ceteris paribus* be lower for Lithuania than for the euro area average, which needs to be counteracted both by a prudent macro stance and appropriate supervisory practices. An appropriate and timely use of macro-prudential policies will also be important in limiting any undesirable consequences related to excessive credit growth.

The long-term outlook for financial stability in Lithuania is favourable, assuming that the prudent business model of the banks and the proactive attitude of the supervisor are maintained. Furthermore, the assumption of responsibility for macro-prudential policy by the Bank of Lithuania should also be a supportive factor. The close cooperation with the Swedish, Norwegian and Danish authorities on cross-border supervision and crisis management are expected to continue in the banking union with the ECB as the new supervisor of Lithuania's largest banks after euro adoption by Lithuania.

Conclusion

Overall, a broad-based look at underlying factors suggests that sufficiently strong conditions are in place for Lithuania to be able to maintain a robust and sustainable convergence path in the medium term, thus supporting a positive assessment. However, significant challenges remain, and policy discipline will need to be maintained in a determined manner to fully exploit the benefits of participation in the euro area and minimise risks to the convergence path going forward. The on-going strengthening of governance mechanisms in EMU will be a supportive factor in this respect.

6. HUNGARY

6.1. LEGAL COMPATIBILITY

6.1.1. Introduction

The main rules governing the National Bank of Hungary (Magyar Nemzeti Bank, hereafter: MNB) are laid down in Article 41 of the new Hungarian Fundamental Law ([55]) and Act CXXXIX 2013 on the MNB (hereafter: MNB Act). The MNB Act has been subject to frequent changes including some recasts over recent years. The currently applicable MNB Act took effect on 1 October 2013, providing for the MNB to become responsible for macro-prudential policy and, further to the dissolution of the Hungarian Financial Supervisory Authority, micro-prudential supervision of the Hungarian financial sector. The MNB law was amended last on 13 February 2014 ([56]) with regard to certain supervisory tasks of the MNB and related enforcement rights.

6.1.2. Central Bank independence

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

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

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

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

6.1.3. Prohibition of monetary financing and privileged access

Pursuant to Section 36 of the MNB Act and subject to the prohibition of monetary financing set out under Section 146 of the MNB Act, the MNB can provide an emergency loan to credit institutions in the event of any circumstance arising in which the operation of a credit institution jeopardizes the stability of the financial system. In order to comply with the prohibition on monetary

([55]) The Fundamental Law came into effect on 1 January 2012 has been amended five times since.
([56]) Law XVI of 2014 published on 24 February 2014

financing of Article 123 of the TFEU, it should be clearly specified that the loan is granted against adequate collateral to ensure that the MNB would not suffer any loss in case of debtor's default.

Pursuant to Section 37, the MNB may grant loans to the National Deposit Insurance Fund in emergency cases, subject to prohibition of monetary financing under Section 146 of the Act. Though the Act adequately reflects conditions for central bank financing provided to a deposit guarantee scheme a specific requirement should be included to ensure that the loans granted to the National Deposit Insurance Fund are provided against adequate collateral to secure the repayment of the loan. Therefore, Section 37 is incompatible with the prohibition on monetary financing as laid down in Article 123 of the TFEU.

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

6.1.4. Integration in the ESCB

Objectives

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

Tasks

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

- definition of monetary policy and the monetary functions, operations and instruments of the ESCB (Sections 1 (2) 4, 16 – 20, 159 and 171 of the MNB Act);
- conduct of foreign exchange operations (Sections 1(2), 4(3), (4) and (12), 9 and 159(2) of the MNB Act) and the definition of foreign exchange policy (Sections 1(2), 4(4) and (12), 22 and 147 of the MNB Act);
- competences of the ECB and of the Council for banknotes and coins (Article K of the Fundamental Law and Sections 1(2), 4(2) and (12), 9, 23, 26 and 171(1) of the MNB Act);

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

- non-recognition of the role of the ECB in the functioning of the payment systems (Sections 1(2), 4(5) and (12), 9 and 159(2) of the MNB Act);
- non-recognition of the role of the ECB and of the EU in the collection of statistics (Section 1(2), 30(1) and 171(1) of the MNB Act);

- non-recognition of the role of the ECB in the field of international cooperation (Sections 6(1), 15 and 144 of the MNB Act));
- absence of an obligation to comply with the Eurosystem's regime for the financial reporting of NCB operations (Article 12(4)(b) and Law C of 2000/95 (IX.21.) in conjunction with Government Decree 221/2000 (XII.19.));
- non-recognition of the role of the ECB and the Council in the appointment of external auditors (Sections 6 (1) (c), 15 and 144 of the MNB Act).

6.1.5. Assessment of compatibility

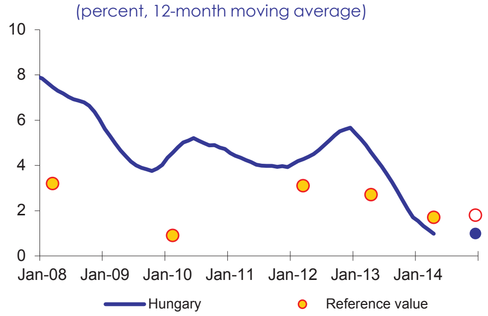
As regards central bank independence of the MNB, the prohibition on monetary financing and the integration of the MNB into the ESCB at the time of euro adoption, existing Hungarian legislation is not fully compatible with the Treaties and the Statute of the ESCB and the ECB pursuant to Article 131 of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

6.2. PRICE STABILITY

6.2.1. Respect of the reference value

The 12-month average inflation rate, which is used for the convergence evaluation, has been above the reference value at the time of the last convergence assessment of Hungary in 2012. Average annual inflation increased to 5.7% by December 2012 and has been decreasing ever since then. In April 2014, the reference value was 1.7%, calculated as the average of the 12-month average inflation rates in Latvia, Portugal and Ireland plus 1.5 percentage points.

Graph 6.1: **Hungary - Inflation criterion since 2008**
(percent, 12-month moving average)



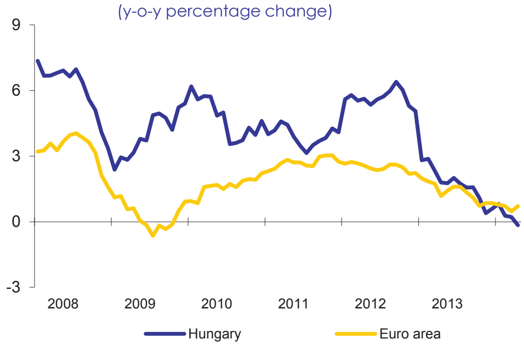
Note: The dots in December 2014 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2014 Forecast.

The average inflation rate in Hungary during the 12 months to April 2014 was 1.0%, i.e. below the reference value. It is projected to remain below the reference value in the months ahead.

6.2.2. Recent inflation developments

Inflation has moved in a quite wide range in Hungary in recent years, mainly reflecting the evolution of energy and food prices, which together represent about 46% of the HICP basket. Administrative measures and taxation also contributed significantly to inflation volatility. HICP inflation increased until September 2012, peaking above 6%, driven up by a bad harvest, a weaker exchange rate and several tax changes. Inflation fell sharply in January 2013, with the fading-out of the effect of earlier indirect tax hikes and the start of a series of utility price reductions. The latter temporarily decreased inflation in 2013 and early 2014, with administered price inflation running well below the headline level. A decline in market energy and food prices also supported disinflation in late 2013, as did weak domestic demand and historically low inflation expectations. On the other hand, excise duty increases and some other government measures (most notably the introduction of the financial transaction duty) had a substantial upward effect. Annual HICP inflation declined to 0.6% by end-2013 and stood at -0.2% in April 2014.

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



Source: Eurostat.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) only partly followed the evolution of HICP inflation. It recorded a large decline (1.3 pp.) in January 2013, when the effect of the 2012 VAT hike dropped out of the index. Then it declined further to below 2% by early 2014. Processed food inflation, although trending down from its peak in 2012, remained elevated in the assessment period, mainly due to

Table 6.1:
Hungary - Components of inflation

	2008	2009	2010	2011	2012	2013	Apr-14	weights in total 2014
					(percentage change)[1]			
HICP	6.0	4.0	4.7	3.9	5.7	1.7	1.0	1000
Non-energy industrial goods	1.3	3.5	1.9	1.3	2.6	0.3	-0.1	213
Energy	12.1	2.1	11.8	9.3	8.6	-6.1	-6.9	170
Unprocessed food	4.5	6.3	5.9	2.8	6.2	6.9	3.3	75
Processed food	10.9	4.4	4.0	6.1	9.0	4.8	3.9	213
Services	5.1	4.5	3.9	2.1	4.1	3.6	3.4	329
HICP excl. energy and unproc. food	5.1	4.1	3.3	3.0	5.0	3.0	2.5	755
HICP at constant taxes	5.9	2.2	2.5	3.7	3.5	1.2	0.7	1000
Administered prices HICP	10.2	7.2	6.7	4.8	5.1	-4.8	-6.0	172

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

Sources: Eurostat, Commission services.

the policy measures affecting tobacco prices. The least volatile components of core inflation (industrial goods prices and services) contributed to disinflation. Industrial goods inflation turned negative in August 2013 and remained so until the end of the assessment period, despite the weakening exchange rate. Services inflation was depressed by the slack in the labour market, while it was lifted by financial services prices, following the introduction (and increase) of the financial transaction duty in 2013. The annual producer price inflation decreased from around 7% in the first half of 2012 to close to -2% in early 2014, due to falling energy prices as well as contained domestic demand.

6.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and cyclical stance

After a short-lived recovery in 2010 and 2011, the Hungarian economy fell into recession again as GDP contracted by 1.7% in 2012, partly on account of a severe drought. Economic activity recovered in 2013 with GDP growth at 1.1%, mainly driven by an improved performance of the agriculture and construction sectors, while industry also contributed positively to economic growth. Investment turned positive, mainly as a result of public investment, but gross fixed capital formation of the corporate sector also started to accelerate on the back of a speeding-up in the absorption of EU funds and the central bank's extended Funding for Growth Scheme (FGS, providing subsidized lending to SMEs). A sharp decline in inflation contributed to increasing households' real disposable income, but the still high unemployment and ongoing deleveraging continued to drag on consumer spending. As a result, the output gap remained wider than -3% of potential GDP in both 2012 and 2013. Based on the Commission services' 2014 Spring Forecast, real GDP growth is expected to reach 2.3% in 2014 and 2.1% in 2015, driven by a further pick-up in domestic demand, while the contribution of net exports is projected to be neutral. Although gradually closing, the output gap is expected to remain negative throughout the forecast horizon.

The fiscal policy stance, as measured by changes in the structural balance, was substantially tightened in 2012 (by over 3 percentage points of GDP), mostly on account of revenue measures (reflecting around 2/3 of the improvement). While it remained broadly neutral in 2013, it is projected by the Commission services' 2014 Spring Forecast to be loosening gradually over the forecast horizon by 1.5 percentage points, due to increasing expenditures.

Monetary policy, conducted within an inflation targeting framework ([57]), has been loosened significantly since 2012, in view of weak underlying inflation pressures and a negative output gap. Starting from a relatively tight level in August 2012, the base rate was reduced in 21 consecutive steps by 4.5 percentage points till April 2014 to 2.5%. The MNB reduced the pace of the cuts from 25 to 20 bps in mid-2013 and later to 15 and then to 10 bps. In addition to rate cuts, the MNB further loosened the monetary policy stance through the FGS, which was introduced as a new

([57]) Following a decision in August 2005, the MNB pursues a continuous medium-term inflation target of 3% for the period starting in 2007 with a permissible ex post fluctuation band of +/- 1 percentage point.

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

	2008	2009	2010	2011	2012	2013 1)	2014 2)	2015 2)
HICP inflation								
Hungary	6.0	4.0	4.7	3.9	5.7	1.7	1.0	2.8
Euro area	3.3	0.3	1.6	2.7	2.5	1.3	0.8	1.2
Private consumption deflator								
Hungary	5.3	3.9	3.9	4.2	6.1	1.7	1.0	2.8
Euro area	2.7	-0.4	1.6	2.4	2.1	1.3	0.9	1.3
Nominal compensation per employee								
Hungary	7.2	-1.7	-0.5	3.6	0.8	4.7	3.6	3.4
Euro area	3.5	1.8	2.0	2.2	2.0	1.7	1.6	1.9
Labour productivity								
Hungary	2.7	-4.4	0.2	1.3	-1.7	0.7	1.6	1.5
Euro area	-0.3	-2.4	2.6	1.4	0.2	0.5	0.9	1.0
Nominal unit labour costs								
Hungary	4.4	2.8	-0.7	2.3	2.5	4.0	1.9	1.9
Euro area	3.8	4.3	-0.6	0.7	1.8	1.1	0.7	0.8
Imports of goods deflator								
Hungary	1.7	1.1	1.9	5.1	4.2	-0.6	1.9	0.3
Euro area	4.2	-8.1	5.7	6.6	2.3	-1.9	-1.0	0.8

1) 2013 data (except HICP inflation) are estimates.
2) Commission services' Spring 2014 Forecast.

Source: Eurostat, Commission services.

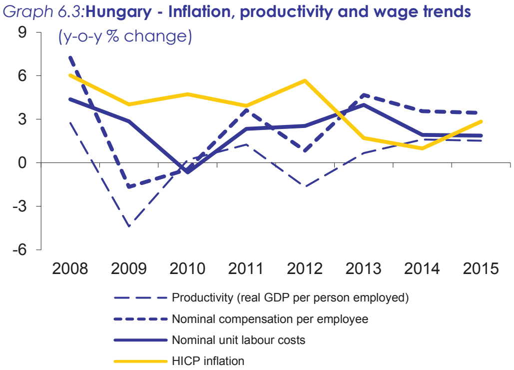
instrument, primarily to foster lending to SMEs ([58]). Nevertheless, general credit conditions remained tight toward both corporates and households in the last two years, reflecting negative net lending flows and contributing to disinflationary effects. The first allocation of the FGS scheme temporarily relieved tight credit supply constraints toward SMEs in Q3 2013, but net lending to corporates was again negative in the following two quarters.

Wages and labour costs

The Hungarian labour market is relatively flexible, with decentralized wage setting and a low coverage of collective agreements. The labour market reacted rather swiftly to the sharp economic downturn in 2008, with compensation per employee declining over 2009 and 2010 reflecting wage cuts in the public sector as well as substantial wage moderation in the private sector. The unemployment rate reached 10.9% in 2011-12 before decreasing to 10.2% in 2013.

Compensation per employee started to increase in 2011 and a further pick-up in wages contributed to a ULC increase of around 4% in 2013, after Hungary experienced ULC growth of around 2.5% in 2011-2012. Labour productivity growth remained rather subdued at below 1% in 2013. ULC growth is forecast to decelerate to around 2% in 2014 and 2015. This pattern primarily reflects the projected pace of nominal wage growth of around 3.5%, while productivity growth is expected to pick-up slightly to around 1.5% in 2014 and 2015.

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



Source: Eurostat, Commission services' Spring 2014 Forecast.

External factors

Given the high degree of openness of the Hungarian economy, developments in import prices play an important role in domestic price formation. The impact of lower energy and

([58]) For more on the FGS, see e.g. the 4th PPS Review Note: http://ec.europa.eu/economy_finance/assistance_eu_ms/documents/hu_efc_note_4th_pps_mission_en.pdf agricultural commodity prices on headline inflation is accentuated by their relatively high weight in the HICP basket. Growth of import prices (measured by the imports of goods deflator), had an inflationary impact in 2012, while the disinflationary impact started to dominate in 2013.

Import price dynamics have been significantly influenced by exchange rate fluctuations. After having depreciated by around 4.5% on average in 2012 relative to 2011, the forint's nominal effective exchange rate (measured against a group of 36 trading partners) weakened further around 1% in 2013. Looking ahead, the growth of import prices is expected to remain supportive of a low-inflation environment in Hungary, pending no further weakening of the exchange rate.

Administered prices and taxes

The share of administered prices ([59]) in the HICP basket is relatively high in Hungary at around 17%, compared to the euro area average (13%). From 2004 to 2011, the growth rate of administered prices was significantly higher than headline inflation, reaching on average almost 10%. After an increase of 5.1% in 2012, administered prices declined by 4.8% in 2013, chiefly on account of three waves of cuts in regulated energy and other utility prices introduced as of January, July and November. These measures had an overall effect on the inflation rate of over -1 pp. for 2013 and entail − as a full-year effect − an additional reduction in the inflation rate of around 1 pp. for 2014. A further round of utility price cuts is due to be introduced as of April, September and October 2014, which could decrease the annual HICP by an additional 0.2 pp. in 2014 and 2015. Overall, administered prices lowered headline inflation by about 0.1 pp. in 2012 and 1.3 percentage points in 2013.

Changes in taxation related to fiscal adjustment measures have also had a substantial impact on inflation. In January 2012, the general VAT rate was increased from 25% to 27%, which together with several rounds of excise duty hikes increased annual HICP inflation by 2.2 pp., as measured by the constant-tax index (HICP-CT). The contribution of indirect tax changes to HICP inflation dropped to 0.5 pp. in 2013 and it mostly reflected excise duty hikes on alcohol, tobacco and liquid petroleum gas. Tobacco products contributed overall by about 0.7 pp. to headline inflation in 2013, as they were also affected by an increase in the guaranteed profit margin of retailers. Although not accounted as an indirect tax measure in HICP, the introduction of the financial transaction duty on banking transactions triggered a significant rise in financial services prices, which contributed to inflation by around 0.5 pp. in 2013.

Medium-term prospects

The historically low inflation figures over the past year have been driven to a large extent by the influence of one-off or volatile factors (regulated utility price cuts and declining agricultural and market energy prices). Core inflation stood at a moderate level, below 2% in early 2014, reflecting the effect of a still negative output gap. The latter is expected to close gradually, but to remain negative throughout the forecast horizon. Therefore once the effects of one-off factors fade away, inflation is expected to converge towards the central bank's 3% target. Accordingly, the Commission services' 2014 Spring Forecast projects HICP inflation to average 1.0% in 2014 and 2.8% in 2015.

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

The level of consumer prices in Hungary stood at about 59% of the euro area average in 2012. As in other new Member States, the remaining gap vis-à-vis the euro area is larger for services than goods. This suggests that there is scope for further price level convergence in the long term, as income levels (around 62% of the euro area average in PPS in 2012) rise towards the euro area average.

Medium-term inflation prospects will depend strongly on wage and productivity developments, notably on efforts to avoid excessive wage increases in the non-tradable sector and on the

([59]) According to the Eurostat definition, administered prices in Hungary *inter alia* include water supply, refuse and sewerage collection, electricity, gas, heat energy, pharmaceutical products and certain categories of passenger transport. For details, see http://epp.eurostat.ec.europa.eu/portal/page/portal/hicp/documents_meth/HICP-AP/HICP_AP_classification_2011_2014_02.pdf

Table 6.3:
Hungary - Budgetary developments and projections **(as % of GDP unless indicated otherwise)**

Outturn and forecast [1]	2008	2009	2010	2011	2012	2013	2014	2015
General government balance	-3.7	-4.6	-4.3	4.3	-2.1	-2.2	-2.9	-2.8
- Total revenues	45.5	46.9	45.6	54.3	46.6	47.6	47.3	46.5
- Total expenditure	49.3	51.5	49.9	50.0	48.6	49.8	50.2	49.3
of which:								
- Interest expenditure	4.2	4.7	4.1	4.1	4.3	4.2	3.8	3.8
p.m.: Tax burden	40.4	40.2	38.2	37.4	39.3	39.4	39.2	38.6
Primary balance	0.5	0.1	-0.2	8.5	2.2	2.1	0.9	1.0
Cyclically-adjusted balance	-4.9	-2.4	-2.5	5.5	-0.1	-0.6	-1.9	-2.3
One-off and temporary measures	-0.4	-0.1	0.7	9.5	0.7	0.2	0.3	0.0
Structural balance [2]	-4.5	-2.3	-3.2	-4.0	-0.8	-0.8	-2.2	-2.3
Government gross debt	73.0	79.8	82.2	82.1	79.8	79.2	80.3	79.5
p.m: Real GDP growth (%)	0.9	-6.8	1.1	1.6	-1.7	1.1	2.3	2.1
p.m: Output gap	2.5	-4.9	-3.9	-2.5	-4.2	-3.4	-2.1	-1.0

Convergence programme	2014	2015	2016	2017
General government balance	-2.9	-2.8	-2.5	-1.9
Structural balance [2] [3]	-2.2	-2.2	-2.3	-2.4
Government gross debt	79.1	78.9	77.5	74.7
p.m. Real GDP (% change)	2.3	2.5	2.1	3.1

1) Commission services' Spring 2014 Forecast.
2) Cyclically-adjusted balance excluding one-off and other temporary measures.
3) Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures taken from the programme (0.4% of GDP in 2014, deficit-reducing; zero afterwards).
Sources: Commission services, the 2014 Convergence Programme of Hungary.

success with anchoring inflation expectations at the central bank's 3% target.

6.3. PUBLIC FINANCES

6.3.1. Recent fiscal developments

On 21 June 2013, the Council decided to abrogate the decision on the existence of an excessive deficit according to Article 126 (12) TFEU, thereby closing the excessive deficit procedure for Hungary ([60]). The consequences of the financial crisis hit also public finances, leading to a budget deficit of 4.6% of GDP in 2009, albeit a number of important structural steps (e.g. pension reform) in the framework of the EU/IMF financial assistance programme limited the deterioration. Despite a lacklustre recovery in 2010-2011, and a renewed recession in the following year with a GDP decline of 1.7%, the headline general government deficit was brought down to 2% of GDP in 2012, on the back of an over 3 pp. structural improvement. This was achieved against the backdrop of numerous consolidation measures skewed toward the revenue side, which was also reflected in the increase in the tax burden by close to 2 pp. from the previous year (see Table 6.3).

The 2012 budget targeted a deficit of 2.5% of GDP on the basis of a 0.5% growth assumption. However, the constantly deteriorating macroeconomic outlook throughout 2012 implied important revenue shortfalls, while some expenditure overruns also occurred, altogether amounting to 1¾% of GDP. These adverse impacts were more than offset by the following deficit-reducing measures and developments: (i) the full cancellation of the budgeted extraordinary reserves of 1.1% of GDP ([61]), (ii) a better-than-expected local government sector's balance by 0.7% of GDP in the context of the reallocation of responsibilities from local to the central government levels, (iii) within-the-year corrective measures of 0.3% of GDP enacted by the government, and (iv) higher-than-budgeted one-off revenues of 0.2% of GDP related to the further transfer of assets from the

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

([61]) The extraordinary reserves were in-built security buffers with a specific regulation governing their potential release: these could not be spent before September 30, 2012 and the government could have decided on the use only if in the Autumn 2012 fiscal notification the expected EDP deficit for 2012 would not exceed 2.5% of GDP.

private to the public pension pillar. The expenditure-to-GDP ratio temporarily fell from 50% in 2011 to 48.6% in 2012, before returning to around 50% in 2013, partly explained by changes in absorption of EU funds.

The April 2013 Convergence Programme contained a deficit target of 2.7% of GDP for 2013. Last year's outturn was 2.2% of GDP, which implies a stabilisation in the structural balance. Compared to the budgeted figures, revenues turned out to be overall lower by about 0.5% of GDP, even after including the impact of the June 2013 tax-increasing measures of 0.4% of GDP, such as higher financial transaction duties and sectoral taxes on the energy and telecommunication companies, and after substantially higher-than-expected social security contributions. The lower tax revenues partly stem from lower-than-expected inflation, but are also linked to the overestimation of the budgetary impact of selected tax measures (e.g. the introduction of the financial transaction duty). In net terms, expenditure slippages amounted to 0.35% of GDP, which, inter alia, reflected the brought-forward introduction of a new compensation scheme in the education sector and other extra wage-related payments as well as higher-than-budgeted outlays on goods and services. In total, the above-mentioned revenue shortfalls and expenditure overruns amounting altogether to 0.85% of GDP were more than offset by the cancellation of the extraordinary budgetary reserve buffer of 1.3% of GDP.

Gross general government debt decreased from 82.1% of GDP in 2011 to 79.8% in 2012, primarily reflecting the sizeable multi-year fiscal corrective package, but an important appreciation of the forint by some 7% compared to its end-2011 level also contributed to the debt reduction. The debt-to-GDP ratio further declined by around half percent of GDP in 2013, mainly on account of the end-year reduction in the state cash deposits as well as the accelerated utilisation of the transferred pension assets for refinancing debt obligations.

6.3.2. Medium-term prospects

The 2014 budget was adopted by Parliament on 17 December 2013. It targets a deficit of 2.9% of GDP, i.e. a slight upward revision compared to the 2.7% of GDP target laid down in the 2013 Convergence Programme. On the revenue side, the budget contains notably the extension of the family tax allowances (0.15% of GDP) as well as the full-year impact of the distance-based road-toll (0.2% of GDP) introduced from mid-2013. On the expenditure side, it incorporates in particular the planned further increase of wages in the public education sector. These elements are projected to be partly offset by a nominal freeze of public wages in most areas of the public sector, the enhancement of tax administration and the effect of economic recovery. In addition, the implementation of specific investment projects of 0.4% of GDP is legislated to be conditional on the realisation of one-off revenues from the sale of telecommunication licences. Finally, in order to counterbalance potential unforeseen adverse developments, an extraordinary budgetary reserve of over 0.3% of GDP was established (on top of the standard general reserve of close to 0.4% of GDP).

The Commission services' 2014 Spring Forecast projects the current year's deficit to reach 2.9% of GDP, i.e. identical with the official target. The better-than-expected budgetary outturn in 2013 has only a limited base effect. Compared to the budgeted figures, tax revenues are projected to be lower by around 0.3% of GDP due to a lower-than-expected inflation as well as a more cautious assessment of measures aiming to enhance tax administration. The forecast is based on the assumption that the extraordinary reserve buffer (0.3% of GDP) will not be spent. The debt-to-GDP ratio is forecast to increase again to over 80% in 2014, mainly due to the revaluation of the FX component, reflecting the recent HUF depreciation.

The 2014 Convergence Programme was submitted on 30 April. It aims at a nominal deficit trajectory below the Treaty reference value, which would bring down the deficit to 1.9% of GDP by the end of the programme period. It represents an upward shift in the deficit path compared to the 2013 Convergence Programme, e.g. for 2016, the deficit target is currently set at 2.5% of GDP opposed to the target of 1.3% of GDP in last year’s Convergence Programme. This revision is mainly linked to the projected change in the official medium-term macroeconomic scenario, in particular to the reduced nominal GDP growth path. For 2015, the Commission services' 2014 Spring Forecast projects the achievement of the deficit target of 2.8% of GDP. However, while the authorities' forecast presented in the 2014 Convergence Programme calculates with a still remaining extraordinary reserve of around 0.3% of

GDP, the Commission services assumes that no reserve buffer will be left (similarly to 2014). The programme envisages a gradual, but continuous decrease in the government debt-to GDP ratio, from 79.2% in 2013 to 74.7% in 2017.

Further details on the assessment of the 2014 Convergence Programme for Hungary can be found in the Commission Staff Working Document, which accompanies the Commission Recommendation for a Council Recommendation on the 2014 National Reform Programme of Hungary and delivering a Council Opinion on the 2014 Convergence Programme of Hungary.

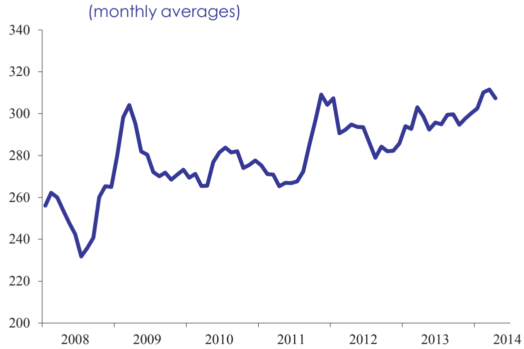
In March 2012, Hungary signed the Treaty on Stability, Coordination and Governance in the EMU. This implies an additional commitment to conduct a stability-oriented and sustainable fiscal policy. The TSCG will apply to Hungary in its entirety upon lifting its derogation from participation in the single currency.

6.4. EXCHANGE RATE STABILITY

The Hungarian forint does not participate in ERM II. Between mid-2001 and early 2008, the MNB operated a mixed framework that combined an inflation target with a unilateral peg of the forint to the euro, with a fluctuation band of +/-15%. The central parity was devalued once in June 2003, from 276.1 to 282.4 HUF/EUR. On 26 February 2008, the exchange rate bands were abolished and a free-floating exchange rate regime was adopted that however allows for foreign exchange interventions by the Central Bank. The move aimed at helping the MNB to better control inflation by removing possible conflicts between maintaining the exchange rate band and the inflation target, thereby more firmly anchoring inflation expectations.

The forint exchange rate against the euro has been volatile in recent years. The forint depreciated after the parliamentary elections in spring 2010, but it gradually recovered to the previous level by April 2011. It then weakened some 15% to the euro in the second half of 2011, in the context of the euro area sovereign debt crisis and the controversial early-FX-mortgage loan repayment scheme. From early 2012 to August 2012 the forint appreciated against the euro, amid a pick-up in global risk appetite and expectations about a potential new international financial assistance package to Hungary. The forint was broadly stable against the euro in the second half of 2012, but fell to 303 HUF/EUR in March 2013, with uncertainties around the Cyprus macroeconomic assistance programme and speculations about monetary policy under the new MNB management. Supported by increased investor interest in EU financial assets and improvements in the macroeconomic situation, the forint strengthened to around 293 HUF/EUR in May and has remained relatively stable in the range of 290-300 HUF/EUR for the rest of 2013, except for some days ahead of the Fed's September meeting and in late December. The forint has remained at levels over 300 HUF/EUR in the first months of 2014, with temporary pressures linked mainly to emerging market developments triggered by expectations of a gradual normalisation of US monetary policy, the continuation of the domestic monetary easing cycle, as well as the political crisis in Ukraine. During the two years before this assessment, the forint depreciated against the euro by about 4%.

Graph 6.4: **Exchange rates - HUF/EUR**
(monthly averages)

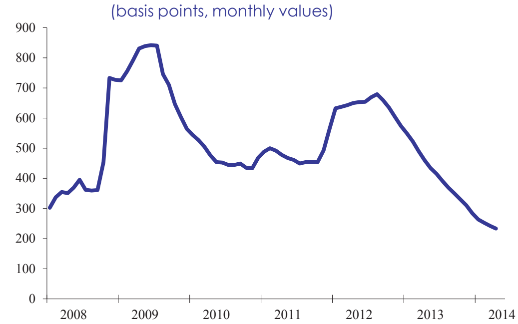


Source: ECB.

International reserves peaked close to EUR 39bn in late 2011 and since early 2012 have hovered broadly around EUR 35bn, at a level two times higher than that of the 2006-2008 pre-crisis period. Fluctuations were mainly due to major sovereign debt management steps and to the uneven payment of EU funds. In particular, after the early repayment of the IMF liabilities from the 2008-2010 programme (Hungary repaid around EUR 5bn to the IMF in 2013), international reserves fell to around EUR 31bn in August and September 2013. However, reserves were replenished to EUR 34.7bn by end-November by large EU-funds transfers and a USD-denominated bond issue by the government. At the end of 2013, international reserves corresponded to about 35% of the full year 2013 GDP.

Short-term interest rate differentials vis-à-vis the euro area increased from October 2011 to summer 2012, reaching around 680 basis points in August 2012, as domestic monetary policy was tightened in the context of deteriorating financial market sentiment, while policy rates were reduced in the euro area. In August 2012, the MNB started a rate-cutting cycle which initially lowered the policy rate by 25 basis points per month. The pace of monthly reductions was scaled back to 20 bps in August 2013, to 15 bps in January 2014 and to 10 bps in March, reducing the key policy rate overall from 7% to 2.5%. As Hungarian interbank market rates closely followed the path of the policy rate, the short-term interest rate differential to the euro area reflected the changes in the base rate. At the cut-off date of this report, the 3-month spread vis-à-vis the euro area reached around 230 basis points.

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



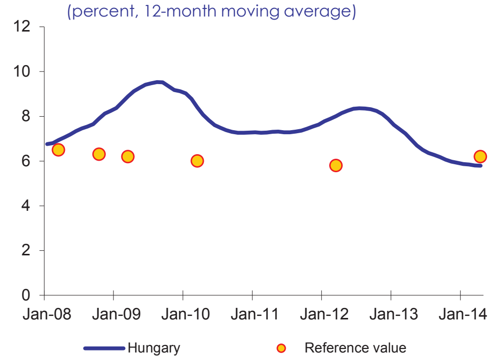
Source: National Bank of Hungary.

6.5. LONG-TERM INTEREST RATES

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

The Hungarian 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion has been above the reference value at the time of the 2012 convergence assessment. It was rising in 2012 till July, when it reached 8.4%, and has been falling since then until the cut-off date. In April 2014, the latest month for which data are available, the reference value, given by the average of long-term interest rates in Latvia, Portugal and Ireland plus 2 percentage points, stood at 6.2%. In that month, the twelve-month moving average of the yield on the Hungarian benchmark bond stood at 5.8%, 0.4 percentage points below the reference value.

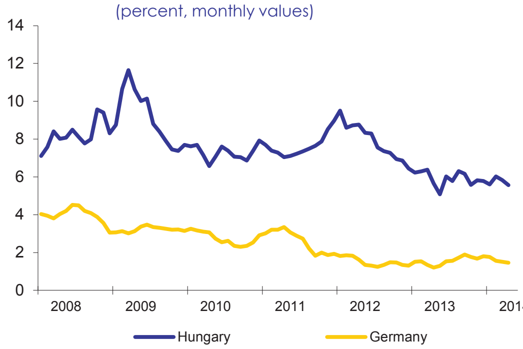
Graph 6.6: **Hungary - Long-term interest rate criterion**
(percent, 12-month moving average)



Source: Commission services.

The monthly long-term interest rate of Hungary has been on a declining trend since early 2012, when it peaked at around 9.5%. With improving financial market confidence and a global search for yields, the long-term rate fell to around 5% by May 2013. Afterwards, with changing expectations about the forthcoming scaling back of the quantitative easing by the Fed, long-term yields temporarily rose during the summer of 2013 and in early 2014, but have fluctuated generally around their April 2013 level. Long-term spreads vis-à-vis the German benchmark bond stood at some 410 basis points in April 2014 ([62]).

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



Source: Eurostat.

6.6. ADDITIONAL FACTORS

The Treaty (Article 140 TFEU) calls for an examination of other factors relevant to economic integration and convergence to be taken into account in the assessment. The assessment of the

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

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

	2008	2009	2010	2011	2012	2013
Current account	-7.3	-0.2	0.2	0.4	0.8	3.0
of which: Balance of trade in goods	-1.1	2.6	2.5	3.2	3.6	4.4
Balance of trade in services	1.4	2.2	3.0	3.2	3.5	3.6
Income balance	-7.1	-5.4	-5.7	-6.5	-6.6	-6.1
Balance of current transfers	-0.5	0.4	0.4	0.6	0.4	1.1
Capital account	1.0	1.2	1.8	2.3	2.7	3.5
External balance [1)]	-6.4	1.0	2.0	2.7	3.5	6.5
Financial account	8.5	-0.6	-1.3	-0.8	-5.0	-7.4
of which: Net FDI	2.6	0.1	0.8	1.1	2.2	0.6
Net portfolio inflows	-2.4	-4.1	-0.2	6.6	1.9	3.2
Net other inflows [2)]	15.7	9.5	1.2	-4.5	-12.6	-10.0
Of which International financial assistance	6.6	8.0	0.0	-2.0	-4.0	-5.2
Change in reserves (+ is a decrease)	-7.3	-6.1	-3.1	-4.0	3.4	-1.2
Financial account without reserves	15.9	5.5	1.9	3.2	-8.5	-6.3
Errors and omissions	-2.2	-0.4	-0.7	-1.9	1.5	1.0
Gross capital formation	23.5	18.0	19.3	19.2	17.5	17.6
Gross saving	16.6	17.9	19.6	19.8	18.6	20.7
External debt	117.0	150.0	143.7	134.7	128.7	118.7
International investment position	-106.0	-117.2	-113.3	-107.4	-103.2	-93.0

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

Sources: Eurostat, Commission services, Magyar Nemzeti Bank.

additional factors – including balance of payments developments, product and financial market integration – gives an important indication of a Member State's ability to integrate into the euro area without difficulties.

In November 2013, the Commission published its third Alert Mechanism Report (AMR 2014) ([63]) under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.5). The AMR 2014 scoreboard showed that Hungary exceeded the indicative threshold in four out of eleven indicators, two in the area of external imbalances (i.e. the net international investment position and export market shares) and two in the area of internal imbalances (i.e. the public sector debt and unemployment rate). In line with the conclusion of the AMR 2014, Hungary was subject to an in-depth review, which found that Hungary continues to experience macroeconomic imbalances, which require monitoring and decisive policy action.

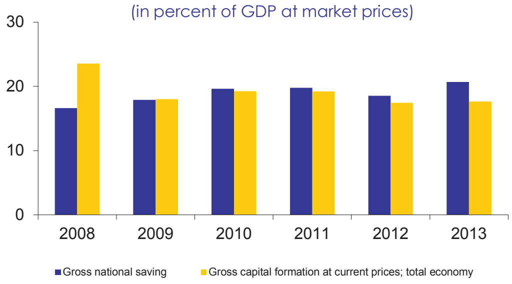
6.6.1. Developments of the balance of payments

The external balance of Hungary (i.e. the combined current and capital account), turned into a surplus in 2009, which has gradually increased each year since then, reaching 6.5% of GDP in 2013. Since 2011, the improvement has reflected higher goods and, to a lesser extent, services trade surpluses. The balance of current transfers has also improved, while the deficit of the income balance decreased in 2013 for the first time since 2009. The growing surplus of the capital account reflects higher absorption of EU funds.

Hungary's savings-investment surplus increased in 2012 and 2013. The savings rate in the economy declined from 2011 to 2012 as the county experienced a recession. Both the household and the enterprise sector's savings rate were lower than in previous years while the government sector's corresponding indicator stagnated. However, the decline in the investment rate exceeded that of savings, resulting in an improved net lending position. In 2013 the household savings rate increased while it declined further in the corporate sector. Overall investment as a share of GDP has declined between 2010 and 2012, but remained stable in 2013, reflecting positive real growth in gross fixed capital formation for the first time since 2008.

([63]) http://ec.europa.eu/europe2020/pdf/2014/amr2014_en.pdf

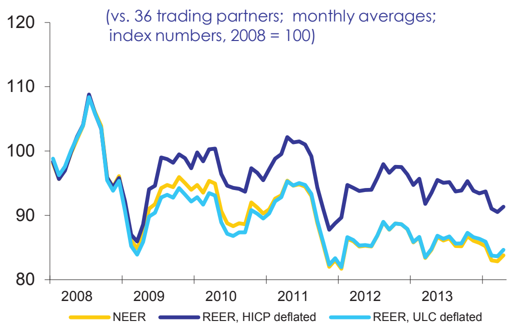
Graph 6.8: **Hungary - Saving and investment**
(in percent of GDP at market prices)



Source: Eurostat, Commission services.

Despite some volatility, price and cost competitiveness indicators of Hungary have been broadly stable in the last years. The nominal depreciation of the forint in the second half of 2011 was reflected in the real-effective exchange rates deflated by HICP or ULC, which were corrected in early 2012 and have remained broadly stable since then. Hungary's export performance improved over recent years, in particular in 2013.

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



Source: Commission services.

Mirroring a continuous external surplus, the financial account has been in deficit since 2009. Net FDI inflows were 2.2% of GDP in 2012 (mostly due to the automobile sector and recapitalisation in the banking sector), but decreased to 0.6% of GDP in 2013. Net portfolio investment inflows reached 1.9% of GDP in 2012 and rose to 3.2% in 2013, while international reserves were quite stable despite large repayments of institutional financial assistance loans. This, coupled with the fast deleveraging of the banking sector resulted in a sharp decline in external debt, by about 6% and 10% of GDP in 2012 and 2013. Consequently, gross external debt to GDP declined significantly from around 135% at end-2011 to about 119% by 2013. The net international investment position improved from its lowest level in 2009 (-117.2% of GDP) to -93% of GDP by 2013.

The balance-of-payments assistance granted to Hungary by the EU and the IMF in autumn 2008 expired in late 2010. Of the EUR 5.5 bn disbursed by the EU, EUR 3.5 bn are still outstanding. EUR 2 bn are due on 7 November 2014, while an amount of EUR 1.5 bn is due on 6 April 2016. The IMF loan had been reimbursed by 2013. Although Hungary asked for precautionary balance of payments assistance from the EU and the IMF in November 2011, as the country's financial market situation has stabilised, this request has been withdrawn in January 2014.

According to the Commission services' Spring Forecast, the external surplus is expected to decrease from 6.1% of GDP in 2014 to 5.7% in 2015. This reflects a deterioration in the trade balance due to a pick-up in the economy as well as a lower level of EU funds by the end of the forecast horizon.

6.6.2. Market integration

The Hungarian economy is highly integrated to the euro area through trade and investment linkages. Its degree of trade openness has increased rapidly since EU accession, from 67% in 2005 to 91% in 2012, reflecting the deeper integration of the Hungarian economy into continental and global supply chains. Intra-euro area flows dominate both directions of trade, accounting for 55% of trade in goods. Outside the euro area, the main trading partners are Russia, Romania, Poland and the Czech Republic.

Hungary’s export of goods is heavily tilted towards high- and medium-high technology products. However, the economic crisis affected the share of high technology products, which came down from over 22% of total exports in 2010 to just 17% in total exports in 2012. The high-tech trade surplus narrowed to just 1% in 2012, but the share of machinery and electrical equipment is over 40% in total exports in 2012, the highest among non-euro area Member States.

FDI inflows to Hungary decreased during the economic crisis, but have strongly rebounded in the recent years, reaching a high 11.1% of GDP in 2012. However, this primarily reflected a steep jump in capital in transit and the recapitalisation of the financial sector due to losses, and not the effect of increased new investment activities. Without the former two factors, FDI inflows amounted to around 2½% of GDP in 2012, only slightly higher

Table 6.5:
Hungary - Product market integration

	2007	2008	2009	2010	2011	2012
Trade openness 1) (%)	80.9	81.5	75.2	82.3	88.4	91.0
Intra-EA trade in goods GDP ratio 2) (%)	40.0	39.2	35.8	39.4	42.6	44.0
Intra-EA trade in services GDP ratio 3) (%)	5.9	6.1	6.9	6.9	7.4	7.4
Extra-EA trade in goods GDP ratio 4) (%)	30.1	30.9	27.3	32.5	35.4	35.7
Export in high technology 5) (%)	21.3	20.2	22.2	21.8	20.9	17.3
High-tech trade balance 6) (%)	1.9	2.1	2.4	2.3	3.0	1.0
Total FDI inflows GDP ratio 7) (%)	2.9	4.1	1.6	1.7	4.2	11.1
Intra-EA FDI inflows GDP ratio 8) (%)	3.8	4.5	-4.9	0.4	3.7	7.7
FDI intensity 9)	2.8	2.8	1.5	1.3	3.8	10.0
Internal Market Directives 10) (%)	1.2	0.6	0.4	1.4	1.4	0.5
Time to start up a new company 11)	16.0	5.0	4.0	4.0	4.0	5.0
Real house price index 12)	120.2	116.9	106.5	100.0	92.6	84.1
Residential investment 13) (%)	4.1	4.2	4.3	3.2	2.3	2.1
Building permits index 14)	248.2	247.1	163.0	100.0	67.9	57.3

1) (Imports + Exports of goods and services / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics, Balance of Payments).
2) (Intra-EA-18 Imports + Exports of goods / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).
3) Intra-EA-17 trade in services (average credit and debit in % of GDP at current prices) (Balance of Payments).
4) (Extra-EA-18 Imports + Exports of goods / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).
5) Taken directly from Eurostat's databases: Exports of high technology products as a share of total exports.
6) (Exports - imports in high tech) / GDP at current prices x 100, since 2007 the data based upon SITC Rev. 4 (earlier SITC Rev. 3).
7) Total FDI inflows (in % of GDP at current prices).
8) Intra-EA-17 FDI inflows (in % of GDP at current prices).
9) FDI intensity (average intra-EU-27 inflows and outflows in % of GDP at current prices).
10) Percentage of internal market directives not yet communicated as having been transposed, in relation to the total number.
11) Time to start a new company (in days), Doing Business World Bank.
12) Deflated house price index (2010=100), Eurostat.
13) Gross capital formation in residential buildings (in % of GDP), Eurostat.
14) Number of new residential building permits (2010=100), Eurostat.

Sources: Eurostat, Sectoral Performance Indicators Database (SPI), Commission services.

than in previous years. Inward FDI (filtered from the effect of capital in transit and recapitalisation in the financial sector) stood at 1¾% of GDP in 2013. In 2012, the largest FDI investors in terms of stocks were Germany, Luxembourg, the Netherlands and Austria. Around 45% of the total net FDI stock is allocated in the manufacturing sector, suggesting that FDI plays a pivotal role in enhancing Hungary's export capacity and contribute significantly to the integration of the Hungarian economy with the euro area.

In the past five years, real house prices have fallen by a third in Hungary. In particular, in 2012 house prices decreased 9% (and 8% in 2011). During this period of house price decline, building permits were also cut by 77% between 2007 and 2012. The housing market remained depressed also in 2013, as indicated by a 29% fall in the number of housing permits compared to the previous year. Investment in dwellings has also been falling steadily in the last years. It stabilised at over 2% of GDP in 2011-2012, halving the 2007-2009 levels.

Value added in the construction sector decreased by 22% between 2008 and 2012. The share of construction in total value added stood at 4% in 2012.

Concerning the business environment, Hungary performs in general worse than most euro area Member States in international rankings ([64]). It ranks particularly low in terms of the legal and regulatory framework, which is complex and unstable due to frequent and sometimes ad-hoc modifications ([65]). Finally, according to the 2013 Internal Market Scoreboard, Hungary's transposition deficit of EU Directives went down to 0.5% in 2012 which is on par with the target proposed by the European Commission in the Single Market Act (2011).

([64]) For instance, Hungary ranks 54th (out of 189 economies) on the World Bank's 2014 Ease of Doing Business Index and 63rd (out of 148 economies) on the World Economic Forum's 2013-2014 Global Competitiveness Index.
([65]) For a more detailed assessment see section 4 of the 2014 in-depth review on Hungary.

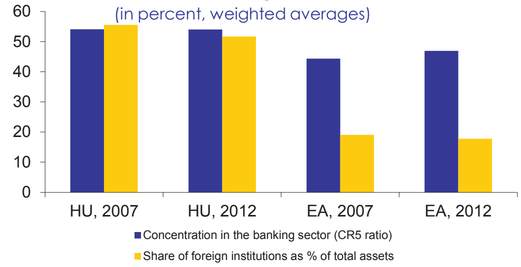
The Hungarian labour market can be considered as rather flexible in terms of employment protection, according to the 2013 OECD employment protection indicator for permanent workers (Hungary scored well below the euro-area-OECD countries' average). The crisis experience has confirmed that the private sector reacts flexibly to profitability pressures both in terms of wages and employment. Nevertheless, there are certain weaknesses affecting the functioning of the labour market. The major problem seems to be the persistently low level of private sector employment, which is linked to both demand and supply side constraints but also reflects inefficient government intervention. From the demand side, private sector employment is hindered by a low level of productivity growth and capital accumulation. From the supply side, skill mismatches, and in particular a high share of low-skilled workers, seem to be a persistent problem. In this respect, recurrent substantial increases in minimum wages could decrease the demand for low-productivity workers. Both domestic and international labour mobility is rather low in Hungary, although the latter has increased recently. Domestic labour mobility is hindered by a weakly functioning rental market as well as high commuting costs in underdeveloped regions.

6.6.3. Financial market integration

Hungary's financial sector is well integrated into the EU's financial system. This integration is noticeable in the share of foreign ownership of the banking system as well as in the participation of the Budapest Stock Exchange (BSE) in the CEE Stock Exchange Group. Most of Hungary's major banks are subsidiaries or branches of EU-headquartered financial institutions. The exception is the country's largest lender in terms of assets, OTP. The share of bank assets owned by foreign lenders has somewhat declined (to 51.7% in 2012 down from 55.5% in end-2007) as foreign groups have been steadily deleveraging their Hungary-based business since 2010.

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

(in percent, weighted averages)



Source: ECB, Structural financial indicators.

Bank concentration, as measured by the market share of the largest five credit institutions in total assets, is above the euro-area average and has been rather stable since EU entry.

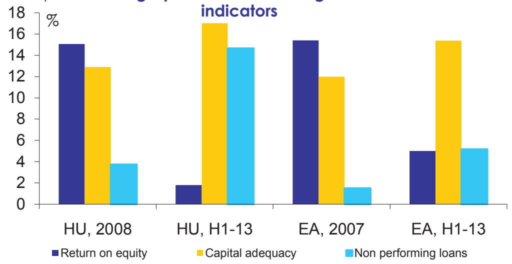
Hungary has one of the best-developed financial sectors in CEE. Total assets of the banking sector were worth EUR 108 billion in 2012 (around 110% of GDP). Indirect intermediation is predominant in Hungary, with domestic bank credit amounting to almost 50% of GDP in 2012, down from 61% in 2007. In the few years preceding the 2008-09 global financial crisis, the banking sector had been expanding at a fast pace, mainly thanks to rapid credit growth fuelled among others by ample liquidity supplied by parent banks. In the past three years bank lending to households and to the non-financial private sector fell compared to levels recorded back in 2009. In 2012 banks' total assets were shrinking by 6.1% y-o-y, with household loans decreasing by a considerable 11.7% and corporate loans down by 5.6%. The deleveraging of the private sector continued throughout 2013. Nevertheless, banks in Hungary continue to be heavily exposed to wholesale and foreign-currency funding and parental support constraints. Furthermore, given the high share of foreign-currency-denominated loans, with a large majority in Swiss franc, the exposure of the private sector to exchange rate risk is to remain substantial in the years to come. The aggregate private sector debt of around 131% of GDP in 2012 was somewhat below the euro area average (145% of GDP) ([66]).

The Hungarian banking system remains well-capitalized, with a record-high capital adequacy ratio of 17% in mid-2013. However, the return on equity in the first half of 2013 was a mere 1.8%. Banks' profitability in the recent years has been

([66]) Data on private sector debt are based on consolidated ESA 95 data of non-financial corporations and households (and non-profit institutions serving households) sectors' liabilities related to loans and securities other than shares.

suppressed by losses related to the early-FX-mortgage repayment scheme and the heavy tax burden imposed on the financial sector. Moreover, loan portfolio quality has been continuously deteriorating since the 2008-09 crisis. Non-performing loans reached 14.7% of the loan book by mid-2013.

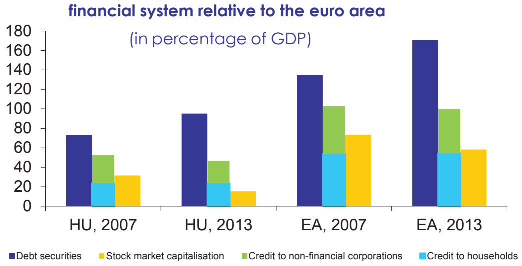
Graph 6.11: **Hungary - selected banking sector soundness indicators**



Note: For 2007 EU-27 non performing loans are a proxy for EA.
For 2007, EA RoE and CAR averages are unweighted.
Source: ECB, EC calculations.

The share of financial intermediaries other than banks and credit cooperatives in total assets of the Hungarian financial system declined after 2008. Following the outbreak of the financial crisis investment funds were hit by losses suffered on the capital market and by withdrawals of capital, but inflows have picked up strongly in 2012 and 2013. The pension funds industry suffered a major setback in 2011 after the second-pillar pension funds were transferred to the state social security system.

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



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

The stock exchange does not play a decisive role in the financing of the economy. The market capitalisation of the BSE equalled just about 15% of the 2013 GDP, around half of its 2007 level. The activity of both national and international trading members declined significantly. As a result of high central government issuance, the total value of outstanding fixed income securities amounted to some 95% of GDP in 2013. Private sector bond issuance followed a pan-European growth trend and represented about 7% of GDP in 2012.

As of 1 October 2013 the Hungarian financial market supervision framework was changed. The new framework opts for an integrated supervisory structure where the competence for both macro- and micro-prudential supervision as well as consumer protection in the financial services area is consolidated within the central bank. Hungary complied with the transposition of EU financial services legislation.

7. POLAND

7.1. LEGAL COMPATIBILITY

7.1.1. Introduction

The Act on the Narodowy Bank Polski (the NBP Act) was adopted on 29 August 1997. The consolidated version that includes all amendments to the NBP Act was published in Dziennik Ustaw of 2013, item 908. The NBP Act has not been amended since the 2012 Convergence Report. Therefore, the comments provided in the 2012 Convergence Report are largely repeated in this year's assessment.

7.1.2. Central bank independence

The NBP Act does not explicitly prohibit the NBP and members of its decision-making bodies from seeking or taking outside instructions; it also does not expressly prohibit the Government from seeking to influence members of NBP decision-making bodies in situations where this may have an impact on NBP's fulfilment of its ESCB related tasks. The absence of such a reference constitutes an incompatibility with respect to Article 130 of the TFEU and Article 7 of the ESCB/ECB Statute.

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

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

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

The Law on the State Tribunal provides for suspension of the Governor from his duties following a procedure which is incompatible with the principle of central bank independence and Article 14.2 of the Statute of the ESCB and of the ECB. Pursuant to the second sentence of Article 11(1) of the Law on the State Tribunal read in conjunction with Article 3 and Article 1(1)(3) of the very law, the Governor of the NBP can be suspended as a result of an indictment by the Parliament even before the State Tribunal has delivered its judgment on the removal from the office. The procedure violates the principle of central bank independence and Article 14 (2) of the Statute given that the latter has to be understood as allowing for removal on grounds of serious misconduct only if the Governor has been guilty as established by a court decision ('guilty'). A suspension from office on grounds of serious misconduct and further to parliamentary indictment deprives the Governor of the possibility to continue exercising the duties until a court has found the governor guilty of serious misconduct pursuant to Article 14.2 of the Statute. Therefore, this procedure breaches the Statute and Article 130 of the TFEU.

According to Article 203(1) of Poland’s Constitution, the Supreme Chamber of Control (Najwyższa Izba Kontroli (NIK)) is entitled to examine the NBP's activities as regards its legality, economic prudence, efficiency and diligence. The NIK controls are not performed in the capacity of an independent external auditor, as laid down in Article 27.1 of the ESCB/ECB Statute and thus, should be clearly defined so as to respect Article 130 of the Treaty and Article 7 of the ECB/ESCB Statute. The relevant provision of the Constitution is therefore, incompatible and needs to be adapted in order to respect the ECB/ESCB Statute.

7.1.3. Prohibition of monetary financing and privileged access

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

7.1.4. Integration in the ESCB

Objectives

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

Tasks

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

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

There are also some imperfections regarding:

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

7.1.5. Assessment of compatibility

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

7.2. PRICE STABILITY

7.2.1. Respect of the reference value

The 12-month average inflation rate for Poland, which is used for the convergence evaluation, was above the reference value at the time of the last convergence assessment of Poland in 2012. Average annual inflation declined gradually from above 4% in mid-2012 to below 1% by late 2013. In April 2014, the reference value was 1.7%, calculated as the average of the 12-month average inflation rates in Latvia, Portugal and Ireland plus 1.5 percentage points. The corresponding inflation rate in Poland was 0.6%, i.e. 1.1 percentage points

Table 7.1:
Poland - Components of inflation

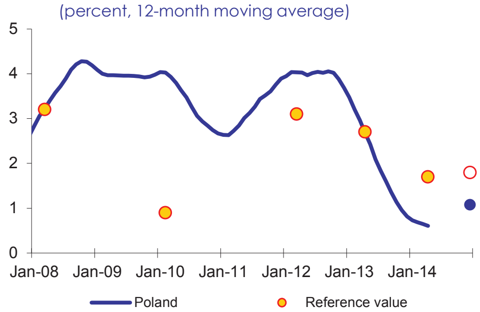
	2008	2009	2010	2011	2012	2013	Apr-14	weights in total 2014
(percentage change)[1]								
HICP	4.2	4.0	2.7	3.9	3.7	0.8	0.6	1000
Non-energy industrial goods	-0.3	0.2	0.0	1.1	0.9	-0.3	-0.5	280
Energy	8.5	5.9	6.2	9.2	8.0	-1.6	-1.9	149
Unprocessed food	2.8	7.1	3.1	2.7	4.2	3.3	2.9	87
Processed food	7.9	5.7	4.0	6.2	4.4	2.1	2.0	183
Services	4.4	4.5	2.5	3.0	3.5	1.6	1.5	301
HICP excl. energy and unproc. food	3.6	3.3	2.0	3.1	2.8	1.0	0.9	763
HICP at constant taxes	3.5	3.2	2.5	3.1	3.4	0.6	0.3	1000
Administered prices HICP	6.4	6.9	3.9	5.3	5.4	1.7	1.7	143

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

Sources: Eurostat, Commission services.

below the reference value. The 12-month average inflation rate is likely to remain below the reference value in the months ahead.

Graph 7.1: **Poland - Inflation criterion since 2008**
(percent, 12-month moving average)



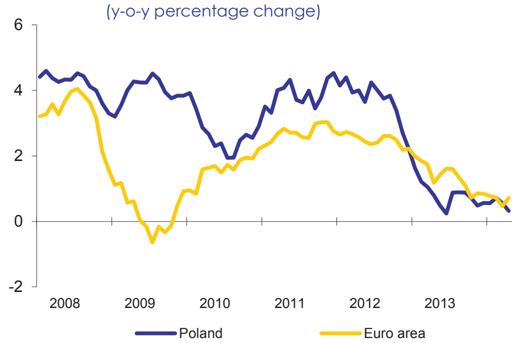
Note: The dots in December 2014 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2014 Forecast.

7.2.2. Recent inflation developments

Annual inflation remained relatively stable until mid-2012 and then decelerated substantially, reflecting, inter alia, the impact of international energy prices and, to a lesser degree, food prices. Weakening domestic demand exerted downward pressure on prices of services, while non-energy industrial goods prices benefited from a stable exchange rate and weak inflationary pressure in the global markets.

More specifically, annual HICP inflation posted only a marginal decline from 4.1% in January 2012 to 3.8% in September 2012, due to favourable base effects (energy) and decelerating inflation of imported industrial goods. It fell rapidly in late 2012 and during the first half of 2013, posting the lowest annual increase on record of 0.2% in June. Apart from favourable commodity price developments, this strong disinflation also reflected an abrupt decrease in the prices of telecommunication services. HICP inflation increased again to 0.9% in the third quarter of 2013, partly on account of a pick-up in annual growth of unprocessed food prices and a sharp one-off increase in waste removal fees in July 2013. As a result, annual HICP inflation averaged 0.8% in 2013. In early 2014, annual inflation remained below 1%.

Graph 7.2: **Poland - HICP inflation**
(y-o-y percentage change)



Source: Eurostat.

Until the end of 2012, core inflation (measured as HICP inflation excluding energy and unprocessed food) evolved broadly in line with HICP inflation, albeit at a lower level. Core inflation declined gradually from above 3% in early 2012 to below 1% by mid-2013, stabilising during the second half of 2013. The smaller decline compared to headline inflation reflected relatively more persistent inflation of services and processed food prices while prices of non-energy industrial goods fell in 2013. In the absence of cost pressures, annual average producer price inflation for total industry also turned negative, averaging -1.3% in 2013.

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

	2008	2009	2010	2011	2012	2013 1)	2014 2)	2015 2)
HICP inflation								
Poland	4.2	4.0	2.7	3.9	3.7	0.8	1.1	1.9
Euro area	3.3	0.3	1.6	2.7	2.5	1.3	0.8	1.2
Private consumption deflator								
Poland	4.3	2.5	2.5	4.9	3.7	0.7	1.1	1.9
Euro area	2.7	-0.4	1.6	2.4	2.1	1.3	0.9	1.3
Nominal compensation per employee								
Poland	8.6	3.6	8.2	5.1	3.5	2.4	3.5	4.4
Euro area	3.5	1.8	2.0	2.2	2.0	1.7	1.6	1.9
Labour productivity								
Poland	1.3	1.3	6.7	3.9	1.9	1.6	2.7	2.8
Euro area	-0.3	-2.4	2.6	1.4	0.2	0.5	0.9	1.0
Nominal unit labour costs								
Poland	7.2	2.3	1.4	1.1	1.5	0.7	0.8	1.6
Euro area	3.8	4.3	-0.6	0.7	1.8	1.1	0.7	0.8
Imports of goods deflator								
Poland	0.3	8.7	1.8	9.5	5.8	-0.8	-1.0	1.8
Euro area	4.2	-8.1	5.7	6.6	2.3	-1.9	-1.0	0.8

1) 2013 data (except HICP inflation) are estimates.
2) Commission services' Spring 2014 Forecast.

Source: Eurostat, Commission services.

7.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy-mix and cyclical stance

Real GDP growth declined to 1.6% in 2013, down from 2% a year earlier, well below estimates of potential output growth of around 3¼%. Growth was mainly supported by net exports. The output gap is thus estimated to have narrowed considerably in 2012 before turning negative in 2013. According to the Commission services' 2014 Spring Forecast, real GDP growth is projected to rebound to 3.2% in 2014 and 3.4% in 2015, implying a stabilisation of the negative output gap.

After a counter-cyclical fiscal contraction in 2011, the fiscal stance, as measured by changes in the structural balance, was further tightened in 2012 and in 2013. Fiscal consolidation is expected to resume in 2014-2015 as Poland is committed to ensuring a timely correction of its excessive deficit.

Monetary policy, conducted within an inflation targeting framework ([67]), was last tightened in May 2012 when annual inflation was near its peak. In line with the subsequent disinflation trend, the Monetary Policy Council (MPC) cut its main policy rate steadily from 4.75% in early November 2012 to 2.5% in July 2013. The MPC then kept the policy rate unchanged during the second half of 2013 and in early 2014.

Wages and labour costs

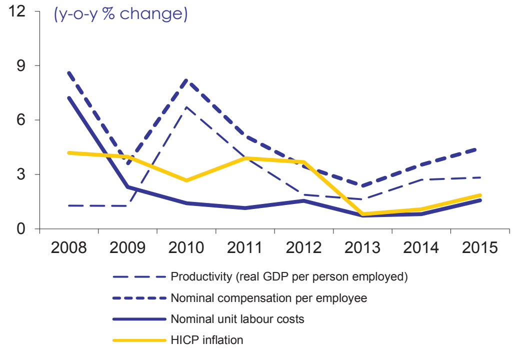
Wage negotiations in the private sector are rather decentralised and flexible, with wage setting taking place mostly at the enterprise level, although collective bargaining has a stronger impact on wage formation in sectors dominated by state enterprises, such as mining. The unemployment rate has increased marginally in 2012 and 2013 as total employment stagnated.

Despite lower labour productivity growth, the temporary economic rebound of 2010-2011 was still partly reflected in growth of compensation per employee in 2012, implying higher nominal ULC growth. In 2013, the continued weakening of aggregate economic activity translated into more limited wage increases. As a result, nominal ULC increased by less than 1%. ULC growth is expected to remain contained in 2014 before picking up in 2015 as growth of compensation per

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

employee should accelerate faster than labour productivity growth.

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



Source: Eurostat, Commission services' Spring 2014 Forecast.

External factors

Although external trade represents a lower share of GDP in Poland than in regional peers, prices of imported goods and services play an important role in domestic price formation. Import prices (measured by the imports of goods deflator) surged in 2011, driven by a substantial depreciation of the nominal effective exchange rate (measured against a group of 36 trading partners). Import prices continued to rise in 2012, mainly as a result of higher global commodity prices, before broadly stabilising in 2013. The import deflator is forecast to increase somewhat in 2014, mainly on account of an expected pick-up in global economic activity and thus price pressures.

Administered prices and taxes

Increases in administered prices ([68]), with a weight of around 14% in the HICP basket (compared to 13% in the euro area), significantly exceeded HICP inflation in recent years. The average annual increase in administered prices remained above 5% in 2012, driven by increases in tariffs for gas, electricity and heating as well as increasing local fees (housing, public transport). It fell to 1.7% in 2013, on the back of a cut in regulated gas prices for households in January 2013 and a decrease in the price of electricity in July 2013, though their effect was somewhat counterbalanced by an increase in waste management fees. Administered prices should continue increasing at a moderate pace in 2014, mainly due to limited growth of electricity and gas prices.

The impact of tax measures on the overall consumer price developments was marginal in 2012 and 2013 as constant tax inflation lingered only some 0.2-0.3 percentage points below headline inflation. A marginally positive inflation contribution from higher excise duties on alcohol is expected in 2014.

Medium-term prospects

Looking ahead, price inflation is expected to increase only gradually on account of a negative output gap. The deflationary impact of one-off measures (lower prices of telecommunication services) effective in 2013 should largely fade out in 2014. The Commission services' 2014 Spring Forecast projects HICP inflation to average 1.1% in 2014 and 1.9% in 2015.

Risks to the inflation outlook appear to be broadly balanced. Stronger exchange rate depreciation, driven by a gradual withdrawal of monetary stimulus in the US and associated capital outflows from emerging markets, could result in higher consumer price growth. On the other hand, the outlook for global growth and related price pressures remains fragile.

The level of consumer prices in Poland was close to 56% of the euro-area average in 2012. This suggests potential for further price level convergence in the long term, as income levels (about 62% of the euro-area average in PPS in 2012) increase towards the euro-area average.

Medium-term inflation prospects in Poland will hinge upon wage and productivity trends as well as on the functioning of product markets. Further structural measures to increase labour supply and to facilitate the effective allocation of labour market resources will play an important role in alleviating potential wage pressures, resulting *inter alia* from negative demographic developments. As to product markets, there is scope to enhance the competitive environment, especially in the services and energy sectors. At the macro level, a prudent fiscal stance will be essential to contain inflationary pressures.

([68]) According to the Eurostat definition, administered prices in Poland include *inter alia* water supply, refuse and sewerage collection, electricity, gas, heat energy and certain categories of passenger transport. For details, see http://epp.eurostat.ec.europa.eu/portal/page/portal/hicp/documents_meth/HICP-AP/HICP_AP_classification_2011_2014_02.pdf

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

Outturn and forecast [1]	2008	2009	2010	2011	2012	2013	2014	2015
General government balance	-3.7	-7.5	-7.8	-5.1	-3.9	-4.3	5.7	-2.9
- Total revenues	39.5	37.2	37.5	38.4	38.3	37.5	47.0	38.3
- Total expenditure	43.2	44.6	45.4	43.4	42.2	41.9	41.3	41.2
of which:								
- Interest expenditure	2.2	2.6	2.7	2.7	2.8	2.6	2.1	2.2
p.m.: Tax burden	34.3	31.8	31.8	32.3	32.5	32.0	32.3	32.7
Primary balance	-1.5	-4.8	-5.1	-2.4	-1.0	-1.7	7.8	-0.7
Cyclically-adjusted balance	-5.3	-8.2	-8.4	-5.8	-4.0	-3.8	6.2	-2.4
One-off and temporary measures	0.0	0.3	0.0	0.0	0.1	0.0	9.0	0.0
Structural balance [2]	-5.3	-8.5	-8.4	-5.8	-4.1	-3.8	-2.8	-2.4
Government gross debt	47.1	50.9	54.9	56.2	55.6	57.0	49.2	50.0
p.m: Real GDP growth (%)	5.1	1.6	3.9	4.5	2.0	1.6	3.2	3.4
p.m: Output gap	4.1	1.7	1.5	1.9	0.4	-1.2	-1.2	-1.2

Convergence programme	2014	2015	2016	2017
General government balance	5.8	-2.5	-1.8	-1.2
Structural balance [2] [3]	-2.8	-2.2	-1.8	-1.4
Government gross debt	49.5	49.5	47.5	45.5
p.m. Real GDP (% change)	3.3	3.8	4.3	4.3

1) Commission services' Spring 2014 Forecast.
2) Cyclically-adjusted balance excluding one-off and other temporary measures.
3) Commission services' calculations on the basis of the information in the programme.
There are 4 one-off and/temporary measures in the programme. All of them take place in 2014: transfer of assets of open pension funds (9% GDP), the sale of radio frequencies(0.1%), the execution of the sentence of the Constitutional Court to pay some specific pension (-0.1% of GDP) and of another sentence of the Constitutional Court to pay some nursing benefits (-0.1% GDP).
Sources: Commission services, the 2014 Convergence Programme of Poland.

7.3. PUBLIC FINANCES

7.3.1. The excessive deficit procedure for Poland

On 7 July 2009, the Council decided in accordance with Article 104(6) of the Treaty establishing the European Community (TEC) that an excessive deficit existed and addressed recommendations to Poland, in accordance with Article 104(7) TEC with a view to bringing an end to the situation of an excessive government deficit by 2012.

On 21 June 2013, the Council concluded that Poland had taken effective action but adverse economic events with major implications on public finances had occurred, and issued revised recommendation under Article 126(7) TFEU, in which it recommended that Poland should put an end to the excessive deficit situation by 2014. The Council established the deadline of 1 October 2013 for Poland to take effective action.

On 10 December 2013, the Council established in accordance with Article 126(8) TFEU that Poland had not taken effective action. It adopted a new recommendation under Art.126 (7) TFEU, according to which Poland should bring an end to the excessive deficit situation by 2015 in a credible and sustainable manner. Moreover, Poland should reach a headline deficit target of 4.8% of GDP in 2013, a deficit of 3.9% of GDP in 2014 and of 2.8% of GDP in 2015 (excluding the impact of the assets transfers due to the reversal of the pension reform which have been subsequently enacted in December 2013). For 2014 this is consistent with an improvement of the structural balance of 1% of GDP and 1.2% of GDP for 2015, based on the Commission services' 2013 Autumn Forecast. The Council established the deadline of 15 April 2014 for Poland to take effective action and to report in detail the consolidation strategy that is envisaged to achieve the targets. ([69])

7.3.2. Recent fiscal developments

The headline general government deficit declined gradually from 7.8% of GDP in 2010 to 3.9% in 2012 before increasing again to 4.3% in 2013.

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

In 2012, the deficit reduction was driven by the fall in government expenditures. On the revenue side, an unexpected fall in indirect tax revenues (by 0.3% of GDP) offset the new structural consolidation measures, notably an increase by 2 percentage points of the disability contribution rate, a new tax on copper and silver extraction, a continued freeze in PIT thresholds and some changes in excise duties. On the expenditure side, the improvement was mostly due to the sharp cut in public investments. Moreover, the government maintained the freeze in the wage fund of public sector employees and decreased the complementary direct payments to farmers in the framework of the Common Agricultural Policy.

In 2013, the deficit increased mainly due to a weak performance of revenues related to slow economic growth. General government revenues were nevertheless positively affected by the full-year carry-over effect of measures taken in 2012 (an increase in the disability contribution rate and the new mining tax) and of keeping the nominal PIT thresholds unchanged. The total expenditure-to-GDP ratio fell thanks to a cut in public investments. Notwithstanding some structural expenditure measures (a continued freeze of wages of most central government employees, the start of a gradual increase in retirement age and an amendment to the 2013 state budget containing expenditure cuts), current expenditures grew slightly more than the nominal GDP.

The debt-to-GDP ratio remained below but close to 60% of GDP as a result of persistent general government deficits. It slightly fell from 56.2% in 2011 to 55.6% in 2012 and then rose to 57% in 2013.

7.3.3. Medium-term prospects

In 2014-15, the general government budget balance will be affected by the reversal of the systemic pension reform. It includes the following asset transfers from the second, private pension pillar to the first one: a one-off transfer of assets worth about 9% of GDP in 2014 as well as annual transfers of assets of persons who retire within 10 years, starting in 2014. Under current accounting rules (ESA95), such asset transfers are treated as general government revenue. Under the new rules, which will come into force in autumn 2014 (ESA2010), such transfers will not count as revenue anymore.

As a result, according to the Commission services' 2014 Spring Forecast the general government budget balance is projected to turn into a surplus of 5.7% of GDP in 2014 under ESA95, while it is set to post a deficit of 3.6% with the asset transfers from the second pension pillar not treated as revenue. Apart from the reversal of the pension reform, the main measures with a positive and permanent effect on the general government balance in 2014 include changes in VAT and excise duties, a continued freeze in PIT thresholds, a partial public wage freeze and a gradual increase in the retirement age. Expenditure savings will be partially offset by the costs of a legislated extension of maternity leave and other increases in social spending.

In 2015, due to the one-off nature of the large improvement in 2014, the general government budget balance is expected to turn negative again, posting a deficit of 2.9% of GDP under ESA95. Excluding the asset transfers due to the reversal of the pension reform, the deficit is projected to reach 3.1% of GDP in 2015.

The structural deficit is estimated in the Commission services' 2014 Spring Forecast to gradually improve, from 3.8% of GDP in 2013 to 2.4% of GDP in 2015.

The general government debt-to-GDP ratio is forecast to fall to 49.2% in 2014, mainly as a result of the transfer of pension fund assets, before increasing to 50% in 2015. The projected debt figures are, however, subject to considerable uncertainty in view of possible valuation effects of the sovereign debt denominated in foreign currency due to exchange rate fluctuations.

The 2014 Convergence Programme was submitted on 23 April 2014. It confirms the government's commitment to bring the deficit below the EDP reference value of 3% of GDP by 2015 and sets a 2018 deadline to achieve the Medium Term Objective of a structural deficit of not more than 1% of GDP. The nominal balance is expected in the programme to reach a surplus of 5.8% of GDP in 2014 and a deficit of -2.5% of GDP in 2015 under ESA95. These projections are more optimistic compared to Commission services' 2014 Spring Forecast, in particular due to a more optimistic macroeconomic scenario underpinning these budgetary projections.

Further details on the assessment of the 2014 Convergence Programme for Poland can be found in the Commission Staff Working Document, which accompanies the Commission Recommendation for a Council Recommendation on the 2014 National Reform Programme of Poland and delivering a Council Opinion on the 2014 Convergence Programme of Poland.

In March 2012, Poland signed the Treaty on Stability, Coordination and Governance in the EMU. The TSCG will apply to Poland in its entirety upon lifting its derogation from participation in the single currency.

7.4. EXCHANGE RATE STABILITY

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

Following a sharp depreciation in the second half of 2011 – which induced foreign exchange market interventions by the NBP – the zloty's exchange rate against the euro partially recovered in early 2012. The zloty thereafter broadly stabilised and predominantly traded in the range of 4.1-4.3 PLN/EUR until early 2014. Compared to April 2012, the exchange rate of the zloty against the euro was thus basically unchanged in April 2014.

Graph 7.4: **Exchange rates - PLN/EUR**
(monthly averages)

Source: ECB.

After remaining broadly stable at around EUR 75 billion in 2011, international reserves increased throughout 2012 to some EUR 85 billion in early 2013. Afterwards, the reserve level declined again gradually to about EUR 77 billion (20% of GDP) by end-2013.

Graph 7.5: **Poland - 3-M Wibor spread to 3-M Euribor**
(basis points, monthly values)

Source: Eurostat.

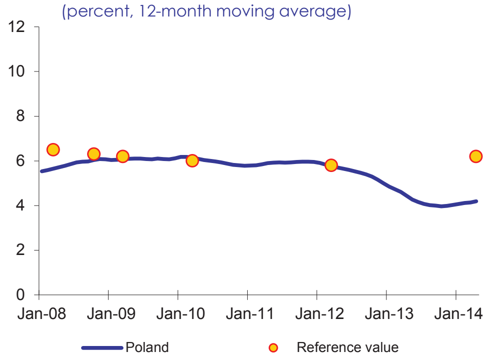
Short-term interest rate differentials vis-à-vis the euro area widened in late 2011 and during the first eight months of 2012, as the ECB loosened its policy stance while rates on the Polish money market increased somewhat. After peaking at above 470 basis points in August 2012, short-term spreads declined to below 250 by mid-2013 reflecting considerable monetary policy easing by the NBP which gradually cut its key reference rate by 225 basis points between November 2012 and July 2013. At the cut-off date of this report, the 3-month spread vis-à-vis the euro area remained closed to 240 basis points.

7.5. LONG-TERM INTEREST RATES

Long-term interest rates in Poland used for the convergence examination reflect secondary market yields on a single benchmark government bond with a residual maturity of close to but below 10 years.

The Polish 12-month average long-term interest rate relevant for the assessment of the Treaty criterion was exactly at the reference value at the time of the last convergence assessment in 2012. It declined gradually from close to 6% in late 2011 to about 4% by end-2013. In April 2014, the latest month for which data are available, the reference value, given by the average of long-term interest rates in Latvia, Portugal and Ireland plus 2 percentage points, stood at 6.2%. In that month, the 12-month moving average of the yield on the Polish benchmark bond stood at 4.2%, i.e. 2 percentage points below the reference value.

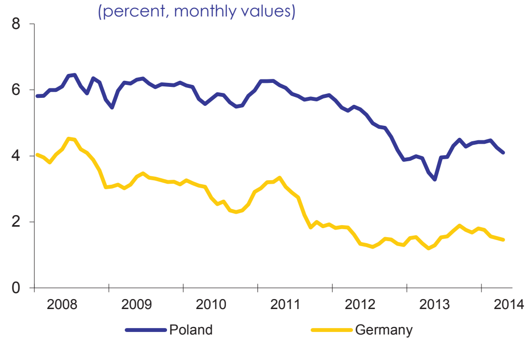
*Graph 7.6:***Poland - Long-term interest rate criterion**
(percent, 12-month moving average)



Source: Commission services.

Long-term interest rates declined from above 6% in early 2011 to below 4% by end-2012, reflecting improved investor sentiment towards the country as well as a substantial fall in domestic inflation. Long-term interest rates increased again during the second half of 2013 as risk appetite in global financial markets dwindled. As a result, long-term interest rate spreads vis-à-vis the German benchmark bond hovered around 270 basis points in early 2014 ([70]).

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



Source: Eurostat.

7.6. ADDITIONAL FACTORS

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

In November 2013, the Commission published its third Alert Mechanism Report (AMR 2014) ([71]) under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.5). The AMR 2014 scoreboard showed that Poland exceeded the indicative threshold for two out of ten indicators, both in the area of external imbalances (i.e. the current account balance and the international investment position). In line with the conclusions of the AMRs 2012-2014, Poland has not been subject to in-depth reviews in the context of the MIP.

7.6.1. Developments of the balance of payments

Poland's external balance (i.e. the combined current and capital account) remained in deficit in 2012, but it narrowed considerably due to a lower trade deficit. The improvement in the trade balance was driven by sustained export growth, fuelled by increasing geographical diversification of exports and a low cost base, and subdued imports, reflecting sluggish domestic demand growth. The external balance turned positive in 2013, reflecting a further improvement in the trade balance, which shifted into a surplus as exports continued to grow while lacklustre growth of domestic demand dampened imports. At the same time, the negative balance of primary income and the positive balance of current transfers remained broadly stable in 2011-2013.

As far as the saving-investment balance is concerned, gross national saving (as a percentage of GDP) decreased in 2012. The decrease was driven by falling gross saving by the private sector, in particular households, which was only partially offset by higher government saving. Gross national saving remained stable in 2013, despite a substantial decline in government saving, as households started to increase their savings again. At the same time, after a temporary increase in 2010-2011, domestic investment activity (as a percentage of GDP) decreased in 2012 and 2013, on the back of decreasing investment spending by the corporate and government sectors. Overall, the corporate sector investment-to-GDP ratio in Poland is one of the lowest in the EU and compares unfavourably to its peers.

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

([71]) http://ec.europa.eu/europe2020/pdf/2014/amr2014_en.pdf

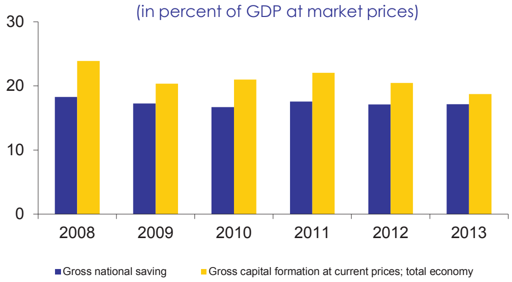
Table 7.4:
Poland - Balance of payments **(percentage of GDP)**

	2008	2009	2010	2011	2012	2013
Current account	-6.6	-3.9	-5.1	-5.0	-3.7	-1.3
of which: Balance of trade in goods	-5.8	-1.7	-2.5	-2.7	-1.4	0.6
Balance of trade in services	1.0	1.1	0.7	1.1	1.2	1.3
Income balance	-2.4	-3.8	-4.1	-4.5	-4.6	-4.2
Balance of current transfers	0.6	0.5	0.8	1.2	1.0	1.0
Capital account	1.1	1.6	1.8	2.0	2.2	2.3
External balance 1)	-5.4	-2.3	-3.3	-3.0	-1.5	1.0
Financial account	7.8	4.6	5.5	5.0	2.3	0.4
of which: Net FDI	1.9	1.9	1.4	2.4	1.1	-0.2
Net portfolio inflows	-0.5	3.3	5.4	3.2	4.1	-0.1
Net other inflows 2)	5.7	2.7	1.9	0.6	-0.6	0.9
Change in reserves (+ is a decrease)	0.7	-3.4	-3.2	-1.3	-2.3	-0.2
Financial account without reserves	7.1	7.9	8.7	6.2	4.6	0.6
Errors and omissions	-2.4	-2.3	-2.2	-1.9	-0.8	-1.4
Gross capital formation	23.9	20.3	21.0	22.1	20.5	18.7
Gross saving	18.3	17.3	16.7	17.6	17.1	17.1
External debt	45.9	64.8	67.5	62.6	74.6	73.3
International investment position	-56.3	-58.8	-65.4	-64.0	-66.5	-68.6

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

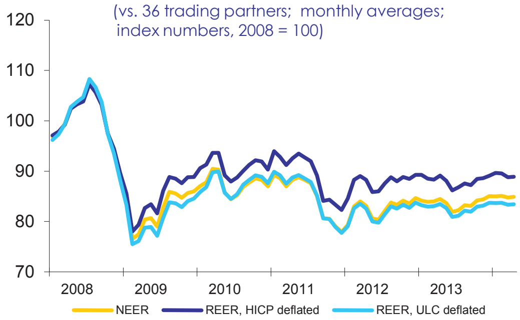
Sources: Eurostat, Commission services, National Bank of Poland.

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



Source: Eurostat, Commission services.

*Graph 7.9:***Poland - Effective exchange rates**



Source: Commission services.

Poland's external competitiveness appears to have remained solid in recent years as confirmed by its continuously improving export performance. After a substantial nominal and real depreciation in the second half of 2011, the real effective exchange rate appreciated somewhat in 2012, in line with the change in the nominal effective exchange rate. It remained broadly stable over 2013.

On the financing side of the balance of payments, net inflows of foreign direct investment (FDI), which covered almost 50% of the current account deficit in 2011, declined substantially in 2012, mostly as a result of lower direct investment in Poland, and then turned marginally negative in 2013. Due to rapidly increasing holdings of government debt securities by non-residents, net inflows of portfolio investment were the main source of foreign financing between 2009 and 2012. Portfolio investment flows were broadly balanced in 2013 as non-residents' holdings of government debt securities stabilised. Net inflows of other investment and financial derivatives have

Table 7.5:
Poland - Product market integration

	2007	2008	2009	2010	2011	2012
Trade openness 1) (%)	42.2	41.9	39.4	42.8	45.7	46.6
Intra-EA trade in goods GDP ratio 2) (%)	20.6	20.2	19.1	20.3	21.4	21.0
Intra-EA trade in services GDP ratio 3) (%)	n.a.	3.4	3.4	3.6	3.7	3.9
Extra-EA trade in goods GDP ratio 4) (%)	15.2	15.3	13.9	15.6	17.3	18.3
Export in high technology 5) (%)	3.0	4.3	5.7	6.0	5.1	5.9
High-tech trade balance 6) (%)	-2.6	-2.5	-2.3	-2.3	-2.3	-2.0
Total FDI inflows GDP ratio 7) (%)	5.5	2.8	3.2	3.0	4.0	1.2
Intra-EA FDI inflows GDP ratio 8) (%)	3.9	2.2	2.1	2.1	4.0	1.0
FDI intensity 9)	3.4	1.8	2.2	2.2	2.8	0.7
Internal Market Directives 10) (%)	1.7	2.0	1.4	1.7	2.1	1.8
Time to start up a new company 11)	31.0	31.0	32.0	32.0	32.0	32.0
Real house price index 12)	n.a.	112.3	106.5	100.0	94.6	89.0
Residential investment 13) (%)	3.0	3.2	2.9	2.6	2.6	2.7
Building permits index 14)	143.5	133.5	102.0	100.1	106.1	94.7

1) (Imports + Exports of goods and services / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics, Balance of Payments).
2) (Intra-EA-18 Imports + Exports of goods / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).
3) Intra-EA-17 trade in services (average credit and debit in % of GDP at current prices) (Balance of Payments).
4) (Extra-EA-18 Imports + Exports of goods / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).
5) Taken directly from Eurostat's databases: Exports of high technology products as a share of total exports.
6) (Exports - imports in high tech) / GDP at current prices x 100, since 2007 the data based upon SITC Rev. 4 (earlier SITC Rev. 3).
7) Total FDI inflows (in % of GDP at current prices).
8) Intra-EA-17 FDI inflows (in % of GDP at current prices).
9) FDI intensity (average intra-EU-27 inflows and outflows in % of GDP at current prices).
10) Percentage of internal market directives not yet communicated as having been transposed, in relation to the total number.
11) Time to start a new company (in days), Doing Business World Bank.
12) Deflated house price index (2010=100), Eurostat.
13) Gross capital formation in residential buildings (in % of GDP), Eurostat.
14) Number of new residential building permits (2010=100), Eurostat.

Sources: Eurostat, Sectoral Performance Indicators Database (SPI), Commission services.

remained relatively low in recent years, mainly due to lower external borrowing by the private sector.

Total gross external debt increased from 63% of GDP in 2011 to 73% of GDP in 2013, while the negative net international investment position also widened considerably. The stability of the balance of payments was supported by the IMF's Flexible Credit Line arrangement, which was initially granted in May 2009 and renewed in January 2011 and January 2013, when it was increased and extended for another two years.

According to the Commission services' 2014 Spring Forecast, the external balance is expected to remain broadly stable in 2014 before deteriorating somewhat in 2015 as imports are foreseen to outpace exports.

7.6.2. Market integration

Poland's economy is well integrated to the euro-area through both trade and investment linkages. Following a decrease in 2008-2009 as a result of the crisis, trade openness increased further in the following years, reaching some 47% of GDP in 2012, a higher percentage than for some euro-area Member States. The share of extra-euro-area trade in goods, as percent of GDP, has increased in recent years, reflecting the increase in competiveness on the international stage, while the share of intra-euro-area trade has remained broadly stable over the period under review. The share of intra-euro-area trade in services has increased somewhat, spurred by business process outsourcing activities.

The composition of Polish exports in goods has evolved towards medium-to-high technology goods, though the share of traditional industries (e.g. metal products, food, mineral fuels, chemicals, furniture) remains high. In 2012, the export structure was dominated by machinery and electrical equipment (24%) as well as vehicles, aircraft and vessels (14%), reflecting the presence of multinational corporations in these sectors which lead to technology transfers and contribute to export competitiveness. The high-tech trade deficit, which was historically around 2.5%, has come down in 2012 to just 2% of the GDP, reflecting an increase in exports with high technological content. This evolution is slow, partly due to the limited inflow of FDI into high technology sectors, as well as low domestic R&D spending, weak links between research institutes and the private sector and relatively low quality of the research institutional framework.

FDI inflows mainly originated in Germany, the Netherlands, France and Luxembourg, which together provided over 50% of the FDI stock at the end of 2012. The significant size and growth of the domestic market as well as a good access to large regional markets are pointed out as main reasons for the attractiveness of the country for FDI.

According to Eurostat, real house prices in Poland declined by over 20% between 2008 and 2012. In 2012, the year-on-year decline amounted to 6%. Investment in dwellings has remained stable at around 3% of GDP for the past six years. Value-added in construction increased steadily in real terms since 2005, but seems to have come to a halt in 2012. After falling significantly during the crisis years, building permits stabilised but a double digit decline (11% y-o-y) re-appeared in 2012, indicating that construction activity may be subdued in the coming years.

Concerning the business environment, Poland performs in general worse than most euro-area Member States in international rankings. Two legislative packages were adopted in 2011 aimed at reducing the number of procedures and administrative obligations imposed on businesses, including by replacing administrative certificates with declarations, and to reduce information obligations. These changes, among others, have contributed to a slight increase in the scores recorded by Poland in international rankings ([72]). According to the 2013 Internal Market Scoreboard, Poland has yet to attain the 1% threshold deficit in the transposition of EU directives.

One of the strengths of the Polish economy is its endowment with a high-quality labour force and the regulatory set-up of the labour market. The labour force is relatively skilled, labour taxes are comparatively low, though not for the low skilled, and labour laws provide for a sufficient degree of flexibility. In particular, protection of permanent employees against collective and individual dismissals is (according to the 2013 OECD employment protection indicator) below the euro-area-OECD countries' average while collective wage bargaining usually takes place at the company level, allowing for a flexible wage adjustment process.

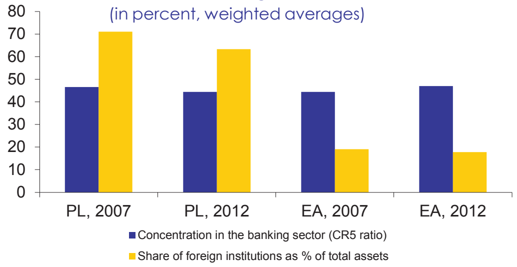
However, this legal framework did not prevent the development of a segmented labour market with a high share of temporary employment, which might hinder productivity growth and human capital formation. Moreover, existing special retirement schemes, in particular for farmers, inhibit internal labour migration and reallocation of labour from low-productivity sectors. Moreover, outward migration flows, especially after EU accession, were substantial, while non-EU immigration is limited by the existing restrictions on long-term immigration. Finally, the low quality and applicability of higher education and poor access to good quality apprenticeships and work-based learning aggravates the mismatch between the supply of skills and labour market needs, especially for non-tertiary education graduates.

7.6.3. Financial market integration

Poland's financial sector is well integrated within the overall EU financial system. In 2012, over 63% of the Polish banking sector's assets were owned by foreign financial institutions, predominantly headquartered in EU Member States. Among the top ten banks operating in Poland in 2013 just two are domestic, seven are subsidiaries of major European banks and one belongs to a US financial institution. Concentration in the Polish banking sector has remained close to the euro-area average. The share of total assets owned by the five largest lenders amounted to 47% after a number of mergers were finalised in 2012/13.

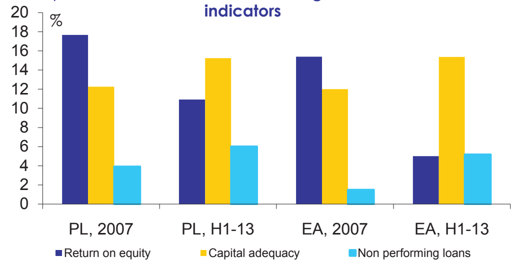
([72]) For instance, Poland ranks 45th (out of 189 economies) on the World Bank's 2014 Ease of Doing Business Index and 42nd (out of 148 economies) on the World Economic Forum's 2013-2014 Global Competitiveness Index.

Graph 7.10: **Poland - Foreign ownership and concentration in the banking sector**
(in percent, weighted averages)



Source: ECB, Structural financial indicators.

Graph 7.11: **Poland - selected banking sector soundness indicators**



Note: For 2007 EU-27 non performing loans are a proxy for EA.
For 2007, EA RoE and CAR averages are unweighted.
Source: ECB, EC calculations.

With an aggregated asset size close to EUR 340 billion (end-2013) Poland has the biggest and one of the most developed banking sectors among the new EU Member States. However, rising uncertainties and slower economic growth in the past year were also reflected in the pace of the banking sector's balance sheet expansion, with credit to the non-financial private sector increasing by 3.8% in 2013. Nonetheless, when looking at the longer-term trend, credit to the private economy was equivalent to 51% of GDP in 2013, compared to 39% in 2007. The share of foreign-currency denominated loans remains significant, particularly in the mortgage loan segment where every second housing loan is denominated either in Swiss franc or euro. Nevertheless, the share of FX loans has been gradually declining as most banks dropped FX mortgages from their offer already back in 2009. Private sector debt ([73]) remained close to 75% of GDP in 2012, significantly below the euro-area average of 145%.

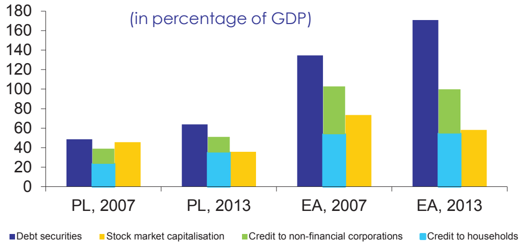
The capitalisation of banks continued to improve reaching a capital adequacy ratio (CAR) of 15.3% in mid-2013. At almost 11%, the return on equity (ROE) remained considerable in the first half of 2013, double the euro-area average. The non-performing loans ratio followed the euro-area trend and deteriorated during the crisis to about 6½% in 2009-2010, up from 3.9% in 2007, before dropping to 6% in June 2013.

Non-banking institutions such as private pension funds, asset management companies and insurance companies play a relatively important role in financial intermediation in Poland and represent about 30% of the aggregated assets of all domestically-based financial institutions at the end of 2012. The private pension funds launched in 1999 are the biggest players in this category with assets totalling about EUR 64 billion (end-2012) and also belong to the biggest domestic institutional investors. Their size is, however, set to shrink by about half in mid-2014 as a result of new rules concerning the distribution of pension assets between the public pay-as-you-go scheme and private pension funds. The insurance sector has also been growing, but its size is still far below the euro-area average. It remains dominated by three major players controlling about 75% of the insurance premia. Investment funds have rapidly expanded through 2012 and 2013 increasing in size by 28% and 15%, respectively, on the back of the good stock market performance.

Stock market capitalisation represented 36% of GDP in 2013, down from a pre-crisis record high of 46% of GDP in 2007. Both domestic and international investors have access to the Warsaw Stock Exchange (WSE), the latter owning almost half of WSE's capitalisation. The WSE has so far not taken part in the European stock exchange consolidation process. The debt securities market, amounting to some 64% of GDP in 2013, is the largest and most liquid in the region. It is dominated by government bonds (over 90% share) while corporate bonds account for about 7% of the outstanding amounts.

([73]) Data on private sector debt are based on consolidated ESA 95 data of non-financial corporations and households (and non-profit institutions serving households) sectors' liabilities related to loans and securities other than shares.

Graph 7.12: **Poland - Recent development of the financial system relative to the euro area**



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

Since 2006, the supervision of the financial sector has been consolidated within the Polish Financial Supervision Authority (KNF). In 2013, the scope of KNF's supervision was expanded to also cover credit unions (SKOK), which suffered from comparatively low capital ratios. Nonetheless, their total assets make up only a small part of the total financial sector balance sheet. The KNF actively cooperates with its peers in the European System of Financial Supervisors and has signed memoranda of understanding with the home authorities of local foreign-bank subsidiaries. Poland achieved full compliance with the EU financial services legislation and implemented on time most of the subsequent directives.

8. ROMANIA

8.1. LEGAL COMPATIBILITY

8.1.1. Introduction

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

The BNR law has not been amended since the Convergence Report 2012. Therefore, the comments provided in the Convergence Report 2012 are largely repeated in this year's assessment. Government Emergency Ordinance 90/2008 on the statutory audit of the annual financial statements and of the consolidated annual financial statements has been amended with a view to achieve compatibility with Article 123 TFEU.

8.1.2. Central Bank independence

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

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

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

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

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

Article 33(7) of the Law provides that no member of the Board of BNR may be recalled from office for other reasons or following a procedure other than those provided in Article 33(6) of this Law. Law 161/2003 on certain measures for transparency in the exercise of public dignities, public functions and business relationships and for the prevention and sanctioning of corruption and the Law 176/2010 on the integrity in the exercise of public functions and dignities define the conflicts of interest incompatibilities applicable to the Governor and other members of the Board of the BNR and require them to report on their interests and wealth. For the sake of legal certainty, it is recommended to remove this imperfection and provide a clarification that the sanctions for the breach of obligations under those Laws do not constitute extra grounds for dismissal of the Governor of the Board of BNR, in addition to those contained in Article 33 of the BNR Law.

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

Article 43 of the BNR Law provides that the BNR must transfer to the State budget an 80% share of the net revenues left after deducting expenses relating to the financial year, including provisions for credit risk, and any losses relating to previous financial years that remain uncovered. Such a procedure could, in certain circumstances, be seen as an intra-year credit, which negatively impacts on the financial independence of the BNR. A Member State may not put its central bank in a position where it has insufficient financial resources to carry out its ESCB tasks, and also its own national tasks, such as financing its administration and own operations. Article 43(3) of the BNR Law also provides that the BNR sets up provisions for credit risk in accordance with its rules, after having consulted the Ministry of Public Finance. The central bank must be free to independently create financial provisions to safeguard the real value of its capital and assets. Article 43 of the BNR Law is incompatible with Article 130 of the TFEU and Article 7 of the ECB/ ESCB Statute and should, therefore, be adapted, to ensure that the above arrangements do not undermine the ability of the BNR to carry out its tasks in an independent manner.

8.1.3. Prohibition of monetary financing and privileged access

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

Articles 6(1) and 29(1) of the BNR Law prohibit the direct purchases by the BNR of debt instruments issued by the State, national and local public authorities, autonomous public enterprises, national corporations, national companies and other majority state-owned companies. Article 6(2) of the BNR Law extends this prohibition to the debt instruments issued by other bodies governed by public law and public undertakings of other EU Member States. Article 7(2) of the BNR Law prohibits the BNR from granting overdraft facilities or any other type of credit facility to the State, central and local public authorities, autonomous public service undertakings, national societies, national companies and other majority state owned companies. Article 7(4) of the BNR Law extends this prohibition to other bodies governed by public law and public undertakings of Member States. These provisions do not fully mirror the entities listed in Article 123 of the TFEU (amongst others, a reference to Union institutions is missing) and, therefore, have to be amended.

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

As noted above in point 8.1.2., Article 43 of the BNR Law provides that the BNR shall transfer to the State on a monthly basis 80% of its net revenues after deduction of the expenses related to the financial year and the uncovered loss of the previous financial year. This provision does not rule out the possibility of an intra-year anticipated profit distribution under circumstances where the BNR would accumulate profit during the first half of a year, but suffer losses during the second half. The adjustment would be made by the State only after the closure of the financial year and would thus imply an intra-year credit to the State, which would breach the prohibition on monetary financing. This provision is, therefore, also incompatible with the Article 123 of the TFEU and has to be amended.

8.1.4. Integration in the ESCB

8.1.4.1 Objectives

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

8.1.4.2 Tasks

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

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

There are also imperfections regarding the:

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

8.1.5. Assessment of compatibility

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

8.2. PRICE STABILITY

8.2.1. Respect of the reference value

The 12-month average inflation rate for Romania, which is used for the convergence evaluation, at the last convergence assessment of Romania in 2012 was well above the reference value. Average annual inflation increased from below 3% in mid-2012 to 4.5% in mid-2013, before declining sharply thereafter. In April 2014, the reference value was 1.7%, calculated as the average of the 12-month average inflation rates in Latvia, Portugal and Ireland plus 1.5 percentage points. The corresponding inflation rate in Romania was 2.1%, i.e. 0.4 percentage points above the reference value. Romania's 12-month average inflation rate is projected to remain above the reference value in the months ahead.

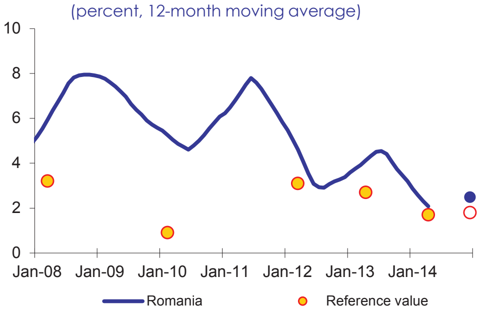
Table 8.1:
Romania - Components of inflation

	2008	2009	2010	2011	2012	2013	Apr-14	weights in total 2014
						(percentage change)[1]		
HICP	7.9	5.6	6.1	5.8	3.4	3.2	2.1	1000
Non-energy industrial goods	3.0	4.1	3.5	3.3	2.4	2.0	1.9	248
Energy	9.9	4.0	7.6	9.3	6.9	4.1	2.5	122
Unprocessed food	7.1	3.4	2.9	5.4	0.6	6.4	2.6	161
Processed food	10.9	7.3	10.4	7.5	3.5	2.3	0.7	214
Services	8.2	8.5	4.1	3.5	4.2	2.6	2.8	256
HICP excl. energy and unproc. food	7.6	6.6	6.4	5.0	3.3	2.3	1.9	717
HICP at constant taxes	7.1	4.0	1.8	3.8	3.2	3.0	2.0	1000
Administered prices HICP	7.8	7.1	5.4	7.6	5.3	6.0	4.9	144

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

Sources: Eurostat, Commission services.

Graph 8.1: **Romania - Inflation criterion since 2008**
(percent, 12-month moving average)

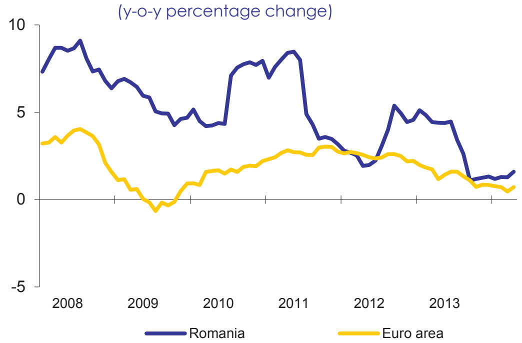


Note: The dots in December 2014 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2014 Forecast.

8.2.2. Recent inflation developments

Romania has recorded volatile and elevated inflation rates in recent years. Annual inflation peaked at 8.5% in May 2011 following an increase in the standard VAT rate in mid-2010 and a rise in food prices. It fell significantly during the second half of 2011 and in early 2012 to a low of 1.9% in April 2012, mainly due to a favourable base effect supported by a good harvest in 2011 and lower energy commodity prices. Inflation picked up again in the second half of 2012 due to rising food prices, the impact of which was exacerbated by the large share of food items in the consumer basket, and the pass-through effects associated with the leu's exchange-rate depreciation. Energy price increases following the roadmap to phase out administratively-set prices also added to inflationary pressures, especially by end-2012 and at the beginning of 2013. As a result, annual inflation remained above 4% between September 2012 and June 2013. Weak domestic demand and an abundant harvest induced considerable disinflation in the second half of 2013 which was supported by the reduction in the VAT rate on bread and flour from 24% to 9% in late 2013. In early 2014, annual HICP inflation thus hovered around 1.6%.

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



Source: Eurostat.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) has been on a downward trend from 3.6% in the first quarter of 2012 to 1.9% in the first quarter of 2014. The main drivers were slowing inflation for services and processed food. The levelling off in late 2012 was on account of the evolution in processed food prices, which are correlated to overall food commodity prices. Annual average producer price inflation for total industry decreased strongly to below 1% in 2013 and turned negative in first quarter of 2014, in line with overall receding inflation pressures.

8.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy-mix and cyclical stance

The Romanian economy growth accelerated to 3.5% in 2013 and is estimated to continue to operate slightly above potential in 2014 and 2015. A very weak harvest and the difficult external environment resulted in a slowdown of GDP growth to only 0.7% in 2012. GDP growth increased to 3.5% in 2013 on the back of a very good harvest and strong exports, while domestic demand remained weak. According to the Commission services' 2014 Spring Forecast growth is set to slow, but to remain robust at 2.5% in 2014 and 2.6% in 2015, amid a gradual rebalancing of growth drivers towards domestic demand. The output gap is estimated to have narrowed to 1.6% of GDP in 2013 and it is expected to further decline over the forecast horizon.

The fiscal stance, as measured by changes in the structural balance, has tightened in 2011-2013. Significant fiscal adjustment measures have been adopted under the joint EU-IMF financial assistance programme to bring public finances back on a sustainable path. The pace of fiscal tightening has declined, from a structural adjustment of some 2¼% of GDP in 2011 and 1¼% of GDP in 2012 to ¾% in 2013. The structural adjustment is expected to be limited in 2014-2015.

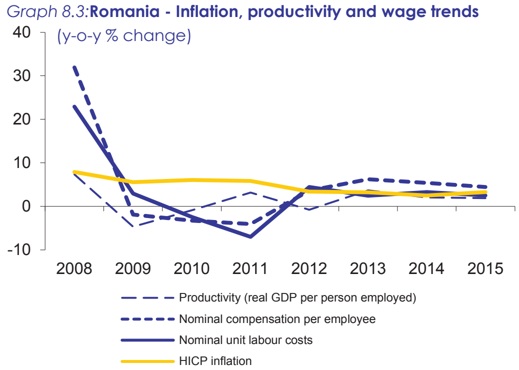
The BNR, operating within an inflation targeting framework ([74]), kept its key policy rate stable at 5.25% from March 2012 until May 2013, amid uncertainties related to a temporary spike in inflation due to rising food prices and related to the liberalisation of certain categories of administered prices. In view of an improved inflation outlook, it gradually cut the policy rate by a total of 175 basis points between July 2013 and in February 2014, in order to stimulate lending and domestic demand. It also reduced minimum reserve requirements with the medium term goal to align them increasingly with ratios prevailing in the rest of the EU. Nevertheless, the banking sector's loan portfolio contracted in 2013 and credit growth remained negative at the beginning of 2014.

Wages and labour costs

The labour market situation was considerably affected by the economic downturn. After three years of continuous decline, total employment grew in 2012 only to decrease somewhat again in 2013, despite a strong pick-up in economic growth. It is expected to expand only gradually in 2014-2015. The unemployment rate has fluctuated between 7.0% and 7.3% in recent years and is expected to remain at a similar level.

Nominal compensation per employee declined in the period 2009-2011, but recovered strongly in 2012 and 2013. Compensation per employee is expected to increase further by around 5% in 2014-2015. Labour productivity growth was negative in 2012 with employment recovering faster than output. Labour productivity picked up in 2013 on the back of economic recovery and decreasing employment. It is projected to increase by about 2% in 2014-15, in line with a projected moderate pace of economic expansion accompanied by sluggish employment growth. As a result, growth of nominal unit labour costs (ULC) is expected to remain relatively moderate, at around 3% in 2014-2015.

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



Source: Eurostat, Commission services' Spring 2014 Forecast.

External factors

Given its deepening integration into the world and the EU economy, developments in import prices play an important role in domestic price formation in Romania. Import price inflation (measured by the imports of goods deflator) outpaced consumer price inflation in 2011-2012, before turning negative in 2013.

([74]) Year-end annual inflation targets of 3.0% in terms of annual consumer price index growth (with a tolerance band of ± 1 percentage point) were set for end-2011 and end-2012. Starting in 2013, the BNR follows a flat multi-annual inflation target of 2.5% (± 1pp.).

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

	2008	2009	2010	2011	2012	2013 1)	2014 2)	2015 2)
HICP inflation								
Romania	7.9	5.6	6.1	5.8	3.4	3.2	2.5	3.3
Euro area	3.3	0.3	1.6	2.7	2.5	1.3	0.8	1.2
Private consumption deflator								
Romania	10.0	3.7	7.7	4.3	3.9	4.4	2.9	3.2
Euro area	2.7	-0.4	1.6	2.4	2.1	1.3	0.9	1.3
Nominal compensation per employee								
Romania	31.9	-1.9	-3.3	-4.1	3.6	6.2	5.4	4.5
Euro area	3.5	1.8	2.0	2.2	2.0	1.7	1.6	1.9
Labour productivity								
Romania	7.3	-4.7	-0.9	3.2	-0.8	3.7	2.1	1.9
Euro area	-0.3	-2.4	2.6	1.4	0.2	0.5	0.9	1.0
Nominal unit labour costs								
Romania	22.9	2.9	-2.4	-7.0	4.4	2.5	3.3	2.5
Euro area	3.8	4.3	-0.6	0.7	1.8	1.1	0.7	0.8
Imports of goods deflator								
Romania	17.2	2.2	6.1	6.5	6.0	-2.1	0.2	0.9
Euro area	4.2	-8.1	5.7	6.6	2.3	-1.9	-1.0	0.8

1) 2013 data (except HICP inflation) are estimates.
2) Commission services' Spring 2014 Forecast.
Source: Eurostat, Commission services.

Energy and food commodity prices have been an important determinant of import price inflation in Romania, in particular given the large weight of these categories in the Romanian HICP. Following a substantial increase in 2011, the contribution of energy prices to HICP inflation declined gradually to about 0.5 pp. in 2013 as primary commodity prices remained broadly flat in 2012-2013.

Fluctuations of the leu have only moderately influenced import price dynamics in recent years. The nominal effective exchange rate (measured against a group of 36 trading partners) depreciated somewhat in mid-2012 reflecting volatile capital flows and political uncertainty. It recovered again in late 2012 and early 2013 and then remained broadly stable throughout 2013 and in early 2014.

Administered prices and taxes

Changes in administered prices and indirect taxes have significantly contributed to inflationary pressures in Romania in recent years. Administered prices have a somewhat larger weight in the HICP basket of around 15% (compared to 13% in the euro area) ([75]). Annual inflation in administered prices decreased from 7.6% in 2011 to 5.3% in 2012 on the back of stable commodity prices and a favourable base effect stemming from changes in taxation in 2011. It increased to 6.0% in 2013. The liberalisation of prices of gas and electricity for households started in the second half of 2013. This is, *ceteris paribus*, expected to put upward price pressure on energy and therefore on administered prices. Relatively low international commodity prices however counterbalanced this upward pressure in the second half of 2013.

Increases in fuel and tobacco excise duties contributed moderately to inflation in Romania in 2012 and 2013. As a result, the constant tax-inflation measure remained below HICP inflation in 2012 and during the first half of 2013. The reduction of VAT rates on bread and flour contributed to the inversion of the trend in late 2013. By April 2014, annual constant tax-inflation was some 0.1 pp. below HICP inflation.

([75]) According to the Eurostat definition, administered prices in Romania include *inter alia* regulated electricity and gas prices, regulated utility prices, medical products, postal services and cultural services and part of public transport. For details, see http://epp.eurostat.ec.europa.eu/portal/page/portal/hicp/documents_meth/HICP- AP/HICP_AP_classification_2011_2014_02.pdf

Medium-term prospects

According to the Commission services' 2014 Spring Forecast, annual inflation is projected to decelerate from 3.2% in 2013 to 2.5% in 2014, mainly due to falling food prices, reaching historical lows in the first half of 2014. Inflation is expected to return to the upper part of the central bank's target band (2.5%±1pp.) in the second half of the year. In 2015, a gradual recovery in domestic demand and continued price convergence towards the EU average are expected to translate into higher annual average inflation (3.3%). It should nevertheless still remain within the central bank's target band.

Risks to the inflation outlook are broadly balanced. Domestic demand might surprise on the upside leading to inflationary pressures. Upside risks are also related to a possible rise of global commodity prices, with the overall impact amplified by the relatively large weight of commodities in the consumption basket. A gradual withdrawal of monetary stimulus in the US and associated capital outflows from emerging markets might exert some downward pressure on the exchange rate which would feed into higher inflation. On the other hand, the continued need for banks to repair their balance sheets might constrain credit flows. Low inflation in the euro area might also spill-over via the extensive trade links with the Romanian economy.

Over the long run, there is significant potential for further price level convergence, in line with the expected catching-up of the Romanian economy (with income levels at about 46% of the euro-area average in PPS in 2013). The level of consumer prices in Romania was around 54% of the euro-area average in 2012, with the relative price gap widest for services.

Medium-term inflation prospects will hinge upon productivity and wage developments as well as on developments in some categories of administered prices. The liberalisation of electricity and gas markets, as agreed under the joint EU-IMF financial assistance programme, should, *ceteris paribus,* imply sizeable inflationary pressures during 2014-2018. The actual impact of such measures on inflation will also depend on developments in global commodity prices and on further price liberalisation. Anchoring inflation expectations at a low level will be also important going forward. A prudent fiscal policy and continuation of structural reforms, reaffirmed by the commitments of the Romanian authorities under the ongoing joint EU-IMF assistance programme, should support sustainable convergence going forward.

8.3. PUBLIC FINANCES

8.3.1. Recent fiscal developments

On 21 July 2013, the Council decided to abrogate the decision on the existence of an excessive deficit according to Article 126 (12) TFEU, thereby closing the excessive deficit procedure for Romania ([76]).

Since 2009, Romania benefited from medium-term financial assistance from the EU provided in conjunction with a stand-by arrangement by the IMF. Romania was able to regain market access during the first financial assistance programme (2009-2011) and has treated the second programme (2011-2013) as pre-cautionary. In July 2013, the authorities requested a third financial assistance programme, also of pre-cautionary nature, which was granted by the Council in October 2013 ([77]). The current programme, running until 2015, aims to support Romania in reaching its medium-term budgetary objective in 2015, as recommended by the Council ([78]), to improve fiscal governance and to implement other structural reforms.

During the crisis, the headline government deficit peaked at 9.4% of GDP in 2009. The authorities opted for a front-loading of fiscal consolidation focused on the expenditure side, but also involving some revenue measures. This included reduction of public wages, reduction in social spending and an increase in the standard VAT rate and helped the deficit to decline to 5.5% of GDP in 2011. Total expenditure declined from 39.4% of GDP in 2011 to 35.0% in 2013. Since 2011, the revenue-to-GDP ratio decreased from 33.9% to 32.7% in 2013.

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

([77]) The precautionary international assistance package provides for a total of EUR 4 billion, equally split between EU and IMF. For further information on this and past programmes, see http://ec.europa.eu/economy_finance/assistance_eu_ms/romania/index_en.htm

([78]) http://ec.europa.eu/europe2020/making-it-happen/country-specific-recommendations/index_en.htm

Table 8.3:

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

Outturn and forecast [1]	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	
General government balance	-5.7	-9.0	-6.8	-5.5	-3.0	-2.3	-2.2	-1.9	
- Total revenues	33.6	32.1	33.3	33.9	33.7	32.7	32.6	32.8	
- Total expenditure	39.3	41.1	40.1	39.4	36.7	35.0	34.8	34.7	
of which:									
- Interest expenditure	0.7	1.5	1.5	1.6	1.8	1.8	1.8	1.8	
p.m.: Tax burden	28.8	27.7	27.6	28.5	28.5	27.7	27.6	27.7	
Primary balance	-5.0	-7.5	-5.3	-3.9	-1.2	-0.5	-0.5	-0.2	
Cyclically-adjusted balance	-8.5	-9.1	-6.0	-5.0	-1.9	-1.7	-1.8	-1.7	
One-off and temporary measures	-0.5	0.5	0.0	-1.2	0.5	0.0	0.0	0.0	
Structural balance [2]	-8.0	-9.6	-6.1	-3.8	-2.5	-1.7	-1.8	-1.7	
Government gross debt	13.4	23.6	30.5	34.7	38.0	38.4	39.9	40.1	
p.m: Real GDP growth (%)	7.3	-6.6	-1.1	2.3	0.6	3.5	2.5	2.6	
p.m: Output gap	8.6	0.2	-2.3	-1.8	-3.2	-1.6	-1.2	-0.8	
Convergence programme							**2014**	**2015**	**2016**	**2017**
General government balance							-2.2	-1.4	-1.3	-1.1
Structural balance [2) 3)]							-1.8	-1.0	-1.0	-0.9
Government gross debt							39.9	39.6	39.1	38.5
p.m. Real GDP (% change)							2.5	2.6	3.0	3.3

1) Commission services' Spring 2014 Forecast.
2) Cyclically-adjusted balance excluding one-off and other temporary measures.
3) Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures are: 0.6% of GDP in 2006, 0.1% of GDP in 2007, 0.5% of GDP in 2008 and 1.2% of GDP in 2011, all deficit increasing; 0.5% of GDP in 2009, deficit-decreasing.
Sources: Commission services, the 2014 Convergence Programme of Romania.

In 2012, the deficit decreased further to 3.0% of GDP. This was mainly driven by measures on the expenditure side. Social security spending was lowered by keeping pensions mostly flat and by streamlining the social assistance programmes. Excises for tobacco and diesel were raised to strengthen the revenue side. 2013 saw a further decline of the headline deficit to 2.3% of GDP. Reductions in expenditure provided for the adjustment of the deficit, including savings in social assistance.

Revenue measures included: i) the introduction of a turnover tax for certain SMEs; ii) the introduction of a tax on windfall gains related to the deregulation of gas prices; and iii) increases of excises on tobacco and alcoholic beverages. These revenue measures were offset by weak tax collection due to less tax-rich growth, the restructuring of the tax administration agency and a reduction in the VAT on bread and flour. The structural deficit decreased from 3.8% of GDP in 2011 to 1.7% in 2013 according to the Commission services' 2014 Spring Forecast.

The debt-to-GDP ratio, which stood at 13.4% in 2008, increased significantly as a result of high government deficits and unfavourable effects from higher interest rates and stock-flow adjustments. It has nonetheless stabilised below 39% in 2012-2013 thanks to the reduced deficit and improved financing conditions. At the end of 2013, public debt stood at 38.4% of GDP.

8.3.2. Medium-term prospects

The budget for 2014 was adopted by Parliament on 4 December 2013 targeting a deficit of 2.2% of GDP. The consolidation measures adopted are mainly on the revenue side and include: i) an increase in excises on fuel; ii) the introduction of inflation indexation of excise duties; iii) a base broadening of the property tax; and iv) an increase in royalties on mineral resources other than oil and gas. Policies increasing the expenditure include the indexation of pensions foreseen by law and a limited and targeted rise in public sector salaries. The budget also allows for a rise in expenditure related to the co-financing of EU funds to cater for accelerated absorption.

Taking these measures into account the Commission services' 2014 Spring Forecast projects a deficit of 2.2% of GDP in 2014, in line with the authorities' target. In 2015, the nominal deficit is expected to decrease further to 1.9% of

GDP under a no-policy-change assumption. Under this scenario, the policies implemented by the authorities are expected to lead to a slight decrease in the expenditure-to-GDP ratio. It is expected to decrease from 35.0% in 2013 to 34.7% in 2015. Revenue as a percent of GDP is expected to increase slightly from 32.7% in 2013 to 32.8% in 2015. According to the Commission services' 2014 Spring Forecast, the underlying fiscal position in 2014-2015, as measured by the change in the structural balance (cyclically-adjusted balance excluding one-offs and other temporary measures), is expected to remain unchanged. The debt-to-GDP ratio is expected to increase to 40.1% of GDP in 2015.

Romania submitted the 2014 Convergence Programme on 5 May 2014. The Programme aims to reach the MTO in 2015. The Convergence Programme foresees a deficit of 2.2% of GDP in 2014, 1.4% of GDP in 2015, 1.3% of GDP in 2016 and 1.1% of GDP in 2017. The Commission services' 2014 Spring Forecast expects the deficit to slightly decrease to 2.2% of GDP in 2014 and further to 1.9% of GDP in 2015 under a no-policy-change assumption.

Further details on the assessment of the 2014 Convergence Programme for Romania can be found in the Commission Staff Working Document, which accompanies the Commission Recommendation for a Council Recommendation on the National Reform Programme 2014 of Romania and delivering a Council Opinion on the 2014 Convergence Programme of Romania.

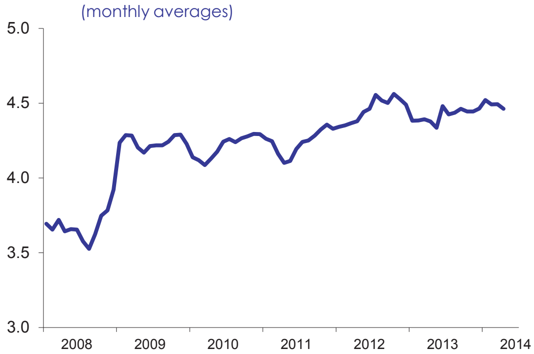
In March 2012, Romania signed the Treaty on Stability, Coordination and Governance in the EMU and declared its intension to comply with the Title III Fiscal Compact already now. This implies an additional commitment to conduct a stability-oriented and sustainable fiscal policy. The TSCG will apply to Romania in its entirety upon lifting its derogation from participation in the single currency. The Fiscal Responsibility Law was amended on 10 December 2013 with a view to comply with the above-mentioned Treaty.

8.4. EXCHANGE RATE STABILITY

The Romanian leu does not participate in ERM II. Romania has been operating a *de jure* managed floating exchange rate regime since 1991 with no preannounced path for the exchange rate ([79]). *De facto*, the exchange rate regime moved gradually from a strongly managed float – including through the use of administrative measures until 1997 – to a more flexible one. In 2005, Romania shifted to a direct inflation targeting framework combined with a floating exchange rate regime. The BNR has, nonetheless, stressed that currency intervention remains available as a policy instrument.

After the global financial crisis in late 2008 and early 2009, the leu broadly stabilised and mostly traded between 4.1-4.3 RON/EUR from 2009 until late 2011. The lower short-term volatility of the leu reflected – in addition to the positive effects associated with the EU-IMF international financial assistance to Romania and easing global market conditions – also operations by the BNR in the interbank as well as in the foreign exchange market. The leu depreciated towards historical lows of above 4.5 RON/EUR in July 2012. It firmed somewhat in late 2012 and early 2013, as foreign interest in leu-denominated assets increased following the parliamentary elections in December 2012. The leu's exchange rate against the euro temporarily depreciated in May-June 2013, reflecting heightened global risk aversion, but the weakening was more moderate in comparison with other regional peers operating under floating exchange rate regimes. The leu came again under depreciation pressures in early 2014. During the two years before this assessment, the leu depreciated against the euro by 1.9%.

Graph 8.4: **Exchange rates - RON/EUR**
(monthly averages)



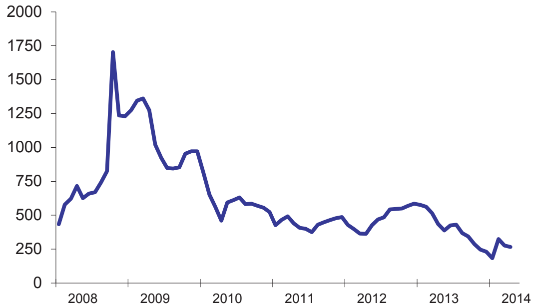
Source: ECB.

The gross international reserves remained robustly high in 2012 and 2013, amounting on average to

([79]) On 1 July 2005 the Romanian Leu (ROL) was replaced by the new leu (RON), with a conversion factor of 1 RON = 10,000 ROL. For convenience, however, the text of this report consistently refers to leu, meaning ROL before and RON after the conversion.

around EUR 35bn, despite gradual repayments of international financial assistance. Its short-term fluctuations in recent years have mainly reflected changes in the foreign exchange reserve requirements of credit institutions, as well as foreign exchange operations by the government. The reserve level was at around 25% of GDP by end-2013.

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



Source: National Bank of Romania.

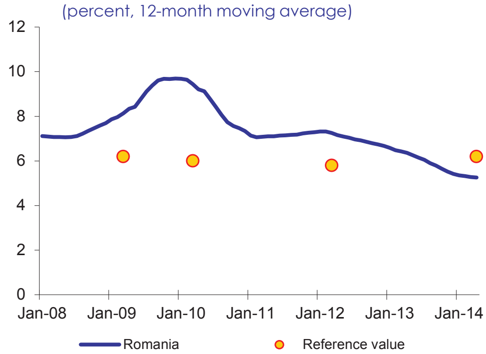
Short-term interest rate differentials vis-à-vis the euro area decreased to below 400 basis points by end-2011. They widened again during 2012, as the ECB loosened its policy stance, while rates on the Romanian money market increased substantially due to political instability concerns. After peaking at above 580 basis points in late 2012, short-term spreads declined gradually throughout 2013 to around 200 basis points by end-2013, reflecting considerable monetary policy easing by the BNR from July 2013 to February 2014 by reducing the key policy rate by 175bps. At the cut-off date of this report, the 3-month spread vis-à-vis the euro area increased to around 270 basis points.

8.5. LONG-TERM INTEREST RATES

Long-term interest rates in Romania used for the convergence examination reflect secondary market yields on a single government benchmark bond with a residual maturity of around nine years. However, the limited number of Romanian long-term bonds issued and the illiquidity of the secondary market may pose some difficulties in interpreting the data.

The Romanian 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion stayed above the reference value at each convergence assessment since EU accession in 2007. It peaked at 9.7% in the fourth quarter of 2009, but gradually declined thereafter and hovered at just around 7% in 2011. It was above the reference value at the time of the last convergence assessment of Romania in 2012. Since then, it declined further to around 5.5% by the end of 2012 and floated around 5.3% over the most of 2013. In April 2014, the latest month for which data are available, the reference value, given by the average of long-term interest rates in Latvia, Portugal and Ireland plus 2 percentage points, stood at 6.2%. In that month, the 12-month moving average of the yield on the Romanian benchmark bond stood at 5.3%, i.e. 0.9 percentage points below the reference value.

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

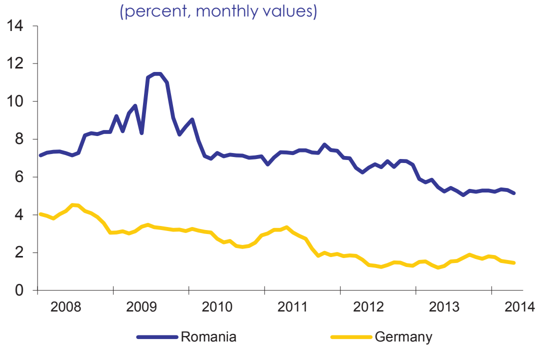


Source: Commission services.

After having remained at just above 7% for most of the period 2010-2011, long-term interest rates declined gradually to below 5.5% in the second quarter of 2013, reflecting a reduced country risk premium backed by a solid fiscal consolidation track record as well as a gradual downward adjustment of the expected path of interbank rates and the precautionary EU-IMF programme. They then remained broadly stable, hovering between 5% and 5½% until early 2014. At the same time, the long-term spread vis-à-vis the German benchmark bond declined from above 500 basis points in late 2012 to below 350 basis points in late 2013 and it stood at around 380 basis points in April 2014 ([80]).

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

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



Source: Eurostat.

8.6. ADDITIONAL FACTORS

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

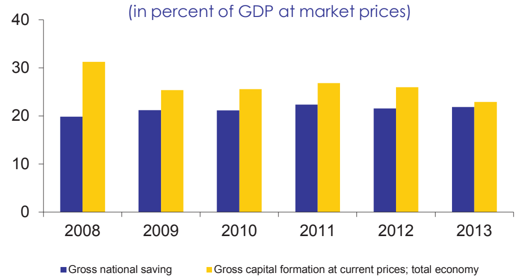
In November 2013, the Commission published its third Alert Mechanism Report (AMR 2014) ([81]) under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.5). The AMR 2014 scoreboard showed that Romania exceeded the indicative threshold in two out of eleven indicators in the area of external imbalances (i.e. the net international investment position and the current account deficit). Romania currently benefits from a precautionary EU-IMF financial assistance programme totalling up to about EUR 4 billion which is foreseen to last until September 2015. Close surveillance related to this arrangement implies that Romania is not subject to in-depth reviews in the context of the MIP in order to avoid the duplication of surveillance procedures ([82]).

8.6.1. Developments of the balance of payments

Romania's external balance (i.e. the combined current and capital account) improved markedly during the global crisis. After having recorded a deficit of around 4% of GDP in 2009-2011 it narrowed somewhat in 2012 and then shifted into a surplus in 2013. The improvement in the external balance reflected a significant decline in the trade deficit, due to strong export growth and mostly flat imports. The negative net income balance widened in 2012-2103, reflecting an increase in FDI-related profits. At the same time, the positive balance of current transfers remained broadly stable. Finally, the capital account recorded an increasing surplus due to improved absorption of EU funds.

Romania's saving-investment gap continued to narrow from 4.5% in 2011 to 1.0% in 2013. Both gross savings and investment declined somewhat in 2012. While savings increased again in 2013, investment continued to decline, inducing the significant adjustment of the current account balance. The need of the corporate sector to repair its balance sheets appears to have been the main driver, while the savings-investment gap of the public sector also continued to narrow.

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



Source: Eurostat, Commission services.

External price and cost competitiveness continued to improve in the first half of 2012, largely due to NEER depreciation. Competitiveness then deteriorated somewhat in 2013, as NEER appreciation was accompanied by relatively higher price and cost increases in Romania compared to its main trading partners. Nevertheless, Romania managed to increase its export market share considerably in 2013.

([81]) http://ec.europa.eu/europe2020/pdf/2014/amr2014_en.pdf
([82]) http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:140:0001:0010:EN:PDF

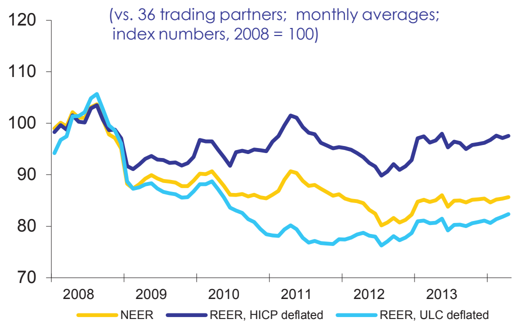
Table 8.4:
Romania - Balance of payments **(percentage of GDP)**

	2008	2009	2010	2011	2012	2013
Current account	-11.6	-4.2	-4.4	-4.5	-4.4	-1.1
of which: Balance of trade in goods	-13.6	-5.8	-6.1	-5.6	-5.6	-2.4
Balance of trade in services	0.5	-0.2	0.3	0.3	0.9	1.9
Income balance	-2.7	-1.6	-1.5	-1.7	-2.3	-3.2
Balance of current transfers	4.3	3.5	2.9	2.5	2.6	2.6
Capital account	0.4	0.5	0.2	0.5	1.4	2.3
External balance [1]	-11.1	-3.6	-4.2	-4.0	-3.0	1.2
Financial account	12.6	4.7	4.6	3.6	2.4	-2.0
of which: Net FDI	6.7	3.0	1.8	1.4	1.7	1.9
Net portfolio inflows	-0.4	0.4	0.7	1.3	2.7	2.7
Net other inflows [2]	6.3	2.3	4.7	1.7	-3.1	-5.1
Of which International financial assistance		7.5	6.4	1.8	-0.6	-2.8
Change in reserves (+ is a decrease)	0.1	-1.0	-2.6	-0.7	1.1	-1.4
Financial account without reserves	12.6	5.8	7.2	4.3	1.3	-0.6
Errors and omissions	-1.5	-1.1	-0.4	0.4	0.6	0.8
Gross capital formation	31.3	25.4	25.6	26.8	26.0	22.9
Gross saving	19.8	21.2	21.2	22.4	21.5	21.9
External debt	51.8	68.7	74.4	75.1	75.8	67.5
International investment position	-53.4	-62.2	-63.7	-65.4	-67.5	-62.3

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

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

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



Source: Commission services.

Romania has been a recipient of international financial assistance since 2009. When the international financial turmoil escalated in late 2008, the large external shortfall in combination with the banking system's heavy reliance on foreign funding raised concerns about external debt sustainability. The first two-year joint EU-IMF financial assistance programme of around 18 billion euros was provided to Romania amid tightening market conditions and growing government refinancing needs in 2009. It was followed by two joint EU-IMF programmes, granted in 2011 and 2013. Unlike the first programme, both subsequent programmes have been treated as precautionary, and no funding has been requested so far.

External financing pressures eased further in 2012-2013 amid improvement in the external balance and recovery in global risk appetite. Net FDI inflows, which had fallen sharply in 2009-10, broadly stabilised in 2011-13, averaging around 1.5% of GDP. Net portfolio inflows increased gradually in recent years to nearly 3% of GDP in 2012 and 2013. The success in attracting significant amounts of portfolio investment into government securities also reflected the inclusion of Romania in a number of international benchmark indices. Net other inflows turned negative in 2012 and 2013 due to repayments of international financial assistance. Gross external debt rose in 2011-2012 to above 75% of GDP mainly driven by an increase of public external debt. It declined to below 70% of GDP in 2013, due to a reduction of banks' external debt and plateauing public external debt. The net international investment position peaked at -68% of GDP in 2012. It has declined to some –62% of GDP in 2013, on the back of the strong current

Table 8.5:
Romania - Product market integration

	2007	2008	2009	2010	2011	2012
Trade openness 1) (%)	36.3	37.0	33.6	38.3	42.7	43.0
Intra-EA trade in goods GDP ratio 2) (%)	17.5	16.9	15.8	17.9	19.8	19.5
Intra-EA trade in services GDP ratio 3) (%)	n.a.	3.3	3.3	2.8	3.0	3.4
Extra-EA trade in goods GDP ratio 4) (%)	14.9	15.6	13.0	15.9	18.3	18.3
Export in high technology 5) (%)	3.5	5.4	8.2	9.8	8.8	6.3
High-tech trade balance 6) (%)	-2.6	-2.2	-1.5	-1.6	-1.5	-1.8
Total FDI inflows GDP ratio 7) (%)	5.8	6.8	2.9	1.8	1.4	1.6
Intra-EA FDI inflows GDP ratio 8) (%)	5.1	n.a.	3.0	n.a.	1.2	0.9
FDI intensity 9)	3.0	3.5	1.4	0.9	0.7	0.8
Internal Market Directives 10) (%)	0.8	0.4	0.3	0.5	1.2	0.4
Time to start up a new company 11)	9.0	9.0	9.0	9.0	13.5	9.5
Real house price index 12)	n.a.	158.5	116.8	100.0	82.3	74.0
Residential investment 13) (%)	2.4	3.2	3.0	3.0	2.7	n.a.
Building permits index 14)	134.5	144.9	115.8	100.2	93.6	89.9

1) (Imports + Exports of goods and services / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics, Balance of Payments).
2) (Intra-EA-18 Imports + Exports of goods / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).
3) Intra-EA-17 trade in services (average credit and debit in % of GDP at current prices) (Balance of Payments).
4) (Extra-EA-18 Imports + Exports of goods / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).
5) Taken directly from Eurostat's databases: Exports of high technology products as a share of total exports.
6) (Exports - imports in high tech) / GDP at current prices x 100, since 2007 the data based upon SITC Rev. 4 (earlier SITC Rev. 3).
7) Total FDI inflows (in % of GDP at current prices).
8) Intra-EA-17 FDI inflows (in % of GDP at current prices).
9) FDI intensity (average intra-EU-27 inflows and outflows in % of GDP at current prices).
10) Percentage of internal market directives not yet communicated as having been transposed, in relation to the total number.
11) Time to start a new company (in days), Doing Business World Bank.
12) Deflated house price index (2010=100), Eurostat.
13) Gross capital formation in residential buildings (in % of GDP), Eurostat.
14) Number of new residential building permits (2010=100), Eurostat.
Sources: Eurostat, Sectoral Performance Indicators Database (SPI), Commission services.

account adjustment and robust nominal economic growth.

According to the Commission services' 2014 Spring Forecast, the external balance is expected to remain broadly balanced in 2014 and in 2015. Romania's external position is expected to benefit from a higher absorption of EU funds.

8.6.2. Market integration

Romania's economy is well integrated into the euro area through both trade and investment. The trade openness of Romania has increased significantly in the aftermath of the crisis, but is still relatively low. Trade openness in 2012 stood at around 43% of GDP. Trade with the euro area dominates, and in particular with Germany, Italy, France and the Netherlands.

Romania's trade pattern reflects the country's labour-cost advantages and price competitiveness. However, its trade specialisation has changed to some extent in the recent years, taking advantage from its increased integration with the EU economy and from substantial technology transfers by companies from the euro-area Member States. The cumulative share of a few sectors (namely machinery and electrical equipment, vehicles, aircraft, vessels) increased significantly in recent years, reaching almost 40% in 2012. However, the upward trend in the share of high-technology products in exports reversed to just 6.3% GDP in 2012 in comparison with the 8.8% reached in 2011. This decline is explained to a large extent by the relocation abroad of an important cell phone manufacturer. The high-tech trade balance deficit declined significantly from 2007 to 2011, but experienced a slight rebound in 2012. This is in part explained by reduced investment, deleveraging and a significant fall in FDI inflows.

Due to wage competitiveness, favourable corporate tax rates and a relatively large domestic market, Romania attracted substantial FDI inflows in the years before the crisis. However, in the aftermath of the crisis FDI inflows declined considerably. FDI inflows have remained relatively low, at around 1.5% of GDP in 2011-2012. Despite a slight recovery in 2013, they are expected to remain substantially below their pre-crisis level. The FDI stock reached 56% of GDP in 2012, much lower than in other non-euro area Member States. The main FDI inflows originate from euro-area Member States, with the Netherlands, Austria and Germany accounting for more than half of the FDI inflows in 2012. In terms of sectoral allocation, the FDI stock was 31% in manufacturing, some 19% in financial intermediation and insurance, and 9% in construction and real estate. In Romania, FDI has a tendency to concentrate in the main metropolitan areas, with the Bucharest region attracting more than two-thirds in 2012.

According to Eurostat, house prices have followed a negative trend since 2008 (the first year with available data). In particular, the real house price index halved between 2008 and 2012. The speed of the adjustment has declined over time (from a 26% year-on-year decrease in 2009 to 9% in 2012). Investment in dwellings has been stable at around 3% of GDP in the past five years. Building permits rose by 121% in the period 2003-2008. Since then, the number of licenses decreased by 38% in 2008-2012 and remained unchanged in 2013. Real value added in the construction sector has shrunk over the last years, after double-digit increases in the pre-crisis period, and stands at 10% of total value added in 2012. Employment in the real estate sector has fallen notably in the last years (by 14% in 2012 alone).

Concerning the business environment, Romania performs, in general, worse than most euro-area Member States in international rankings ([83]). In particular, Romania has low ranks in trading across borders and in registering property. According to the 2014 World Bank Doing Business report, the ease of paying taxes and of opening a business has recently improved. According to the November 2013 Internal Market Scoreboard, Romania had a transposition deficit (0.6%), close to the 0.5 % target as proposed by the European Commission in the Single Market Act (2011), which is on par with the EU average. Public administration as a whole also performs relatively poorly according to the World Bank's Worldwide Governance Indicators ([84]).

In terms of resilience during the crisis, the capacity of the Romanian labour market to adjust has been improved. Since the major reform of the social dialogue code in 2011, wage-setting is largely decentralised, with only few multi-company wage agreements being in place. Changes in the labour code implemented in 2011 affecting provisions regarding fixed-term contracts, collective dismissals and individual redundancies, working-time flexibility and temporary agency contracts, started to pay off. Yet in terms of capacity to generate new jobs and income, labour market continues to under-perform as it remains characterised by a low employment rate (20-64 age group around 64% in 2012-2013), high youth unemployment (around 23% in 2012-2013) and a low share of temporary and fixed-term employment contracts. The 2011 reform of the labour and social dialogue code is being complemented by only very limited active labour market policies and only hesitant reforms in education and vocational training that aim to address skill mismatches. Due to a limited recovery of employment in 2012-2013, the propensity to emigrate in search of better job opportunities abroad is still strong among the Romania's labour force: population at working age continued to decline faster than total population in 2011-2012.

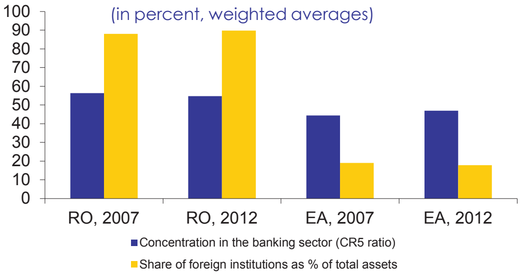
8.6.3. Financial market integration

The Romanian financial sector is highly integrated into the EU financial sector, in particular through the strong presence of foreign banks in Romania. The share of foreign-owned banks, mainly euro area parent banks, in the total assets of the Romanian banking sector has slightly increased and reached some 90% in 2012 compared to 88% in 2007. Concentration in the banking sector, as measured by the market share of the largest five credit institutions, declined marginally between 2007 and 2012, but remained above the euro area average.

([83]) Romania ranks 73rd (out of 189 economies) on the World Bank's 2014 Ease of Doing Business Index and 76th (out of 148 economies) on the World Economic Forum's 2013-2014 Global Competitiveness Index .

([84]) http://info.worldbank.org/governance/wgi/index.aspx#home

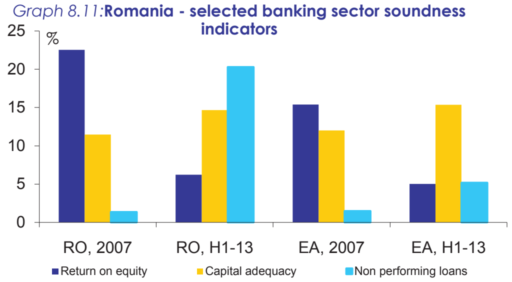
Graph 8.10:**Romania - Foreign ownership and concentration in the banking sector**
(in percent, weighted averages)



Source: ECB, Structural financial indicators.

After a rapid financial deepening in the years before the onset of the financial crisis, credit activity in Romania has weakened considerably since 2007, reflecting both demand and supply side factors. Romania still lags considerably behind the euro area as regards bank credit to the private non-financial sector (around 34% of GDP). Foreign-currency loans have played an important role in lending to the private sector, as the share of these loans increased steadily in the period 2007–2012 to roughly 67% of the total loans to households in 2012, i.e. up by roughly 14 percentage points compared to 2007 (though part of this increase is due to the depreciation of the leu). Lending to non-financial corporates has also been dominated by foreign-currency loans, albeit to a lesser extent. Foreign-currency loans to corporates increased to 59% of total loans in 2012, compared to 55% in 2007. However, recent trends show a decrease in foreign-currency lending for both households and corporates, inter alia due to the measures introduced by the National Bank of Romania to curb foreign-currency lending to unhedged households and corporates, in particular SMEs. Private sector debt declined from 124% of GDP in 2009 to 74% by end-2012.

Graph 8.11:**Romania - selected banking sector soundness indicators**

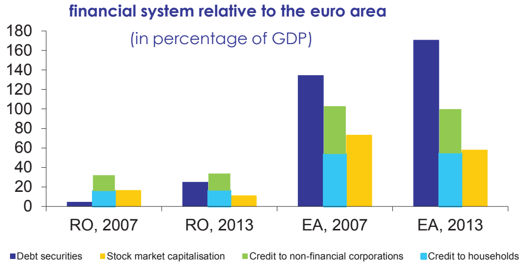


Note: For 2007 EU-27 non performing loans are a proxy for EA.
For 2007, EA RoE and CAR averages are unweighted.
Source: ECB, EC calculations, NBR.

The Romanian banking sector has remained resilient and maintained sufficient capital buffers, notwithstanding the still on-going deterioration in asset quality. The banking system has remained well-capitalised, as capital adequacy at system level stood at roughly 14.7% at the end of June 2013. The shareholders of banks have provided capital support, if necessary, so that no public resources have been used for banking sector rescue measures. Nonetheless, the deterioration in asset quality and the increase in loan-loss provisions, inter alia due to two collateral audits mandated by the banking supervisor in 2012 and 2013, have put a strain on banking sector profitability. Consequently, return on equity declined from 22.5% in 2007 to 6.2% in mid-2013. Non-performing loans (90 days overdue) have increased significantly compared to the pre-crisis period (i.e. from below 2% in 2007 to roughly 20% in mid-2013).

In spite of the recovery in economic activity, Romania has continued to show a comparatively low penetration of financial market services. In the insurance sector, gross written premiums recorded a positive trend in 2012 as they increased by 5.6% compared to 2011. Insurance penetration (i.e. the ratio between gross written premiums for life and non-life insurance and GDP) in Romania stood at roughly 1.4 % of GDP in 2012, which is still one of the lowest in the EU. Notwithstanding the difficult economic environment, the private pension system including mandatory pension funds (Pillar II) and voluntary pension funds (Pillar III) introduced in Romania in 2007 has recorded a positive trend. Total net assets of the Pillar II pension funds increased from 0.2% of GDP in 2008 to 1.8% in June 2013. The net assets of the pillar III pension funds also went up and reached around 0.1% of GDP in June 2013. Furthermore, the private pension funds (mostly Pillar II funds) are currently the largest domestic institutional investors on the Romanian capital market, ahead of mutual investment funds and insurance companies.

Graph 8.12:**Romania - Recent development of the financial system relative to the euro area**
(in percentage of GDP)



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

Equity and debt markets in Romania have remained comparatively underdeveloped. Stock market capitalisation has continued to be very low as compared to the euro area and regional peers. The stock market capitalisation of 11% of GDP in 2013 ranked Romania low among its peers in Central and Eastern Europe. The stock market capitalisation gap vis-à-vis the euro area has remained broadly unchanged amid high market volatility, though the Romanian market largely moved in sync with global markets. Debt securities markets have been dominated by issuances of government debt (T-bills and bonds denominated in both RON and foreign currency), whereas the issuance of corporate and municipal bonds has remained limited.

Romania established in 2013 a single regulator for the non-bank financial sector (i.e. Authority for Financial Supervision – AFS), which replaced the former sectoral supervisory authorities in the area of securities, insurance and pensions. Whereas the establishment of a single regulator constitutes a first step towards a more efficient and effective supervision of the non-bank financial sector, several aspects need further improvement in order to bring the ASF in line with good international practices. Romania has transposed roughly 93% of all post-FSAP directives into national legislation as of mid-December 2013. As regards the Alternative Investment Fund Managers Directive (AIFMD)([85]), Romania has partially notified its transposition to the Commission services.

([85]) http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:32011L0061

9. SWEDEN

9.1. LEGAL COMPATIBILITY

9.1.1. Introduction

The legal rules governing the Swedish Central Bank (Riksbank) are laid down in the Instrument of Government (as part of the Swedish Constitution) and the Riksbank Act from 1988. No amendments to these legal acts were passed with regard to the incompatibilities and the imperfection mentioned in the 2012 Convergence Report.

9.1.2. Central Bank Independence

Article 3 of Chapter 6 of the Riksbank Act obliges the Riksbank to inform the minister appointed by the Swedish Government about a monetary policy decision of major importance prior to its approval by the Riksbank. A dialogue between a central bank and third parties is not prohibited as such, but regular upfront information of government representatives about monetary policy decisions, especially when Riksbank would consider them as of major importance, could structurally offer to the government an incentive and the possibility to influence Riksbank when taking key decisions. Therefore, the obligation to inform the minister about a monetary policy decision of major importance prior to its approval by the Riksbank limits the possibility for the Riksbank to independently take decisions and offers the possibility for the Government to seek to influence them. Such procedure is incompatible with the prohibition on giving instructions to the Central Bank, pursuant to Article 130 of the TFEU and Article 7 of the ESCB/ECB Statute. Article 3 of Chapter 6 should be reformulated in order to ensure that monetary policy decisions of major importance are communicated to the minister, if ever, only after its approval by the Riksbank and for information purpose only.

Pursuant to Article 2 of Chapter 3 of the Riksbank Act and Article 13 of Chapter 9 of the Instrument of Government, the prohibition on the members of the Executive Board to seek or take instructions only covers monetary policy issues. The provisions do not provide for their independence in the performance of ESCB-related tasks directly entrusted by the Treaty. By means of broad interpretation through reference to the explanatory memorandum to the Law (the memorandum extends the coverage to all ESCB tasks), one could consider these tasks as tacitly encompassed by the prohibition. However, the principle of the Riksbank's institutional independence cannot be considered as fully respected from a legal certainty perspective as long as the legal text itself does not contain a clear reference to them. Both provisions are therefore considered as incompatible with Article 130 of the TFEU and Article 7 of the ESCB/ECB Statute.

Pursuant to Article 4 of Chapter 10 of the Riksbank Act, the Swedish Parliament approves the Central Bank's profit and loss account and its balance sheet and determines the allocation of the Central Bank's profit. This practice impinges on the financial independence of the Riksbank and is incompatible with Article 130 of the TFEU. The Parliament must not be involved in the relevant decision-making process. Its right should be limited to approving the Central Bank's decision on the profit allocation. Legislative proposals to tackle the flaw have been submitted by the Swedish legislator but still provide for a decisive role of the Parliament in profit distribution and budget allocation, which are incompatible with the principle of financial independence as enshrined in Article 130 of the TFEU.

Article 4 of Chapter 1 of the Riksbank Act provides for the replacement of the Governor, in case of absence or incapacity, by the Vice-Governors nominated by the General Council. To ensure smooth and continuous functioning of the Riksbank in case of expiry of the term of office, resignation, dismissal or other cause of termination of office, the Act needs to remove this imperfection and provide for procedures and rules regarding the successor of the Governor in case of termination of office.

9.1.3. Prohibition of monetary financing and privileged access

Under Article 8 of Chapter 6 of the Riksbank Act, the Riksbank may, in exceptional circumstances, grant credits or provide guarantees on special terms to banking institutions and Swedish companies that are under the supervision of the Financial Services Authority. In order to comply with the prohibition on monetary financing of

Article 123 of the TFEU it should be clearly specified that the loan is granted against adequate collateral to ensure that the Riksbank would not suffer any loss in case of the debtor's default. Therefore, it constitutes an incompatibility with the prohibition on monetary financing under Article 123 of the TFEU.

Pursuant to Article 1(2) of Chapter 8 of the Riksbank Act, the Riksbank shall not extend credits or purchase debt instruments "directly from the State, another public body or institution of the European Union". The Article does not enumerate the entities covered by the prohibition of monetary financing correctly. Therefore, Article 1 is incompatible with the wording of Article 123(1) of the TFEU and 21(1) of the ESCB/ECB Statute.

According to the Article 1(4) of Chapter 8 of the Riksbank Act, the Riksbank may grant credit to and purchase debt instruments from financial institutions owned by the State or another public body. This provision of Article 1 does not fully comply with Article 123(2) of the TFEU and Article 21.3 of the ESCB/ECB Statute because the exemption only covers publicly owned institutions. For the sake of legal certainty it should be added that, in the context of the supply of reserves by central banks, these publicly owned credit institutions should be given the same treatment as private credit institutions.

The provisions of Article 4 of Chapter 10 on the allocation of the Riksbank's profit are supplemented by non-statutory guidelines on profit distribution, according to which the Riksbank should pay 80% of its profit to the Swedish State, after adjustment for exchange rate and gold valuation effects and based on a five-year average, with the remaining 20% used to increase its own capital. Although these guidelines are not legally binding and there is no statutory provision limiting the amount of profit that may be paid out, such practice could constitute an incompatibility with the principle on the prohibition of monetary financing under Article 123 of the TFEU. For legal certainty reasons the law should ensure that the reserve capital of Riksbank is left unaffected in any case and that the actual contribution to the State budget does not exceed the amount of the net distributable profit.

9.1.4. Integration in the ESCB

Objectives

Chapter 1, Article 2 of the Riksbank Act should include a reference to the secondary objective of the ESCB, while the promotion of a safe and efficient payment system should be subordinated to the primary and secondary objectives of the ESCB.

Tasks

The incompatibilities of the Riksbank Act with regard to the ESCB/ECB tasks are as follows:

- absence of a general reference to the Riksbank as an integral part of the ESCB and to its subordination to the ECB's legal acts (Chapter 1, Article 1);
- definition of monetary policy and monetary functions, operations and instruments of the ESCB (Chapter 1, Article 2 and Chapter 6, Articles 2, 3 and 5 and 6, Chapter 11, Article 1 and 2a of the Act; Chapter 9, Article 13 of the Instruments of Government);
- conduct of foreign exchange operations and the definition of foreign exchange policy (Chapter 7 of the Act; Chapter 8, Article14 and Chapter 9, Article 12 of the Instruments of Government); Articles 1 to 4 of the Law on Exchange Rate Policy;
- right to authorise the issue of banknotes and the volume of coins and definition of the monetary unit (Chapter 5 of the Act; Chapter 9, Article 14 of the Instruments of Government);
- ECB's right to impose sanctions (Chapter 11, Articles 2a, 3 and 5).

There are furthermore some imperfections regarding the:

- non-recognition of the role of the ECB and of the EU in the collection of statistics (Chapter 6, Articles 4(2) and Article 9);
- non-recognition of the role of the ECB in the functioning of payment systems (Chapter 1, Article 2; Chapter 6, Article 7);

- non-recognition of the role of the ECB and of the Council in the appointment of an external auditor;
- non-recognition of the role of the ECB in the field of international cooperation (Chapter 7, Article 6).

9.1.5. Assessment of compatibility

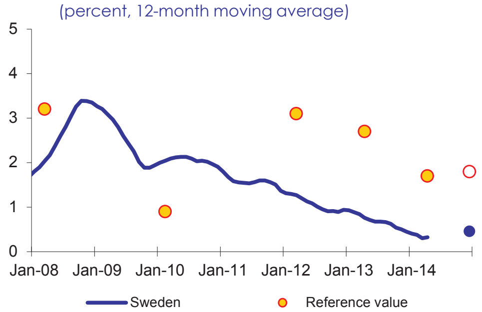
As regards the prohibition on monetary financing, the independence of the Riksbank as well as its integration into the ESCB at the time of euro adoption, the legislation in Sweden, in particular the Riksbank Act and the Instrument of Government as part of the Swedish Constitution, is not fully compatible with the compliance duty under Article 131 of the TFEU.

9.2. PRICE STABILITY

9.2.1. Respect of the reference value

The 12-month average inflation rate, which is used for the convergence evaluation, was below the reference value at the time of the last convergence assessment of Sweden in 2012. In April 2014, the reference value was 1.7%, calculated as the average of the 12-month average inflation rates in Latvia, Portugal and Ireland, plus 1.5 percentage points. The corresponding inflation rate in Sweden was 0.3%, i.e. well below the reference value. Sweden's 12-month average inflation rate is likely to remain well below the reference value in the months ahead.

Graph 9.1: **Sweden - Inflation criterion since 2008**
(percent, 12-month moving average)

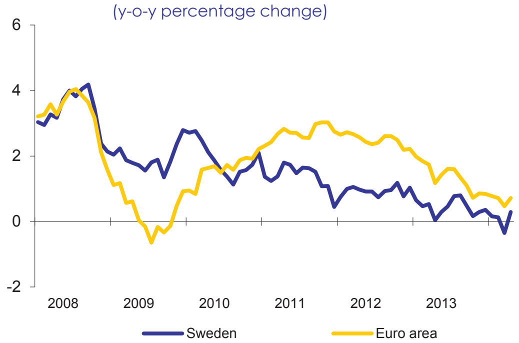


Note: The dots in December 2014 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2014 Forecast.

9.2.2. Recent inflation developments

HICP inflation in Sweden has been trending downwards since end-2008. In recent years, inflation fell from an average of 1.4% in 2011 to 0.9% in 2012, before declining further to 0.4% in 2013. The decline in inflation over the last two years was driven by the strengthening of the krona and sluggish internal and external demand, and was broad-based across various goods and services. Annual inflation was below its historical averages for all main HICP components in 2013. HICP inflation stood, on average, at 0.0% in the first four months of 2014.

Graph 9.2: **Sweden - HICP inflation**
(y-o-y percentage change)



Source: Eurostat.

Core inflation (measured as HICP excluding energy and unprocessed food) followed a similar downward trend. It declined from 1.1% in 2011 to 1% in 2012 and 0.5% in 2013. The reversal of headline inflation towards core inflation in 2012 primarily reflects the abating impact of previously elevated energy price inflation, which turned negative in 2013, bringing headline below core inflation. Although unprocessed food price inflation reached 3.5% in 2013, its impact on headline inflation was relatively minor due to its low weight in the HICP. Producer price inflation was mostly negative since end-2011, with occasional episodes of mildly positive figures (e.g. from October 2013 to January 2014).

9.2.1. Underlying factors and sustainability of inflation

Macroeconomic policy-mix and cyclical stance

Following the strong recovery of the Swedish economy from the 2008-2009 recession, real GDP growth was sluggish in 2012 (0.9%) but started to pick up again in 2013, when real GDP grew at a rate of 1.5%. Steady growth in domestic demand, supported by expansionary fiscal and monetary policy, helped to sustain economic growth against the impact of the weak external environment. Nonetheless, the negative output gap is estimated

Table 9.1:
Sweden - Components of inflation

	2008	2009	2010	2011	2012	2013	Apr-14	weights in total 2014
					(percentage change)[1]			
HICP	3.3	1.9	1.9	1.4	0.9	0.4	0.3	1000
Non-energy industrial goods	-0.1	1.5	0.9	-0.5	-1.0	-0.8	-0.6	277
Energy	9.5	-0.8	5.5	4.8	0.5	-1.3	-1.4	107
Unprocessed food	6.5	3.3	0.9	-1.8	1.6	3.5	2.2	60
Processed food	7.6	2.7	1.8	2.7	2.4	1.3	1.2	140
Services	2.2	2.6	1.8	1.7	1.8	1.1	0.9	417
HICP excl. energy and unproc. food	2.3	2.3	1.5	1.1	1.0	0.5	0.4	834
HICP at constant taxes	2.7	1.8	1.9	1.4	1.3	0.4	0.2	1000
Administered prices HICP	2.3	3.2	1.7	1.9	3.1	1.9	1.7	135

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

Sources: Eurostat, Commission services.

to have increased over the past two years. According to the Commission services' 2014 Spring Forecast, real GDP growth will be gradually picking up from 2.8% in 2014 to 3.0% in 2015, leading to a narrowing of the negative output gap.

In the wake of a counter-cyclical fiscal expansion, the fiscal stance, as measured by changes in the structural balance, continued to be moderately expansionary in 2012 and 2013. The headline surplus of 2011 turned into a moderate deficit in 2012 which increased in 2013. Stronger GDP growth and the fiscal framework should help to reduce the headline deficit as from 2015, with the fiscal stance projected to turn restrictive in 2014 and 2015.

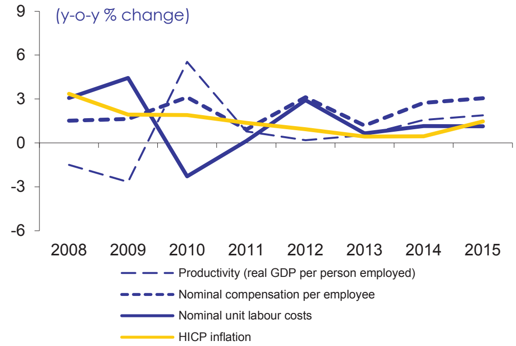
Monetary policy, conducted within an inflation targeting framework ([86]), was loosened significantly between 2011 and 2013. In response to low inflationary pressures and sluggish economic growth, the Riksbank gradually cut its main policy rate from 2% in autumn 2011 to 0.75% in December 2013. Nevertheless, inflation has been below the target of 2% since 2011, due to the weak international economic activity and dampened export price growth abroad. The high level of private debt, and the associated potential financial and macroeconomic risks, is perceived as implying certain limitations for the Riksbank's monetary policy.

([86]) Since 1995, the Riksbank has targeted increases in the domestic CPI with the aim of keeping inflation at 2%.

Wages and labour costs

The Swedish labour market proved to be resilient during the period of sluggish growth. Employment grew by some 2% in 2011 and by around 1% in 2012 and 2013. In spite of the steadily growing employment, the unemployment rate has remained at some 8% since 2011 due to an increase in the labour force. Annual growth of nominal compensation per employee increased to above 3% in 2012 but moderated to close to 1% in 2013. Improved economic activity and the lower unemployment rate are likely to translate into relatively higher wage increases in the forthcoming period, with annual wage growth projected to average 2.7% in 2014 and 3.0% in 2015.

Graph 9.3:**Sweden - Inflation, productivity and wage trends**



Source: Eurostat, Commission services' Spring 2014 Forecast.

Growth in labour productivity was moderate in the last two years (0.2% and 0.5% in 2012 and 2013, respectively). Accordingly, growth in nominal unit labour cost (ULC), which stood at some 3% in 2012 and fell to 0.7% in 2013, is projected to hover around levels slightly above 1% in 2014-2015. These developments point to relatively

Table 9.2:
Sweden - Other inflation and cost indicators **(annual percentage change)**

	2008	2009	2010	2011	2012	2013 1)	2014 2)	2015 2)
HICP inflation								
Sweden	3.3	1.9	1.9	1.4	0.9	0.4	0.5	1.5
Euro area	3.3	0.3	1.6	2.7	2.5	1.3	0.8	1.2
Private consumption deflator								
Sweden	3.1	2.1	1.5	1.7	1.2	0.6	0.6	1.6
Euro area	2.7	-0.4	1.6	2.4	2.1	1.3	0.9	1.3
Nominal compensation per employee								
Sweden	1.5	1.6	3.1	0.9	3.1	1.2	2.7	3.0
Euro area	3.5	1.8	2.0	2.2	2.0	1.7	1.6	1.9
Labour productivity								
Sweden	-1.5	-2.7	5.5	0.8	0.2	0.5	1.6	1.9
Euro area	-0.3	-2.4	2.6	1.4	0.2	0.5	0.9	1.0
Nominal unit labour costs								
Sweden	3.1	4.4	-2.3	0.1	2.9	0.7	1.2	1.1
Euro area	3.8	4.3	-0.6	0.7	1.8	1.1	0.7	0.8
Imports of goods deflator								
Sweden	4.3	-1.0	0.3	-0.3	-1.8	-3.8	0.2	0.6
Euro area	4.2	-8.1	5.7	6.6	2.3	-1.9	-1.0	0.8

1) 2013 data (except HICP inflation) are estimates.
2) Commission services' Spring 2014 Forecast.
Source: Eurostat, Commission services.

limited price pressures from labour costs in the years ahead.

External factors

Given the high openness of the Swedish economy, developments in import prices play an important role in domestic price formation. Import price growth (measured by the imports of goods deflator) has been negative since 2011. The decline can be explained by falling international commodity price inflation, subdued demand in the EU and the appreciating krona. Looking ahead, the import deflator is expected to return to a low but positive growth path as from 2014, thus dampening external disinflationary pressures.

The nominal effective exchange rate of the Swedish krona (measured against a group of 36 trading partners) was strong in 2012 and 2013. It increased markedly between early 2012 and early 2013, as the krona benefitted from safe-haven flows, and remained broadly stable since then. The strong nominal effective exchange rate significantly contributed to the subdued inflation in Sweden in recent years.

Administered prices and taxes

Changes in administered prices ([87]) and indirect taxes significantly influenced Swedish inflation over the past two years, albeit in opposite directions. The share of administered prices in the HICP basket is 14% in Sweden (compared to 13% in the euro area). Annual growth in administered prices fell from 3.1% in 2012 to 1.9% in 2013, considerably lifting headline inflation in both years. To a large extent, this was due to the increase in rents, which are subject to a high level of regulation in Sweden and represent by far the largest component of administered prices. At the same time, the price of medical services increased significantly in the beginning of 2012, bringing medical service price inflation to historical highs; passenger transport prices were raised as well.

Tax changes, on the other hand, contributed to a moderation in consumer price developments in 2012 and 2013. Although the excise tax on tobacco

([87]) According to the Eurostat definition, fully administered prices in Sweden *inter alia* include water supply, refuse and sewerage collection, hospital services and combined passenger transport. Mainly administered prices *inter alia* include actual rents for housing and medical services. For details, see http://epp.eurostat.ec.europa.eu/portal/page/portal/hicp/documents_meth/HICP-AP/HICP_AP_classification_2011_2014_02.pdf was raised in the beginning of 2012, this rise was more than offset by a reduction in the VAT rate for restaurant and catering services as well as tax changes in the climate and energy area. The HICP-CT index (a rough measure of inflation at constant tax rates) increased by 1.3% in 2012 and by 0.7% in 2013, compared to increases in the HICP index of 0.9% and 0.4%, respectively.

Medium-term prospects

On the back of a gradual pick-up in growth, inflation is likely to increase only very moderately in the course of 2014. No particular upward pressure is foreseen from any HICP component, and wage developments are projected to remain moderate as resource utilisation is low. Accordingly, the Commission services' 2014 Spring Forecast projects annual average inflation at 0.5% in 2014 and 1.5% in 2015.

Risks to the inflation outlook appear to be broadly balanced. Stronger economic growth in Sweden with faster-than-expected wage growth, a rise in global commodity prices and a reversal of the recent appreciation of the krona would raise inflationary pressures. Conversely, a further appreciation of the krona or a downward correction of house prices would have disinflationary effects.

The level of consumer prices in Sweden relative to the euro area gradually increased since Sweden joined the EU in 1995. In 2012, the Swedish price level was at some 126% of the euro-area average, compared to 122% in 2011. At the same time, the income level in Sweden continued to rise, reaching 126% of the euro-area average in PPS in 2012, compared to 102% in 2009.

In the medium term, inflation is likely to pick up as the recovery progresses and unemployment decreases further. With the expected normalisation in demand, companies are projected to raise prices and cautiously compensate for the subdued price levels in the last two years. On the other hand, moderate wage developments, the ample spare capacity lingering in the Swedish economy and strong international competition will dampen any upward pressure on consumer price developments. Amid low inflationary pressures, loose monetary conditions could prevail for a longer time, with a possible further repo rate cut by the Riksbank foreseen in 2014.

9.3. PUBLIC FINANCES

9.3.1. Recent fiscal developments

After two years with small surpluses, the general government balance turned into a deficit of 0.6% of GDP in 2012 which widened to 1.1% in 2013. This reflected lacklustre growth and a number of government measures to support the economy, which focused on corporate taxation, active labour market policies and infrastructure investment. The surplus in the structural balance narrowed from 0.3% of GDP in 2012 to 0.1% in 2013, reflecting the discretionary measures taken. The expenditure-to-GDP ratio increased from 51.8% of GDP in 2012 to 52.6% in 2013, while the revenues-to-GDP ratio increased by 0.3 pp. to 51.5% of GDP.

Nevertheless, Swedish public finances remain robust. The budgetary outcome in 2013 (-1.1% of GDP) was better than the deficit of 1.6% of GDP targeted in the 2013 Convergence Programme.

The decline in the government debt-to-GDP ratio over the previous years reversed in 2013. Gross government debt increased from 38.3% in 2012 to 40.6% in 2013, mainly on account of an additional borrowing of SEK 100 billion (EUR 11 billion) to strengthen the foreign currency reserves of the Riksbank.

9.3.2. Medium-term prospects

The 2014 Budget Bill, which was adopted on 18 December 2013, uses the fiscal space available to improve household disposable income in a time of weak economic growth. The measures taken amount to SEK 21 billion (EUR 2.4 billion), including notable income tax cuts.

Consequently, according to the Commission services' 2014 Spring Forecast, the general government deficit is projected to reach 1.8% of GDP in 2014 and the structural balance is forecast to turn into a deficit, reflecting the expansionary stance of fiscal policy. In 2015, the nominal deficit is expected to decline to 0.8% on the back of the economic recovery, with the structural balance improving.

Gross government debt is expected to increase further in 2014, reaching 41.6% of GDP, before falling back to 40.4% of GDP in 2015.

Table 9.3:
Sweden - Budgetary developments and projections **(as % of GDP unless indicated otherwise)**

Outturn and forecast [1]	2008	2009	2010	2011	2012	2013	2014	2015	
General government balance	2.2	-0.7	0.3	0.2	-0.6	-1.1	-1.8	-0.8	
- Total revenues	53.9	54.0	52.3	51.5	51.2	51.5	50.5	50.5	
- Total expenditure	51.7	54.7	52.0	51.3	51.8	52.6	52.2	51.3	
of which:									
- Interest expenditure	1.7	1.0	0.8	1.0	0.7	0.6	0.7	0.6	
p.m.: Tax burden	46.9	47.1	45.9	45.0	44.6	45.0	44.8	44.7	
Primary balance	3.8	0.2	1.1	1.2	0.2	-0.5	-1.1	-0.2	
Cyclically-adjusted balance	1.9	2.7	1.2	0.4	0.3	0.1	-0.9	-0.4	
One-off and temporary measures	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Structural balance [2]	1.6	2.7	1.2	0.4	0.3	0.1	-0.9	-0.4	
Government gross debt	38.8	42.6	39.4	38.6	38.3	40.6	41.6	40.4	
p.m: Real GDP growth (%)	-0.6	-5.0	6.6	2.9	0.9	1.5	2.8	3.0	
p.m: Output gap	0.4	-5.8	-1.5	-0.4	-1.4	-2.0	-1.4	-0.7	
Convergence programme							**2014**	**2015**	**2016**	**2017**
General government balance							-1.4	-0.2	0.3	0.7
Structural balance [2] [3]							0.0	0.7	0.5	0.8
Government gross debt							41.3	39.7	37.3	34.8
p.m. Real GDP (% change)							2.7	3.3	3.5	2.5

1) Commission services' Spring 2014 Forecast.
2) Cyclically-adjusted balance excluding one-off and other temporary measures.
3) Commission services' calculations on the basis of the information in the programme.
There are no one-off and other temporary measures in the programme.
Sources: Commission services, the 2014 Convergence Programme of Sweden.

The medium-term budgetary strategy of the 2014 Convergence Programme aims at achieving the government's target of a general government surplus of 1% of GDP over the cycle and a surplus of at least 1% of GDP by 2018. Therefore, any new expenditure-increasing reform proposed in the Budget Bills for both 2015 and 2016 will have to be funded "krona for krona" by revenue and/or expenditure measures as already exemplified in the proposed 2014 Spring Budget Bill. Until 2011, this one-percent surplus target coincided with Sweden's Medium-Term Objective (MTO). However, since 2012, the MTO is -1% of GDP, i.e. the minimum required. The change is explained by a wish to separate the minimum fiscal requirements for EU Member States from the more ambitious 1% surplus target set by the Swedish authorities. The authorities rely on a set of indicators to measure the fulfilment of the surplus target. According to the Commission's calculations based on the Commission 2014 Spring Forecast, the structural balance for Sweden will be more stringent than its MTO over the forecast horizon.

Further details on the assessment of the 2014 Convergence Programme for Sweden can be found in the forthcoming Commission Staff Working Paper, accompanying the Commission recommendation for a Council Recommendation on the National Reform Programme 2014 of Sweden and delivering a Council opinion on the Convergence Programme of Sweden.

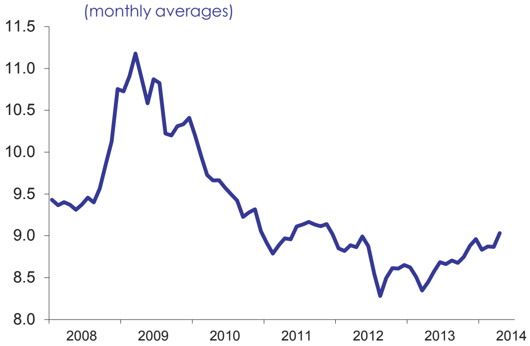
In March 2012, Sweden signed the Treaty on Stability, Coordination and Governance in the EMU (TSCG). This implies an additional commitment to conduct a stability-oriented and sustainable fiscal policy. The TSCG will apply to Sweden in its entirety upon lifting its derogation from participation in the single currency.

9.4. EXCHANGE RATE STABILITY

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

Following the strong depreciation of the krona against the euro at the onset of the financial crisis in 2008, the krona appreciated by some 35% between March 2009 and August 2012, reaching a twelve-year high of 8.3 SEK/EUR in August 2012. While this appreciation was also a correction of the krona's previous weakening, safe-haven flows, resulting from the intensification of the euro-area sovereign debt crisis, significantly contributed to it. Since then the krona has depreciated by some 7% against the euro, averaging 8.9 SEK/EUR in the first four months of 2014. Overall, during the two years before this assessment, the krona depreciated against the euro by some 2%.

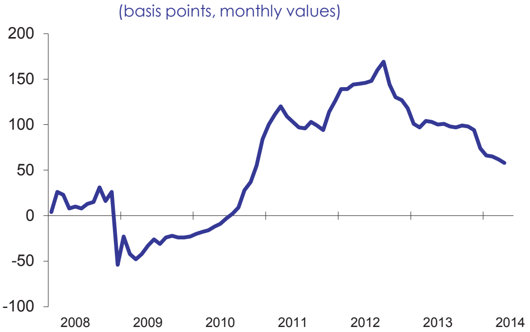
Graph 9.4: **Exchange rates - SEK/EUR**
(monthly averages)



Source: ECB.

Until mid-2012, the krona was also supported by a significant widening of short-term interest rate differentials vis-à-vis the euro area, which increased to around 170 basis points in August 2012. The increase in spreads was driven by a marked decline in euro-area short-term rates as from mid-2011, reflecting a loosening of the euro-area monetary policy stance and the provision of additional liquidity to the banking system by the ECB. Between August 2012 and end-2013 short-term spreads declined by some 100 basis points on the back of falling short-term rates in Sweden (as the Riksbank cut its policy rate by 75 bps) and largely unchanged rates on euro-area money markets. At the cut-off date of this report, the 3-month spread vis-à-vis the euro area had fallen below 60 basis points.

Graph 9.5: **Sweden - 3-M Stibor spread to 3-M Euribor**
(basis points, monthly values)



Source: Eurostat.

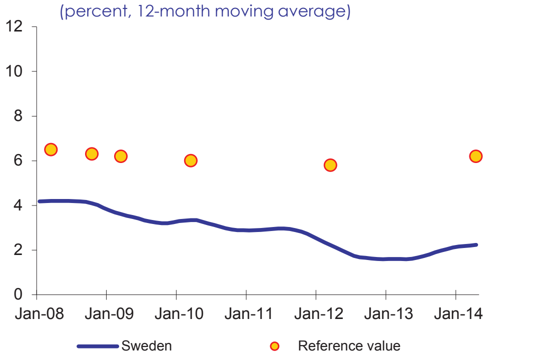
International reserves remained broadly stable at around SEK 345 billion between Q4-2011 and Q4-2012. In December 2012, the Riksbank decided to increase the foreign currency reserves by SEK 100 billion in the light of higher commitments to the IMF and to maintain its readiness to provide the Swedish banking sector with liquidity in foreign currency. Following this increase, official reserves remained broadly unchanged throughout 2013, averaging SEK 430 billion. By the end of 2013, they covered some 12% of GDP.

9.5. LONG-TERM INTEREST RATES

Long-term interest rates in Sweden used for the convergence examination reflect secondary market yields on a single benchmark government bond with a residual maturity of close to but below 10 years.

The Swedish 12-month moving average long-term interest rate, relevant for the assessment of the Treaty criterion, gradually declined from above 4% in 2008, bottomed out at some 1.6% between October 2012 and May 2013 and has been increasing again since then. It was markedly below the reference value at the time of each past convergence assessment. In April 2014, the latest month for which data are available, the reference value, given by the average of long-term interest rates in Latvia, Portugal and Ireland plus 2 percentage points, stood at 6.2%. In that month, the 12-month average of the yield on the Swedish benchmark bond stood at 2.2%, i.e. 4.0 percentage points below the reference value.

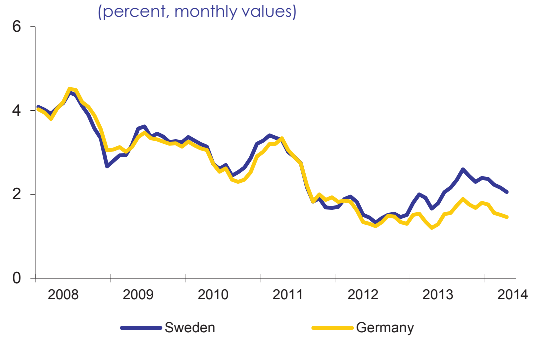
Graph 9.6: **Sweden - Long-term interest rate criterion**
(percent, 12-month moving average)



Source: Commission services.

Long-term interest rates trended down from above 3.3% in early 2011 to historically low levels of around 1.3% in mid-2012 on the back of falling domestic inflation, a gradual loosening of monetary policy and safe-haven flows into Swedish government bonds. They subsequently increased to 2.6% in September 2013. This increase reflected a reversal of safe-haven flows following the OMT announcement by the ECB and, as from May 2013, a generalised increase in interest rates following heightened expectations of a decrease in the pace of asset purchases by the US Federal Reserve. Since October 2013, long-term interest rates have been declining, to 2.1% in April 2014. Long-term interest spreads vis-à-vis the German benchmark bond, which had been very low in recent years, widened between end-2012 and autumn 2013 and have fluctuated around 65 basis points since then. They stood at some 60 basis points in April 2014 ([88]).

Graph 9.7: **Sweden - Long-term interest rates**
(percent, monthly values)



Source: Eurostat.

9.6. ADDITIONAL FACTORS

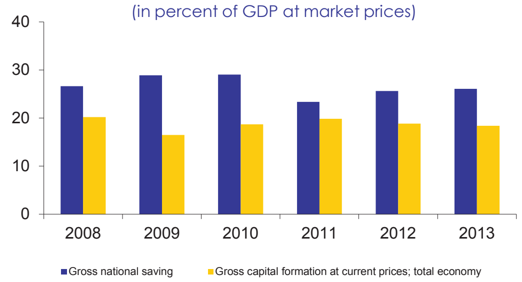
The Treaty (Article 140 TFEU) calls for an examination of other factors relevant to economic integration and convergence to be taken into account in the assessment. The assessment of the additional factors – including balance of payments developments, product and financial market integration – gives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

In November 2013, the Commission published its third Alert Mechanism Report (AMR 201) ([89]) under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.5). The AMR 2014 scoreboard showed that Sweden exceeded the indicative threshold for three out of eleven indicators, linked to both external and internal imbalances (i.e. the current account balance, export market shares and private sector debt). In line with the conclusion of the AMR 2014, Sweden was subject to an in-depth review, which found that Sweden continues to experience macroeconomic imbalances, which require monitoring and policy action.

9.6.1. Developments of the balance of payments

The surplus on Sweden's external balance (i.e. the combined current and capital account) has been on a declining trend since 2007, falling from above 9% of GDP in 2007 to 6.6% in 2013. The decline in the current account surplus is partly explained by a structural decrease in Sweden's merchandise trade surplus; net exports declined markedly since the mid-2000s due to the increased importance of the services sector in the Swedish economy and due to increased international competition. The services trade surplus remained slightly above 3% of GDP since 2010 and the income balance increased somewhat, reflecting the continued strengthening of Sweden's net international investment position. Current transfers have delivered a relatively steady negative impact, reflecting Sweden's foreign aid and positive net contributions to international organisations, as well as remittances transferred by foreign workers in Sweden to their home countries.

Graph 9.8: **Sweden - Saving and investment**
(in percent of GDP at market prices)



Source: Eurostat, Commission services.

Sweden's large savings-investment surplus persisted in 2012 and 2013, reflecting high net savings by the private sector, fiscal prudence and the low level of residential investment. Gross national savings averaged some 25% of GDP in 2012 and 2013, little changed from previous years. While households have increased precautionary savings following the 2008 financial crisis, corporate and household saving had also risen as a result of reforms introduced in the 1990s, such as the introduction of a pension plan of defined contributions. Gross fixed capital formation declined in both 2012 and 2013, as firms postponed investment in the uncertain economic environment.

([88]) The reference to the German benchmark bond is included for illustrative purposes, as a proxy of the euro area long-term AAA yield.
([89]) http://ec.europa.eu/europe2020/pdf/2014/amr2014_en.pdf

Table 9.4:
Sweden - Balance of payments **(percentage of GDP)**

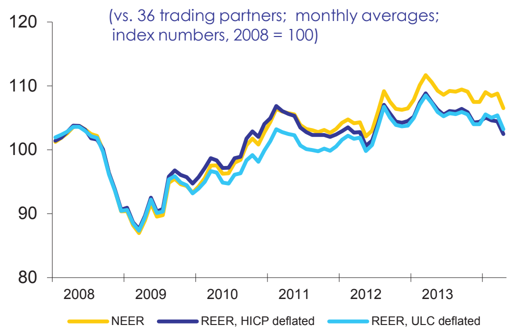
	2008	2009	2010	2011	2012	2013
Current account	9.1	6.2	6.3	6.1	6.0	6.2
of which: Balance of trade in goods	3.5	3.0	2.5	2.2	2.1	2.0
Balance of trade in services	3.4	2.8	3.1	3.2	3.2	3.2
Income balance	3.5	1.8	2.1	2.2	2.5	2.7
Balance of current transfers	-1.4	-1.3	-1.4	-1.4	-1.8	-1.7
Capital account	-0.2	-0.1	-0.1	-0.2	-0.2	-0.2
External balance [1)]	8.9	6.1	6.2	5.9	5.8	6.0
Financial account	4.2	-2.7	-7.8	-8.7	-2.1	-3.9
of which: Net FDI	1.4	-4.0	-4.4	-3.2	-2.4	-4.5
Net portfolio inflows	-6.1	15.6	4.2	4.9	2.8	8.0
Net other inflows [2)]	8.9	-10.5	-7.7	-10.2	-2.4	-4.6
Change in reserves (+ is a decrease)	0.0	-3.7	0.1	-0.1	-0.1	-2.7
Financial account without reserves	4.2	1.1	-8.0	-8.6	-2.0	-1.2
Errors and omissions	-13.1	-3.4	1.6	2.8	-3.7	-2.2
Gross capital formation	20.2	16.5	18.7	19.9	18.9	18.4
Gross saving	29.0	23.4	25.6	26.1	25.3	25.0
External debt	200.3	213.5	193.9	200.0	191.2	196.8
International investment position	-11.1	-11.2	-9.1	-11.1	-12.1	-5.0

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

Sources: Eurostat, Statistics Sweden, Commission services.

Indicators of cost competitiveness showed a mixed picture in the past years. Both the ULC- and the HICP-deflated real-effective exchange rate (REER), which have been moving very closely together over the last two years, continued their gradual appreciation in 2012 and early 2013, peaking in March 2013. Since then, they have been trending downwards, reflecting the decline of the NEER. Sweden's export performance deteriorated in 2012 and 2013 as goods exports lost further ground to international competitors.

*Graph 9.9:***Sweden - Effective exchange rates**



Source: Commission services.

Sweden's financial account deficit declined in 2012 to around 2% of GDP, from a deficit of 8.7% in 2011. Since 2009, the negative financial account balance has reflected Sweden's role as a net FDI investor abroad and foreign bank lender. Net portfolio inflows have been positive since 2009 and increased further in 2013 driven by the refinancing of banks on international capital markets. External reserves increased markedly in 2013, as the Riksbank increased foreign currency reserves by SEK 100 billion to re-align them with the exposure of Swedish banks to foreign capital markets. Gross external debt to GDP continued to decline from 200% of GDP at end-2011 to 197% of GDP at end-2013, mainly driven by the reduction in public debt. While Sweden's mildly negative net international investment position remained broadly stable in 2011 and 2012, it is estimated to have improved in 2013 on the back of a sizeable current account surplus and favourable valuation changes.

According to the Commission services' 2014 Spring Forecast, the external surplus is projected to continue its gradual decline to some 6% of GDP in 2014 and 2015. The projected decline reflects the fact that, compared to previous recoveries, net

Table 9.5:
Sweden - Product market integration

	2007	2008	2009	2010	2011	2012
Trade openness 1) (%)	48.2	50.2	44.8	46.4	47.1	45.6
Intra-EA trade in goods GDP ratio 2) (%)	15.7	15.8	13.3	14.2	14.6	13.6
Intra-EA trade in services GDP ratio 3) (%)	4.1	4.3	4.5	4.3	4.3	4.5
Extra-EA trade in goods GDP ratio 4) (%)	19.0	20.1	17.4	18.9	19.3	18.5
Export in high technology 5) (%)	13.3	13.2	14.6	14.5	13.8	12.9
High-tech trade balance 6) (%)	0.5	0.6	0.3	0.2	0.1	-0.1
Total FDI inflows GDP ratio 7) (%)	6.2	7.6	2.5	0.0	1.7	3.1
Intra-EA FDI inflows GDP ratio 8) (%)	n.a.	n.a.	2.7	0.8	0.0	0.8
FDI intensity 9)	7.3	6.9	4.5	2.2	3.5	4.4
Internal Market Directives 10) (%)	1.0	0.9	0.4	0.9	0.6	0.1
Time to start up a new company 11)	16.0	16.0	16.0	16.0	16.0	16.0
Real house price index 12)	94.9	93.2	93.8	100.0	100.6	100.4
Residential investment 13) (%)	3.9	3.5	3.0	3.3	3.6	3.2
Building permits index 14)	103.3	87.9	77.6	100.0	101.5	88.2

1) (Imports + Exports of goods and services / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics, Balance of Payments).
2) (Intra-EA-18 Imports + Exports of goods / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).
3) Intra-EA-17 trade in services (average credit and debit in % of GDP at current prices) (Balance of Payments).
4) (Extra-EA-18 Imports + Exports of goods / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).
5) Taken directly from Eurostat's databases: Exports of high technology products as a share of total exports.
6) (Exports - imports in high tech) / GDP at current prices x 100, since 2007 the data based upon SITC Rev. 4 (earlier SITC Rev. 3).
7) Total FDI inflows (in % of GDP at current prices).
8) Intra-EA-17 FDI inflows (in % of GDP at current prices).
9) FDI intensity (average intra-EU-27 inflows and outflows in % of GDP at current prices).
10) Percentage of internal market directives not yet communicated as having been transposed, in relation to the total number.
11) Time to start a new company (in days), Doing Business World Bank.
12) Deflated house price index (2010=100), Eurostat.
13) Gross capital formation in residential buildings (in % of GDP), Eurostat.
14) Number of new residential building permits (2010=100), Eurostat.

Sources: Eurostat, Sectoral Performance Indicators Database (SPI), Commission services.

exports are expected to contribute little or nothing to GDP growth.

9.6.2. Market integration

Sweden's economy is highly integrated into the euro area through trade and investment linkages. Its openness had only temporarily been reduced by the economic crisis in 2008-2009 and subsequently recovered gradually. Intra-EA trade represents an important share of Swedish exports. In 2012, 42% of Swedish goods exports were oriented to EA markets. Sweden's main EA trading partners were

Germany and Finland, while the UK, Denmark, Norway and the US remained important non-EA export markets. There has been some increase in the importance of exports to the BRICs, in particular China. Between 2007 and 2012, the share of services in total Swedish exports increased as a result of the increasing role of outsourcing services in the industry, but remained stable in intra-EA trade.

The composition of trade in goods reflects the main features of Sweden's manufacturing industries, which are mainly concentrated in capital-intensive sectors and high and medium-high technology industries. Goods exports include traditional products, such as pulp and paper, iron and steel, as well as more innovation-driven products such as machinery, car parts, pharmaceuticals and communication appliances. The share of high technology exports (mainly electronic and telecommunication equipment) was broadly stable at 13% over the past two years.

While Sweden has traditionally been a destination for FDI, total FDI inflows in percent of GDP decreased sharply between 2008 and 2010 owing to increased economic uncertainty. Since then, they have recovered only slowly, reaching some 3% of GDP in 2012. Approximately 60% of total FDI emanates from the euro area.

After a temporary dip in 2008, house prices resumed their upward trend in 2010 and stabilised thereafter. The annual percentage change in the real house price index stood at -0.2 in 2012 (and 0.7 in 2011). Although house prices have not been growing extensively since 2010, inefficiencies in the Swedish housing market continue to imply potential risks for macroeconomic stability, in particular in case of potential house price corrections ([90]). In 2010-2011, building permits recovered from their drastic decline in the previous years, before falling again in 2012. The latest figures available point to a renewed increase in building permits. Residential investment has remained broadly constant at around 3% of GDP in the last years. The share of construction in total value added has remained stable at around 5%.

Regarding the business environment, Sweden performs well above the average of the euro-area Member States in international rankings ([91]). The Swedish economy is characterised by a business-friendly climate, a transparent legal and regulatory framework, a skilled labour force, and a stability-oriented macroeconomic framework. Transaction costs related to starting or closing a business are relatively low. However, additional efforts could be made to further simplify procedures for new firms ([92]).()Finally, according to the 2013 Internal Market Scoreboard, the transposition of EU Internal Market directives further improved over the period under review; in 2012, Sweden had an average transposition deficit of 0.1%, the lowest in the EU.

The Swedish labour market, characterised by constructive cooperation between social partners, produces relatively positive labour market outcomes and is adequately flexible. The employment rate was around 74% in 2012, one of the highest in the euro area. Unemployment is comparatively low and the share of long-term unemployed is among the lowest in the euro area. The wage-setting system is based on negotiations between employee and employer confederations, with the majority of wage bargaining taking place at firm level within the framework of sectoral agreements. Individual salaries are generally set locally, allowing for differentiation according to individual performances. Wages have been developing broadly in line with benchmarks based on both internal labour market adjustment and external competitiveness ([93]).

Sweden has a relatively high incidence of flexible working time arrangements. While the employment protection of permanent workers is comparatively high (close to the euro-area-OECD countries' average, according to the 2013 OECD employment protection indicator), the employment protection of temporary workers is comparatively low (roughly half of the euro-area-OECD countries' average). Adjustment by labour mobility is adequate, with a relatively low dispersion of regional unemployment rates. The integration of low-skilled and foreign-born remains the key challenge for the Swedish labour market since the employment rate of both groups is significantly below the overall employment rate.

9.6.3. Financial market integration

Sweden's financial sector is well integrated into the EU financial sector, especially through inter-linkages in the Nordic-Baltic financial cluster. The main integration channels are the Swedish ownership of financial intermediaries in all countries of the region, bank funding on international financial markets and consolidation of the Stockholm stock exchange in the Nasdaq-OMX Group. The foreign exposure of Swedish banks accounts for about half of their total lending and is mainly directed towards Denmark, Finland, the US, Germany and the UK. Exposure to the Baltic countries corresponds to around 5% of the aggregated loan book, but plays a dominant role in the Estonian, Latvian and Lithuanian market. On the other hand, foreign ownership in the Swedish market is relatively low (8.5% in 2012) and slightly declined in recent years. The Swedish banking sector is dominated by four large banks and the market concentration is higher than in the euro area. In 2012, the five largest banks held more than 60% of domestic bank assets, compared to a euro-area average of 50%.

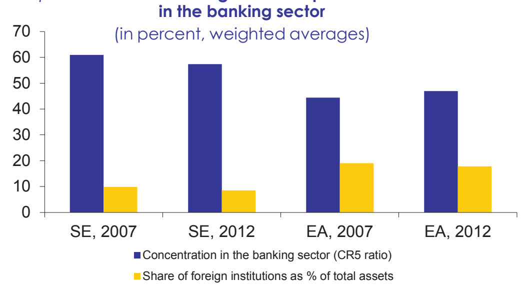
([90]) For a more detailed analysis, see European Commission (2014), "Macroeconomic Imbalances - Sweden 2014", *European Economy*. Occasional Papers. 186. March 2014.

([91]) For instance, Sweden ranks 14th (out of 189 economies) on the World Bank's 2014 ease of doing business index and 6th (out of 148 economies) on the World Economic Forum's 2013-2014 Global Competitiveness Index.

([92]) According to the 2014 World Bank Doing Business Report the time to start a business in Sweden is 16 calendar days, which is slightly longer than the EU average of 14 days.

([93]) The methodology for wage benchmarks is published in European Commission (2013), "Benchmarks for the assessment of wage developments", *European Economy*. Occasional Papers. 146. May 2013.

Graph 9.10: **Sweden - Foreign ownership and concentration in the banking sector**

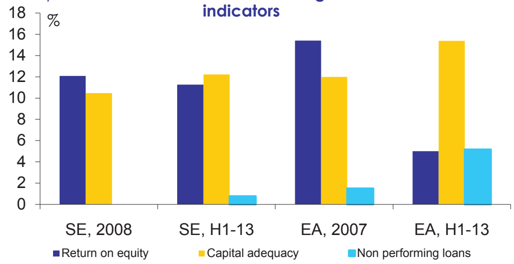


Source: ECB, Structural financial indicators .

Total assets of the Swedish banking sector, including foreign operations, amount to about 400% of GDP, which is above the euro-area average. The structure of the financial sector is similar to the euro area. Relative to GDP, the banking sector assets and stock market capitalisation are higher in Sweden, while the size of the debt markets is comparable. Loans constitute about 55% of total bank assets. In recent years, loans to households have been gaining relative to loans to non-financial corporations, increasing from 62% of GDP in 2007 to 78% in 2013. In the euro area, this ratio increased only marginally, from some 54% of GDP to 55% of GDP. The credit expansion exerted also upward pressure on house prices, although they have not grown extensively since 2010. Following the introduction of the 85% loan-to-value cap on new mortgages in 2010, the Swedish Financial Supervisory Authority (FSA) took further steps to contain growing household indebtedness, in particular through introducing a 15% risk weight floor for mortgages and a recommendation for individual amortisation plans in 2013. Corporate loans in Sweden remained close to 50% of GDP in 2013, the same as in 2007. In the euro area, the ratio declined from 49% to 45% over the same time span. Total consolidated private debt stabilised at around 210% of GDP since 2010, significantly above the euro-area average of 145% of GDP ([94]).

The capital adequacy of Swedish banks measured by standard regulatory ratios remains relatively high, with a capital adequacy ratio of above 12% in mid-2013 (compared to some 15% in the euro area). However, as Swedish banks apply low weights in their risk calculation, due to low historical loss levels, the average ratio of capital to total non-risk weighted assets is relatively low. The ratio of non-performing loans stayed below 1% for a number of years (0.8% in 2013). The high asset quality, cost-efficiency and market concentration support the profitability of Swedish banks. In 2013, the average return on equity (RoE) was at 11.3%, almost double the euro-area average. Among other factors that contributed to the good performance of the Swedish banks are high leverage (linked with high private indebtedness), diversified business models and low funding costs.

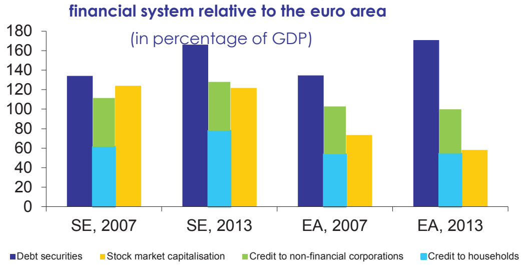
Graph 9.11: **Sweden - selected banking sector soundness indicators**



Note: For 2007 EU-27 non performing loans are a proxy for EA.
For 2007, EA RoE and CAR averages are unweighted.
Source: ECB, EC calculations.

Deposits account for only 30% of banking sector liabilities in Sweden. Due to their large size relative to the economy, Swedish banks are bound to rely extensively on market funding, half of which is in foreign currency. This also results from the composition of savings, with a relatively low share held as bank deposits and a high share placed in securities, pension funds and insurance products. Sweden's safe haven status during the euro area debt crisis led to substantial capital inflows and low funding costs for banks. Since market financing tends to be more volatile than funding via deposits, funding risk is an inherent challenge for the Swedish banking sector ([95]).

Graph 9.12: **Sweden - Recent development of the financial system relative to the euro area**



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

The assets of non-bank financial intermediaries account for about 45% of the total assets of financial institutions, having increased over the

([94]) For a more detailed analysis, see European Commission (2014), "Macroeconomic Imbalances - Sweden 2014", *European Economy*. Occasional Papers. 186. March 2014.

([95]) ibid.

past two years. Sweden has a developed and relatively large insurance sector, including almost 300 domestic companies and almost 40 foreign branches ([96]). Notwithstanding the number of undertakings, the sector is quite concentrated, with the ten largest companies holding 85% of the market in 2012 (in terms of investment assets). Total premiums received in 2012 corresponded to 7.1% of GDP, of which some three quarters were accounted for by life insurances ([97]). The insurance companies managed assets amounting to 89% of GDP. The assets under management of the Swedish investment funds corresponded to 57% of GDP, while the state pension funds' (AP Funds) total assets increased to 32% GDP.

Shareholding is widespread in Sweden, making the equity market large and liquid. Households directly hold around 10% of the listed shares and further 25% through investment funds as well as insurance and pension schemes. Foreign investors hold about 40% of the stocks; their participation has been increasing ([98]). Stock market capitalisation increased to 122% of GDP in 2013, coming back to the pre-crisis level and exceeding twice the euro-area average. NASDAQ OMX Stockholm is the dominant trading venue, sharing the same listed companies with the stock exchanges in Helsinki, Copenhagen and Reykjavik ("Nordic list"). The value of the outstanding debt securities increased from 134% of GDP in 2007 to 166% in 2013, in line with evolution of the euro-area average. The long term debt market in SEK is dominated by issuances of covered bonds by mortgage institutions (45% of the total) and central government debt securities (30%). Banks rank third, although the bulk of their issuance is done in foreign currencies on the international market ([99]). The issuance of corporate debt has increased since 2007, but remains relatively limited, which is also the case for bonds issued by municipals and county councils. The Swedish money market, accounting for about one tenth of the bond market in terms of size, halved after the financial crisis and has been recovering only slowly in recent years. Sweden has also developed a foreign exchange market as well as markets for interest-rate and forex derivatives.

Since 1991, the Swedish Financial Supervisory Authority (FSA) has been the single micro-prudential supervisor for the banking, securities and insurance sectors. In 2013, the government decided to grant responsibility for macro-prudential oversight to the FSA as well, thus concentrating micro- and macro-prudential tools in a single authority. The Riksbank and the Ministry of Finance will remain involved in macro-prudential policy in the areas of their competencies, not least through participation in the Financial Stability Committee ([100]). Sweden has implemented most of the EU financial services directives.

([96]) As at the end of 2012. Source: Sveriges Riksbank (2013), *The Swedish Financial Market*.
([97]) Swiss Re Sigma (2013), *World Insurance in 2012*.
([98]) 2012 data. Source: Sveriges Riksbank (2013), *The Swedish Financial Market*.
([99]) Issues in foreign currencies are typically converted in SEK via derivatives, primarily currency swaps.
([100]) The FSC (Financial Stability Committee), established by a government decision of December 2013, will also include the FSA and the Swedish National Debt Office. The first of its official semi-annual meetings is foreseen for June 2014. The establishment of the FSC formalises the inter-institutional cooperation on financial stability and crisis management dating back to 2005.