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REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

CONVERGENCE REPORT 2016

(prepared in accordance with Article 140(1) of the Treaty on the Functioning of the European Union)
{SWD(2016) 191 final}

1. PURPOSE OF THE REPORT

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

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

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

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

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

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

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

Convergence criteria

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

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

Article 1 of the Protocol on the convergence criteria further provides that *"the criterion on price stability [...] shall mean that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1.5 percentage points that of, at most, the three best-performing Member States in terms of price stability. Inflation shall be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions"*[4]. The requirement of sustainability implies that the satisfactory inflation performance must essentially be attributable to the behaviour of input costs and other factors influencing price developments in a structural manner, rather than the influence of temporary factors. Therefore, the convergence examination includes an assessment of the factors that have an impact on the inflation outlook and is complemented by a reference to the most recent Commission services' forecast of inflation[5]. Related to this, the report also assesses whether the country is likely to meet the reference value in the months ahead.

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

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

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

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

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

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

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

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

the criterion[10]. In case of Cyprus, deeply negative inflation mainly reflected the adjustment needs and exceptional situation of the economy. In case of Romania, it was mainly due to large VAT rate reductions. Against that background, Bulgaria, Slovenia and Spain, the Member States with the next-lowest average inflation rates, are used for the calculation of the reference value.

The convergence **criterion dealing with public finances** is defined in the second indent of Article 140(1) TFEU as *"the sustainability of the government financial position: this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 126(6)"*. Furthermore, Article 2 of the Protocol on the convergence criteria states that this criterion means that *"at the time of the examination the Member State is not the subject of a Council decision under Article 126(6) of the said Treaty that an excessive deficit exists"*. As part of an overall strengthening of economic governance in EMU, the secondary legislation related to public finances was enhanced in 2011, including the new regulations amending the Stability and Growth Pact[11].

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

Article 3 of the Protocol on the convergence criteria provides: *"The criterion on participation in the exchange rate mechanism of the European Monetary System (…) shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against the euro on its own initiative for the same period"*[12].

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

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

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

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

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

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

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

2. BULGARIA

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

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

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

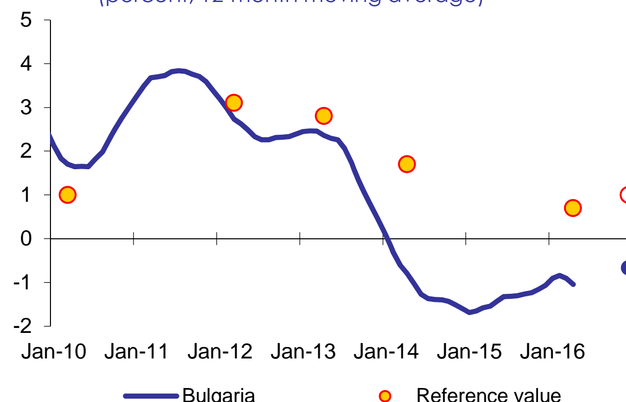
The annual HICP inflation rate in Bulgaria has been negative since summer 2013, with the downturn triggered by an unusually strong combination of disinflationary factors. Inflation reached a trough of -2.4% in January 2015 and then increased to -0.3% in May 2015, before falling back again. Core inflation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

Inflation is expected to rise gradually as the effect from the decline in commodity prices slowly tapers off, although it is set to remain negative throughout most of

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

2016. Accordingly, the Commission services' Spring 2016 Forecast projects annual average inflation at -0.7% in 2016 and 0.9% in 2017. The low price level in Bulgaria (47% of the euro-area average in 2014) suggests significant potential for further price level convergence in the long term.

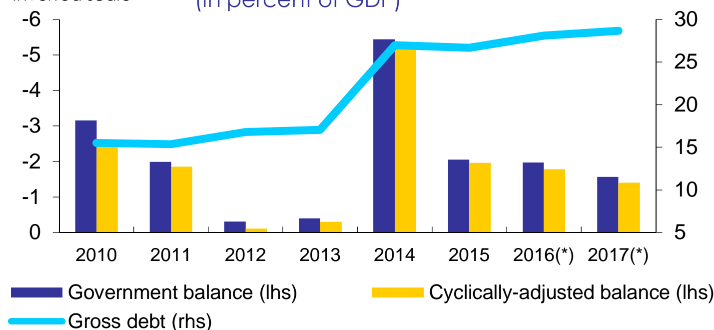
Graph 2a: **Bulgaria - Inflation criterion since 2010**
(percent, 12-month moving average)



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

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

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



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

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

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

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

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

3. THE CZECH REPUBLIC

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

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

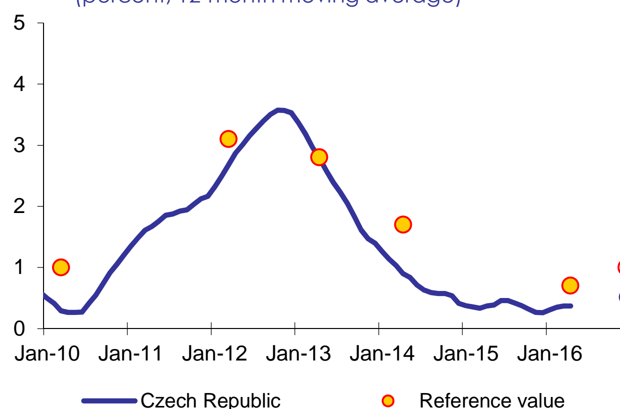
[14] Countries' long-term interest spreads vis-à-vis the euro-area long-term benchmark bonds (n.b. the German benchmark bond is used as a proxy for the euro area) are computed using the monthly series "EMU convergence criterion bond yields" published by Eurostat. The series is also published by the ECB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

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

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

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

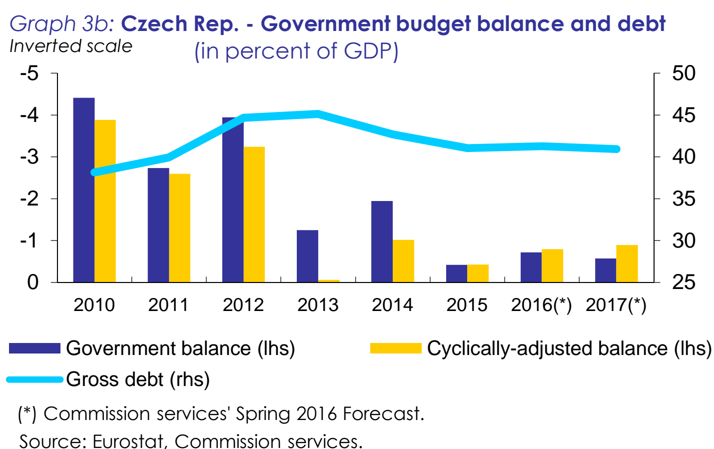
Graph 3a: **Czech Republic - Inflation criterion since 2010**
(percent, 12-month moving average)



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

The Czech Republic fulfils the criterion on public finances. The Czech Republic is not the subject of a Council Decision on the existence of an excessive deficit. The general government deficit declined substantially from 1.9 % of GDP in 2014 to 0.4% of GDP in 2015. According to the Commission services' Spring 2016 Forecast, the general government deficit is projected at 0.7% of GDP in 2016 and to 0.6% in 2017, under a no-policy-change assumption. The gross public debt ratio declined from its peak of 45.1% of GDP in 2013 to 41.1% of GDP in 2015. It is projected to fall to 40.9% of GDP in 2017. Based on the Commission's assessment of the 2016 Convergence Programme, the Czech Republic is expected to comply with the provisions of the Stability and Growth Pact. The Czech Republic's fiscal framework is one of the weakest in the EU. Adoption of the reform package aimed at strengthening it has been repeatedly delayed, putting on hold the completion of

transposition of the Directive on national budgetary frameworks into the Czech legal order, which was due by the end of 2013.



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

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

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

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

4. CROATIA

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

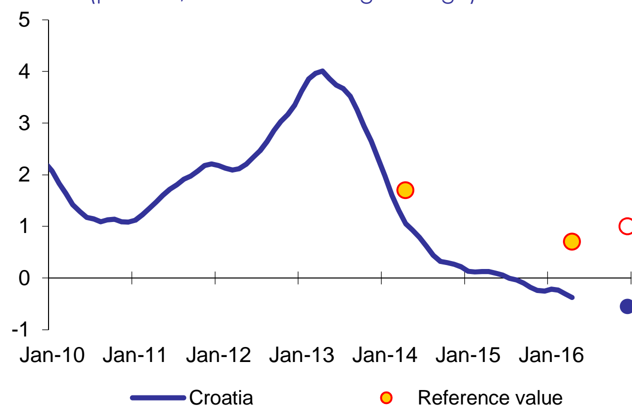
Legislation in Croatia is fully compatible with the compliance duty under Article 131 TFEU.

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

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

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

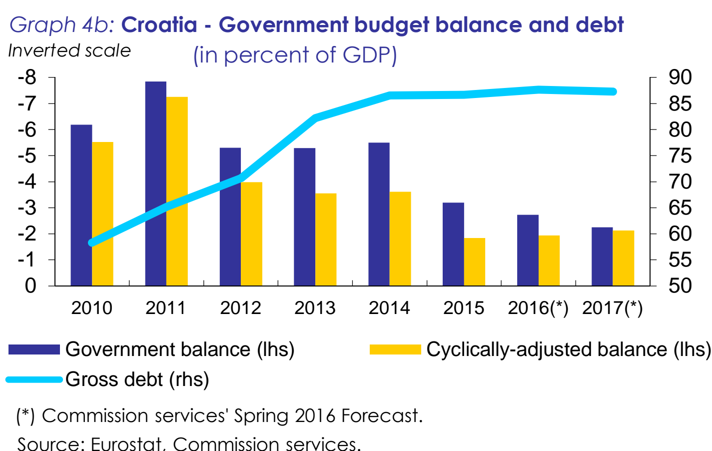
Graph 4a: **Croatia - Inflation criterion since 2010**
(percent, 12-month moving average)



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

Croatia does not fulfil the criterion on public finances. Croatia is at present the subject of a Council Decision on the existence of an excessive deficit (Council Decision of 28 January 2014), which the Council recommended to correct by 2016. After having increased to 5.5% of GDP in 2014, the general government deficit declined to 3.2% of GDP in 2015. The Commission services' Spring 2016 Forecast projects the deficit to decline to 2.7% of GDP in 2016 and 2.3% of GDP in 2017. The general government debt-to-GDP ratio is projected to peak at 87.6% of GDP in 2016 and then to decline slightly in 2017. Based on the Commission's assessment of

the 2016 Convergence Programme, there is a risk that Croatia will not comply with the provisions of the Stability and Growth Pact. Therefore, further measures will be needed to ensure compliance in 2017. Despite some recent improvements, the Croatian fiscal framework remains relatively weak in terms of design and execution, mostly due to the magnitude and frequency of budget plan revisions, the extent of off-budget transactions and the insufficient safeguards regarding the independence of the national monitoring body.



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

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

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

Additional factors have also been examined, including balance of payments developments and integration of markets. Croatia's external surplus (i.e. the combined current and capital account) increased significantly from 1% of GDP in 2014 to some 5.6% of GDP in 2015, partly as a result of losses incurred by foreign-owned banks due the legislated conversion of CHF loans. The Croatian economy is well integrated with the euro area through trade and investment linkages. On the basis of selected indicators relating to the business environment, Croatia performs worse than most euro-area Member States. The financial sector is highly integrated into the EU financial system through foreign ownership of domestic banks. In the context of the Macroeconomic Imbalance Procedure, Croatia was subject to an in-depth review in 2016, which found that Croatia continues to experience excessive

macroeconomic imbalances. Vulnerabilities were linked to high levels of public, corporate and external debt in a context of high unemployment.

5. HUNGARY

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

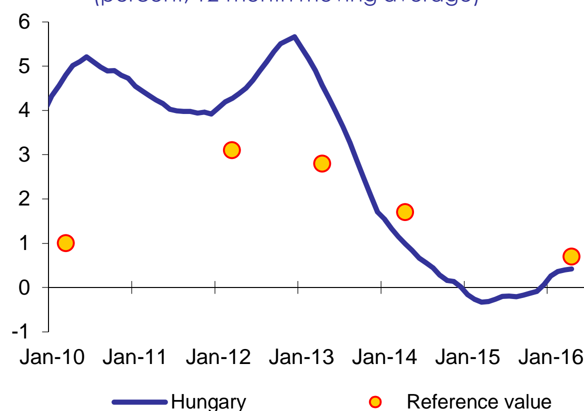
Legislation in Hungary - in particular the Law on the Magyar Nemzeti Bank (MNB) - **is not fully compatible** with the compliance duty under Article 131 TFEU. Incompatibilities notably concern the independence of the MNB, the prohibition of monetary financing and central bank integration into the ESCB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

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

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

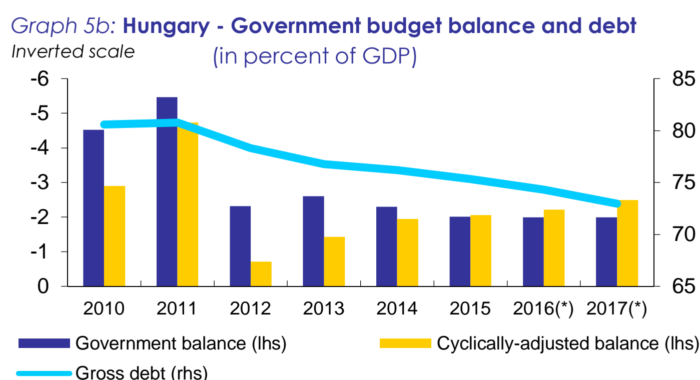
Inflation is projected to increase to 0.4% in 2016 and to 2.3% in 2017 according to the Commission services' Spring 2016 Forecast, mainly due to less favourable commodity price developments and strengthening domestic demand. The relatively low price level in Hungary (about 57% of the euro-area average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

Graph 5a: **Hungary - Inflation criterion since 2010**
(percent, 12-month moving average)



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

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



Graph 5b: **Hungary - Government budget balance and debt** (in percent of GDP)

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

Hungary does not fulfil the exchange rate criterion. The Hungarian forint is not participating in ERM II. Hungary operates a floating exchange rate regime, allowing for foreign exchange market interventions by the central bank. The forint depreciated in summer 2014 to around 314 HUF/EUR, but regained those losses in the autumn, as the rate-cutting cycle was suspended in Hungary and the MNB provided foreign-currency liquidity for housing mortgage loan-related currency conversions. The forint weakened again in January 2015 (to 316.5 HUF/EUR), following the SNB's decision to let the Swiss franc appreciate. It then strengthened to around 299 in April in the wake of further monetary easing in the euro area, until the MNB responded with policy rate reduction in June 2015. From then on, the forint was broadly stable against the euro trading mostly in the range of 310 to 315. During the two years before this assessment, the forint depreciated against the euro by about 1%.

Hungary fulfils the criterion on the convergence of long-term interest rates. The average long-term interest rate in the year to April 2016 was 3.4%, below the reference value of 4.0%. The monthly average long-term interest rate declined from around 6% in early 2014 to close to 3% by early 2015, due to improving market confidence against the background of a global search for yields. Long-term interest

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

rates temporarily rose to near 3.9% in mid-2015, together with rising US and euro-area yields, and were then fluctuating around 3.3% from autumn 2015. Long-term spreads vis-à-vis the German benchmark bond stood at some 290 basis points in April 2016.

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

6. POLAND

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

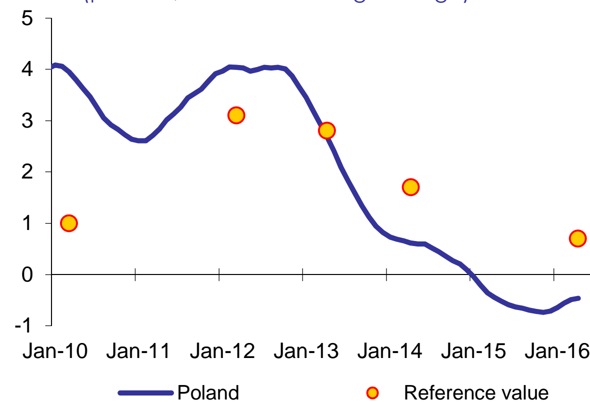
Legislation in Poland - in particular the Act on the Narodowy Bank Polski (NBP) and the Constitution of the Republic of Poland - **is not fully compatible** with the compliance duty under Article 131 TFEU. Incompatibilities concern the independence of the central bank, the prohibition of monetary financing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

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

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

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

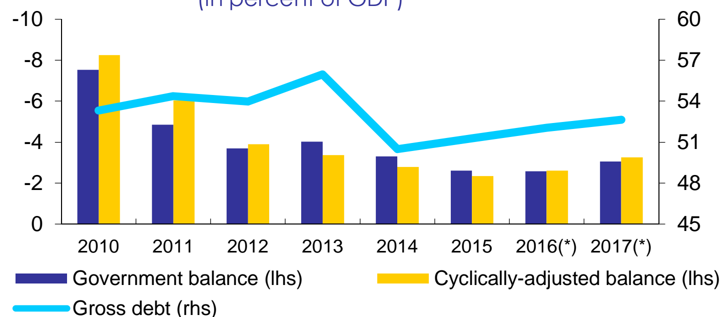
Graph 6a: **Poland - Inflation criterion since 2010**
(percent, 12-month moving average)



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

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

Graph 6b: **Poland - Government budget balance and debt**
Inverted scale (in percent of GDP)



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

Poland does not fulfil the exchange rate criterion. The Polish zloty is not participating in ERM II. Poland operates a floating exchange rates regime, allowing for foreign exchange market interventions by the central bank. After broadly stabilising until end-2014 in the range of 4.1-4.3 PLN/EUR, the zloty appreciated steeply until April 2015 to 4.0 PLN/EUR, supported by accelerating economic growth, ECB easing and end of the monetary easing cycle in Poland. It reversed the trend thereafter, affected by domestic political uncertainties. Exchange rate volatility

in early 2016 was driven by factors such as a credit rating downgrade, global risks and compression of risk premia. Poland has benefited from a Flexible Credit Line arrangement with the IMF since 2009. Compared to April 2014, the exchange rate of the zloty against the euro was around 2.9% weaker in April 2016.

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

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

7. ROMANIA

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

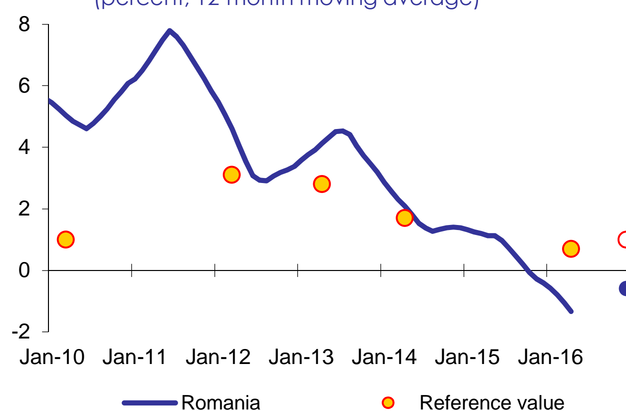
Legislation in Romania – in particular Law No. 312 on the Statute of the Bank of Romania (the BNR Law) – **is not fully compatible** with the compliance duty under Article 131 TFEU. Incompatibilities concern the independence of the central bank, the prohibition of monetary financing and central bank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

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

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

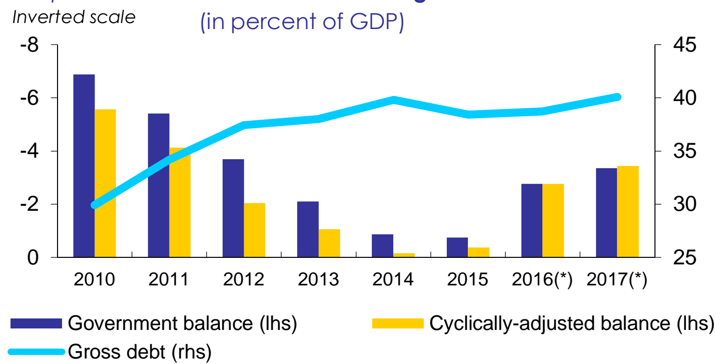
The Commission services' Spring 2016 Forecast projects annual HICP inflation to average -0.6% in 2016 and to rebound to 2.5% in 2017, once the transitory impact of the VAT rate cut for food products fades out, as the output gap closes and domestic pressures are mounting. Upside risks relate mainly to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

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



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

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



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

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

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

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

8. SWEDEN

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

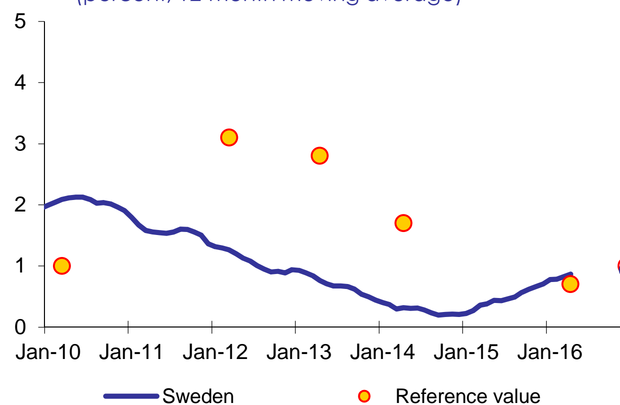
Legislation in Sweden - in particular the Sveriges Riksbank Act, the Instrument of Government and the Law on the Exchange Rate Policy - **is not fully compatible** with the compliance duty under Article 131 TFEU. Incompatibilities and imperfections exist in the fields of independence of the central bank,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

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

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

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

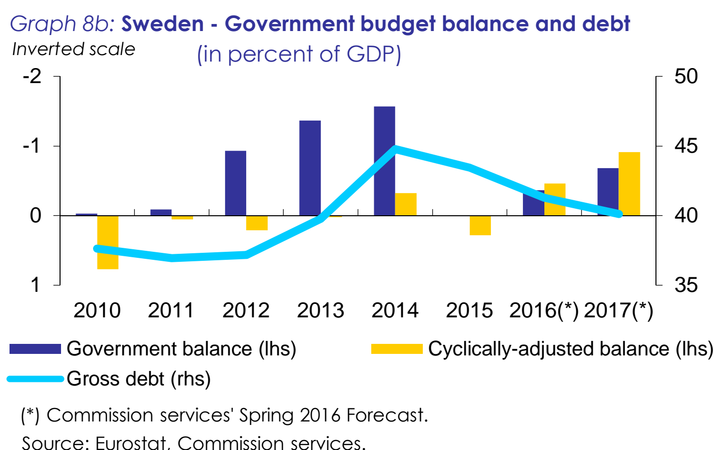
Graph 8a: **Sweden - Inflation criterion since 2010**
(percent, 12-month moving average)



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

Sweden fulfils the criterion on public finances. Sweden is not the subject of a Council Decision on the existence of an excessive deficit. The general government balance improved from 1.6% of GDP in 2014 to 0.0% of GDP in 2015, reflecting mainly a strong rise in tax revenues, supported by buoyant private consumption and tax increases. According to the Commission services' Spring 2016 Forecast, the general government deficit is expected to reach 0.4% of GDP in 2016 and 0.7% in 2017. The gross general government debt ratio reached 43.4% of GDP in 2015 and is

expected to gradually decline in the coming years to 41.3% of GDP in 2016 and 40.1% of GDP in 2017. Based on the Commission's assessment of the 2016 Convergence Programme, Sweden is expected to comply with the provisions of the Stability and Growth Pact. Sweden has a strong national fiscal framework, which is also reflected in its extensive track record of budgetary soundness.



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

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

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

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