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CONVERGENCE REPORT 2012 - TECHNICAL ANNEX

Accompanying the document

REPORT FROM THE COMMISSION

CONVERGENCE REPORT 2012

**(Prepared in accordance with Article 140(1) of the the Treaty on the functioning of the
European Union)**

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European Commission
Directorate-General for Economic and Financial Affairs

Convergence Report 2012

ABBREVIATIONS

Member States

BG	Bulgaria
CZ	Czech Republic
LV	Latvia
LT	Lithuania
HU	Hungary
PL	Poland
RO	Romania
SE	Sweden
EA	Euro area
EU-27	European Union, 27 Member States
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
LVL	Latvian lats
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)
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 Națională a României (National Bank of Romania – central bank of Romania)

Other abbreviations

AMR	Alert Mechanism Report
BoP	Balance of Payments
BPO	Business process outsourcing
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
FSA	Financial Supervisory Authority
FSAP	Financial Sector Action Plan
GDP	Gross domestic product
HICP	Harmonised index of consumer prices
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

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Convergence Report 2012

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

Report

Convergence Report 2012

Technical annex

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) and Estonia (2011) have joined 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 on 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 join the euro, they are not the subject of an assessment as to whether they fulfil the necessary conditions.

In 2010, the Commission and the ECB adopted their latest regular Convergence Reports ⁽⁷⁾. Following the Convergence Reports and on the basis of a proposal by the Commission, the Ecofin Council decided in July 2010 that Estonia fulfilled the necessary conditions for adopting the euro as of 1 January 2011 ⁽⁸⁾. None of the other Member States assessed was deemed to meet the necessary conditions for adopting the euro.

In 2012, two years will have elapsed since the last regular reports were made. 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, Latvia, Lithuania, Hungary, Poland, Romania and Sweden. This Commission Staff Working Document is a Technical Annex to the Convergence Report 2012 and includes a detailed assessment of the progress with convergence.

The financial and economic crisis, along with the recent euro-area debt crisis, has exposed gaps in the current economic governance system of EMU and showed that its existing instruments need to be used more fully. With the aim of ensuring a sustainable functioning of economic and monetary union, an overall strengthening of economic governance in the Union was undertaken over past two years. Accordingly, this Commission Staff Working Document makes references where appropriate to procedures that help to strengthen the assessment of each Member States' convergence process and its sustainability. In particular, it incorporates references to the strengthened surveillance of macroeconomic imbalances (see section 1.2.6.).

⁽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 2010, COM(2010) 238 final, 12 May 2010; European Central Bank, Convergence Report 2010, May 2010.

⁽⁸⁾ Council Decision of 13 July 2010 (OJ L 196, 28.7.2010, 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."

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 as they appear in Article 140(1) (see Box 1.1). The cut-off date for the statistical data included in this Convergence Report was 30 April 2012.

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 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. What is more, the provisions on tasks

in national central banks laws are assessed against the relevant provisions 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” (see Box 1.2).

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⁽¹⁰⁾ provided the basis for a change of the HICP index base reference period from 1996=100 to 2005=100.

⁽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 Regulations (EC) No 1882/2003 and No 596/2009 of the European Parliament of the Council.

⁽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 1.2: 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 and EU-27 for reports as of 2007.

The notion of '**best performer**' is not defined explicitly in the Treaty. It is appropriate to interpret this notion in a dynamic way, 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 (Lithuania's average 12-month inflation was at that time 2.3 percentage points below the euro area average 12-month inflation). 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. Table 1.1 lists the reference value in the Convergence Reports issued since 1998.

(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, Germany, France	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

1) EU15 until April 2004; EU25 between May 2004 and December 2006; EU27 from January 2007 onwards.

2) In case of equal rounded average inflation for several potential best performers, the ranking is determined on the basis of unrounded data.

3) Reference values are only computed at the time of Convergence Reports. All calculations of the reference value between the Convergence Reports are purely illustrative.

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

Sources: Eurostat and Commission services.

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.

Over the 12-month period covering April 2011-March 2012, the three best-performing Member States in terms of price stability were Sweden (1.3%), Ireland (1.4%) and Slovenia (2.1%), yielding a reference value of 3.1%.

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 temporary factors. Therefore, this Technical Annex examines also the role of the macroeconomic situation and cyclical stance in inflation performance, developments in unit labour costs as a result of trends in labour productivity and nominal compensation per head, developments in import prices to assess how external price developments have impacted on domestic inflation. Similarly, the impact of administered prices and indirect taxes on headline inflation is also considered.

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 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 are to 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:

“(a) whether the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value [specified in the Protocol as 3 percent], 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;

(b) whether the ratio of government debt to gross domestic product exceeds a reference value [specified in the Protocol as 60 percent], 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 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.

⁽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.

(Continued on the next page)

Box (continued)

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. ⁽¹⁾

The next step in the procedure is the formulation by the Economic and Financial Committee of an opinion on this report, which according to the Stability and Growth Pact must occur within two weeks of its adoption by the Commission (Article 126(4)). 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, the Council decides, after an overall assessment, including any observation that the concerned Member State may have, whether an excessive deficit exists (Article 126(6)). The Stability and Growth Pact prescribes that any such decision has to be adopted as a rule within four months of the reporting dates (1 April, 1 October).

At the same time as deciding on the existence of an excessive deficit, the Council has to issue a recommendation to the Member State concerned with a view to bringing that situation to an end within a given period, on the basis of a Commission recommendation (Article 126(7)). According to the Stability and Growth Pact, 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 at most 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 in this 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. 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 States considered in this report. Following a Council decision establishing, under Article 126(8), that the Member State did not take effective action in response to a Council recommendation under Article 126(7), the Council, on recommendation by the Commission, addresses to Member States with a derogation a new recommendation under Article 126(7).

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

⁽¹⁾ 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.

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 existence of an excessive deficit is determined in relation to the two criteria for budgetary discipline set in Article 126(2), namely the government deficit and the government debt.

⁽¹¹⁾ According to the Commission services' Spring 2012 Forecast, the inflation reference value is forecast to stand at 3.1% in December 2012, with Sweden, Ireland and Spain as best performers in terms of price stability. Greece has been excluded from the best performers in December 2012 as its average inflation rate is forecasted to become negative and, at the same time, to deviate from the euro area average by a wide margin, being at 2.9 percentage points below the euro area average inflation. The forecast of the reference value is subject to significant uncertainties given that it is calculated on the basis of the inflation forecasts for the three Member States projected to be the best performers in terms of price stability in the forecast period, thereby increasing the possible margin of error.

Failure by a Member State to fulfil the requirements under either of these criteria can lead to a decision by the Council on the existence of an excessive deficit, in which case the Member State concerned does not comply with the budgetary convergence criterion⁽¹²⁾.

The issue of sustainability deserves particular attention at a time when the financial crisis has significantly impacted on the fiscal positions in many Member States. Related to this, economic governance in the EMU was substantially strengthened in 2011. This included, *inter alia*, the operationalisation of the debt criterion in the Excessive Deficit Procedure⁽¹³⁾.

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”.

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

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 close 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 sixteen Member States, the representative interest rates used in this report incorporate all of the above characteristics. For ten Member States, the residual maturity of the benchmark bond is below 9.5 years, in particular for Lithuania with a residual maturity below 8 years. All yields are calculated on the basis of secondary market rates. For the Czech Republic, Germany and Spain a basket of bonds is used, while a single benchmark bond is used in twenty-three 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.U2.L.L40.CI.0000.EUR.N.Z).

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.

Some Member States, as was already the case at the time of the 2010 Convergence Report, have received international balance-of-payments assistance during the assessment period for this report. In order to determine whether this constitutes evidence that a country has faced severe tensions in its exchange rate, the Commission examines several factors, including the situation that led to the need for official external financing, the magnitude and financing

⁽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.

profile of the assistance programme, the residual financing gap, the policy conditionality attached to it as well as developments in foreign exchange and financial markets.

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 1 May 2010 to 30 April 2012.

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).

At the current juncture, sovereign bond markets in some Member States are subject to severe distortions. In particular, some Member States face episodes of unusually high nominal long-term interest rates and/or closure of market access. This makes their long-term interest rates not an economically meaningful benchmark for the assessment of convergence and including them would severely affect the reference value and thus the fairness of the criterion. Against this background, the calculation of the reference value excludes Ireland, i.e. one of the three best-performing Member States in terms of price stability⁽¹⁶⁾.

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. Taking into account the current exceptional economic circumstances, in line with Article 4 of the Protocol (referring to 'at most the three best performing Member States'), the reference value for March 2012 is calculated as the simple average of the average long-term interest rates in Sweden (2.2%) and Slovenia (5.4%) plus 2 percentage points, yielding a reference value of 5.8%.

⁽¹⁶⁾ In March 2012, the 12-month average long-term interest rate in Ireland was 9.1%. Ireland has been the beneficiary of an EU/IMF financial assistance programme since December 2010.

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 "6-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 would 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⁽¹⁾. 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 interest-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, 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 2012 Alert Mechanism Report (AMR)

As a first step in implementing the MIP, the Commission published its first Alert Mechanism Report on 14 February 2012. The AMR made an economic reading of the scoreboard as foreseen by the legislation and on this basis 12 Member States were identified for which in-depth reviews on different possible imbalances are warranted. Three of them are Member States covered in this report (Bulgaria, Hungary and Sweden). The in-depth reviews were conducted in the course of spring 2012 in the context of the European Semester.

⁽¹⁾ These decisions are taken with so called "reversed qualified majority voting" (RQMV), which implies that there needs to be a majority against taking the step (as opposed to the normal approach where a decision needs the backing of a qualified majority).

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 and product 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 chapter on price stability.

The assessment of additional factors is equally important indication of whether the integration of a Member State into the euro area would proceed without difficulties. As regards the balance of payments, the focus is on the situation and development of the external balance⁽¹⁷⁾. Integration of product markets 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.

For the first time, the Convergence Report is aligned with the broader "European semester" approach which takes an integrated and upstream look at the economic policy challenges facing the 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 (MIP – see Box 1.5), that was adopted in December 2011 as one of the key elements of the legislative package (the "6-pack") to enhance the governance structures in EMU, and integrates its results into the assessment⁽¹⁸⁾.

⁽¹⁷⁾ 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.

⁽¹⁸⁾ 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.

2. BULGARIA

2.1. LEGAL COMPATIBILITY

2.1.1. Introduction

The Law on the Bulgarian National Bank (BNB Law), adopted in 1997, constitutes the legal basis for the Bulgarska narodna banka (BNB – central bank of Bulgaria) and deals with the BNB's structure and functions. Some amendments were made to it after the 2010 convergence report was published: (1)) In relation to the conflict of interests, the BNB Law now refers to the Conflict of Interest Prevention and Ascertainment Act; (2) the BNB Law now provides for competences of the BNB in the area of licensing and supervision of payment institutions, payment systems and electronic money institutions.

2.1.2. Central Bank independence

Article 14(1) and (2) of the BNB Law Bank do not accurately mirror the grounds for dismissal of the Governor as laid down in Article 14.2 of the ESCB/ECB Statute. Article 14(1) of the BNB Law provides that a member of the BNB Governing Council amongst others can be relieved from office if "he no longer fulfils the conditions required for the performance of his duties under Article 11(4), if "he is in practical inability to perform his duties for more than six months" or if "he has been guilty of serious professional misconduct". The second dismissal ground mentioned in Article 14(1) is not provided in Article 14.2 of the Statute, whereas the third criterion narrows down the concept of "serious misconduct" of Article 14.2 of the Statute to "serious professional misconduct". In order to remove this imperfection and limit interpretation problems a clear definition of these grounds, in line with Article 14.2 of the Statute, would be required.

In order to be in line with the term duration requirements of Article 14.2 of the Statute, Article 14(2) of the BNB Law should explicitly foresee that a person replacing the Governor whose mandate has ceased as member of the Governing Council should also be elected or appointed for a term of office of at least five years.

Pursuant to Article 33(1) in conjunction with Article 3(13) of the Conflict of Interest Prevention and Ascertainment Act, the breach of conflict of interest prevention and ascertainment duties by the Governor shall be a ground for his dismissal. The Act should remove this incompatibility and specify that the dismissal is only possible if, as per Article 14.2 of the Statute, the breach of the duty is a lack of fulfilment of the conditions required for the performance of the Governor's duty or a serious misconduct of which the Governor has been guilty.

Article 12(1) and (2) of the BNB Law provides for the National Assembly's powers to elect the Governor and the Deputy Governors of the BNB. The National Assembly has claimed that it has the power to annul or amend its previous decisions, including decisions concerning the election of the Governor and Deputy Governors of the BNB taken under Article 12(1) and (2) of the Law. The National Assembly has justified its claim on the basis of a Constitutional Court decision of February 26, 1993 stating that the Constitution does not contain an express provision prohibiting the National Assembly from annulling or amending its acts. The Law should remove this incompatibility and ensure that the Governor, when elected or appointed, shall not be dismissed under conditions other than those mentioned in Article 14.2 of the ESCB/ECB Statute, even if he has not yet taken up his duties.

Article 44 of the BNB law provides that 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. Neither the Council of Ministers nor any other body or institution shall give instructions to the members of the Governing Council. This provision constitutes an imperfection and does not correspond to the wording of the Article 130 of the TFEU and the Article 7 of the ESCB/ECB Statute (e.g. Union institutions are not included) and should therefore be brought into line with it.

2.1.3. Prohibition of monetary financing and privileged access

Article 45(1) 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. Pursuant to Article 45(2) of the Law on BNB, this 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. Article 45(1) should include all entities which are mentioned in Article 123(1) of the TFEU and Article 21.1 ESCB/ECB Statute. The provisions of Article 45(1) and (2) provide for incompatibility with the wording of Article 123 of the TFEU and Article 21.1 of the ESCB/ECB Statute and thus, should be amended. What is more, the prohibition of monetary financing prohibits the direct purchase of public sector debt, but such purchases in the secondary market are allowed as long as such secondary market purchases are not used to circumvent the objective of Article 123 of the TFEU. For this reason the word 'direct' should be inserted in Article 45(1) of the Law to remove this imperfection and be fully in line with Article 123 of the TFEU.

2.1.4. Integration in the ESCB

Objectives

The objectives of the BNB are compatible with the TFEU.

Tasks

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

There are also numerous imperfections regarding:

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

2.1.5. Assessment of compatibility

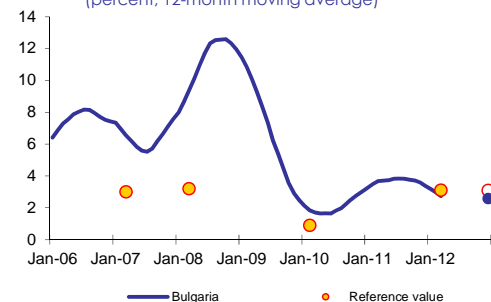
As regards the central bank integration into the ESCB at the time of euro adoption, the independence of the central bank and the prohibition on monetary financing, the legislation in Bulgaria - in particular, the BNB Law and the Conflict of Interest Prevention and Ascertainment Act - are not fully compatible with the compliance duty under Article 131 of the TFEU.

2.2. PRICE STABILITY

2.2.1. Respect of the reference value

The 12-month average inflation rate for Bulgaria, which is used for the convergence assessment, was above the reference value at each convergence assessment since Bulgaria became an EU Member State in 2007. Average annual inflation rose from 1.6% in April 2010 to 3.8% by June 2010, before declining to 3.4% by end-2011. In March 2012, the reference value was 3.1%, calculated as the average of the 12-month average inflation rates in Sweden, Ireland and Slovenia plus 1.5 percentage points. The average inflation rate in Bulgaria during the 12 months to March 2012 was 2.7%, i.e. below the reference value. It is projected to remain below the reference value in the months ahead.

Graph 2.1: Bulgaria - Inflation criterion since 2006
(percent, 12-month moving average)

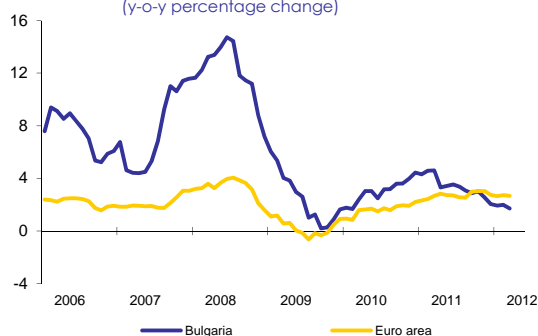


Note: The dots in December 2012 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2012 Forecast.

2.2.2. Recent inflation developments

The inflation rate in Bulgaria has fluctuated over the past two years, reflecting the impact of volatile international commodity prices on energy and food prices. With the turn in the commodity cycle and the strong recession, headline inflation declined to close to zero by late 2009. Strengthening commodity prices, indirect tax increases and still significant wage growth put inflation back on an upward trend in 2010 and it reached a peak of 4.6% in early 2011 before decreasing again with the fading of the impact of the former two factors to 2% by end-2011, well below the euro area average. By March 2012, annual inflation fell further to 1.7%. Indirect taxes contributed positively to inflation in 2010, but their impact was minor from 2011, when fiscal consolidation became even more expenditure-based.

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



Source: Eurostat.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) was by construction more resilient to the import price shocks than headline inflation. The gap between the two measures of inflation varied mainly depending on global commodity price fluctuations, with headline rising above core inflation in early 2010 and reverting to it at end-2011. Core inflation

picked up slightly in late 2010 amid rising processed food inflation, but this short-lived trend reversed by mid-2011 as the commodity price pressure on processed food abated. Core inflation fell to 1% by March 2012. Prices of non-energy industrial goods continued to fall, partly due to weak domestic demand. Decreasing producer price inflation confirmed the easing of cost pressures in 2011, but its year-on-year level remained elevated in early 2012.

2.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy-mix and cyclical stance

Following a long period of dynamic growth, real GDP contracted by more than 5% in 2009, as foreign capital flows dried up and export markets were hit by the effects of the financial crisis. Exports rebounded in 2010 and 2011, but domestic demand remained very sluggish. Output was overall broadly stable in 2010 and increased by around 2% in 2011. The correction of large pre-crisis imbalances started somewhat later in Bulgaria than in other countries of the region. Available indicators for the first quarter of 2012 suggest that domestic demand remains weak. According to the Commission services' Spring 2012 Forecast, Bulgaria's GDP will increase by 0.5% in 2012 and by 1.9% in 2013. The Bulgarian economy is estimated to have operated well below its potential since 2009 and a sizeable negative output gap is projected to remain even in 2013.

The fiscal stance, as measured by changes in the structural balance, has been restrictive since 2010, allowing for a frontloaded correction of the structural deficit that emerged in 2009. The correction of the headline deficit was achieved mainly by structural measures, in particular in 2010, and fiscal consolidation was concentrated on the expenditure side. In view of the good starting budgetary position and the ambitious tackling of the fiscal slippage in 2009, the drag on the economy from fiscal consolidation is expected to be rather moderate, with the fiscal stance projected to be slightly restrictive in 2012 and broadly neutral in 2013.

In the context of its currency board arrangement to the euro, monetary conditions tightened in Bulgaria with the international financial crisis. The

Table 2.1:

Bulgaria - Components of inflation	(percentage change) ¹⁾							weights
	2006	2007	2008	2009	2010	2011	Mar-12	2012
HICP	7.4	7.6	12.0	2.5	3.0	3.4	2.7	1000
Non-energy industrial goods	2.6	4.4	6.0	2.9	0.3	-0.4	-0.5	234
Energy	5.2	5.1	12.5	-5.7	9.2	8.9	7.2	137
Unprocessed food	5.4	6.3	10.9	1.3	-1.6	1.6	1.7	84
Processed food	18.5	13.4	17.2	2.4	7.5	7.7	5.1	221
Services	6.5	7.8	12.7	5.8	1.5	1.9	2.0	324
HICP excl. energy and unproc. food	8.1	8.2	12.0	4.1	2.5	2.6	2.1	779
HICP at constant taxes ²⁾	5.4	7.2	11.3	1.9	2.1	3.2	3.0	1000
Administered prices HICP	5.8	5.8	10.6	7.2	3.6	2.5	2.5	162

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

2) Last observation for HICP at constant taxes is February 2012.

Sources: Eurostat, Commission services.

partial relaxation in the local financial regulatory environment, which included the lowering of the reserve requirement by early 2010, could not fully counterbalance the impact of increased risk aversion and reduced funding by foreign parent banks. The uncertain economic outlook, in particular the heightened risk of unemployment and falling real estate prices, lowered credit demand as well. The flow of new credit recovered somewhat during 2011, as the banking sector's reliance on foreign funding declined.

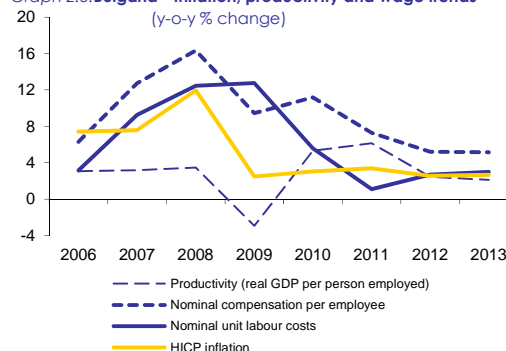
Wages and labour costs

Bulgaria entered the recession with a tight labour market. The initial labour market reaction was a drop in employment of almost 3% in 2009, but the situation turned even more severe in 2010, when the employment loss reached almost 5%, before a further 4% decline in 2011. The unemployment rate rose from below 6% in 2008 to slightly above 11% by 2011, as jobs were lost mainly in the non-tradable sector, but the manufacturing sector also suffered heavily. Despite these factors and wage restraint in the public sector from 2010, nominal wage growth remained high in the private sector. This suggests that skills mismatches impeded labour market flexibility, despite a relatively decentralized wage setting process.

Labour productivity turned negative in 2009, as output fell faster than employment, but it increased strongly in 2010 and 2011 with continuing labour force reductions amid rising exports. Accordingly, the growth in nominal unit labour cost (ULC) remained high in 2009, before moderating to

around 5% in 2010 and 1% in 2011⁽¹⁹⁾. Looking ahead, ULC growth is expected to rise, as the growth in nominal compensation per employee is to remain high and productivity growth is likely to decrease with the stabilization of the labour market.

Graph 2.3: Bulgaria - Inflation, productivity and wage trends (y-o-y % change)



Source: Eurostat, Commission services' Spring 2012 Forecast.

External factors

Given the high openness of the Bulgarian economy, developments in import prices play an important role in domestic price formation. Import prices, as measured by the imports of goods deflator in the national accounts, dropped at a double-digit rate in 2009, but increased markedly in 2010 and 2011. Annual growth in import prices is expected to remain significant in 2012 mainly on account of rising oil prices.

The development of Bulgaria's import prices is closely linked to the fluctuations in international commodity prices. Accordingly, energy and food

⁽¹⁹⁾ Significant revisions to data on nominal compensation per employee make it more difficult to interpret ULC developments.

Table 2.2:

Bulgaria - Other inflation and cost indicators		(annual percentage change)						
	2006	2007	2008	2009	2010	2011¹⁾	2012²⁾	2013²⁾
HICP inflation								
Bulgaria	7.4	7.6	12.0	2.5	3.0	3.4	2.6	2.7
Euro area	2.2	2.1	3.3	0.3	1.6	2.7	2.4	1.8
Private consumption deflator								
Bulgaria	2.2	9.0	7.2	1.5	2.4	3.8	3.0	3.2
Euro area	2.2	2.2	2.7	-0.4	1.7	2.5	2.2	1.7
Nominal compensation per employee								
Bulgaria	6.3	12.7	16.3	9.4	11.2	7.3	5.2	5.1
Euro area	2.5	2.6	3.4	1.8	1.7	2.2	1.9	1.9
Labour productivity								
Bulgaria	3.1	3.2	3.5	-2.9	5.3	6.1	2.4	2.1
Euro area	1.9	1.3	-0.3	-2.4	2.5	1.2	0.1	1.0
Nominal unit labour costs								
Bulgaria	3.1	9.3	12.5	12.7	5.6	1.1	2.7	3.0
Euro area	0.8	1.4	3.8	4.2	-0.8	0.8	1.6	0.8
Imports of goods deflator								
Bulgaria	11.4	7.3	10.8	-13.7	8.5	9.5	5.8	2.0
Euro area	3.9	1.0	4.2	-7.7	5.7	6.9	3.6	1.3

1) 2011 data (except HICP inflation) are estimates.

2) Commission services' Spring 2012 Forecast.

Source: Eurostat, Commission services.

products were the most relevant channels of imported inflation, in particular when taking into account their relatively large share in the consumer basket. Energy and processed food inflation rose to high levels in early 2010, but moderated by late 2011, reflecting commodity price changes with a time lag. The good local harvest in 2011 helped to keep unprocessed food inflation moderate and non-energy industrial goods prices, another typical channel of import price transmission, declined marginally in the past two years.

The nominal effective exchange rate of the lev (measured against a group of 35 trading partners) was relatively strong from early 2009, after the currencies of some trading partners depreciated to the euro in reaction to the financial crisis. This strength was lost by mid-2010 and then gradually regained by the summer of 2011. From late-2011, the nominal effective exchange rate of the lev depreciated somewhat. Overall, fluctuations in the nominal effective exchange rate do not appear to have had a significant impact on inflation developments.

Administered prices and taxes

Administered prices⁽²⁰⁾ and indirect tax changes played a significant role in determining Bulgarian inflation over the past few years. The share of administered prices in the HICP basket is around 16%. The annual increase of administered prices fell from 3.6% in 2010 to 2.6% in 2011, as pressure to correct the budget deficit abated, but energy prices were increasingly pushing up costs. Overall, administered prices lifted headline inflation in 2010, but lowered it in 2011. The excise tax increase on tobacco in 2010 had a major impact on the price level, but other indirect tax changes were not significant.

The pressing need for fiscal consolidation led to significant increases in administered prices in 2010, mostly in the categories of water supply, sewage collection, pharmaceutical products, education and other services. In 2011, the price of hospital services went up markedly. On the other hand, the price increase of electricity was low over

⁽²⁰⁾ 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/methodology/administered_prices

the past two years, while the price of heat energy fluctuated with global energy prices.

In line with tax harmonisation requirements within the EU and the need to increase budget revenues, the excise tax on tobacco was raised sharply in the beginning of 2010. Accordingly, tobacco products contributed by an estimated 1.3 and 0.5 percentage points to average annual inflation in 2010 and 2011, respectively.

Medium-term prospects

After the decline until March 2012, inflation is expected to pick up slightly during the course of 2012, as commodity price increases in the beginning of the year will feed through and high nominal wage growth is set to lift services prices, despite weak domestic demand. Accordingly, the Commission services' 2012 Spring Forecast projects annual average inflation at 2.6% in 2012 and 2.7% in 2013.

Risks to the inflation outlook appear to be broadly balanced. A stronger economic recovery with an even faster private sector wage growth, potentially spreading to the public sector, a recovery in bank lending or a further rise in global commodity prices would raise inflationary pressures. Conversely, a moderation of wage growth due to high unemployment or a reversal of international commodity prices would have disinflationary effects.

The level of consumer prices in Bulgaria was at 49% of the euro area average in 2010. 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 41% of the euro area average in PPS terms in 2010).

Medium-term inflation prospects will depend on the gap between wage and productivity growth, which could widen again, as the allocation of labour market resources does not appear to be efficient and unemployment created during the downturn could become structural. Bulgaria is particularly exposed to rising global commodity prices, due to the high share of commodity-type products in the consumer basket. A prudent fiscal stance is expected to help contain inflationary pressures, but the need to harmonize excise taxes with EU legal requirements on tobacco, natural

gas, gas oil and kerosene is expected to add to inflation over the medium-term.

2.3. PUBLIC FINANCES

2.3.1. The excessive deficit procedure for Bulgaria

On 13 July 2010, the European Council adopted a decision on the existence of an excessive deficit in Bulgaria in accordance with Article 126(6) of TFEU. The decision was based on data notified by the Bulgarian authorities for the general government deficit in 2009, showing that the deficit exceeded the 3% of GDP reference value. The Council issued a set of recommendations to Bulgaria in accordance with Article 126(7) TFEU with a view to bringing an end to the situation of an excessive deficit by 2011. In its recommendations, the Council established a deadline of 13 January 2011 for effective action to be taken and invited the Bulgarian authorities to take necessary measures to avoid deterioration of the 2010 deficit beyond the planned 3.8% of GDP; ensure a fiscal effort of at least ¾% of GDP in 2011; and specify and implement the measures that were necessary to achieve the correction of the excessive deficit by 2011. To limit risks to the adjustment, Bulgaria was recommended to strengthen its fiscal governance and transparency by reinforcing the Ministry of Finance's spending controls, strengthening the binding nature of its medium-term budgetary framework as well as improving the monitoring of the budget execution throughout the year. The Bulgarian authorities were also invited to ensure that budgetary consolidation towards the medium-term objective for the budgetary position was sustained after the excessive deficit has been corrected. Finally, the Bulgarian authorities were encouraged to improve the efficiency of public spending by fully implementing the planned structural reforms in the area of public administration, healthcare, education, and pensions. On 15 February 2011, the Council concluded that Bulgaria had taken effective action representing adequate progress towards correcting its deficit within the time limit set in the recommendations and that no further steps under the excessive deficit procedure were required⁽²¹⁾.

⁽²¹⁾ An overview of all on-going and previous excessive deficit procedures can be found at: <http://ec.europa.eu/>

Table 2.3:

Bulgaria - Budgetary developments and projections								
(as % of GDP unless indicated otherwise)								
Outturn and forecast¹⁾	2006	2007	2008	2009	2010	2011	2012	2013
General government balance	1.9	1.2	1.7	-4.3	-3.1	-2.1	-1.9	-1.7
- Total revenues	36.2	40.9	40.0	36.3	34.3	33.1	33.3	33.6
- Total expenditure	34.4	39.8	38.3	40.7	37.4	35.2	35.2	35.3
of which:								
- Interest expenditure	1.3	1.2	0.9	0.8	0.6	0.6	0.8	1.0
p.m.: Tax burden	30.7	33.5	31.9	28.7	27.3	27.0	27.0	27.2
Primary balance	3.2	2.3	2.5	-3.6	-2.5	-1.5	-1.1	-0.7
Cyclically-adjusted balance	0.8	-0.3	-0.2	-3.1	-1.6	-1.0	-0.7	-0.8
One-off and temporary measures	-0.1	-3.1	0.0	0.0	-0.1	0.0	0.0	0.0
Structural balance ²⁾	0.9	2.8	-0.2	-3.1	-1.5	-1.0	-0.7	-0.8
Government gross debt	21.6	17.2	13.7	14.6	16.3	16.3	17.6	18.5
p.m.: Real GDP growth (%)	6.5	6.4	6.2	-5.5	0.4	1.7	0.5	1.9
p.m.: Output gap	3.1	4.0	5.1	-3.4	-4.1	-3.1	-3.3	-2.5
Convergence programme						2012	2013	2014
General government balance						-1.6	-1.3	-0.5
Structural balance ²⁾³⁾						-0.6	-0.5	-0.1
Government gross debt						19.8	18.4	18.0
p.m. Real GDP growth (%)						1.4	2.5	3.5
								4.0

1) Commission services' Spring 2012 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 2012 Convergence Programme of Bulgaria

2.3.2. Recent fiscal developments

Bulgaria has maintained a relatively strong budgetary position prior to the crisis and in the context of a very tax-rich growth structure. The general government budget posted surpluses of above 1.5% of GDP on average in 2006-08 which contributed to the accumulation of sizeable fiscal reserves (above 12% of GDP in 2008). In 2009, however, the crisis impacted severely on public finances and the budget balance turned from a surplus of 1.7% of GDP in 2008 to a deficit of 4.3% of GDP in 2009. In response, the government undertook strict consolidation measures which led to a gradual improvement of the budgetary position over the period of 2010-11. The measures aimed at raising revenue collection while maintaining a tight control on the expenditure side, including through freezing the public sector wage bill and pensions. Thus, the general government deficit narrowed to 3.1% of GDP in 2010 and improved further to 2.1% of GDP in 2011, against an initially set target of 2.5% of GDP in the 2011 Convergence Programme.

The better-than-expected budget outcome in 2011 was mainly due to a further drop in the expenditure-to-GDP ratio, largely on account of lower-than-projected capital spending. Thanks to frontloading of the consolidation measures the structural deficit improved by 1.6 percentage points in 2010 and dropped further by another 0.5 percentage points to -1.0% of GDP in 2011. The fiscal consolidation was facilitated by a gradual recovery of GDP with the growth structure becoming more broad based.

Bulgaria's public debt is one of the lowest among the EU Member States. The debt-to-GDP ratio increased moderately from 14.6% in 2009 to 16.3% in 2010. The ratio stayed unchanged in 2011, thus remaining well below the 60% of GDP reference value. The debt dynamics reflect the negative impact from the development in the headline fiscal balance which is partly compensated by debt-reducing stock-flow adjustments related to drawing down the accumulated fiscal reserves.

2.3.3. Medium-term prospects

The 2012 Budget Law was adopted by parliament on 16 December 2011. The budget targets a general government deficit of 1.5% of GDP (1.3%

of GDP in cash terms). There are no major tax policy or rate changes except for increasing the excise taxes on some energy goods to the minimum EU levels in accordance with agreed transition periods and the introduction of natural gas excise tax as of 1 June, 2012. Budget sector wage bill and pensions will be frozen for a third year in row.

In the Commission services' 2012 Spring Forecast the general government balance is projected to improve further to -1.9% and -1.7% of GDP in 2012 and 2013, respectively. The structural deficit is forecast to decline to -0.8% of GDP in 2013, implying a cumulative structural fiscal effort of 0.2 pp. over 2012-13. The general government gross debt is set to increase moderately from 16½% of GDP in 2011 to 18½% of GDP in 2013. The debt forecast does not include possible external debt issuance in 2012 to pre-fund the repayment of Eurobonds of around 2% of GDP in January 2013.

The 2012 Convergence Programme was submitted on 12 April 2012. After the expected correction of the excessive deficit in 2011, as recommended by the Council, the programme aims at achieving a close to balanced budget position by the end of the programme period (2015). The official targets for the general government budget balance have been marginally revised to -1.6% of GDP in 2012 and -1.3% of GDP in 2013, while the targets for 2014 and 2015 have been kept unchanged. The small deviation of the targets for 2012-2013 compared with the Commission services' 2012 Spring Forecast is mainly due to a more favourable macroeconomic scenario underlying the programme.

Further details on the assessment of the 2012 Convergence Programme for Bulgaria can be found in the forthcoming Commission Staff Working Document, which accompanies the Commission Recommendation for a Council Recommendation on the 2012 National Reform Programme of Bulgaria and delivering a Council Opinion on the 2012 Convergence Programme of Bulgaria ⁽²²⁾.

In March 2012, Bulgaria signed the Treaty on Stability, Coordination and Governance in the EMU. This implies an additional commitment to conduct stability-oriented and sustainable fiscal

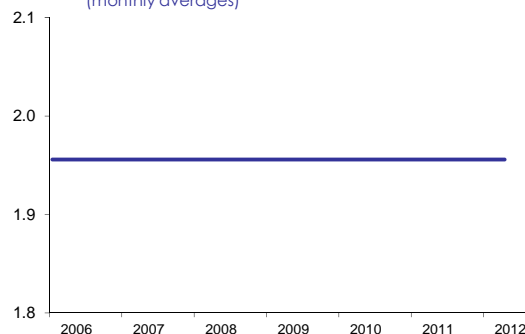
policies. This Treaty will apply to contracting Member States with a derogation which have ratified the Treaty as from the date when the decision abrogating that derogation will come into force unless they declare their intention to be bound at an earlier date by some or all of the provisions on the fiscal compact and on economic policy coordination and convergence.

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.

Since the onset of the financial crisis, the CBA has operated in a difficult and uncertain environment, as capital inflows turned down and the banking sector was challenged by deteriorating asset quality and linkages to Greece. However, the export-driven economic recovery, a relatively strong public finance position and sizable reserve buffers have underpinned the resilience of the CBA.

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



Source: ECB, Reuters EcoWin.

Bulgaria's international reserves covered around 176% of the monetary base and close to half of broad money (M3) as of end-March 2012. A high reserve coverage was deliberately built into the framework for Bulgaria's CBA, to cater for

⁽²²⁾ Available at: http://ec.europa.eu/economy_finance/economic_governance/sgp/convergence/programmes/2012_en.htm

potential financial sector stress following the 1996-97 crisis. The government keeps the bulk of its fiscal reserve deposited in the BNB. International reserves remained fairly stable over the past two years, as the reduction in government deposits was counterbalanced by other items, namely by increases in cash in circulation, banks' deposits and accumulated profit of the BNB. At end-2011, international reserves covered some 133% of Bulgaria's short-term debt (at original maturity, excluding liabilities related to direct investments).

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 spiked in late-2008 with tighter liquidity and heightened risk perception towards new Member States. The 3-month spread declined gradually until July 2011 from its peak of around 490 basis points of March 2009 and stabilized somewhat above 200 basis points since then. Bulgarian overnight interbank rates were however typically below those of the euro area in 2011 and early 2012.

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



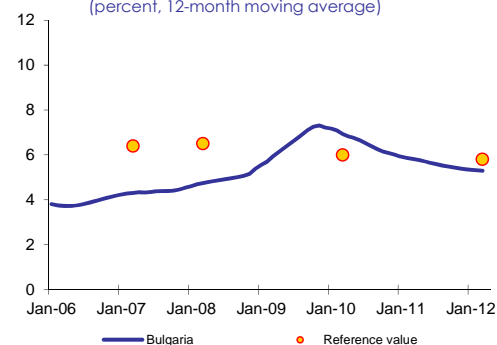
2.5. LONG-TERM INTEREST RATES

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 above the reference value at the 2010 convergence assessment. It gradually declined from above 7% in early 2010 to

somewhat above 5% by end-2011. In March 2012, the latest month for which data are available, the reference value, given by the average of long-term interest rates in Sweden and Slovenia plus 2 percentage points, stood at 5.8%. In that month, the twelve-month moving average of the yield on the Bulgarian benchmark bond stood at 5.3%, i.e. about 0.5 percentage points below the reference value.

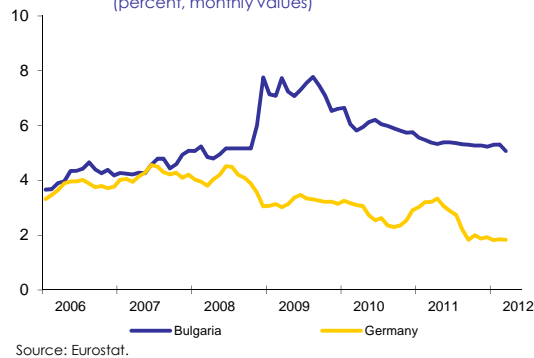
Graph 2.6: Bulgaria - Long-term interest rate criterion
(percent, 12-month moving average)



The long-term interest rate spread vis-à-vis the euro area rose sharply in 2008, during the turmoil of the international financial crisis. The spread started to decline from autumn 2009, as Bulgarian bond yields fell with the calming of global financial tensions. There was a temporary bout of pressure in mid-2010 linked to the sovereign debt crisis and concerns about the quality of Bulgarian public finance statistics, but the improving trend resumed relatively soon. Long-term government yields of Bulgaria were broadly resilient to international financial tensions in late 2011, as the liquidity position of the local banking system improved by year-end. Spreads to the Bund remained elevated, reaching around 320 basis points in March 2012, as yields of the latter were influenced by safe haven inflows⁽²³⁾.

⁽²³⁾ The reference to the German benchmark bond is included for illustrative purposes, as a proxy of the euro area long-term AAA yield.

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



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 and financial market integration – is an important indication that the integration of a Member State into the euro area would proceed without difficulties.

The section on additional factors makes reference *inter alia* to 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. Related to this, following the adoption of the legislation establishing the new procedure for surveillance and correction of macroeconomic imbalances (MIP) ⁽²⁴⁾, the Commission published its Alert Mechanism Report (AMR) in February 2012 ⁽²⁵⁾. The scoreboard shows that Bulgaria exceeds the indicative threshold in four out of ten indicators, three in the area of external imbalances (namely on the current account balance, net international investment position and nominal ULC growth) and one in the area of internal imbalances (on private sector debt). In line with the conclusion of the AMR which was based on economic analysis and the scoreboard for 2010, Bulgaria was subject to an in-depth review in the context of the MIP.

⁽²⁴⁾ The package of six legislative proposals to strengthen the economic governance of the EU entered into force in December 2011.
<http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/898>

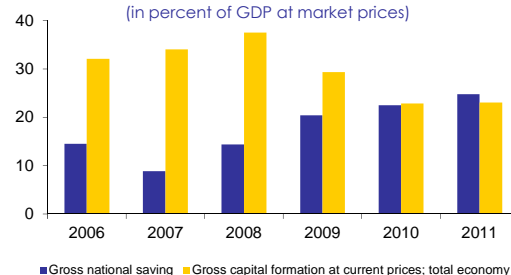
⁽²⁵⁾ http://ec.europa.eu/economy_finance/articles/governance/2012-02-14-alert_mechanism_report_en.htm

2.6.1. Developments of the balance of payments

Bulgaria's external balance (i.e. the combined current and capital account) adjusted from very large deficits until 2008 to around balance in 2010 and to a surplus of around 2% of GDP in 2011. The improvement was mostly on account of merchandise trade, as imports fell with lower domestic demand, but exports also grew dynamically in 2010 and 2011. The surpluses on services and current transfers increased, the latter favourably influenced by remittances of Bulgarians working abroad. The income account improved temporarily in 2009, reflecting lower profits on FDI, but it returned close to 2008 levels in 2011. The current transfers and capital account surpluses also reflect sizeable net inflows from EU funds, although EU funds absorption could be improved further.

The large savings-investment gaps of 2006-2008 closed by 2010, as capital flows moderated following the international financial crisis. Gross national savings hovered at a historically high level of around 25% of GDP in 2011, as companies underwent balance sheet adjustment after several years of high credit growth and households were cautious in the context of rising unemployment. Gross fixed capital formation declined both in 2010 and 2011, as firms postponed investment in the uncertain economic environment.

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



Competitiveness indicators showed a mixed picture in the past years. After some correction in 2009 and early 2010, the ULC-deflated real-effective exchange rate continued its sharp appreciation trend, partly due to the rising NEER and ULC of Bulgaria, while the HICP- and manufacturing sector ULC-based REER remained considerably more stable. Bulgaria's export market share increased significantly in 2010 and 2011,

Table 2.4:

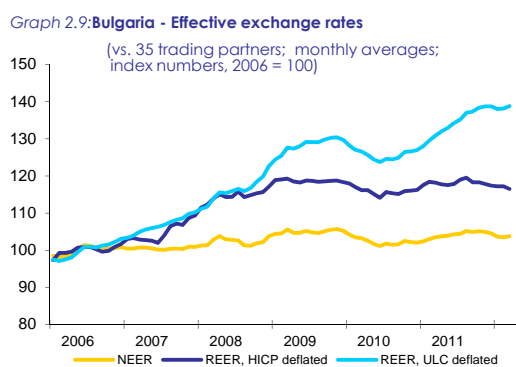
Bulgaria - Balance of payments	(percentage of GDP)					
	2006	2007	2008	2009	2010	2011
Current account	-17.6	-25.2	-23.1	-8.9	-1.0	0.9
of which: Balance of trade in goods	-21.0	-23.5	-24.3	-11.9	-7.7	-5.1
Balance of trade in services	3.5	3.8	3.7	3.7	5.6	5.9
Income balance	-2.6	-7.7	-5.0	-3.4	-3.1	-4.3
Balance of current transfers	2.5	2.2	2.4	2.7	4.2	4.4
Capital account	0.7	-1.9	0.8	1.4	0.8	1.3
External balance ¹⁾	-16.9	-27.1	-22.3	-7.6	-0.2	2.2
Financial account	20.0	34.2	30.5	5.2	-0.9	-3.5
of which: Net FDI	23.0	28.7	17.5	7.2	2.9	3.1
Net portfolio inflows	1.1	-1.7	-2.1	-1.8	-1.8	-0.9
Net other inflows ²⁾	1.6	16.6	16.9	-2.1	-3.0	-5.3
Change in reserves (+ is a decrease)	-5.7	-9.5	-1.9	1.9	1.1	-0.4
Financial account without reserves	25.7	43.6	32.4	3.3	-1.9	-3.1
Errors and omissions	-3.1	-7.0	-8.1	2.4	1.1	1.3
Gross capital formation	32.1	34.1	37.5	29.4	22.9	23.1
Gross saving	14.5	8.8	14.4	20.4	22.5	24.8
External debt	78.1	94.3	105.1	108.3	102.8	91.9
International investment position	-58.0	-81.1	-98.4	-101.8	-94.7	-85.3

1) The combined current and capital account.

2) Including financial derivatives.

Sources: Eurostat, Commission services, Bulgarian National Bank.

although the pace of improvement moderated with the slow-down in export growth towards the end of 2011.



Mirroring the improvement in the external balance, the financial account turned into a deficit by 2010. The net FDI balance remained positive, but diminished, as new investments were mainly related to companies already present in Bulgaria. The long-term trend of net outflows of portfolio investment continued, as the government did not issue on the international market and interest in the Bulgarian stock market remained weak. The reduction in net external funding of the banking

sector resulted in a significant deficit on net other inflows, especially in 2011. Gross external debt to GDP declined significantly from around 108% at end-2009 to about 92% by end-2011, supported by strong nominal GDP growth and repayment of foreign debt by the banking sector. The improvement was similar in the net international investment position, but its negative balance remained substantial.

According to the Commission services' Spring 2012 Forecast, the external surplus is projected to remain unchanged in 2012, as domestic demand is expected to stagnate while export growth is to slow somewhat.

2.6.2. Product market integration

The Bulgarian economy is well integrated into the EU economy through trade and investment linkages. As a small open economy, Bulgaria is characterised by a high ratio of trade openness reaching 70% of GDP in the recent years. In 2009, the global crisis resulted in a temporary contraction of trade openness, as external demand faltered and both imports and exports contracted in real terms. The rebound of global trade in 2010 resulted in an increase in openness, both on the

Table 2.5:

Bulgaria - Product market integration

	2005	2006	2007	2008	2009	2010
Trade openness ¹⁾ (%)	48.1	70.0	69.3	68.5	51.9	58.4
Intra-EU trade in goods GDP ratio ²⁾ (%)	28.7	31.3	34.1	32.9	25.4	28.8
Intra-EU trade in services GDP ratio ³⁾ (%)	9.3	9.9	9.2	9.0	8.5	7.7
Extra-EU trade in goods GDP ratio ⁴⁾ (%)	18.0	20.0	23.4	23.9	15.5	19.4
Export in high technology ⁵⁾ (%)	2.9	3.3	3.5	3.6	4.6	n.a.
Technological balance ⁶⁾ (%)	-3.6	-3.4	-3.2	-2.9	-2.0	n.a.
Total FDI inflows GDP ratio ⁷⁾ (%)	13.6	23.5	29.4	18.9	9.4	4.9
Intra-EU FDI inflows GDP ratio ⁸⁾ (%)	10.1	19.6	25.0	16.1	8.0	4.4
FDI intensity ⁹⁾	5.5	9.9	12.6	8.6	3.7	2.3
Internal Market Directives ¹⁰⁾ (%)	:	:	0.8	0.4	0.3	0.4
Value of tenders in the EU Official Journal ¹¹⁾	:	:	49.4	42.0	63.3	34.8
Time to start up a new company ¹²⁾	32.0	32.0	32.0	49.0	18.0	18.0
Real house price index ¹³⁾	100.0	112.2	132.7	154.9	121.5	107.9
Residential investment ¹⁴⁾ (%)	3.1	5.7	5.3	6.1	5.3	4.3
Building permits index ¹⁵⁾	100.0	162.0	195.0	150.0	61.0	39.0

1) $(\text{Imports} + \text{Exports of goods and services} / (2 \times \text{GDP at current market prices})) \times 100$ (Foreign Trade Statistics, Balance of Payments).

2) $(\text{Intra-EU-27 Imports} + \text{Exports of goods} / (2 \times \text{GDP at current market prices})) \times 100$ (Foreign Trade Statistics).

3) Intra-EU-27 trade in services (average credit and debit in % of GDP at current prices) (Balance of Payments).

4) $(\text{Extra-EU-27 Imports} + \text{Exports of goods} / (2 \times \text{GDP at current market prices})) \times 100$ (Foreign Trade Statistics).

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

6) $(\text{Exports} - \text{imports in high tech}) / \text{GDP at current prices} \times 100$, 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-EU-27 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) Public procurement - Value of public procurement which is openly advertised in the EU Official Journal in total public procurement.

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

13) Experimental house price index (2005=100), Eurostat.

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

15) Number of new residential buildings (2005=100), Eurostat.

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

export and import side. This trend was maintained in 2011.

Bulgaria shows a pattern of intermediate technology exports. Trade in goods reveals a comparative advantage mainly in the export of textiles, basic metals, fuels and tobacco, registering a combined 60% export share in 2010. A breakdown of exported goods by product category demonstrates a predominance of labour- and raw-material-intensive, low- and medium-quality goods over high technology goods. The share of high value-added goods in exports has increased slightly recently (reaching 4.6% of GDP in 2009), reflecting a gradual, albeit slow, upward shift in the economy's specialisation pattern in the productivity scale while the technological trade deficit almost halved in 2009 (-2%) compared to 2005 (-3.6%). In the medium-to-long term, the economy should move further away from labour-intensive sectors towards a larger reliance on higher value-added sectors and services.

FDI inflows were more than three times higher than the EU 27 average in the period 2005-2010. Bulgaria particularly benefited from lower costs of inputs, especially labour, and a fairly well-trained work force. FDI inflows peaked at around 29% of GDP in 2007 and dried up considerably during the global economic crisis down to 3.4% of GDP in 2010. The FDI stock was 101% of GDP at the end 2009, substantially higher than that in Romania (42%) and the EU 27 average (70%). The EU 27 is the main contributor to FDI inflows, accounting for well over 85% of total FDI stock at the end of 2009 (the most important source countries were the Netherlands, Austria and Greece). The dominant part of the FDI inflows went however to industries serving local needs, including housing construction and trade and did not significantly improve the export capacity of the country. Almost 70% of the total FDI stock at the end of 2009 was in the service sector (real estate and business activities, and financial intermediation), while the

share of FDI in manufacturing (food, textile, metal and chemical products) was around 16%.

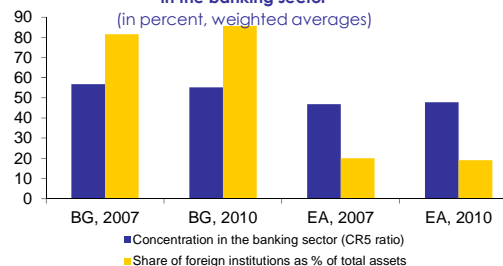
House prices and residential construction boomed prior to the crisis. The cumulative real house price growth from trough (in the second quarter of 2002) to peak (in the third quarter of 2008) stood at around 230%, with average quarterly year-on-year price growth reaching 23%. Real house prices dropped substantially during the crisis, by close to 40% since the end of 2008. From 2004 until 2008 the share of residential construction in GDP tripled (as it went from about 2% to 6%), and readjusted to about 4% in 2010. The correction in building permits started already in 2008, is still on-going, and has been much sharper than the correction in investment.

Concerning the business environment, Bulgaria scores below the average of euro area Member States in international rankings ⁽²⁶⁾. Based on the World Bank Doing Business indicators, the performance of Bulgaria deteriorated in 2011 in the area of starting a business, dealing with construction permits and registering property, and protecting investors and resolving insolvency. In terms of income and corporate tax rates, Bulgaria is still very competitive in the EU. Finally, according to the November 2011 Internal Market Scoreboard, Bulgaria had a transposition deficit below the EU average (0.9% compared to 1.2%) while the share of public procurement tenders announced in the EU Official Journal has been higher than the EU average (average of 47.4% between 2007 and 2010 compared to 17.7% for the EU 27) ⁽²⁷⁾.

2.6.3. Financial market integration

Bulgaria's financial sector is well integrated into the EU financial system, in particular through a high level of foreign ownership in its banking sector. The share of foreign-owned institutions in total credit institution assets remained broadly stable at over 80%. Bank concentration, as measured by the market share of the largest five credit institutions in total assets, decreased somewhat since EU accession, but was still above the euro area average in 2010.

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



Source: ECB, Structural indicators for the EU banking sector, December 2011.

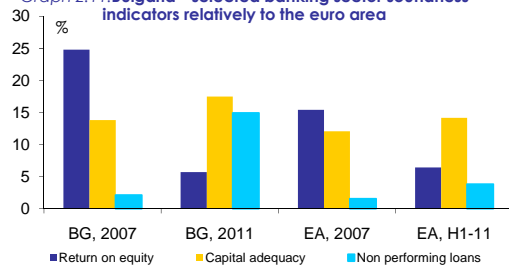
Financial intermediation in Bulgaria is mainly indirect, with domestic bank credit above 70% of GDP at the end of 2011. Rapid credit expansion ended by 2009 as changes in the international financial environment constrained access to foreign funding and the economy started to deleverage. The attractiveness of domestic deposit collection increased and competition among banks led to high deposit rates in some periods. By the end of 2011, the banking sector managed to substantially reduce its reliance on external funding from the 2009 levels and most banks had only small net external positions. Credit to non-financial corporations by the domestic banking sector increased modestly since 2009, partly due to accounting reasons (cross-border transfers of debt owed previously to non-residents). The share of foreign currency loans (predominantly in euro) increased somewhat during the past two years and stood around 77% for non-financial corporations and 40% for households at the end of 2011.

The Bulgarian financial system has proved resilient to the international financial crisis and its consequences. No banking system rescue measure had to be taken by the government. Confidence in the currency board arrangement is strong and international reserves remain at high level, supported by government deposits, which were prudently accumulated earlier. Contagion from Greece has remained limited, despite significant Greek ownership in the Bulgarian banking sector.

⁽²⁶⁾ For instance, Bulgaria ranks on 74th and 59th place according to the 2011-2012 Global Competitiveness index and the 2012 World Bank Doing Business respectively.

⁽²⁷⁾ The value of tenders published in the EU Official Journal may serve as a proxy of the extent to which national public procurement are open to foreign bidders.

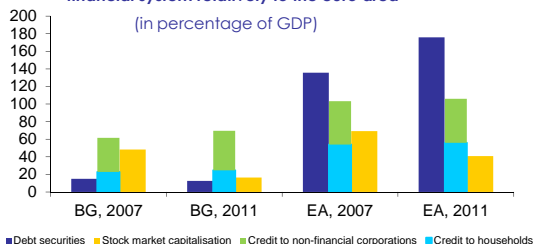
Graph 2.11: Bulgaria - selected banking sector soundness indicators relatively to the euro area



Note: For 2007 and 2011, EU-27 non performing loans are a proxy for EA. For 2007, EA RoE and CAR averages are unweighted.
Source: ECB, Bulgarian National Bank, EC calculations.

Slow mortgage lending and unsold real estate projects contributed to declining house prices in 2011, but profitability of the domestic banking sector remained positive ever since EU accession. The banking system is fairly liquid and well capitalized, with a capital adequacy ratio of 17.5% at the end of 2011. The quality of the loan portfolio is, however, still deteriorating, with the share of non-performing loans reaching 14.9% at end 2011, as domestic demand recovery has been weak.

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



Note: Debt Securities other than shares, excluding financial derivatives.
Source: Eurostat, ECB, Bulgarian National Bank, FESE, Reuters EcoWin.

The non-bank financial sector remains underdeveloped relative to the euro area. Total assets managed by insurance companies, though growing, are still very low at 4.1% of GDP at the end of 2010. Health insurance, in particular, is still characterised by a very low penetration rate in Bulgaria. Pension funds have shown a somewhat more dynamic development since the start of the financial crisis, with total assets increasing from 3.3% of GDP in 2008 to 5.7% of GDP in 2010.

The deepening of capital markets, which progressed considerably during the economic boom, came to a halt with the financial crisis. The capitalization of the stock market declined markedly since its highs of 2007, but it regained more than 15% in 2011. 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. Private sector debt of 169% of GDP in 2010 is slightly above the euro area average (164.6% of GDP)⁽²⁸⁾.

Regulation and supervision of the 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 closely with the BNB, as well as with international partners, especially from the neighbouring countries. While all FSAP directives have been transposed, no notification has been received yet by the European Commission on the transposition of two of the post-FSAP directives.

⁽²⁸⁾ Data on private sector debt are based on unconsolidated 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.

3. CZECH REPUBLIC

3.1. LEGAL COMPATIBILITY

3.1.1. Introduction

Česká národní banka (ČNB – central bank of the Czech Republic) was established on January 1, 1993, following the division of the State Bank of Czechoslovakia. Its creation was based on the Czech National Council Act No. 6/1993, adopted on December 17, 1992.

The Act on ČNB was last amended in 2010 and 2011. The recent amendments did not introduce significant changes which would remove the incompatibilities or imperfections covered by the last Convergence Report.

3.1.2. Independence

Article 9(1) of the ČNB Act in conjunction with Article II(1)(c) of the Law No 442/2000 Coll prohibit 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.

According to Article 3 of the Act on the ČNB, the ČNB shall submit a report on the monetary development to the Chamber of Deputies of the Parliament for review. 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 legal possibility for the Parliament to ask for amendments and, thus, to influence the content of the ČNB's report on the monetary development 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 Act and Article II(1)(c) of the Law 442/2000 need to be adapted to fully reflect the provisions of Article 130 of the Treaty and Article 7 of the Statute and consequently to expressly prohibit third parties from giving instructions to the ČNB and its Board members who are involved in ESCB-related tasks.

Articles 7 and 8 of the Law provide for the replacement of the Governor by a Vice-Governor nominated by him in case of absence. To ensure smooth and continuous functioning of the ČNB 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 cases of termination of office.

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

As regards the personal independence of the ČNB's decision making bodies, Article 6(11)-(13) provides for grounds of dismissal, which are not exactly corresponding to those of Article 14.2 of the ESCB/ECB Statute. In order to remove this incompatibility and limit interpretation problems those provisions should be brought in line with Article 14.2 of the ESCB/ECB Statute.

Pursuant to Article 11(1) of the ČNB Act 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. Paragraph (2) of this Article provides for a possibility for 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), 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 offer to the Government the possibility to influence the central bank when taking its key decisions. Therefore, Article 11(1) 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

According to Article 30(2) of the Act on the ČNB, the ČNB is not allowed to provide returnable funds or any other financial support to the Czech Republic or its bodies or to any other authority and body governed by public law, with the exception of public banks. The wording of this provision constitutes an imperfection. It is rather extensive and does not take fully into account Article 123(2) of the TFEU. It provides de facto a wider exemption than the one foreseen in Article 123(2) of the TFEU, which exempts publicly owned credit institutions only 'in the context of the supply of reserves by central banks'.

In addition, point 1(d) of Section II of Law No 442/2000 Coll. does not cover the prohibition on a direct purchase by the ČNB of debt instruments from public sector entities and thus, it constitutes a further incompatibility with Article 123(1) of the TFEU. For legal certainty reasons, Article 30(2) and point 1(d) of Section II of Law No 442/2000 Coll should be amended to ensure the correct application of the EU law in the field of prohibition of monetary financing.

3.1.4. Integration in the ESCB

Objectives

No incompatibilities with the TFEU exist in this area.

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 26a, 28, 29, 32, 33);
- conduct of exchange rate operations and the definition of exchange rate policy (Articles 35 and 36);
- holding and management of foreign reserves (Article 1(4) and Articles 35(d) and 36);

- 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);

- ECB's right to impose sanctions (Article 46b).

There are also some imperfections regarding:

- the absence of reference of the role of the ECB and of the EU for the collection of statistics (Article 41);
- non-recognition of the role of the ECB for the functioning of the payment systems (Article 38);
- non-recognition of the role of the ECB and of the Council for the appointment of the external audit of the ČNB (Article 48(2));
- absence of an obligation to comply with the Eurosystem's regime for the financial reporting of NCB operations (Article 48);
- non-recognition of the role of the ECB in the field of international cooperation (Article 40).

3.1.5. 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 Czech Republic, in particular the Act on the ČNB, is not fully compatible with the compliance duty under Article 131 of the TFEU.

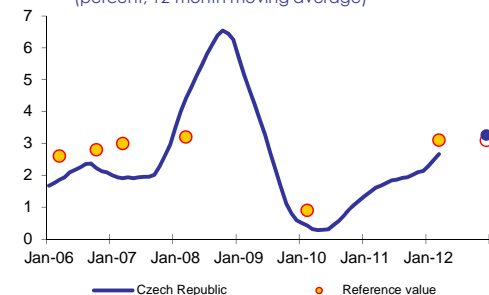
3.2. PRICE STABILITY

3.2.1. Respect of the reference value

The 12-month average inflation rate for the Czech Republic, which is used for the convergence evaluation, was below the reference value at the time of the last convergence assessment in 2010. Average annual inflation bottomed out at 0.3% in the second quarter 2010, before increasing gradually until early 2012. In March 2012, the reference value was 3.1%, calculated as the average of the 12-month average inflation rates in Sweden, Ireland and Slovenia plus 1.5 percentage points. The corresponding inflation rate in the Czech Republic was 2.7%, i.e. 0.4 percentage points below the reference value. The 12-month

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

Graph 3.1: Czech Republic - Inflation criterion since 2006
(percent, 12-month moving average)

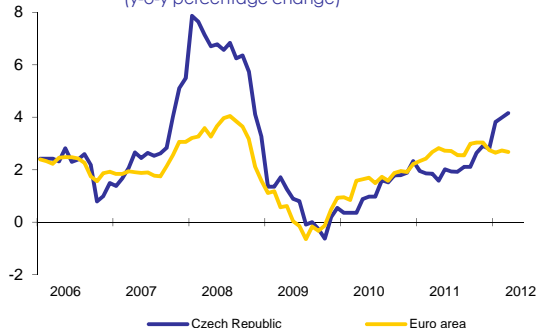


Note: The dots in December 2012 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2012 Forecast.

3.2.2. Recent inflation developments

Annual HICP inflation in the Czech Republic moved broadly in sync with euro area levels in the period between 2004 and late 2007. Inflation spiked temporarily, but very sharply, in 2008 amid rising commodity prices and increases in indirect taxes and administered prices. In 2009, when the effects of large negative cost-push factors receded and the Czech economy entered recession, annual inflation fell sharply and briefly became negative. Inflation remained subdued in 2010 and for most of 2011 amid muted domestic demand, while developments in global commodity prices and the koruna's exchange rate were the main factors affecting domestic prices. Headline inflation picked up towards end-2011, and remained at a higher level in early 2012, largely reflecting an increase in the VAT preferential rate with effect from January 2012.

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



Source: Eurostat.

Subdued core inflation (measured as HICP inflation excluding energy and unprocessed food), averaging 1.0% in 2010-2011, suggests that

underlying price and cost pressures stemming from the real economy were moderate. Since 2010, headline inflation has been running well above core inflation largely due to sizeable energy price increases. Core inflation was partly pushed down by negative non-energy industrial goods inflation due to the volatile but on the whole appreciating koruna exchange rate since 2009. Conversely, relatively sharp price increases in processed food since around mid-2010, amid rising commodity prices and indirect taxes, drove core inflation higher. Annual average producer price inflation for total industry increased to 5.5% in 2011, indicating elevated cost price pressures related to commodity price increases.

3.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy-mix and cyclical stance

The Czech economy is estimated to have been operating well below its potential during the global economic crisis. Economic growth turned negative in 2009, dragged down by a collapse of external demand. Strong exports lifted annual GDP growth to positive territory in 2010 and 2011 (to an average of 2.2%), but muted domestic demand amid the ongoing fiscal consolidation and weak confidence indicators did not allow for a sustained recovery. GDP growth is projected to remain flat in 2012, affected by economic weakness in the euro area, and to increase to 1.5% in 2013 as external conditions gradually improve, according to the Commission services' Spring 2012 Forecast. The Commission services' estimates suggest a sizeable negative output gap to remain over the medium term.

The fiscal stance, as measured by changes in the structural balance, has been restrictive since 2009. The decline in the headline deficit in 2010 and 2011 reflected an improvement in both the cyclical and structural component, with the latter mirroring the impact of fiscal consolidation measures. The fiscal stance is expected to be tightened further in 2012 and to remain stable in 2013.

Monetary policy, conducted within an inflation targeting framework⁽²⁹⁾, was loosened in 2009 and early 2010 in view of an improved inflation

⁽²⁹⁾ As from January 2010, the inflation target of the ČNB is defined as annual consumer price index growth of 2% (with a tolerance band of ± 1 percentage point).

Table 3.1:

Czech Republic - Components of inflation	(percentage change) ¹⁾							weights
	2006	2007	2008	2009	2010	2011	Mar-12	in total
HICP	2.1	3.0	6.3	0.6	1.2	2.1	2.7	1000
Non-energy industrial goods	-2.0	-0.4	-0.2	-2.4	-2.4	-1.8	-1.3	254
Energy	9.7	2.2	11.0	2.7	4.3	7.2	7.8	142
Unprocessed food	0.3	3.1	2.1	-1.8	3.5	0.7	0.5	67
Processed food	1.0	7.6	11.0	0.7	2.1	5.9	6.7	195
Services	3.1	3.2	7.6	2.5	1.9	1.1	1.6	341
HICP excl. energy and unproc. food	0.9	3.1	5.8	0.5	0.5	1.4	2.0	790
HICP at constant taxes ²⁾	1.4	2.4	4.3	0.6	-0.1	2.1	2.3	1000
Administered prices HICP	4.0	4.7	13.6	6.9	5.0	2.9	4.2	112

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.

2) Last observation for HICP at constant taxes is February 2012.

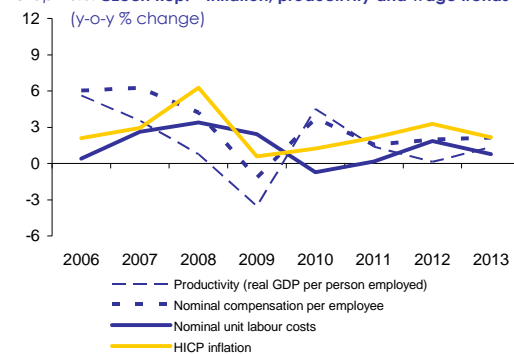
Sources: Eurostat, Commission services.

outlook amid the sharp economic downturn. The ČNB lowered the key policy rate by a cumulative 150 basis points to 0.75% between early 2009 and May 2010. In 2011, *ex post* real interbank interest rates were negative due to an increase in headline inflation. The depreciation of the koruna's exchange rate in the second half 2011 contributed further to an easing of monetary conditions. Credit growth to the private sector slowed down markedly during the crisis amid unfavourable cyclical conditions, though the economy saw some signs of a revival in lending activity in 2011.

Wages and labour costs

The labour market was considerably impacted by the economic downturn. The unemployment rate increased from a low of 4.4% in 2008 to around 7% on average in 2010-2011. Employment fell markedly in 2009-2010, on account of labour shedding in the private sector and cuts in the public sector workforce, and staged only a very modest recovery in 2011. Growth in nominal compensation per employee declined from 3.7% in 2010 to 1.6% in 2011 amid a weakening economy, and an increase of around 2% is expected in 2012 and 2013. Labour productivity growth should remain broadly flat in 2012, but it is projected to regain some momentum in line with a gradual recovery of economic activity in 2013. As a result, growth in nominal unit labour costs (ULC) is projected to remain muted in 2012-2013.

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



Source: Eurostat, Commission services' Spring 2012 Forecast.

The wage-setting process in the private sector is decentralised, with wage agreements largely at the enterprise level. Wage developments, in particular in the private sector, reacted swiftly to the economic downturn. Public sector wage restraint also contributed to a moderate growth of wage costs for the whole economy in 2010-2011. In line with fiscal consolidation efforts of the Czech government, the budget for 2012 assumes continuation of a freeze in the public sector wage bill. In January 2012, the Czech Republic revised the Employment Act and the Labour Code, which is expected to contribute to flexibility on the labour market.

External factors

Given the high degree of openness of the Czech Republic, developments in import prices play an important role in domestic price formation. Import prices, as measured by the imports of goods deflator in the national accounts, contributed to disinflation during the economic downturn in 2009. The annual increase in import prices is projected to pick up gradually in the period of

Table 3.2:

Czech Republic - Other inflation and cost indicators		(annual percentage change)						
	2006	2007	2008	2009	2010	2011 ¹⁾	2012 ²⁾	2013 ²⁾
HICP inflation								
Czech Republic	2.1	3.0	6.3	0.6	1.2	2.1	3.3	2.2
Euro area	2.2	2.1	3.3	0.3	1.6	2.7	2.4	1.8
Private consumption deflator								
Czech Republic	1.5	2.9	4.8	0.2	0.4	1.8	3.2	2.0
Euro area	2.2	2.2	2.7	-0.4	1.7	2.5	2.2	1.7
Nominal compensation per employee								
Czech Republic	6.0	6.3	4.2	-1.2	3.7	1.6	2.0	2.1
Euro area	2.5	2.6	3.4	1.8	1.7	2.2	1.9	1.9
Labour productivity								
Czech Republic	5.6	3.5	0.8	-3.5	4.5	1.4	0.1	1.3
Euro area	1.9	1.3	-0.3	-2.4	2.5	1.2	0.1	1.0
Nominal unit labour costs								
Czech Republic	0.4	2.6	3.4	2.4	-0.7	0.2	1.9	0.8
Euro area	0.8	1.4	3.8	4.2	-0.8	0.8	1.6	0.8
Imports of goods deflator								
Czech Republic	1.1	-1.0	-3.0	-2.6	1.7	3.3	4.5	1.0
Euro area	3.9	1.0	4.2	-7.7	5.7	6.9	3.6	1.3

1) 2011 data (except HICP inflation) are estimates.

2) Commission services' Spring 2012 Forecast.

Source: Eurostat, Commission services.

2010-2012. The inflationary effect of import prices is expected to diminish in 2013 in line with the assumed path for commodity prices.

Import prices were driven up in 2010-2011 by volatile – but on the whole rising – global commodity prices. The contribution of energy prices to HICP inflation increased from around 0.4 percentage points in 2009 to around 0.8 percentage points on average in 2010-2011. Unprocessed food inflation, after increasing markedly in 2010, became negative in the second half of 2011; this reflected easing global food prices, but also the price-dampening effect of favourable domestic harvest.

Import price dynamics have been significantly influenced by fluctuations of the koruna. Most available estimates suggest that the pass-through of the exchange rate to inflation in the Czech Republic is substantial and fast. The koruna's nominal effective exchange rate (measured against a group of 35 trading partners) strengthened by about 9% between 2009 and mid-2011; this helped to moderate the inflationary impulses emanating from global commodity markets. A weakening impetus set in during the second half of 2011 amid a rise in global risk aversion, when the koruna's nominal effective exchange rate lost about 5%.

Administered prices and taxes

Changes in administered prices and indirect taxes have been an important driver of inflation dynamics in the Czech Republic in recent years. The contribution of indirect taxes to headline inflation was particularly strong in 2008 and 2010, notably mirroring fiscal consolidation efforts of the government. The inflationary impact of changes in administered prices has however been on a declining trend. Administered prices had a weight in the HICP basket of around 11% in 2011, i.e. down by about 8 percentage points compared to 2004⁽³⁰⁾.

Administered price inflation declined from 5% in 2010 to 2.9% in 2011, while the narrowing gap vis-à-vis headline average inflation remained positive. The administered price increases in 2011 occurred particularly for items with a comparatively low weight in the headline index (rail fares, postal services and highway toll

⁽³⁰⁾ 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. Eurostat considers gas and electricity as a non-administered item, as the *Czech Energy Regulatory Office* sets price for these items only for part of the sub-index (transmission, distribution and related services). For details, see http://epp.eurostat.ec.europa.eu/portal/page/portal/hicp/methodology/administered_prices

stickers). The indirect tax changes in 2010 included a 1 percentage point increase in both standard and preferential VAT rates and rising excise duties (on tobacco, alcohols and motor fuels). In January 2012, the preferential VAT rate was increased by 4 percentage points to 14% and there was a relatively modest excise duty increase for cigarettes (in line with tax harmonisation requirements within the EU); the first-round effect of these indirect tax changes is estimated to have contributed by around 1 percentage point to annual headline inflation. For 2013, the Czech government plans another 1 percentage point increase in both standard and preferential VAT rates.

Medium-term prospects

Inflation is projected to remain higher in 2012 compared to recent years, in response to the preferential VAT rate increase. Domestic price pressures are, however, expected to remain muted amid a difficult external environment and sluggish domestic demand going forward. Second-round effects from price increases on inflation expectations and wage growth seem unlikely given the weak economy. On this basis, the Commission services' Spring 2012 Forecast projects annual HICP inflation to average 3.3% in 2012 and 2.2% in 2013.

Risks to this inflation outlook are broadly balanced. There are still some downside risks to economic activity, particularly as the weakness in the euro area may affect the highly open economy through the trade channel. Conversely, upside risks are mainly related to a possible further rise in commodity prices. There is also an important two-sided risk to inflation stemming from the koruna's exchange rate.

The level of consumer prices in the Czech Republic was at some 72% of the euro area average in 2010, with the relative price gap widest for services. This suggests potential for further price level convergence in the long term, as income levels (about 74% of the euro area average in PPS in 2010) increase gradually towards the euro area average.

Medium-term inflation prospects will continue to hinge upon productivity and wage developments as well as on the functioning of product markets (e.g. energy and telecommunication prices). Over the longer term, in view of the negative demographic

outlook, further measures to increase labour supply and facilitate the effective allocation of labour resources will play a key role in alleviating possible wage pressures.

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⁽³¹⁾.

3.3.2. Recent fiscal developments

Fiscal policy before the crisis (2006-2008) provided some pro-cyclical stimulus to economic activity as the structural deficit averaged 3.8% of GDP in a relatively high-growth environment. Good economic times were thus not exploited to make progress with fiscal consolidation. Worsening economic conditions during the crisis put a serious strain on public finances. The general government deficit increased from 2.2% of GDP in 2008 to 5.8% of GDP in 2009, mainly as a result of the economic downturn and discretionary measures taken to counter the impact of the crisis. Faced with a severe deterioration of the deficit in 2009, the Czech authorities decided to withdraw

⁽³¹⁾ 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⁾	2006	2007	2008	2009	2010	2011	2012	2013	
General government balance	-2.4	-0.7	-2.2	-5.8	-4.8	-3.1	-2.9	-2.6	
- Total revenues	39.6	40.3	38.9	39.1	39.3	40.3	40.4	40.5	
- Total expenditure	42.0	41.0	41.1	44.9	44.1	43.4	43.3	43.1	
of which:									
- Interest expenditure	1.1	1.1	1.1	1.3	1.4	1.4	1.4	1.5	
p.m.: Tax burden	35.4	35.9	34.5	33.6	33.8	35.0	35.4	35.7	
Primary balance	-1.3	0.4	-1.2	-4.6	-3.4	-1.7	-1.4	-1.1	
Cyclically-adjusted balance	-4.1	-3.1	-4.4	-5.2	-4.5	-2.8	-2.1	-1.8	
One-off and temporary measures	-0.1	0.0	0.0	0.3	0.1	-0.2	-0.3	0.0	
Structural balance ²⁾	-3.9	-3.1	-4.4	-5.6	-4.6	-2.6	-1.8	-1.8	
Government gross debt	28.3	27.9	28.7	34.4	38.1	41.2	43.9	44.9	
p.m.: Real GDP growth (%)	7.0	5.7	3.1	-4.7	2.7	1.7	0.0	1.5	
p.m.: Output gap	4.7	6.5	5.8	-1.7	-0.9	-0.8	-2.1	-2.2	
Convergence programme						2012	2013	2014	2015
General government balance						-3.0	-2.9	-1.9	-0.9
Structural balance ²⁾³⁾						-2.0	-2.1	-1.3	-0.6
Government gross debt						44.0	45.1	44.8	43.4
p.m. Real GDP (% change)						0.2	1.3	2.2	2.8

1) Commission services' Spring 2012 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 2012 are 0.3% of GDP in 2012 and 0.1% of GDP in 2013; deficit-decreasing.

Sources: Commission services, the 2012 Convergence Programme of Czech Republic.

temporary stimulus measures and start fiscal consolidation already in 2010. Consolidation measures included increases in indirect and real estate taxes and cuts in social benefits. Revenue shortfalls and expenditure slippages prompted the government to implement additional cuts in government consumption in the course of 2010 amounting to around 0.5% of GDP. Overall, the expenditure-to-GDP ratio declined by 0.8 percentage points to 44.1% while the revenue-to-GDP ratio increased by 0.2 percentage points to 39.3%, resulting in a reduction of the general government deficit to 4.8% of GDP in 2010.

With consolidation efforts continuing also in 2011, the general government deficit dropped further to 3.1% of GDP. This is a significantly lower outcome than the target of 4.2% of GDP announced in the Czech Republic's 2011 Convergence Programme. Higher-than-expected savings were achieved on the expenditure side, in particular in government consumption and debt servicing. By far the largest cuts occurred in public investment, which declined more than 15% year-on-year or by 0.7% of GDP. On the revenue side, some slippages occurred, mainly in VAT and direct taxes but these were more than compensated by the retrenchment in public investment and

government consumption. The structural deficit improved from 4.6% of GDP in 2010 to 2.6% of GDP in 2011. Fiscal consolidation took place in a period of a relatively low growth whereby the output gap remained negative in both 2010 and 2011.

While remaining still well below the 60% of GDP threshold, the debt-to-GDP ratio increased from 34.4% of GDP in 2009 to 41.2% of GDP in 2011 mainly on account of the high government deficit.

3.3.3. Medium-term prospects

The budget for 2012 was adopted by the Parliament on 14 December 2011. An increase in the preferential VAT rate is expected to bring additional revenue of approximately 0.7% of GDP. A new lottery tax could boost the corporate income tax revenue by around 0.1% of GDP. On the other hand, revenue from personal income tax will be negatively affected by the increase in tax allowances for families with children (0.1% of GDP). Faced with worsening macroeconomic conditions, in March 2012 the Czech authorities approved additional expenditure cuts amounting to 0.6% of GDP. These are expected to further reduce the operational costs of ministries and other central

government bodies (expenditure on goods and services and the wage bill). A moderate rebound in public investment is expected in 2012. Overall, the general government deficit is projected to decrease to 2.9% of GDP in 2012 while the structural balance will improve by 0.8 percentage points according to the Commission services' Spring 2012 Forecast.

Several factors are expected to affect the budgetary outcome in 2013. The planned introduction of the private pension pillar is projected to reduce revenue from the social security contributions by approximately 0.2% of GDP but this effect will be more than compensated by the sizeable consolidation package (1.2% of GDP) approved by the Czech government in April 2012. Main measures of the package which will form the basis for the 2013 budget proposal include a further increase in both VAT rates by 1 percentage point, lower indexation of pensions, stricter conditions for tax deductibility for the self-employed and an increase in the property transfer tax. The consolidation effort together with a modest improvement in the macroeconomic conditions will result in a reduction of the general government deficit to 2.6% of GDP. In 2013, the structural balance is projected to remain unchanged. The debt-to-GDP ratio is projected to increase further over the forecast horizon reaching around 45% in 2013.

The budgetary projections are subject to two main risks. The first risk is related to co-financing of projects from the European Funds. As payments from the Funds have been temporarily suspended due to irregularities, it cannot be excluded that some projects will have to be financed entirely from national sources which could lead to an increase in the general government deficit. The second risk concerns a law on church restitutions currently discussed by the Parliament. Its approval would lead to a one-off increase in the general government deficit by approximately 1.5% of GDP in the year when the law enters into force.

The 2012 Convergence Programme, covering the period 2012-2015, was submitted by the Czech authorities on 25 April 2012. The main goal of the budgetary strategy in the short term is to bring the government deficit below the 3% reference value by 2013. In the medium term, the Czech authorities are committed to reaching the objective of a balanced budget in 2016 and to complying with the medium-term budgetary objective (MTO),

i.e. a structural deficit of 1% of GDP. The MTO should be achieved in 2015 according to the programme. The general government deficit is set to decline gradually from 3% in 2012 to 2.9% and 1.9% of GDP in 2013 and 2014 respectively. The deficit reduction will accelerate in 2015 when the headline deficit is set to decrease to 0.9% of GDP.

Further details on the assessment of the 2012 Convergence Programme for the Czech Republic can be found in the forthcoming Commission Staff Working Document ⁽³²⁾, which accompanies the Commission Recommendation for a Council Recommendation on the 2012 National Reform Programme of the Czech Republic and delivering a Council Opinion on the 2012 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.

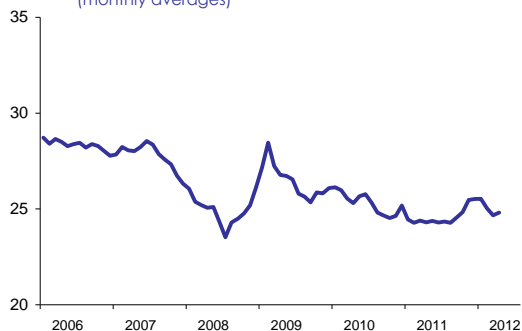
3.4. EXCHANGE RATE STABILITY

The Czech koruna does not participate in ERM II. Since the late 1990's, the ČNB has been applying inflation targeting combined with a floating exchange rate regime. The central bank abstains from currency interventions, though the instrument remains available in principle.

The exchange rate of the koruna against the euro experienced a prolonged nominal appreciation in the period following EU accession in 2004, amid significant capital inflows that helped to support a sustainable economic catching-up. After reaching an all-time-high against the euro in mid-2008, the koruna's exchange rate suffered a strong weakening impetus amid the unfolding global financial crisis and the deterioration in sentiment vis-à-vis emerging markets. The koruna recovered partly in 2009 and followed a broad appreciation trend until mid-2011, reflecting an improvement in the external balance and a rebound in global market sentiment. The koruna depreciated in the midst of renewed global capital market tensions in the second half of 2011, but it recovered part of the losses in early 2012. During the two years before this assessment, the koruna appreciated against the euro by 2.8%.

⁽³²⁾ Available at: http://ec.europa.eu/economy_finance/economic_governance/sfp/convergence/programmes/2012_en.htm

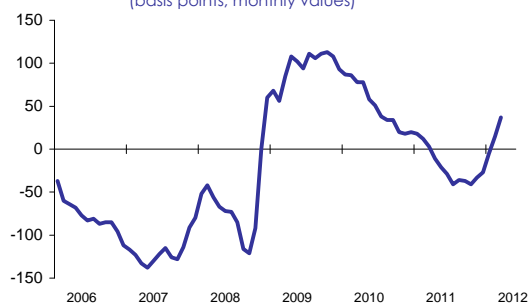
Graph 3.4: Exchange rates - CZK/EUR
(monthly averages)



Source: ECB, Reuters EcoWin.

Short-term interest rate spreads vis-à-vis the euro area were negative between 2006 and late 2008, reflecting the muted outlook for inflation and prolonged appreciation pressures on the Czech currency. The 3-month interest rate differential against the euro area narrowed rapidly and turned positive in late 2008 amid the intensifying global financial crisis and substantial cuts in the ECB policy rates. The 3-month interest rate differential against the euro decreased gradually in late 2009 and 2010, partly reflecting the cuts in policy rates of the ČNB. In May 2010, the ČNB lowered the main policy rate to an all-time low of 0.75%, i.e. 25 basis points below the ECB's key rate. Short-term interest rate spreads vis-à-vis the euro area turned negative in 2011 amid tensions in euro area financial markets. In early 2012, as the stress in the euro area eased, the 3-month interest rate differential became positive. Foreign exchange reserves hovered at an equivalent of around 3 to 4 months of imports in recent years.

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



Source: Eurostat.

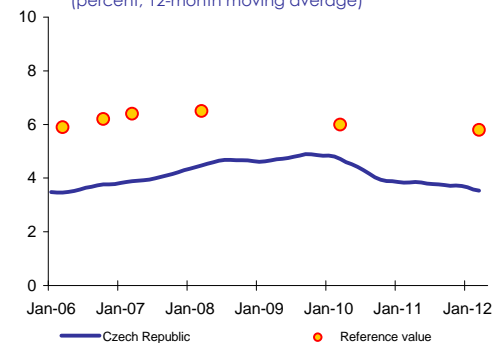
3.5. LONG-TERM INTEREST RATES

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

secondary market yields of a basket of benchmark government bonds with an average residual maturity of around 10 years.

The Czech 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion stayed below the reference value at each convergence assessment since EU accession in 2004. It peaked in the fourth quarter of 2009 at 4.9%, but gradually declined hereafter. In March 2012, the latest month for which data are available, the reference value, given by the average of long-term interest rates in Sweden and Slovenia plus 2 percentage points, stood at 5.8%. In that month, the 12-month moving average of the yield on the Czech benchmark bonds stood at 3.5%, i.e. 2.3 percentage points below the reference value.

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

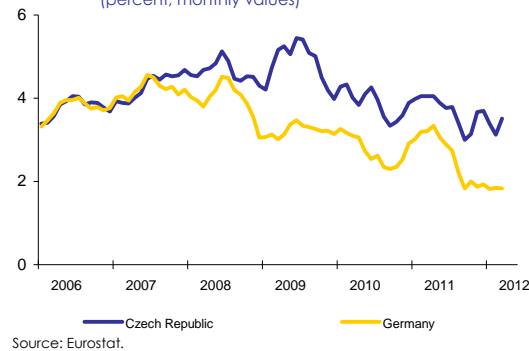


Source: Commission services.

Yields on Czech government bonds broadly mirrored those of the euro area in the period before 2008. The favourable inflation outlook, amidst the trend appreciation of the nominal exchange rate, contributed to a narrowing of the long-term spread vis-à-vis the euro area. In late 2008, long-term interest rate spreads widened abruptly in the midst of the global crisis. The yields on Czech government bonds, nonetheless, stayed less affected than those of regional peers and declined markedly in the period between 2009 and early 2012. This decline was notably driven by downward adjustment in the expected path of interbank rates as well as by solid demand for Czech sovereign bonds, reflecting the comparatively strong fundamentals of the economy. The spread against the German benchmark bond was around 170 basis points in March 2012⁽³³⁾.

⁽³³⁾ The reference to the German benchmark bond is included for illustrative purposes, as a proxy of the euro area long-term AAA yield.

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



3.6. ADDITIONAL FACTORS

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

The section on additional factors makes reference *inter alia* to 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⁽³⁴⁾. Related to this, in February 2012, the Commission published its first Alert Mechanism Report (AMR)⁽³⁵⁾. The AMR scoreboard showed that the Czech Republic exceeded the indicative threshold for two out of ten indicators, both in the area of external imbalances and competitiveness (namely the international investment position and the real effective exchange rate with HICP deflators). In line with the conclusion of the AMR, the Czech Republic was not subject to an in-depth review in the context of Macroeconomic Imbalance Procedure.

⁽³⁴⁾ The package of six legislative proposals to strengthen the economic governance of the EU entered into force in December 2011.
<http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/898>

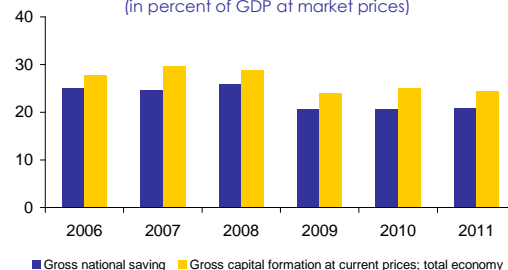
⁽³⁵⁾ http://ec.europa.eu/economy_finance/articles/governance/2012-02-14-alert_mechanism_report_en.htm

3.6.1. Developments of the balance of payments

The external deficit (i.e. the combined current and capital account) declined from a peak of 3.7% of GDP in 2007 to an average of around 2% in 2008-2011. The narrowing of the external shortfall over the past years notably reflected a significant increase in the merchandise trade surplus, due to a solid export performance (benefiting from deep economic integration with the euro area, particularly with Germany), while imports were dampened by persistently weak domestic demand. The services balance continued to record a solid surplus, notably due to a positive contribution of travel services balance. The favourable developments in the trade balance were, nonetheless, largely offset by significant net income outflows amid solid FDI-related profits paid to non-residents. The balance on current transfers and capital account benefited markedly from inflows of EU funds over past years.

In terms of the saving-investment balance, the increase in the external deficit in the pre-crisis period was mainly accounted for by an increase in domestic investment. In 2009, both saving and investment ratios to GDP decreased sharply; the private saving-investment gap fell due to the economic downturn and balance sheet adjustment in the private sector, though the rising government deficit partly acted as an offset. In 2010-2011, the saving-investment gap remained broadly stable, as the improvement in the fiscal balance was largely counterbalanced – amidst the signs of economic stabilisation – by the deterioration in the private saving-investment balance.

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



External competitiveness appears to have remained solid, with the Czech Republic continuing to gain significant export market shares in recent years. A large fraction of real exchange rate fluctuations has been due to swings in the nominal effective

Table 3.4:

Czech Republic - Balance of payments		(percentage of GDP)				
	2006	2007	2008	2009	2010	2011
Current account	-2.0	-4.3	-2.1	-2.4	-3.9	-2.9
of which: Balance of trade in goods	1.8	1.3	0.7	2.3	1.4	2.5
Balance of trade in services	1.5	1.6	1.9	2.0	2.0	1.7
Income balance	-4.9	-7.0	-4.6	-6.7	-7.6	-7.2
Balance of current transfers	-0.3	-0.2	-0.2	0.0	0.2	0.1
Capital account	0.3	0.6	0.7	1.4	0.9	0.4
External balance ¹⁾	-1.7	-3.7	-1.4	-1.1	-3.1	-2.5
Financial account	2.9	3.0	1.4	2.3	3.6	2.8
of which: Net FDI	2.7	4.9	1.0	1.0	2.5	2.0
Net portfolio inflows	-0.8	-1.5	-0.2	4.3	4.0	0.1
Net other inflows ²⁾	1.1	0.1	1.7	-1.4	-1.8	0.2
Change in reserves (+ is a decrease)	-0.1	-0.4	-1.0	-1.6	-1.1	0.5
Financial account without reserves	3.0	3.4	2.5	3.9	4.7	2.3
Errors and omissions	-1.2	0.7	0.0	-1.2	-0.5	-0.3
Gross capital formation	27.7	29.8	28.9	24.0	25.1	24.5
Gross saving	25.1	24.7	26.0	20.7	20.7	20.9
External debt	36.8	39.2	39.2	43.8	47.2	46.9
International investment position	-33.3	-40.4	-37.2	-46.2	-48.9	-47.4

1) The combined current and capital account.

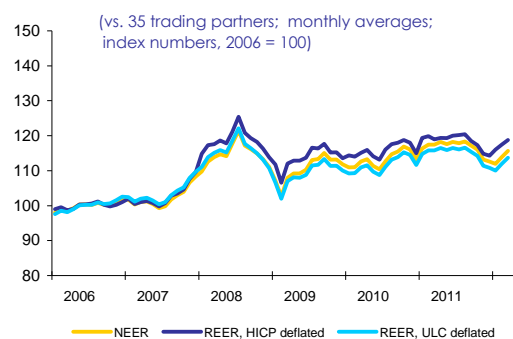
2) Including financial derivatives.

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.

exchange rate of the koruna, while domestic inflation rates remained close to those of the main trade partners. The sharp nominal depreciation in the second half of 2008 led to a strong weakening of the koruna's real effective exchange rate deflated both by HICP and unit labour costs. These gains in price competitiveness were partly offset by the nominal appreciation of the koruna since 2009.

Graph 3.9: Czech Republic - Effective exchange rates



The financial account surplus picked up from an average of 1.8% of GDP in 2008-2009 to an average of 3.2% of GDP recorded in 2010-2011. The upturn was driven by higher foreign direct

investment inflows (FDI), linked largely to an increase in reinvested earnings. Net portfolio inflows recovered in 2009-2010, but sharply declined in 2011 partly due to the absence of sovereign debt issuance on foreign markets. In 2011, total gross external debt broadly stabilised at just above 47% of GDP, broadly the same level as the negative net international investment position.

According to the Commission services' Spring 2012 Forecast, the external deficit is expected to remain at a low level in 2012-2013, with domestic demand projected to recover only gradually going forward.

3.6.2. Product market integration

The Czech economy is highly integrated into the EU economy through trade and investment linkages. The trade openness of the Czech Republic remains very high; it declined sharply during the global crisis, but quickly rebounded in 2010 and exceeded 70% of GDP in 2011. The dominant part of the trade is conducted with the neighbouring euro area Member States, also due to the significant foreign direct investment presence. The share of trade with the EU as a whole is comparatively very high (about 85% and 75% for

Table 3.5:

Czech Republic - Product market integration

	2005	2006	2007	2008	2009	2010
Trade openness ¹⁾ (%)	63.1	65.5	66.9	63.3	57.7	66.3
Intra-EU trade in goods GDP ratio ²⁾ (%)	49.6	52.6	55.1	51.5	45.0	52.2
Intra-EU trade in services GDP ratio ³⁾ (%)	5.9	6.1	6.3	6.7	6.9	7.2
Extra-EU trade in goods GDP ratio ⁴⁾ (%)	9.8	10.7	11.5	12.1	10.2	13.4
Export in high technology ⁵⁾ (%)	11.7	12.7	14.1	14.1	15.2	n.a.
Technological balance ⁶⁾ (%)	-1.2	-1.0	-0.5	-0.3	-0.5	n.a.
Total FDI inflows GDP ratio ⁷⁾ (%)	9.0	3.7	5.8	2.9	1.4	3.4
Intra-EU FDI inflows GDP ratio ⁸⁾ (%)	8.5	3.3	4.5	2.6	0.8	3.3
FDI intensity ⁹⁾	4.2	2.2	2.6	2.2	0.6	2.0
Internal Market Directives ¹⁰⁾ (%)	2.5	1.6	3.4	1.4	1.2	1.2
Value of tenders in the EU Official Journal ¹¹⁾	13.2	20.3	17.0	20.9	19.6	21.5
Time to start up a new company ¹²⁾	40.0	24.0	17.0	20.0	20.0	20.0
Real house price index ¹³⁾	100.0	105.3	121.9	132.5	126.3	123.1
Residential investment ¹⁴⁾ (%)	3.4	3.5	4.1	4.3	3.7	4.4
Building permits index ¹⁵⁾	100.0	109.0	111.0	111.0	92.0	71.0

1) $(\text{Imports} + \text{Exports of goods and services} / (2 \times \text{GDP at current market prices})) \times 100$ (Foreign Trade Statistics, Balance of Payments).

2) $(\text{Intra-EU-27 Imports} + \text{Exports of goods} / (2 \times \text{GDP at current market prices})) \times 100$ (Foreign Trade Statistics).

3) Intra-EU-27 trade in services (average credit and debit in % of GDP at current prices) (Balance of Payments).

4) $(\text{Extra-EU-27 Imports} + \text{Exports of goods} / (2 \times \text{GDP at current market prices})) \times 100$ (Foreign Trade Statistics).

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

6) $(\text{Exports} - \text{imports in high tech}) / \text{GDP at current prices} \times 100$, 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-EU-27 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) Public procurement - Value of public procurement which is openly advertised in the EU Official Journal in total public procurement.

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

13) Experimental house price index (2005=100), Eurostat.

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

15) Number of new residential buildings (2005=100), Eurostat.

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

exports and imports respectively), but it has been on a downward path since mid-2000s. This tendency seems somewhat more marked on the import side, though this was line with development seen for the EU as a whole (i.e. due to a rise in imports from emerging economies).

The gains in market shares of the Czech Republic were driven by a few sectors over past years, namely transport, optical and electrical equipment – while a decrease was recorded *inter alia* for metal and textile products. A rising share of high-tech exports in total exports combined with a technological trade deficit that closes only gradually, points to the significance of outward processing trade. High-tech exports have gained market share over past years (e.g. computers), but the technologically more advanced components are produced abroad (though to a lesser extent recently). The consolidation of a good export performance would benefit from a greater

technological content of exports to build up non-price competitiveness and become less dependent on labour cost advantages.

The massive export-oriented FDIs during the past decade have helped to generate significant merchandise trade surpluses. The Czech Republic attracted more FDIs in the tradable sector than most other Member States with derogation 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 half of the FDI stock in 2009. From a sectoral perspective, FDI were directed mainly to manufacturing, finance and insurance (accounting for more than 50% of the total stock). The motor vehicle industry accounts for 28% of the total FDI stock in manufacturing.

House prices and residential construction increased significantly prior to the crisis, though the dynamics were less pronounced than in other catching-up Member States. Between 2004 and 2008, cumulative real house price growth reached 32%. From the peak in 2008 until the third quarter of 2011, real house prices declined by 10%. Investment in residential construction increased from 3.6 % of GDP in 2000 to 4.6% of GDP in 2011. The number of dwellings increased by 9.2% in the period 2001-2011, though the number of building permits has been on a downward path since 2008. The rental market began a process of gradual deregulation in 2006, which is planned to be finished by end-2012. This may contribute to a larger availability of apartments for rent.

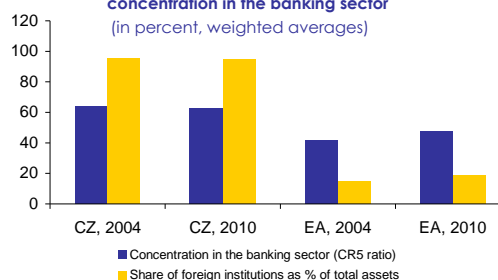
Concerning the business environment, the Czech Republic scores below the average of euro area Member States in international rankings⁽³⁶⁾. The Czech Republic exhibits a persistently higher deficit in the transposition of EU directives than the EU average. In addition, some practices in the area of public procurement lack transparency and suffer from procedural inefficiencies – though the value share of public procurement (openly advertised in the EU Official Journal) is above the EU average⁽³⁷⁾. In particular, there is some tendency to use simplified procedures for smaller tenders, which are just below the limit set by the EU Regulation. The authorities adopted in 2011 an anti-corruption strategy and amendments to the public procurement law (entering into force in April 2012) are expected to contribute to improving competition and transparency of public procurement. Some important initiatives to improve the business environment include measures in the area of reduction of administrative burden, support for innovative start-ups and further development of e-Government services⁽³⁸⁾.

3.6.3. Financial market integration

The Czech Republic's financial sector is 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 95% belonged to foreign groups, are dedicated to 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 past years.

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



Source: ECB, Structural indicators for the EU banking sector, December 2011.

Financial intermediation in the Czech Republic remains heavily bank-based, similar to that in other new Member States. Annual credit growth to the private sector fell from an average of 22.5% in 2007-2008 to around 5% in 2011. In contrast to some other new Member States, the pre-crisis credit boom in the Czech Republic was more muted and the impact of the global financial turmoil on domestic banks remained limited. As a result, domestic bank credit to the private sector relative to GDP expanded from around 45% in 2008 to 50% in 2011. Banks finance their lending activities primarily through abundant domestic deposits and displayed a sound loan-to-deposit-ratio hovering at just below 80% in 2011. The low level of domestic interest rates as well as abundant domestic liquidity made lending in currencies other than the koruna very limited. The share of foreign exchange-denominated credit was negligible for households and stood at around 17% of total loans for companies in 2011. This feature makes the Czech banking system less exposed to vulnerabilities stemming from currency mismatches.

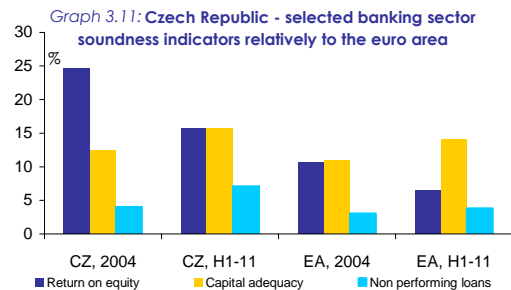
The Czech financial sector has weathered the financial crisis well thus far. Average return on equity in the banking sector remained high at above 15% in 2011 and the capital adequacy ratio (CAR) increased from about 11% in 2007 to above 15% in 2011. The NPL ratio increased during the crisis, but it remains one of the lowest among the new Member States (though above the euro area average). The property market declined moderately

⁽³⁶⁾ For instance, the Czech Republic scores on 38th and 64th place according to the 2011-2012 Global Competitiveness index and the 2012 World Bank Doing Business respectively.

⁽³⁷⁾ The value of tenders published in the EU Official Journal may serve as a proxy of the extent to which national public procurement are open to foreign bidders.

⁽³⁸⁾ The Czech authorities have set a target of reduction of the administrative burden for businesses by 25% over the period 2005–2012 (a reduction of 15.6% was achieved by end-2010)

during the crisis and there seems to be no evidence of large-scale mortgage foreclosures in the Czech Republic.

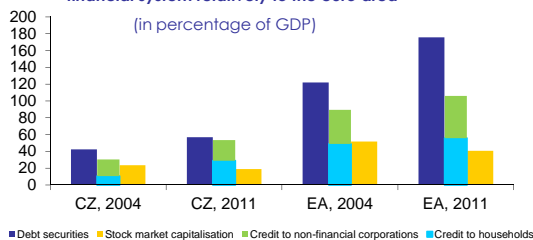


Note: For 2011, EU-27 non performing loans are a proxy for EA.
Source: ECB, IMF, EC calculations.

Market penetration rates for non-bank services remain comparatively low. In 2011, credit institutions managed a large part of the Czech financial system's assets (about 77% of the total), while the share of the insurance sector, pension funds and other financial auxiliaries accounted for about 23% of the total⁽³⁹⁾. The insurance sector remains underdeveloped compared to the euro area, although total assets and the premiums written are increasing steadily, largely due to comparatively low penetration in the life insurance segment. The financial system as a whole remains significantly interlinked through mutual exposures.

Czech equity and debt markets are less developed compared to the euro area. During the crisis, the stock market capitalisation gap vis-à-vis the euro area remained broadly unchanged amid high market volatility, as the Czech market largely moved in sync with global markets. The total amount of outstanding debt securities increased markedly since the EU accession, amounting to about 57% of GDP in 2011. However, both ratios remain well below euro area levels. Private sector debt, at around 77% of GDP in 2010, stood well below the euro area average⁽⁴⁰⁾.

Graph 3.12: Czech Republic - Recent development of the financial system relatively to the euro area



Note: Debt Securities other than shares, excluding financial derivatives.
Source: Eurostat, ECB, Czech National Bank, FESE, Reuters EcoWin.

While all Financial Sector Action Plan (FSAP) directives have been completely transposed, no notification has been received yet by the European Commission on the transposition of one post-FSAP directive. The transposition of three directives is currently examined by the Commission services; the Czech Republic was the first Member State to partially notify the transposition of Solvency II in the insurance sector. The ČNB supervises banks, insurance companies, pension funds and capital markets. Legal amendments aimed at broadening the mandate of the ČNB and regulating the activities of credit unions are under preparation. The ČNB recently improved bank reporting requirements and supervises transactions between parents and subsidiaries, as Czech banks remain as a whole net creditors to their parents.

⁽³⁹⁾ The depth of financial intermediation in the Czech Republic reached about 156% of GDP in 2010, i.e. well below the euro area average.

⁽⁴⁰⁾ Data on private sector debt are based on unconsolidated 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.

4. LATVIA

4.1. LEGAL COMPATIBILITY

4.1.1. Introduction

The Latvijas Banka (Bank of Latvia – central bank of Latvia) was founded in 1922 and re-instated in 1991, under the Law on the Bank of Latvia. This Law was last amended in October 2009.

4.1.2. Central bank independence

Pursuant to Article 17 of the Law on the Bank of Latvia, the Parliament can liquidate the Bank of Latvia by means of a resolution. Any liquidation pre-supposes a bankruptcy. Latvia would have failed to guarantee that the central bank has enough financial resources to ensure the tasks entrusted to it by the TFEU and thereby breach the principle of financial independence. Liquidation by means of a parliamentary resolution would breach the institutional independence of the Bank of Latvia. The Parliament could decide on the Bank's winding-up, while not being legally obliged to provide for a succeeding institution.

As to the personal independence, Article 22(3) contains an imperfection. In line with Article 14.2 of the ESCB/ESB Statute, the Article should clearly state that if the Governor resigns before the term of office, the successor's term should be at least 5 years.

The grounds for dismissal of the Governor pursuant to Article 22(4) do not exactly correspond to those stated in Article 14.2 of the ESCB/ECB Statute. Consequently, Article 22 needs to be adapted to be fully compliant with Article 14.2 of the ESCB/ECB Statute.

Article 28(5) of the Law provides that if the Governor of the Bank of Latvia is absent, his or her rights and obligations are exercised by the Deputy Governor or by the person appointed by an express order. This provision, to the extent that a person who is not a member of the Bank of Latvia Council can be appointed to exercise the Governor's duties, is incompatible with the requirement of central bank independence. Article 28 of the Law needs to be adapted to be fully compliant with Article 14.2 of the Statute.

In addition, to ensure smooth and continuous functioning of the Bank of Latvia in case of expiry of the term of office, resignation, dismissal or other cause of termination of office, the Law on the Bank of Latvia needs to provide for procedures and rules regarding the successor of the Governor in cases of termination of office. The absence of such provisions in the Law on the Bank of Latvia is an imperfection.

According to Article 13, the Bank of Latvia shall be independent in the adoption of its decisions and their implementation in practice. It shall neither seek nor take instructions from the Government or any other institution, nor shall it be subject to the decisions and regulations adopted by these bodies. Article 13 is imperfect as it does not mention Union institutions, bodies, offices or agencies as referred to in Article 130 of the TFEU and Article 7 of the ESCB/EC Statute. Further, Article 13 needs to be adapted to fully reflect Article 130 of the TFEU and Article 7 of the ESCB/EC Statute, in order to expressly prohibit third parties to give instructions to the Bank of Latvia and the members of its decision making bodies.

With regard to financial independence, according to Article 18¹ of the Law, the Bank of Latvia transfers to the state budget, within 15 days following the approval of the annual report by the Council, part of its profit calculated by applying the tax rate for residents under the Law on corporate income tax and a payment for the use of state capital in the amount of 50% of the profit. What is more, Article 19 provides that the profits are transferred to the reserve capital of the Bank of Latvia after the part of its profits specified in Article 18¹ of the Law is transferred to the State budget. This provision, as it stands now, provides for an incompatibility as it reduces significantly the capacity of the Bank of Latvia to decide on the level of its reserves, which limits its financial independence. The sequence of the operations in Articles 18¹ and 19 indicates that the contribution to the State budget is very significant and is deducted before any transfer of profit to the reserve capital of the Bank of Latvia. The law should be amended with a view to increasing the financial independence of the Bank of Latvia.

4.1.3. Prohibition of monetary financing and privileged access

Article 36 of the Law on the Bank of Latvia is incompatible with the prohibition of monetary financing under Article 123 of the TFEU. The Bank of Latvia is not entitled to issue credits to the Government and to buy Government securities on the primary market, but the scope of the public sector entities covered in Article 36 of the Law on the Bank of Latvia needs to be significantly extended to be consistent with the list contained in Article 123 of the TFEU.

4.1.4. Integration in the ESCB

Objectives

There are no incompatibilities but there is one imperfection. The wording of the Bank of Latvia's primary objective (Article 3) does not fully reflect Article 127(1) of the TFEU, given that the objective of price stability should not be confined to territory of the Member State concerned. Article 3 of the Law on the Bank of Latvia should be brought in line with Article 127(1) TFEU and Article 2 of the ESCB/ECB Statute, at the latest by the date of euro adoption by Latvia.

Tasks

The incompatibilities with regard to the ESCB/ECB tasks are as follows:

- definition of monetary policy and monetary functions, operations and instruments of the ESCB (Articles 26 and 34 to 38);
- conduct of foreign exchange operations and the definition of foreign exchange policy (Article 4);
- holding and management of foreign reserves (Article 5(2));
- right to authorise the issue of banknotes and the volume of coins (Articles 4 and 34);
- non-recognition of the role of the ECB in the field of international cooperation (Article 7).

The imperfections with regard to the ESCB/ECB tasks are as follows:

- non-recognition of the role of the ECB and the EU for the collection of statistics (Article 39 and 40);
- non-recognition of the role of the ECB for the functioning of the payment systems (Article 9);
- rules for publishing balance sheets and the absence of an obligation to comply with the Eurosystem's regime for the financial reporting of NCB operations (Article 15);
- non-recognition of the role of the ECB and the Council for the appointment of external auditors and lack of a clear definition of the scope of control performed by the audit commission, whose members are approved by the State Audit Office (Article 43).

4.1.5. Assessment of compatibility

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

4.2. PRICE STABILITY

4.2.1. Respect of the reference value

The 12-month average inflation rate for Latvia, which is used for the convergence assessment, was below the reference value at the time of the last convergence assessment in 2010. Average annual inflation declined from above 2% in early 2010 to -2% in August 2010, before increasing gradually to 4.2% by end-2011. In March 2012, the reference value was 3.1%, calculated as the average of the 12-month average inflation rates in Sweden, Ireland and Slovenia plus 1.5 percentage points. The average inflation rate in Latvia during the 12 months to March 2012 was 4.1%, i.e. 1.0 percentage point above the reference value. It is projected to decrease below the reference value in the months ahead.

Table 4.1:

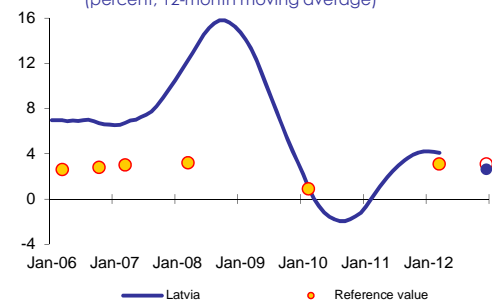
Latvia - Components of inflation	(percentage change) ¹⁾							weights
	2006	2007	2008	2009	2010	2011	Mar-12	in total
HICP	6.6	10.1	15.3	3.3	-1.2	4.2	4.1	1000
Non-energy industrial goods	1.6	3.3	2.7	0.0	-3.5	-1.0	-0.8	241
Energy	12.6	10.4	27.3	4.0	5.4	13.5	13.1	157
Unprocessed food	9.3	12.3	13.7	0.4	-0.1	3.8	2.3	101
Processed food	7.6	14.4	27.4	6.8	1.0	9.1	8.3	209
Services	6.7	12.9	15.4	4.7	-4.5	0.5	1.0	293
HICP excl. energy and unproc. food	5.1	9.7	13.8	3.5	-2.7	2.4	2.5	742
HICP at constant taxes ²⁾	6.2	9.8	13.6	-1.9	-1.4	2.7	2.8	1000
Administered prices HICP	11.8	16.6	31.8	17.6	2.1	7.3	7.6	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.

2) Last observation for HICP at constant taxes is February 2012.

Sources: Eurostat, Commission services.

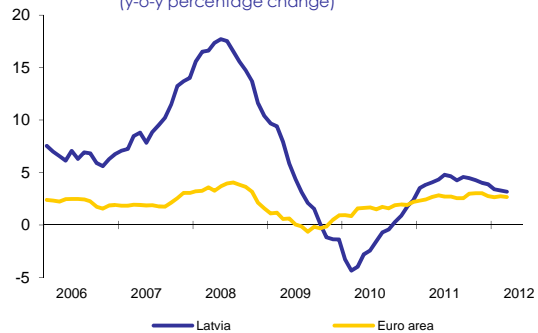
Graph 4.1: Latvia - Inflation criterion since 2006
(percent, 12-month moving average)



Note: The dots in December 2012 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2012 Forecast.

year inflation moderated to 3.2%, as the impact from commodity price and tax increases waned.

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



Source: Eurostat.

4.2.2. Recent inflation developments

In previous years, Latvia's inflation rate moved in a quite wide range mainly as a consequence of volatile commodity price movements and a very intense business cycle. These factors were amplified by the composition of the consumer basket, which includes a relatively high share of food and energy products and by large fiscal consolidation, significantly affecting tax rates.

Headline HICP inflation averaged above 15% in 2008, with price dynamics turning around sharply after the intra-year collapse of demand. Significant nominal wage adjustment and a correction in import prices led to negative headline inflation between October 2009 and November 2010. The inflation rate however rose from -2.8% in April 2010 to 4.8% by May 2011, as the cycle turned and a new global commodity price shock set in, exacerbated by the impact of a regional drought. Average HICP inflation was -1.2% in 2010 and 4.2% in 2011, a year which also saw significant indirect tax increases. By March 2012 year-on-

Core inflation (measured as HICP inflation excluding energy and unprocessed food) has moved broadly in parallel with headline inflation in recent years and stood at 1.4% in March 2012. Core inflation has usually been around two percentage points lower than headline inflation in the past two years, with rising energy prices mainly responsible for the difference. Core inflation turned positive only in 2011, but processed food prices temporarily lifted it over 3% by mid-year. Non-energy industrial goods prices continued to decline until the latest data of March 2012. Services prices started to edge up from 2010 after about two years of a declining trend, as signs of the recovery gradually got stronger. Rising commodity prices and wages started to feed through to services prices in 2011 although the weaker euro also had some impact. High producer price inflation in 2011 and early 2012 indicates the existence of some cost pressure in the pipeline.

4.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy-mix and cyclical stance

Real GDP growth was almost 10% on average between 2005 and 2007, but fell to below -7% between 2008-2010. As credit flows abruptly reversed, Latvia required an EU/IMF led international financial assistance programme and ambitious fiscal consolidation began. The reallocation of resources to the tradable sector created the basis for an export-driven recovery. Domestic demand revived only slowly under the burden of financial deleveraging and fiscal consolidation, but from 2011 it was supported by favourable labour market developments. Real GDP growth rebounded to 5.5% in 2011 and it is projected by the Commission services' 2012 Spring Forecast to moderate to 2.2% in 2012, as a result of adverse external shocks, before increasing to 3.6% in 2013. Commission services estimate that the negative output gap will remain sizeable even in 2013.

The fiscal stance, as measured by changes in the structural balance, deteriorated until 2008, as pro-cyclical fiscal policy contributed to the boom and failed to prepare for the crisis. Fiscal policy turned restrictive in 2009, when a huge adjustment was imposed by the crisis and implemented in the framework of the EU-IMF assistance programme. As a result of the large fiscal adjustment, the structural deficit improved to -3.2% by 2011⁽⁴¹⁾. According to the Commission services' Spring 2012 Forecast, the structural balance is projected to improve further to -2.2% in 2012 and to -1.7% in 2013.

The narrow fluctuation band to the euro, the high degree of euroisation and integration with the European financial system constrain the scope and effectiveness of domestic monetary policy. The Bank of Latvia has left the refinancing rate unchanged at 3.5% since March 2010, but lowered its marginal lending facility rates in March 2012. The reserve requirement was set at 3% for bank liabilities above two years and 5% for all other liabilities included in the reserve base from November 2008 until January 2012, when both

were lowered by 1 percentage point. In July 2010, the Bank of Latvia reduced the interest rate on the 7-day deposit facility by 0.5 percentage points (to 0.5%) and lowered the interest rate on the overnight deposit by 0.125 percentage points (to 0.375%) with a view to encouraging commercial banks to start lending. From November 2010, the Bank of Latvia lowered its deposit rates further to 0.375% and 0.25% respectively. Despite abundant lats liquidity in the system, these efforts had only limited impact in encouraging banks to channel financial resources into the economy, as the banking sector in general has been pursuing a controlled deleveraging strategy. Commercial banks however turned more active in providing new loans, in particular to export-oriented companies, as the economic situation started to stabilize and the increase in non-performing loans reversed in late 2010.

Wages and labour costs

A considerable wage adjustment took place in Latvia over 2009 and 2010, with compensation per employee falling by a cumulative 19% in two years, supported by policies implemented under the BoP assistance programme. Employment declined at a similarly high rate, as jobs were shed in particular in the construction, manufacturing and public sectors. The unemployment rate started to decline from above 20% in early 2010, due mainly to employment growth, and it is expected to fall to close to 13% by 2013. The economic recovery and imported inflation in 2010 prevented nominal private sector wages from falling further and they started to rise again amid some tightening of the labour market in 2011. After substantial declines in 2009 and 2010, growth of nominal unit labour costs (ULC) was about 2% in 2011. Labour productivity growth is expected to be low over the next two years, partly reflecting more cautious business investment.

The Latvian labour market demonstrated substantial flexibility during the crisis, underpinned by a decentralised wage-setting system. That said, large public sector wage cuts indirectly supported nominal wage reduction in the private sector in 2009 and 2010. In 2011, public sector wages picked up somewhat earlier than those of the private sector, partly reflecting a correction of earlier excessive cuts in some fields. In 2012-2013, wages are expected to grow broadly in line with productivity, but structural labour market problems, in particular regional differences

⁽⁴¹⁾ The actual consolidation effort was likely to be much higher during the crisis than what is suggested by the Commission services' structural balance estimates which presumably underestimated the actual revenue loss in particular in 2009.

Table 4.2:

Latvia - Other inflation and cost indicators	(annual percentage change)							
	2006	2007	2008	2009	2010	2011 ¹⁾	2012 ²⁾	2013 ²⁾
HICP inflation								
Latvia	6.6	10.1	15.3	3.3	-1.2	4.2	2.6	2.1
Euro area	2.2	2.1	3.3	0.3	1.6	2.7	2.4	1.8
Private consumption deflator								
Latvia	5.9	9.9	16.2	3.2	-0.5	4.9	2.6	1.8
Euro area	2.2	2.2	2.7	-0.4	1.7	2.5	2.2	1.7
Nominal compensation per employee								
Latvia	23.2	35.1	15.7	-12.7	-5.5	4.2	1.7	2.2
Euro area	2.5	2.6	3.4	1.8	1.7	2.2	1.9	1.9
Labour productivity								
Latvia	5.9	5.8	-4.2	-5.3	4.7	2.0	1.5	2.4
Euro area	1.9	1.3	-0.3	-2.4	2.5	1.2	0.1	1.0
Nominal unit labour costs								
Latvia	16.4	27.7	20.7	-7.9	-9.8	2.1	0.3	-0.1
Euro area	0.8	1.4	3.8	4.2	-0.8	0.8	1.6	0.8
Imports of goods deflator								
Latvia	9.6	5.7	9.7	-6.7	7.6	6.1	2.5	1.9
Euro area	3.9	1.0	4.2	-7.7	5.7	6.9	3.6	1.3

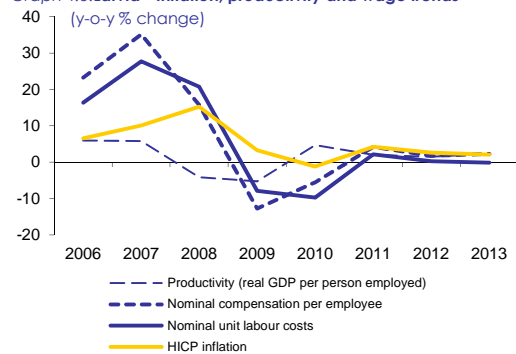
1) 2011 data (except HICP inflation) are estimates.

2) Commission services' Spring 2012 Forecast.

Source: Eurostat, Commission services.

and skills mismatches could lead to some pressures within a few years, if not addressed.

Graph 4.3: Latvia - Inflation, productivity and wage trends



Source: Eurostat, Commission services' Spring 2012 Forecast.

External factors

Over the past two years, consumer prices were largely driven by global commodity prices and a regional food price shock due to a severe drought in 2010. Latvia's small and open economy is in general highly sensitive to external impulses, but the composition of the consumer basket and the relatively high share of material inputs in production costs also aggravate the impact of volatile commodity prices. After supporting disinflation in 2009, import prices, measured by the imports of goods deflator in the national

accounts, rose sharply in the second half of 2010 and early 2011, reflecting increasing world energy and food prices. The subsequent broad stabilization in the Brent oil price (in euro terms), coupled with a good regional harvest in 2011, led to a moderation in the growth of import prices. The contribution of energy prices to HICP inflation was nevertheless high in 2011, with 2.1 percentage points on average.

The nominal effective exchange rate of the lats, measured against a group of 35 trading partners, remained broadly stable since the beginning of 2010. Between late 2008 and early 2010, there was a period when the nominal effective exchange rate of the lats was somewhat stronger, as the currencies of many of Latvia's trading partners depreciated against the euro during this phase of the financial crisis. From May 2010, the currencies of some of Latvia's major trading partners in Central and Eastern Europe depreciated against the euro usually when the euro depreciated to the dollar, which resulted in a broadly stable lats nominal effective exchange rate. Towards the end of 2011, a slight lats nominal effective exchange rate appreciation was evident.

Administered prices and taxes

Changes in administered prices and indirect taxes significantly contributed to inflation over the past two years, although the extent of the contribution fluctuated⁽⁴²⁾. Administered prices, which account for about 14% of the HICP basket, to a large extent reflected the impact of volatile global energy prices, transmitting their generally rising price trend. Indirect tax increases also raised inflation, as the government relied partly on revenue-side measures in stabilizing public finances.

The annual average increase of administrative prices fell from 19% in 2009 to 2.3% in 2010, before picking up again to 7.3% in 2011, largely reflecting the delayed impact of changes in the international price of oil. In particular, tariffs for heat energy rose significantly in the first half of 2010, those of natural gas in the summer of 2010 and 2011 and those of electricity in the first half of 2011.

The indirect tax changes over the past few years were motivated mainly by the need for rapid fiscal consolidation and a strategy to rebalance taxation across bases, as the process of excise tax harmonisation with EU legal requirements has been completed⁽⁴³⁾. In January 2009, the standard VAT rate was increased by 3 percentage points and the reduced VAT rate by 5 percentage points. In January 2011, there was a further VAT increase (of 1 percentage point for the standard rate and of 2 percentage points for the reduced rate) and a further broadening of the tax base under the standard VAT rate. In addition, excise taxes on alcohol, tobacco and fuel were raised from mid-2011. The effect of these latter tax changes is expected to fade from headline inflation figures by late 2012. Annual constant-tax inflation was on average 2.7% in 2011, i.e. about 1.5 percentage points below headline inflation.

⁽⁴²⁾ According to the Eurostat definition, administered prices in Latvia include *inter alia* electricity, gas, heat energy, hospital services, public transport and postal services. For details, see http://epp.eurostat.ec.europa.eu/portal/page/portal/hicp/methodology/administered_prices

⁽⁴³⁾ The impact of indirect tax changes on inflation is particularly difficult to assess during this turbulent period of the Latvian economy. Large excise tax and VAT increases in 2008 and early 2009 may have had a lagged impact on inflation even in late 2010, as the tax increases were not immediately fully passed on to consumers during the recession.

Medium-term prospects

HICP inflation is expected to remain moderate in the context of relatively weak domestic demand. The economic recovery is set to be slowed by a deteriorating external environment, while tight credit conditions and a prudent fiscal policy are expected to contain demand pressures on prices. The available data indicate that inflation expectations remained relatively well-anchored, in the context of decreasing headline inflation and a worsening economic outlook from mid-2011. The Commission services' Spring 2012 Forecast projects the average HICP inflation rate to fall to 2.6% in 2012 and to 2.1% in 2013, compared to 4.2% in 2011.

Risks to the inflation outlook are broadly balanced. Upside risks are mainly related to a possible further rise in commodity prices, to which Latvia is particularly exposed, and to the difficulty of controlling wage growth if economic performance was to surprise positively. In case of strong output growth, labour market conditions could tighten rapidly, which would lead to upward pressure on wages. Downside risks to the inflation outlook could emerge with a weaker-than-expected recovery in Latvia or abroad.

In Latvia, the level of final consumption prices of private households stood at close to 70% of the euro area average in 2010. This suggests potential for further price level convergence in the long term, as income levels (around 47% of the euro-area average in PPS in 2010) rise towards the euro-area average.

Medium-term inflation prospects will hinge on wages growing in line with productivity. Outward migration in search for higher living standards could lead to a shortage of well qualified labour force, which could drive up wages in Latvia. On the other hand, productivity growth will largely depend on improvements in the business environment and progress in attracting new investment. Increased market competition would also support favourable price developments. Finally, if the rising trend of commodity prices continues in the medium-term, Latvia would be severely affected due to the composition of its consumer basket, low energy efficiency and high material input share in production.

4.3. PUBLIC FINANCES

4.3.1. The excessive deficit procedure for Latvia

On 7 July 2009, based on a recommendation by the Commission, the Council decided that an excessive deficit existed in Latvia in accordance with Article 104(6) TEC and addressed recommendations to Latvia in accordance with Article 104(7) TEC with a view to bringing an end to the situation of an excessive government deficit. The Council recommended that Latvia put an end to the excessive deficit situation as rapidly as possible and at the latest by 2012, by ensuring an average annual fiscal effort of at least 2¾% of GDP over the period 2010-2012. In its recommendation, the Council established a deadline of 7 January 2010 for the Latvian government to take effective action and invited Latvia to implement the measures associated with the 16 June 2009 supplementary budget, to adopt a fully articulated 2010 budget with high-quality consolidation measures consistent with the envisaged path for the correction of the excessive deficit, and to broadly outline the measures envisaged for 2011 and 2012. On 16 February 2010 the Council concluded that Latvia had taken action representing adequate progress towards the correction of the excessive deficit within the time limits set by the Council and that no further action under the excessive deficit procedure was necessary, thereby putting the procedure in abeyance⁽⁴⁴⁾.

In 2009-2011 Latvia benefited from a medium-term financial assistance programme with the EU, which was provided in conjunction with an IMF Stand-by agreement and was also financed by the World Bank, the European Bank for Reconstruction and Development, several EU countries and Norway. This assistance was subject to a number of policy conditions including fiscal consolidation and structural reforms which were consistent with the Council recommendations under the EDP. The total amount of the available financing under the programme was EUR 7.5 billion, of which Latvia used EUR 4.5 billion or ca 60%. Given the improving budgetary situation and regained access to international financial markets from June 2011, Latvia did not draw on

programme financing after October 2010⁽⁴⁵⁾. The medium-term financial assistance programme expired in January 2012.

4.3.2. Recent fiscal developments

The reversal of the domestic cycle started in 2007 and was aggravated by the global financial crisis, significantly affecting the headline general government position. The deficit rose from a close-to-balance headline position in 2007 to 4.2% in 2008 and 9.8% in 2009, despite very substantial consolidation measures adopted during 2009. These consolidation efforts, supplemented by further strong action in 2010 and 2011, nevertheless helped to put public finances back on a sustainable path. Although the headline deficit was still high at 8.2% of GDP in 2010, this was partly a reflection of sizeable financial sector stabilisation measures undertaken during the crisis. In 2011, the deficit rapidly declined to 3.5% of GDP, as the tax-to-GDP ratio gradually increased due to tax measures and stronger internal demand, while the expenditure-to-GDP ratio declined noticeably, since exceptional costs became less sizeable and overall government expenditure was kept under tight control.

The 2011 budget deficit was significantly lower than the original target of 6% of GDP in the ECOFIN Council EDP recommendation of July 2009 and also than the target of 4.5% of GDP set in the 2011 Convergence Programme of Latvia. This outcome was achieved in spite of measures to support the restructuring of the Mortgage and Land Bank and to provide stop-gap financing to the national airline, accounting together for around ¾% of GDP. Without the impact of exceptional measures to support the banking sector, the structural deficit improved by around 3½ percent of GDP between 2009 and 2011.

While remaining well below 60% of GDP, the debt-to-GDP ratio rose substantially in particular in 2009 and 2010, reaching 44.7% of GDP by the end of 2010 reflecting high government deficits in these years. The debt ratio declined by 2 percentage points in 2011, as the positive effect of nominal GDP growth more than offset the financing of the deficit and because of a buy-back of government bonds from the Deposit Guarantee Fund in late 2011.

⁽⁴⁴⁾ 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

⁽⁴⁵⁾ With an exception of the last tranche of the World Bank financing in amount of EUR 0.1 billion to support structural reforms.

Table 4.3:

Latvia - Budgetary developments and projections		(as % of GDP unless indicated otherwise)							
Outturn and forecast¹⁾	2006	2007	2008	2009	2010	2011	2012	2013	
General government balance	-0.5	-0.4	-4.2	-9.8	-8.2	-3.5	-2.1	-2.1	
- Total revenues	37.8	35.6	34.9	34.7	35.7	35.6	36.0	34.9	
- Total expenditure	38.3	36.0	39.1	44.4	43.9	39.1	38.1	37.0	
of which:									
- Interest expenditure	0.4	0.4	0.6	1.5	1.4	1.5	1.7	1.8	
p.m.: Tax burden	30.8	30.8	29.7	27.0	27.5	27.9	28.2	27.1	
Primary balance	0.0	0.0	-3.6	-8.3	-6.8	-2.0	-0.4	-0.3	
Cyclically-adjusted balance	-3.0	-4.3	-6.5	-6.9	-5.6	-2.3	-1.2	-1.7	
One-off and temporary measures	0.0	0.0	0.0	-0.3	-0.6	0.8	1.0	0.0	
Structural balance ²⁾	-3.0	-4.3	-6.5	-6.6	-5.0	-3.2	-2.2	-1.7	
Government gross debt	10.7	9.0	19.8	36.7	44.7	42.6	43.5	44.7	
p.m.: Real GDP growth (%)	11.2	9.6	-3.3	-17.7	-0.3	5.5	2.2	3.6	
p.m.: Output gap	9.2	14.2	8.2	-10.3	-9.4	-4.3	-3.1	-1.5	
Convergence programme						2012	2013	2014	2015
General government balance						-2.1	-1.4	-0.8	-0.3
Structural balance ²⁾³⁾						-1.2	-0.9	-0.7	-0.6
Government gross debt						44.5	45.8	46.7	38.9
p.m. Real GDP (% change)						2.0	3.7	4.0	4.0

1) Commission services' Spring 2012 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 2012 Convergence Programme of Latvia.

4.3.3. Medium-term prospects

The budget for 2012 was adopted by Parliament on 15 December 2011. It targeted a deficit of 2.5% of GDP. The measures taken to reach the deficit target were mainly on the expenditure side and included: i) measures to support the nominal freeze of the wage bill of the public sector, ii) limiting other expenditure, in particular that of local governments, iii) reducing subsidies in the area of road maintenance and transport, iv) implementing stricter controls to limit the duration of sickness benefits. On the revenue side the main measures are the broadening of the real estate tax base and giving municipalities the option to abolish the limit on annual increases in real estate tax on land, as well as several measures to strengthen tax administration.

Taking into account these measures and the full year impact of tax increases that entered into force in mid-2011, the general government deficit is expected to decline to 2.1% of GDP in 2012, according to the Commission services' Spring 2012 Forecast. Under the no-policy change assumption, the deficit is expected to remain broadly unchanged in 2013 as the planned increase in state contributions to the funded pension

scheme, after their temporary lowering in 2009-2012, offsets the positive impact of economic growth on tax revenue and unemployment outlays. Nevertheless, as the current policy implies several expenditure restraints (notably freezing of the public sector wage bill in 2012 and of pension indexation in 2012-2013), the underlying structural balance is gradually improving. The general government debt to GDP ratio is expected to moderately increase again in 2012 and 2013, reaching 44.7% by the end of the period, but to decline thereafter as repayments under the international financial assistance programme peak in 2014-2015.

The 2012 Convergence Programme, covering the period 2012-2015, was adopted by the Latvian government on 27 April 2012. The budgetary strategy in the programme confirms the objective of correcting the excessive deficit by the date recommended by the Council (2012), and aims at subsequently approaching the medium-term objective (MTO). The MTO itself was revised in the recent programme from a structural deficit of 1.0% of GDP to a more ambitious objective of a structural deficit of 0.5%. According to recalculated projections in the programme (see table 4.3), the structural deficit would fall below

1.0% of GDP already in 2013, although it would come close to the new MTO only by the end of the programme period ⁽⁴⁶⁾. The new MTO has been updated in line with the draft Fiscal Discipline Law which aims at strengthening the fiscal governance framework; the law is expected to be approved by Parliament in the course of 2012. In terms of general government headline deficit, the targets set in the convergence programme are 2.1% of GDP in 2012, 1.4% of GDP in 2013, and 0.8% and 0.3% of GDP in 2014 and 2015. The expected deficit in 2012 is thus in line with projections in the Commission services' Spring 2012 Forecast, while the Commission services' forecast for 2013 is based on the assumption of an unchanged policy.

Further details on the assessment of the 2012 Convergence Programme for Latvia can be found in the forthcoming Commission Staff Working Document ⁽⁴⁷⁾, which accompanies the Commission Recommendation for a Council Recommendation on the 2012 National Reform Programme of Latvia and delivering a Council Opinion on the 2012 Convergence Programme of Latvia.

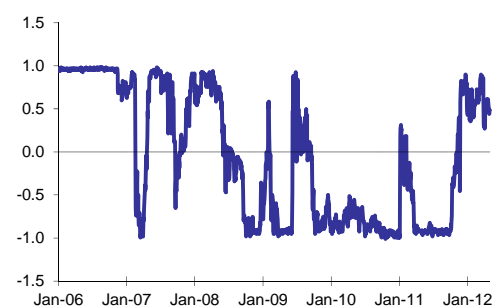
In March 2012, Latvia signed the Treaty on Stability, Coordination and Governance in the EMU. This implies an additional commitment to conduct stability-oriented and sustainable fiscal policies. This Treaty will apply to contracting Member States with a derogation which have ratified the Treaty as from the date when the decision abrogating that derogation will come into force unless they declare their intention to be bound at an earlier date by some or all of the provisions on the fiscal compact and on economic policy coordination and convergence.

4.4. EXCHANGE RATE STABILITY

The Latvian lats entered ERM II on 2 May 2005, i.e. it has spent more than seven years in ERM II at the time of the adoption of this report. The central rate was set at the parity at which the lats had been re-pegged from the SDR to the euro on 1 January

2005 (LVL 0.702804 per EUR 1), with a standard fluctuation band of $\pm 15\%$. Upon ERM II entry, the authorities unilaterally committed to maintain a tighter fluctuation margin of $\pm 1\%$ around the central rate. During the two years preceding this assessment, the official EUR/LVL exchange rate did not deviate from its central rate by more than $\pm 1\%$, in line with the Latvian authorities' unilateral commitment. The evolution of additional indicators also does not suggest that the EUR/LVL exchange rate was subject to severe tensions over the past two years, though Latvia's international financial assistance programme was in place until January 2012.

Graph 4.4: LVL - Spread vs central rate
(as percent, daily values)



Source: Commission services, ECB, Reuters EcoWin.

In 2007-2008, the nominal exchange rate of the lats was relatively volatile within the narrow fluctuation band, influenced by currency devaluation rumours, in the context of large macro-imbalances. Initial failure to stabilize the situation in the banking sector in late 2008 led to capital outflows that forced the Bank of Latvia to intervene heavily to protect the value of the lats. The December 2008 agreement on an international financial assistance package helped to calm markets. However, market stress returned in spring 2009, as it became evident that the fiscal situation was worse than expected and political uncertainty hindered an appropriate policy response. Market tensions peaked in June 2009, when speculation about an imminent lats devaluation drove short-term interest rates to over 30%. More than a third of Bank of Latvia's foreign assets was sold during the financial turmoil between February and end-June to sustain the peg. Following the Latvian authorities' supplementary budget in mid-June and the disbursement of the EU's large second loan tranche in July, financial market conditions rapidly improved.

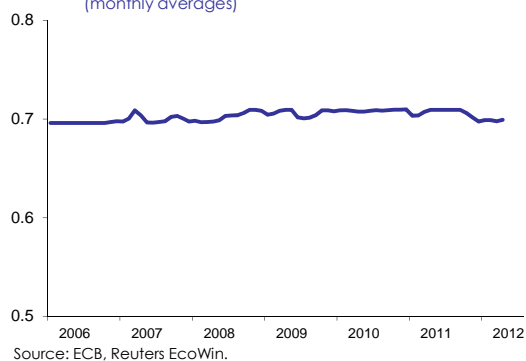
The exchange rate peg did not come under significant pressure over the past two years. The

⁽⁴⁶⁾ These projections should be seen against the high degree of uncertainty related to determining the cyclical position in real time, especially for countries undergoing rapid and significant structural adjustments, and the closeness of the structural position to the MTO in those years.

⁽⁴⁷⁾ Available at: http://ec.europa.eu/economy_finance/economic_governance/sgp/convergence/programmes/2012_en.htm

lats remained within, but for most of the time close to the weak side of, its fluctuation band, and the Bank of Latvia occasionally had to intervene to support it. From the beginning of 2011, the Treasury changed its practice of converting funds received from the international financial assistance programme with the Bank of Latvia and started to buy lats on the market (as it had done before mid-2009). The Treasury pre-announced these transactions to make the exchange rate impact predictable for market participants. Nevertheless, these transactions served effectively as intra-band interventions by selling foreign exchange from official reserves in exchange for lats. In early and late 2011, large (relative to the size of the Latvian market) Treasury transactions drove the lats exchange rate to the strong side of the fluctuation band.

Graph 4.5: Exchange rates - LVL/EUR
(monthly averages)



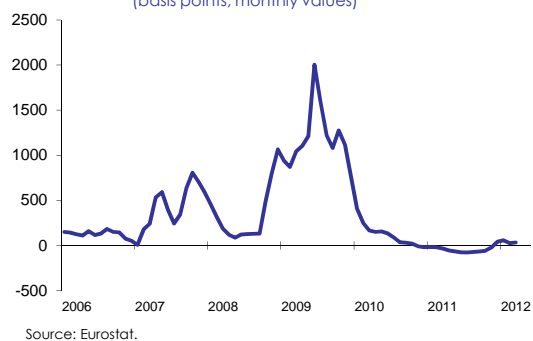
The international reserve position of the central bank has been quite strong since mid-2009 and covered around 200% of base money, boosted mainly by disbursements from the financial assistance programme, in total amounting to around 25% of GDP. The credibility of the peg gradually improved from mid-2009, as indicated by a reversal of deposit euroisation and the return of non-resident deposits to the Latvian banking system. On the other hand, the massive deleveraging of the Latvian economy, in particular in early 2009, was accompanied by large capital outflows related to the reduction of the banking sector's external funding. The continuing, but more moderate outflows in the financial account have been broadly compensated by the surplus of the current and capital accounts since mid-2009. The last disbursements from the IMF and the EU under the programme took place in August 2010 and October 2010, respectively. After that, Latvia opted not to ask for further funds committed by the EU and the IMF under the international Balance of

Payments assistance⁽⁴⁸⁾. In June 2011, Latvia successfully returned to the international bond market by issuing a 10-year USD 500 million bond, with the achieved yield of 5.491% signalling good market access. This was followed by a 5-year USD 1 billion issuance in February 2012 with yield of 5.375%.

Financial market conditions in Latvia improved further since 2010, demonstrating resilience to political uncertainty ahead of the October 2010 and September 2011 parliamentary elections. Rating agencies received positively the results of Latvia's economic stabilization programme. In December 2010, S&P raised its credit rating to BB+ and, in March 2011, Fitch upgraded Latvia to investment grade.

Over the past two years, the policy rates of the Bank of Latvia were broadly aligned with those of the ECB, with the overnight deposit rate at 0.25% since November 2010. Abundant lats liquidity that resulted from the off-market conversion of international programme funds before 2011 kept interbank rates low, at times even below those of the euro area, although the interbank market remained illiquid beyond the very short term. There was some limited tension in the Latvian money market during the Krajbanka insolvency case in late 2011, but the situation calmed down by early 2012.

Graph 4.6: Latvia - 3-M Rigibor spread to 3-M Euribor
(basis points, monthly values)



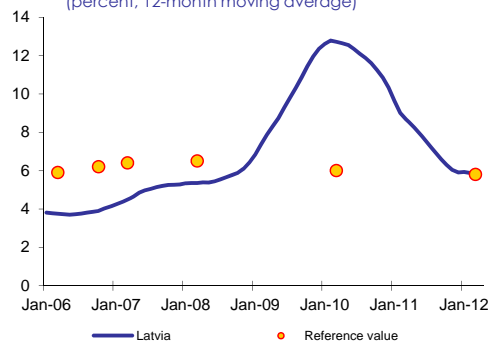
4.5. LONG-TERM INTEREST RATES

For Latvia, the development of long-term interest rates over the current reference period is assessed

⁽⁴⁸⁾ In December 2011 Latvia drew the second development policy loan of the World Bank's Safety Net and Social Sector Reform Program for an amount of EUR 100 million (0.5% of GDP).

on the basis of secondary market yields on a single benchmark government bond with a residual maturity of about 9 years.

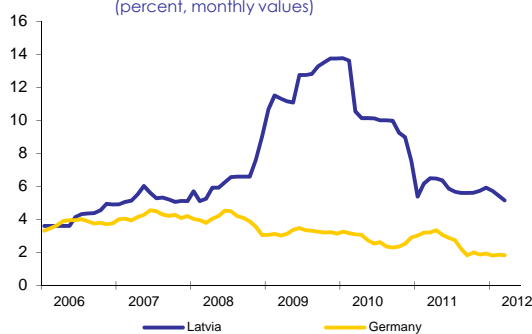
Graph 4.7: Latvia - Long-term interest rate criterion
(percent, 12-month moving average)



Source: Commission services.

The Latvian 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion was above the reference value at the 2010 convergence assessment. It declined strongly from almost 13% in early 2010 to below 6% by end-2011. In March 2012, the last month for which data are available, the reference value, given by the average of long-term interest rates in Sweden and Slovenia plus 2 percentage points, stood at 5.8%. In that month, the 12-month moving average of the yield on the Latvian benchmark bond stood at 5.8%, i.e. at the reference value.

Graph 4.8: Latvia - Long-term interest rates
(percent, monthly values)



Source: Eurostat.

Long-term interest rate spreads vis-à-vis the euro area were gradually rising from their lows in 2006 until late 2008, when they spiked in reaction to fears of a lats devaluation and Latvia's deteriorating fiscal outlook, peaking in late 2009. Spreads compressed in 2010, as confidence in the currency peg was regained, fiscal consolidation yielded results and conversion of assistance programme funds created ample lats liquidity. Against this background, the Treasury returned to

the 10-year domestic bond market with several smaller issues in the first half of 2011, thereby extending the maturity profile of lats-denominated government papers. The favourable market trend broke in July 2011, as international financial markets came under renewed pressure and the issuance of 10-year bonds was temporarily suspended. However, the yields on outstanding 10-year bonds weathered rather well the political uncertainty ahead of the September 2011 early parliamentary election and the late 2011 turmoil in euro area sovereign debt markets. Spreads against the German benchmark bond stood around 330 basis points in March 2012⁽⁴⁹⁾.

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. These additional factors – including balance of payments developments, product and financial market integration – are important indicators that the integration of a Member State into the euro area would proceed without difficulties.

The section on additional factors makes reference *inter alia* to 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 assessment. Related to this, following the adoption of the legislation establishing the new procedure for surveillance and correction of macroeconomic imbalances (MIP)⁽⁵⁰⁾, the Commission published its Alert Mechanism Report (AMR) in February 2012⁽⁵¹⁾. The scoreboard shows that Latvia exceeds the indicative threshold in two out of ten indicators, one in the area of external imbalances (namely on net international investment position) and one in the area of internal imbalances (on unemployment). Based on the conclusion of the

⁽⁴⁹⁾ The reference to the German benchmark bond is included for illustrative purposes, as a proxy of the euro area long-term AAA yield.

⁽⁵⁰⁾ The package of six legislative proposals to strengthen the economic governance of the EU entered into force in December 2011. <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/898>

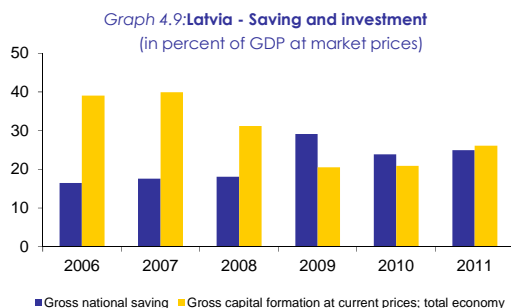
⁽⁵¹⁾ http://ec.europa.eu/economy_finance/articles/governance/2012-02-14-alert_mechanism_report_en.htm

AMR, Latvia was not subject to an in-depth review in the context of the MIP.

4.6.1. Developments of the balance of payments

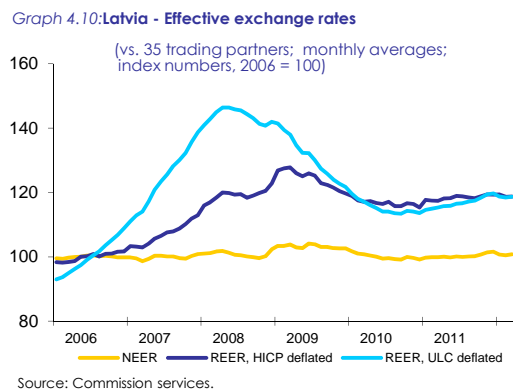
The external balance (i.e. the combined current and capital account) reversed in 2008-2009 from large deficits during the boom years to a surplus of around 11% of GDP in 2009, which decreased to 4.9% of GDP in 2010 and 0.9% of GDP in 2011. The two most important drivers of the external balance were the goods trade deficit and the income balance. The goods trade deficit improved substantially in 2008 and 2009, but it started to slowly deteriorate again with the economic recovery. The surplus on services trade kept improving in 2011. The income account swung into surplus in 2009, reflecting the huge loan loss provisions made by foreign-owned banks, but it returned to a deficit in late 2010, as the banking sector's loan portfolio started to stabilize. Current transfers and capital account surpluses reflected the net inflows from EU funds.

The large savings-investment gap of the pre-crisis years closed abruptly in 2009, with the sudden reversal of capital flows during the international financial crisis. Gross savings peaked in 2009, amid high uncertainty regarding the future prospects for the economy. In contrast, gross public sector saving relative to GDP fell in 2009 and increased in 2010 and 2011, when confidence returned and the private sector gradually reduced its savings. Following the substantial fall in 2008-2009 (albeit from very high levels), investment activity started to recover in 2010 and 2011, but it remained well below pre-crisis levels.



External cost competitiveness has improved markedly between 2008 and 2011, followed by a stabilization amid stronger demand from Latvia's export markets and rising import prices. The real-

effective exchange rate depreciated substantially in 2009-2010, but it appreciated somewhat in 2011 both deflated by HICP and ULC. The overall real exchange rate correction is even larger when the ULC of manufacturing sector is used as a deflator. The nominal effective exchanged rate helped to improve cost competitiveness in 2009 and 2010, but worked somewhat against it in 2011⁽⁵²⁾. Latvia's goods export market shares in both world and EU trade increased in 2010-2011, but the share of its combined goods and services exports with regard to its markets increased at a lesser rate. The growth in export market share was also supported by non-price competitiveness improvements, such as quality upgrades and product differentiation.



The balance of payments assistance granted to Latvia under the EU-IMF programme of late 2008 was successfully concluded by early 2012. Latvia borrowed altogether about EUR 4.5 billion out of the total EUR 7.5 billion that was available under the programme. In confidence of its policies and of its regained market access, Latvia has not requested a follow-up programme.

Outflows in the financial account (without reserves) have continued since 2008, although for varying reasons and at a more moderate pace until the last quarter of 2011. The net FDI balance has improved considerably from 2009, favourably affected by better financial results in the banking sector. Net other inflows turned negative during the crisis, despite the disbursements of the international financial assistance. This reflected mainly the repayment of net external funding of the banking sector, which was very high also towards the end of 2011. Non-resident banking, an important service industry in Latvia, recovered

⁽⁵²⁾ The reference group of 36 trade partners used in this NEER calculation does not include Russia, making this comparison unfavourable to Latvia.

Table 4.4:

Latvia - Balance of payments	(percentage of GDP)					
	2006	2007	2008	2009	2010	2011
Current account	-22.5	-22.4	-13.2	8.6	3.0	-1.2
of which: Balance of trade in goods	-25.7	-24.0	-17.8	-7.1	-7.1	-9.9
Balance of trade in services	3.3	3.5	4.0	6.0	6.1	6.6
Income balance	-2.7	-3.2	-1.6	6.3	0.3	-0.9
Balance of current transfers	2.4	1.3	2.2	3.4	3.6	3.1
Capital account	1.2	2.0	1.5	2.4	1.9	2.1
External balance ¹⁾	-21.3	-20.4	-11.7	11.1	4.9	0.9
Financial account	20.7	21.2	13.5	-11.8	-5.5	-0.3
of which: Net FDI	7.5	6.8	3.1	0.6	1.5	5.2
Net portfolio inflows	0.2	-2.4	1.1	0.7	-0.9	-2.3
Net other inflows ²⁾	22.9	20.2	7.3	-8.1	-2.0	-7.7
Of which International financial assistance			4.2	12.5	6.1	0.5
Change in reserves (+ is a decrease)	-9.9	-3.4	2.0	-5.0	-4.0	4.5
Financial account without reserves	30.6	24.7	11.5	-6.8	-1.5	-4.8
Errors and omissions	0.6	-0.8	-1.8	0.8	0.5	-0.6
Gross capital formation	39.1	40.0	31.2	20.5	20.9	26.2
Gross saving	16.5	17.6	18.1	29.1	23.9	25.0
External debt	114.5	128.1	130.0	156.5	165.4	145.9
International investment position	-69.3	-74.5	-79.0	-83.0	-80.8	-72.8

1) The combined current and capital account.

2) Including financial derivatives.

Sources: Eurostat, Commission services, Bank of Latvia.

strongly from 2009, although the European financial market turmoil and the bankruptcy of Krajbanka caused some headwind in late 2011. Gross external debt to GDP rose significantly to around 165% by 2010, but it fell sharply in 2011, supported by strong nominal GDP growth and by further repayment of inter-company bank funding. The improvement in the international investment position was more modest and the negative net position remained substantial.

According to the Commission services' 2012 Spring Forecast, the external balance is projected to remain in a small surplus in 2012 and to decline towards balance in 2013, as domestic demand will continue to recover, although at a more moderate pace than in 2011.

4.6.2. Product market integration

The Latvian economy is well integrated into the EU economy through trade and investment linkages. Latvia is a small open economy with increasing trade openness since its EU accession (except for a set-back during the crisis of 2008-2009), although the share of exports of goods and services to GDP is still lower than in the other

Baltic countries. In 2009, the global crisis resulted in a temporary contraction of trade openness, as external demand faltered and financial flows reversed. The rebound of global trade in 2010-2011 resulted in an increase in openness. Trade integration with the EU is progressing and there is a clear reallocation in the long-term of import and export shares from Russia to EU trade partners, especially the neighbouring countries. The main trading partners within EU 27 remained Lithuania, Estonia and Germany, while Russia remained the main trading partner outside EU 27.

Latvia still has a predominant specialization in medium-to-low technology products, although there are developments pointing to an improvement of the trade structure toward some medium-to-high technology products. The cumulated shares of exports in machinery, electrical, optical and transport equipment increased in the last couple of years to 24% in 2010 (compared to 15% in 2005), while their cumulated imports shares increased from 34.7% in 2005 to almost 40% in 2007 and then declined to 29% in 2010 as a result of the contraction of investment demand, deleveraging and a temporary

Table 4.5:

Latvia - Product market integration

	2005	2006	2007	2008	2009	2010
Trade openness ¹⁾ (%)	55.4	55.8	52.6	50.0	44.7	54.5
Intra-EU trade in goods GDP ratio ²⁾ (%)	32.6	33.1	31.0	28.4	24.4	32.1
Intra-EU trade in services GDP ratio ³⁾ (%)	6.2	6.3	6.1	6.2	6.3	6.3
Extra-EU trade in goods GDP ratio ⁴⁾ (%)	10.4	11.0	10.0	10.6	9.5	12.4
Export in high technology ⁵⁾ (%)	3.2	4.2	4.6	4.6	5.3	n.a.
Technological balance ⁶⁾ (%)	-2.9	-3.0	-2.4	-2.0	-1.1	n.a.
Total FDI inflows GDP ratio ⁷⁾ (%)	4.4	8.4	8.1	3.8	0.4	1.6
Intra-EU FDI inflows GDP ratio ⁸⁾ (%)	2.8	6.1	7.0	3.0	-2.3	1.1
FDI intensity ⁹⁾	1.6	3.1	3.8	1.7	-1.1	0.5
Internal Market Directives ¹⁰⁾ (%)	1.1	0.5	0.6	0.5	0.4	0.4
Value of tenders in the EU Official Journal ¹¹⁾	60.1	96.7	63.0	61.1	42.1	57.3
Time to start up a new company ¹²⁾	16.0	16.0	16.0	16.0	16.0	16.0
Real house price index ¹³⁾	100.0	165.5	209.8	161.4	93.0	89.4
Residential investment ¹⁴⁾ (%)	2.5	3.4	4.7	4.6	3.2	2.0
Building permits index ¹⁵⁾	100.0	133.0	140.0	54.0	33.0	28.0

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

2) (Intra-EU-27 Imports + Exports of goods / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).

3) Intra-EU-27 trade in services (average credit and debit in % of GDP at current prices) (Balance of Payments).

4) (Extra-EU-27 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-EU-27 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) Public procurement - Value of public procurement which is openly advertised in the EU Official Journal in total public procurement.

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

13) Experimental house price index (2005=100), Eurostat.

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

15) Number of new residential buildings (2005=100), Eurostat.

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

slow down of FDI inflows after the beginning of the international financial crisis.

FDI inflows peaked at around 8% of GDP in 2007 due to single market integration and privatisation policies, but almost evaporated in the aftermath of the financial crisis, before rebounding slightly in 2010 and more markedly in 2011. The FDI stock at the end of 2010 was 45% of GDP, relative to 37% in Lithuania but lower than the EU 27 average (70%), pointing to additional convergence potential in this area. FDI inflows mainly originate in the EU, with Sweden, the Netherlands and Estonia accounting for 37% of the FDI stock at end-2011. The overwhelming majority of the FDI stock was channelled into the service sector, while the share of manufacturing sector was only around 12%. The main competitive advantages in attracting FDI inflows in the medium term include the lower labour cost vis-à-vis the EU average,

relatively low income taxes and a flexible labour market.

Between 2001 and 2007, real house prices experienced double-digit increases in most years. The price upswing was strikingly large even when compared to other catching-up Member States. From the peak to the trough in the first quarter of 2010, real house prices decreased by a cumulative 51%. Residential construction was very responsive to house price developments, and increased from about 1.4% of GDP in 2003 to 4.8% of GDP in 2007, before adjusting rapidly in the downswing phase to 2% of GDP in 2010. A significant shift of resources from construction and real estate to manufacturing and transport sectors took place in recent years and seems to be still ongoing.

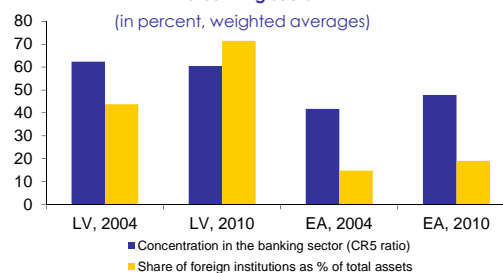
Concerning the business environment, Latvia scores broadly in line with the average of euro area

Member States in international rankings ⁽⁵³⁾. A large number of measures was adopted in 2010 and 2011 to help micro companies and self-employed, especially through reducing start-up costs related to taxation, legal requirements and financial reporting. As a result, there has been a significant growth of new companies in Latvia in the last two years. The civil justice system is rather inefficient in Latvia, with large case backlogs and lengthy proceedings. A major reform enacted in this area was the adoption of a new insolvency law that streamlines the insolvency process and introduces a reorganization option for companies, though the need for some adjustment is already evident. Further reforms include the improvement of the procedures related to the registration of properties and the reduction of the number of days to get a permanent electricity connection. Finally, according to the November 2011 Internal Market Scoreboard, Latvia registers one of the lowest transposition deficits in the EU (0.4% compared to an EU average of 1.2%) while the share of public procurement tenders announced in the EU Official Journal is significantly higher than the EU average (average of 63.4% between 2005 and 2010 compared to 17.7% in the EU average) ⁽⁵⁴⁾.

4.6.3. Financial market integration

Latvia's financial sector is well integrated into the EU financial system, particularly through its strong linkages with Nordic financial groups. The share of foreign-owned credit institutions in total credit institution assets has increased considerably since EU accession. Bank concentration, as measured by the market share of the largest five credit institutions in total assets, was above the euro area average in 2010.

Graph 4.11: Latvia - Foreign ownership and concentration in the banking sector



Source: ECB, Structural indicators for the EU banking sector, December 2011.

Financial intermediation in Latvia is performed predominantly by commercial banks. Rapid financial deepening – in the form of an unsustainable credit boom – ended abruptly in 2008 and the banking sector shifted to a deleveraging strategy, motivated by funding pressures and a deterioration in asset quality. Even foreign-owned banks with stable funding possibilities increased emphasis on local deposit collection and aimed to reduce the loan-to-deposit ratios of their Latvian subsidiaries. Nevertheless, the credit contraction abated in 2011 as house prices bottomed out and lending to export-oriented companies and household mortgages started to recover. The share of foreign currency lending, almost entirely in euro, increased further during the crisis and reached around 90% in the private sector by end-2011. The intermediation of non-resident savings, which represents an important business for domestic banks, recovered quickly as confidence in the stability of the Latvian financial system returned in 2009. The reliance on external funding, the main past vulnerability of the Latvian banking system, was reduced further over the past two years, but it remains substantial.

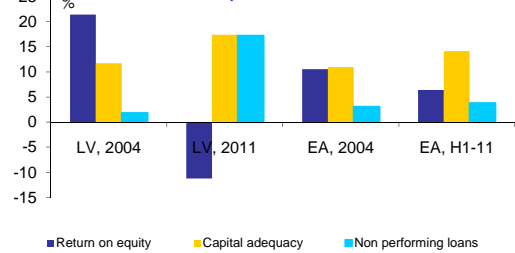
Latvia's financial system has been heavily affected by the financial crisis, leading to the nationalisation of Parex Banka, the second biggest bank in the country at that time. Confidence gradually returned, in particular after mid-2009, supported by large disbursements of international financial assistance and ambitious fiscal consolidation and structural reforms. Latvia achieved progress in dealing with Parex Banka by splitting it into a viable (Citadele) and a resolution bank and initiated the privatisation of Citadele along with the commercial assets of Mortgage and Land Bank. The Latvian financial supervisor decided in November 2011 to limit the operations and subsequently to initiate bankruptcy proceedings against Krajbanka, a subsidiary of Snoras Bank, after Snoras was nationalised by the

⁽⁵³⁾ For instance, Latvia ranks on 64th and 21st place according to the 2011-2012 Global Competitiveness index and the 2012 World Bank Doing Business respectively.

⁽⁵⁴⁾ The value of tenders published in the EU Official Journal may serve as a proxy of the extent to which national public procurement are open to foreign bidders.

Lithuanian government and an insolvency procedure was launched amid allegations of fraud. Krajbanka had a market share of 3.4% and its depositors were compensated from the deposit guarantee fund.

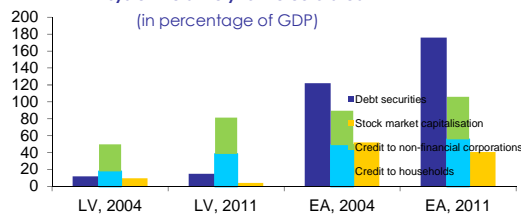
Graph 4.12: Latvia - selected banking sector soundness indicators relatively to the euro area



Note: For 2011, EU-27 non performing loans are a proxy for EA.
Source: ECB, Financial and Capital Market Commission, EC calculations.

The banking sector recorded a considerable loss in 2011, due mainly to new provisions for doubtful and bad loans in the last quarter. However, the surge of non-performing loans (due over 90 days) reversed since the second half of 2010 and their level reached 17.2% at the end of 2011. The Latvian banking sector is well capitalized thanks to additional capital increases by the owners during the recession. The average capital adequacy ratio of the banking sector reached 17.4% at the end of 2011.

Graph 4.13: Latvia - Recent development of the financial system relatively to the euro area (in percentage of GDP)



Note: Debt Securities other than shares, excluding financial derivatives.
Source: Eurostat, ECB, Bank of Latvia, Nasdaq OMX Riga, Reuters EcoWin.

The non-banking part of the Latvian financial sector remains small compared to the euro area average and has grown only slowly. The dynamic increase in second pillar pension savings ended in 2009 with the partial redirection of social security contributions to the budget. The accumulated second-pillar pension savings amounted to around 6.5% of GDP at the end of 2010. Voluntary private pension fund savings amounted to less than 1% of GDP at the end of 2010. Assets managed by life and non-life insurance companies, respectively at below 1% and about 2% of GDP, are still low, even in comparison to other new Member States.

The Riga stock exchange belongs to the NASDAQ OMX group and uses a single trading platform together with other exchanges in the Baltic-Nordic region. Nevertheless, the stock market plays a marginal role in the financing of the Latvian economy. The debt securities market remains dominated by government issuances and represents only a limited source of funding for private companies. Private sector debt of 141% of GDP in 2010 is still below the euro area average⁽⁵⁵⁾.

Regulation and supervision of all financial institutions is carried out by the Financial and Capital Market Commission. In the context of the international financial assistance programme, financial supervision has been strengthened considerably. Cooperation with home country supervisors has been further enhanced. The supervision of the non-resident banking business poses additional challenges to the regulator, inter alia, due to the cross-border nature of transactions. Latvia achieved full compliance with the transposition of the FSAP directives and is on the way of completing transposition of the post-FSAP directives.

⁽⁵⁵⁾ Data on private sector debt are based on unconsolidated 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.

5. LITHUANIA

5.1. LEGAL COMPATIBILITY

5.1.1. Introduction

The Lietuvos Bankas (Bank of Lithuania – central bank of Lithuania) was founded in 1922 and was re-established in March 1990. The Law on the Bank of Lithuania constitutes the legal basis for the establishment of the Bank of Lithuania. This Law was amended several times since the last Convergence Report of 2010.

5.1.2. Central bank independence

Pursuant to Article 14(4) of the Law on the State Audit Office (last amended on 17 November 2011 – Law No XI-1706), the State Control (a public state audit office) can conduct a public audit of the performance of the activities of the Bank provided for in the Law on the Bank of Lithuania, including activities related to the supervision of financial market, as far as this does not conflict with the legal acts of the European Union and the objectives and tasks of the ESCB established therein, and if does not infringe the ESCB's confidentiality and independence. For legal certainty reasons, the law should clearly define the scope of control conducted by the State Control, without prejudice to the activities of the Bank of Lithuania's independent external auditor competences, as provided in Article 27.1 of the ESCB/ECB Statute.

5.1.3. Prohibition of monetary financing and privileged access

No incompatibilities and imperfections exist in this area.

5.1.4. Integration in the ESCB

Objectives

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

Tasks

No incompatibilities and imperfections exist in this area.

5.1.5. Assessment of compatibility

All incompatibilities have been removed gradually, as confirmed by the previous Convergence Reports.

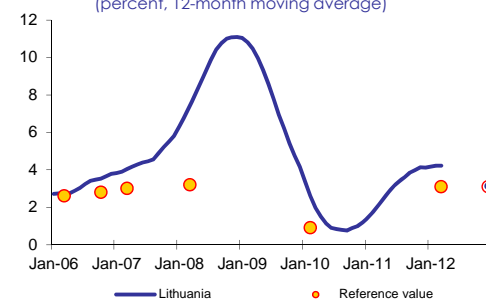
There is one imperfection with regard to central bank independence, given that Article 14(4) of the Law on the State Audit Office should be fully brought in line with Article 27.1 of the ESCB/ECB Statute.

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, has been above the reference value at the time of each convergence assessment since 2006. Having declined from above 11% at the end of 2008 to below 1% in June 2010, average annual inflation started to increase gradually in late 2010, peaking at above 4% in November 2011. In March 2012, the reference value was 3.1%, calculated as the average of the 12-month average inflation rates in Ireland, Sweden and Slovenia, plus 1.5 percentage points. The corresponding inflation rate in Lithuania was 4.2%, i.e. 1.1 percentage points above the reference value. The 12-month average inflation is projected to approach the reference value in the months ahead.

Graph 5.1: Lithuania - Inflation criterion since 2006 (percent, 12-month moving average)



Note: The dots in December 2012 show the projected reference value and 12-month average inflation in the country. Sources: Eurostat, Commission services' Spring 2012 Forecast.

5.2.2. Recent inflation developments

Inflation in Lithuania has been very volatile in recent years, reflecting in particular large

Table 5.1:

Lithuania - Components of inflation	(percentage change) ¹⁾							weights
	2006	2007	2008	2009	2010	2011	Mar-12	in total
HICP	3.8	5.8	11.1	4.2	1.2	4.1	4.2	1000
Non-energy industrial goods	-0.1	-0.2	1.8	0.2	-2.9	-0.7	0.0	243
Energy	7.6	6.8	17.9	8.2	10.4	12.0	11.4	164
Unprocessed food	8.0	8.6	15.3	3.1	-2.3	5.0	4.3	113
Processed food	2.7	10.5	15.8	5.8	5.3	7.0	6.6	232
Services	4.8	6.8	12.2	5.8	-1.5	1.3	1.9	248
HICP excl. energy and unproc. food	2.4	5.2	9.3	3.7	0.0	2.4	2.7	723
HICP at constant taxes ²⁾	3.8	5.5	10.1	0.2	-0.3	4.2	4.3	1000
Administered prices HICP	6.2	9.7	17.0	15.8	6.6	5.0	5.9	167

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.

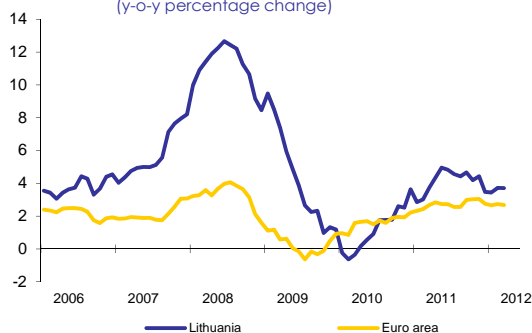
2) Last observation for HICP at constant taxes is February 2012.

Sources: Eurostat, Commission services.

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 gradually to some 5% in May 2011, mainly as a result of substantial commodity price increases. Subsequently, it declined slowly to below 4% at the end of 2011, largely due to lower food price inflation. Annual inflation broadly stabilised in early 2012.

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



Source: Eurostat.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) evolved in parallel with headline inflation in recent years, while mostly remaining somewhat lower. It declined gradually from mid-2008, becoming negative in early 2010, as the large contraction in domestic demand induced a decline in prices of

non-energy industrial goods and services. The inflation contributions of non-energy industrial goods and services became positive again during the first half of 2011, driven by rapidly recovering domestic demand. Core inflation declined again in late 2011, mainly reflecting a smaller inflation contribution of processed food. It then remained broadly stable in early 2012. Annual average producer price inflation for total industry increased to above 10% in 2011, indicating elevated cost price pressures related to commodity price increases.

5.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy-mix and cyclical stance

After contracting by almost 15% in 2009, GDP growth started to recover in 2010 and reached almost 6% in 2011. The recovery was initially driven solely by rapid export growth, implying an associated build-up of inventories, but domestic demand also expanded strongly in 2011, mostly thanks to substantial investment growth. As a result, the output gap, which had turned negative in 2009, narrowed considerably in 2011. According to the Commission services' Spring 2012 Forecast, real GDP growth is projected to fall markedly to 2.4% in 2012 before recovering somewhat to 3.5% in 2013.

The fiscal stance, as measured by changes in the structural balance, was tightened considerably over 2010 and 2011 in line with the gradual recovery in domestic demand. Nevertheless, the structural deficit is estimated to have remained rather elevated at above 4% of GDP in 2011. A further

Table 5.2:

Lithuania - Other inflation and cost indicators		(annual percentage change)						
	2006	2007	2008	2009	2010	2011 ¹⁾	2012 ²⁾	2013 ²⁾
HICP inflation								
Lithuania	3.8	5.8	11.1	4.2	1.2	4.1	3.1	2.9
Euro area	2.2	2.1	3.3	0.3	1.6	2.7	2.4	1.8
Private consumption deflator								
Lithuania	4.7	5.9	10.9	4.5	1.3	4.0	3.2	3.0
Euro area	2.2	2.2	2.7	-0.4	1.7	2.5	2.2	1.7
Nominal compensation per employee								
Lithuania	16.7	13.9	14.3	-9.9	-0.9	3.4	2.1	3.3
Euro area	2.5	2.6	3.4	1.8	1.7	2.2	1.9	1.9
Labour productivity								
Lithuania	5.9	6.8	3.6	-8.6	6.9	3.8	1.8	3.0
Euro area	1.9	1.3	-0.3	-2.4	2.5	1.2	0.1	1.0
Nominal unit labour costs								
Lithuania	10.2	6.6	10.4	-1.4	-7.3	-0.3	0.4	0.3
Euro area	0.8	1.4	3.8	4.2	-0.8	0.8	1.6	0.8
Imports of goods deflator								
Lithuania	8.8	5.0	9.3	-11.5	10.9	14.3	6.0	2.5
Euro area	3.9	1.0	4.2	-7.7	5.7	6.9	3.6	1.3

1) 2011 data (except HICP inflation) are estimates.

2) Commission services' Spring 2012 Forecast.

Source: Eurostat, Commission services.

substantial tightening of the fiscal stance is foreseen for 2012, despite the slowing pace of economic recovery.

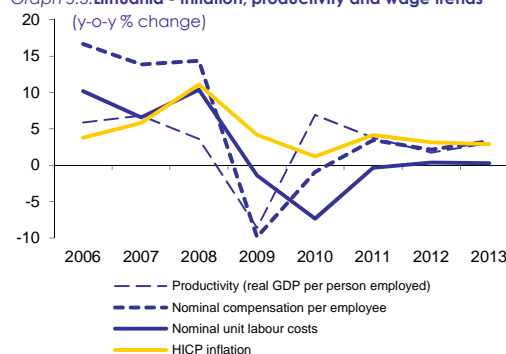
Monetary conditions have been relatively tight in recent years in the framework of the currency board arrangement within ERM II, although real short-term interest rates turned negative during the second half of 2010. Credit conditions worsened significantly in autumn 2008 as the global financial crisis escalated. As a result, the banking sector's loan portfolio has been contracting on an annual basis since mid-2009.

Wages and labour costs

The wage bargaining process in Lithuania is highly decentralised. The labour market situation closely reflected the sharp economic downturn, with unemployment increasing from below 6% in 2008 to almost 18% in 2010 before declining to below 16% in 2011. At the same time, compensation per employee fell by almost 10% in 2009 and then fell further in 2010. This adjustment was supported by a reduction in public sector wages in 2009, followed by a wage freeze extended until 2012. As a result, nominal unit labour costs were falling in 2009 and 2010 despite a significant labour productivity decline in 2009.

In line with the strong recovery in economic activity, compensation per employee started to rise again in 2011. However, due to robust labour productivity growth, unit labour costs still fell marginally in 2011. Lower labour productivity growth is projected to lead to marginal increases in ULC in 2012 and 2013.

Graph 5.3: Lithuania - Inflation, productivity and wage trends



Source: Eurostat, Commission services' Spring 2012 Forecast.

External factors

As a small and open economy, the evolution of import prices significantly affects domestic price formation in Lithuania. In particular, energy and food prices were an important component of imported inflation in the recent past, reflecting their large weight in the HICP basket. Import

prices, as measured by the imports of goods deflator in the national accounts, fell significantly in 2009, mainly reflecting the large drop in prices of primary commodities, accentuated by a moderate nominal effective exchange rate appreciation. Import prices surged in 2010 and 2011, as commodity prices increased rapidly while the nominal effective exchange rate depreciated somewhat in 2010 and then remained broadly stable in 2011. Growth of import prices is expected to moderate in 2012, due to a more favourable outlook for primary commodity price developments.

Administered prices and taxes

Adjustments in administered prices⁽⁵⁶⁾ 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, significantly exceeded HICP inflation in recent years. The average annual increase in administered prices declined from almost 16% in 2009 to below 7% in 2010 and some 5% in 2011, when it was mainly driven by rising prices of gas, heat energy and passenger rail transport. Growth of administered prices should broadly stabilise in 2012.

The standard VAT rate was raised twice in the course of 2009, from 18% to 19% in January and then to 21% in September. In addition, excise duties on cigarettes were increased in March and September 2009. As a result, the average inflation contribution of indirect tax hikes is estimated to have exceeded one percentage point in 2010. Increases in excise taxes on cigarettes and diesel fuel implemented in January 2011 as well as another increase in excise duties on cigarettes effective from March 2012 are estimated to have only a marginal impact on average annual inflation in 2011 and 2012.

Medium-term prospects

The more favourable outlook for primary commodity price developments suggests that the inflation contributions of energy and food products could be somewhat lower in 2012. At the same time, a slower pace of output growth and the

elevated level of unemployment should dampen further domestic price increases. According to the Commission services' Spring 2012 Forecast, average annual inflation is thus projected to decline to about 3% in 2012 and in 2013.

Risks to the inflation outlook appear to be broadly balanced. A negative external shock leading to a larger-than-expected decline in output growth and a related increase in the unemployment rate would likely further dampen domestic price pressures. On the other hand, higher commodity price increases would again be swiftly passed into final consumption prices, with the overall impact amplified by the relatively large weight of commodities in the consumption basket.

The level of consumer prices in Lithuania stood at about 62.5% of the euro area average in 2010. This suggests potential for further price level convergence in the long term, as income levels (around 53% of the euro area average in PPS in 2010) rise towards the euro area average.

Medium-term inflation prospects will depend on wage growth remaining in line with productivity gains. Improvements in the business environment are important in order to support the job creation process and to attract more FDI into manufacturing thus further rebalancing the economy towards the tradable sector. Diversification of supplies and higher competition would also support favourable price developments in the energy sector.

5.3. PUBLIC FINANCES

5.3.1. The excessive deficit procedure for Lithuania

On 7 July 2009, the Council decided that an excessive deficit existed in Lithuania in accordance with Article 104(6) TEC, and, on a recommendation by the Commission, it addressed recommendations to Lithuania in accordance with Article 104(7) TEC with a view to bringing an end to the situation of an excessive deficit by 2011. In its recommendations, the Council established a deadline of 7 January 2010 for effective action to be taken and invited the Lithuanian authorities to implement all fiscal measures as planned in the 2009 budget and in the supplementary May 2009 budget, consider further measures to limit the deterioration of public finances in 2009, and device additional fiscal consolidation measures in

⁽⁵⁶⁾ According to the Eurostat definition, administered prices in Lithuania *inter alia* include 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/met_hodology/administered_prices

2010 and 2011 with an average fiscal effort of at least 1½% of GDP. On 16 February 2010 the Council concluded that the Lithuanian authorities had taken effective action to correct the excessive deficit, but it considered that unexpected adverse economic events with major unfavourable consequences for government finances had occurred, thereby justifying revised recommendations under Article 126(7) TFEU. A new deadline for correction of the excessive deficit by 2012 was given. This required an average annual fiscal effort of 2¼% of GDP over the period 2010-2012, as well as the implementation of the fiscal measures planned in the 2010 budget, adoption of additional measures, if necessary, and continued consolidation in 2011 and 2012. A new deadline of 16 August 2010 was established for Lithuania to take effective action. In its conclusions of 19 October 2010 the Council assessed that Lithuania was making satisfactory progress in correcting its excessive deficit and no further action under the excessive deficit procedure was necessary, thereby putting the procedure in abeyance⁽⁵⁷⁾.

5.3.2. Recent fiscal developments

The recent 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. The measures included substantial cuts in government current expenditure, including differentiated cuts in public sector wages, a 3 percentage points increase in the standard VAT rate and the elimination of most exemptions, as well as a reduction of transfers to the second pillar pension funds. The 2010 budget contained further consolidation measures of above 3% of GDP, mostly on the expenditure side, including notably the public sector wage bill and social benefits. On the revenue side, measures were limited to a full year effect of the VAT rate increase of 2009 and increases in non-tax revenues. As a result, the expenditure-to-GDP ratio fell by 2.9 percentage points to 40.9% in 2010, while the revenue-to-GDP ratio decreased by 0.6 percentage points to 33.7%. The general government deficit went down to 7.2% of GDP in 2010. Fiscal consolidation continued in 2011 and the deficit has fallen to 5.5% of GDP. The

expenditure-to-GDP ratio decreased further to 37.5% following lower spending on personnel, goods and services and social transfers. The revenue-to-GDP ratio fell further to 32.0%, despite the strong recovery of domestic demand and government's efforts to improve tax compliance, mainly reflecting lower tax receipts from corporate profits.

Lithuania's general government deficit was at 5.5% of GDP in 2011 somewhat above the target of 5.3% of GDP set in the 2011 Convergence Programme, mainly due to unforeseen calls on state-guarantees on some corporate loans as well as a higher than planned deficit of local governments. The structural deficit (the cyclically-adjusted balance net of one-offs and other temporary measures) improved from some 7.2% of GDP in 2009 to around 5.1% in 2010 and 4.6% of GDP in 2011 following the implementation of fiscal consolidation measures by the authorities (though structural balances are strongly affected by the large revisions in potential growth following the rapid growth of the Lithuania's economy before the crisis and substantial drop during the crisis). Given the need for urgent fiscal consolidation as well as restoring market confidence, the authorities implemented a pro-cyclical fiscal policy during the severe recession which in Lithuania lasted from the end of 2008 to the beginning of 2010.

While remaining well below 60% of GDP, the debt-to-GDP ratio deteriorated to 38.0% in 2010 from only 15.5% in 2008 as a result of high government deficits and unfavourable effects from the implicit interest rate. The ratio increased somewhat further to 38.5% in 2011 despite high nominal GDP growth and lower implicit interest rates.

5.3.3. Medium-term prospects

The Lithuanian Parliament adopted the 2012 budget on 22 December 2011 targeting a general government deficit of 3.0% of GDP along with a medium-term budgetary framework for 2012-2014. The measures in the budget include further substantial cuts in expenditures, in particular maintaining the public sector wage freeze for the third year. Some temporary measures limiting the growth of social benefits during the crisis have been made permanent. On the other hand, social security pensions, cut at the beginning of the crisis, have been brought back to pre-crisis level. On the revenue side, additional revenue will mainly be

⁽⁵⁷⁾ 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 5.3:

Lithuania - Budgetary developments and projections (as % of GDP unless indicated otherwise)

Outturn and forecast¹⁾	2006	2007	2008	2009	2010	2011	2012	2013	
General government balance	-0.4	-1.0	-3.3	-9.4	-7.2	-5.5	-3.2	-3.0	
- Total revenues	33.0	33.6	33.9	34.3	33.7	32.0	33.5	33.1	
- Total expenditure	33.5	34.6	37.2	43.8	40.9	37.5	36.7	35.9	
of which:									
- Interest expenditure	0.7	0.7	0.7	1.3	1.8	1.8	2.1	2.0	
p.m.: Tax burden	29.6	29.9	30.4	29.7	27.4	26.4	26.9	26.7	
Primary balance	0.3	-0.3	-2.6	-8.2	-5.4	-3.7	-1.2	-0.9	
Cyclically-adjusted balance	-2.2	-3.5	-5.3	-6.8	-5.0	-4.6	-2.6	-2.6	
One-off and temporary measures	0.0	-0.6	-0.1	0.4	0.1	0.0	0.3	-0.5	
Structural balance ²⁾	-2.2	-3.0	-5.2	-7.2	-5.1	-4.6	-2.9	-2.1	
Government gross debt	17.9	16.8	15.5	29.4	38.0	38.5	40.4	40.9	
p.m.: Real GDP growth (%)	7.8	9.8	2.9	-14.8	1.4	5.9	2.4	3.5	
p.m.: Output gap	6.4	9.4	7.5	-9.9	-8.4	-3.3	-2.5	-1.4	
Convergence programme						2012	2013	2014	2015
General government balance						-3.0	-2.0	-1.0	0.0
Structural balance ²⁾³⁾						-2.6	-2.1	-1.5	-0.8
Government gross debt						40.2	38.6	36.7	34.9
p.m. Real GDP (% change)						2.5	3.7	3.4	4.3

1) Commission services' Spring 2012 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 (0.1% of GDP in 2011, 0.3% 2012 to 2013, 0.5% in 2014, 0.4% in 2015; all deficit-increasing).

Sources: Commission services, the 2012 Convergence Programme of Lithuania .

collected from non-tax revenues, including higher dividends from state-owned enterprises and sales of carbon rights. The fiscal plan includes a contingency provision requiring a supplementary budget should revenue fall short of plan or the deficit is likely to be above the target.

Taking into account these measures and the somewhat worse outcome in 2011, the Commission services' Spring 2012 forecast projects the deficit of 3.2% of GDP in 2012. In 2013, some consolidation measures will expire, including the freeze of government wages. However, overall expenditure increase will be contained by the state budget expenditure rule. The government deficit is therefore expected to decrease to 3.0% of GDP in 2013. The overall fiscal stance in 2012, as measured by the change in the structural balance, is expected to be restrictive, showing an improvement of above 1½ percentage point. It will remain restrictive in 2013. The general government debt is expected to increase from 38.5% of GDP in 2011 to nearly 41% of GDP at the end of the forecast period.

The 2012 Convergence Programme, submitted on 27 April 2012, covers the period 2012 to 2015. The main aims of the programme are (i) the

correction of the excessive deficit by 2012, within the deadline recommended by the Council on 16 February 2010 and (ii) making progress towards the medium-term objective (MTO) for the budgetary position of a structural surplus (e.g. the cyclically-adjusted deficit net of one-off and other temporary measures) of 0.5% of GDP over the programme period.

Further details on the assessment of the 2012 Convergence Programme for Lithuania can be found in the forthcoming Commission Staff Working Document, which accompanies the Commission Recommendation for a Council Recommendation on the 2012 National Reform Programme of Lithuania and delivering a Council Opinion on the 2012 Convergence Programme of Lithuania⁽⁵⁸⁾.

In March 2012, Lithuania signed the Treaty on Stability, Coordination and Governance in the EMU. This implies an additional commitment to conduct stability-oriented and sustainable fiscal policies. This Treaty will apply to contracting

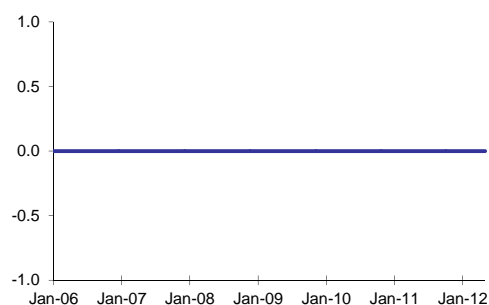
⁽⁵⁸⁾ http://ec.europa.eu/economy_finance/economic_governance/sgp/convergence/programmes/2012_en.htm

Member States with a derogation which have ratified the Treaty as from the date when the decision abrogating that derogation will come into force unless they declare their intention to be bound at an earlier date by some or all of the provisions on the fiscal compact and on economic policy coordination and convergence.

5.4. EXCHANGE RATE STABILITY

Lithuania entered ERM II on 28 June 2004 and has been participating in the mechanism for almost eight 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 $\pm 15\%$. Upon ERM II entry, the authorities unilaterally committed to maintain the currency board within the mechanism. In line with this commitment, there has been no deviation from the central rate since the litas started participating in ERM II.

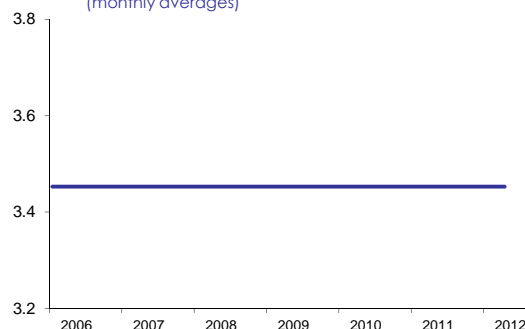
Graph 5.4: LTL - Spread vs central rate
(as percent, daily values)



Source: Commission services, ECB, Reuters EcoWin.

The Bank of Lithuania began operating its 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)

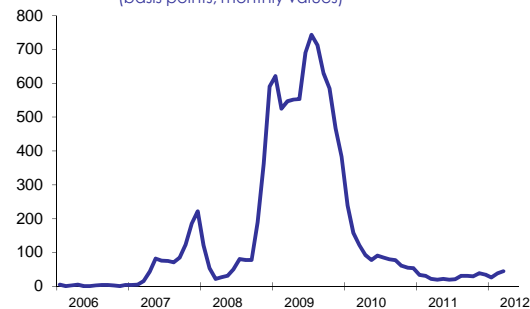


Source: ECB, Reuters EcoWin.

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 remained broadly stable from end-2009 until mid-2011, hovering between EUR 4.5bn and EUR 5bn. They increased to above EUR 6bn at the end of 2011 thanks to strong FDI inflows and successful international sovereign bond issuance. International reserves covered on average around 150% of the monetary base during 2010-2011, well above the required 100% statutory minimum. They accounted for some 157% of short-term external debt at original maturity by the end of 2011.

The Bank of Lithuania 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 operations of Lithuania's currency board arrangement. Nevertheless, varying risk premia led to a substantial divergence of money market rates, especially 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 continued to narrow gradually, declining from around 90 basis points in mid-2010 to some 20 basis points in April 2011. This indicated a steady improvement in the liquidity situation at the domestic interbank market. Short-term spreads widened again to above 30 basis points in the second half of 2011 as monetary policy loosening in the euro area was not fully reflected in local interbank rates. At the cut-off date of this report, the 3-month spread vis-à-vis the euro area amounted to about 45 basis points.

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



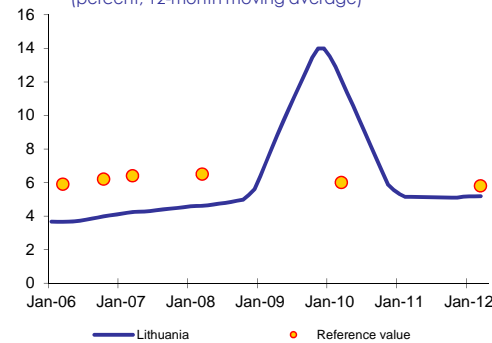
Source: Eurostat.

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 6 years, due to the absence of a suitable alternative bond with longer maturity.

The Lithuanian 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion was above the reference value at the time of the last convergence assessment in 2010. It declined from some 14% at the end of 2009 to below 5.2% in early 2011 and then remained rather stable until early 2012. In March 2012, the latest month for which data are available, the reference value, given by the average of long-term interest rates in Sweden and Slovenia plus 2 percentage points, stood at 5.8%. In that month, the 12-month moving average of the Lithuanian benchmark bond stood at 5.2%, i.e. 0.6 percentage points below the reference value.

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

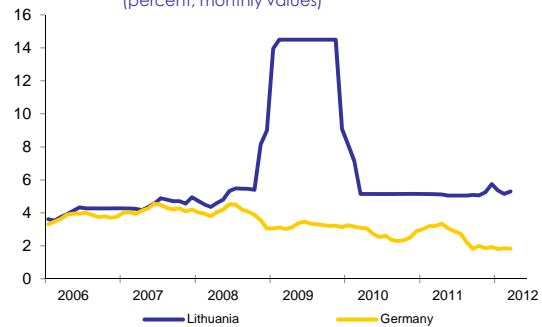


Source: Commission services.

Long-term interest rates remained fairly stable at just above 5% from March 2010 until late 2011

when they increased slightly. Yield developments must, however, be interpreted with great caution as the long-term litas-denominated government bond market is extremely shallow. Nevertheless, the government issued debt securities with original maturity of up to 5 years in 2010 and with original maturity of up to 7 years in 2011. The Lithuanian long-term interest spread vis-à-vis the German benchmark bond⁽⁵⁹⁾ stood at around 350 basis points in early 2012.

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



Source: Eurostat.

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 and financial market integration – is an important indication that the integration of a Member State into the euro area would proceed without difficulties.

The section on additional factors makes reference *inter alia* to 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. Related to this, in February 2012, following the adoption of the legislation establishing the new procedure for surveillance and correction of macroeconomic imbalances (the Macroeconomic Imbalances Procedure - MIP)⁽⁶⁰⁾, the Commission

⁽⁵⁹⁾ The reference to the German benchmark bond is included for illustrative purposes, as a proxy of the euro area long-term AAA yield.

⁽⁶⁰⁾ The package of six legislative proposals to strengthen the economic governance of the EU entered into force in December 2011.

Table 5.4:

Lithuania - Balance of payments	(percentage of GDP)					
	2006	2007	2008	2009	2010	2011
Current account	-10.6	-14.4	-12.9	4.4	1.5	-1.6
of which: Balance of trade in goods	-13.8	-14.9	-12.9	-3.2	-4.6	-4.9
Balance of trade in services	3.6	1.6	1.2	1.9	3.5	3.6
Income balance	-2.7	-4.1	-3.4	1.3	-2.3	-3.8
Balance of current transfers	2.4	3.0	2.2	4.4	4.8	3.5
Capital account	1.2	1.7	1.8	3.4	2.7	2.5
External balance ¹⁾	-9.4	-12.7	-11.1	7.8	4.2	0.9
Financial account	10.4	12.8	11.1	-7.8	-4.2	-0.9
of which: Net FDI	5.0	3.6	3.4	-0.4	1.8	2.5
Net portfolio inflows	-0.8	-0.7	-0.5	2.9	5.1	3.8
Net other inflows ²⁾	11.0	12.9	5.8	-10.6	-9.2	-2.8
Change in reserves (+ is a decrease)	-4.9	-3.0	2.4	0.2	-1.9	-4.5
Financial account without reserves	15.3	15.8	8.7	-8.1	-2.3	3.5
Errors and omissions	-0.9	-0.1	0.0	0.0	0.0	0.0
Gross capital formation	26.0	31.2	26.9	10.5	16.4	18.8
Gross saving	15.8	16.2	13.9	13.2	17.5	17.2
External debt	59.9	71.5	70.9	87.0	87.4	80.8
International investment position	-48.9	-55.8	-51.5	-58.6	-55.9	-52.2

1) The combined current and capital account.

2) Including financial derivatives.

Sources: Eurostat, Commission services, Bank of Lithuania.

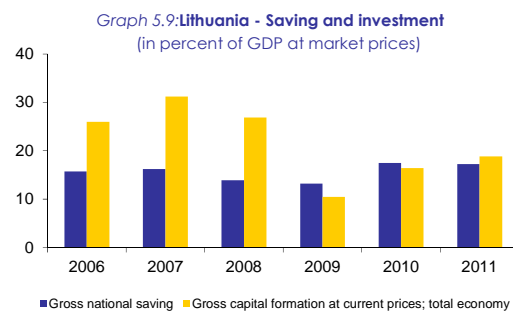
published its first Alert Mechanism Report (AMR) ⁽⁶¹⁾. The AMR scoreboard showed that Lithuania exceeded the indicative threshold for two out of ten indicators (namely the international investment position and the unemployment rate). In line with the conclusion of the AMR, Lithuania was not subject to an in-depth review in the context of the MIP.

5.6.1. Developments of the balance of payments

After turning to a substantial surplus in 2009, Lithuania's external balance (i.e. the combined current and capital account) deteriorated again in 2010 and 2011, reflecting a worsening of both the current and the capital account balance. Despite strong export growth, the trade deficit increased in 2010 and 2011, as the parallel recovery in domestic demand and the closure of the Ignalina nuclear power plant at the end of 2009 resulted in rapidly rising imports. At the same time, the

surplus in the balance of primary incomes and net current transfers also declined gradually.

The primary driver behind the gradually decreasing saving-investment gap in 2010 and 2011 was the recovery in gross capital formation. Gross national saving also increased in 2010, driven by both private and general government sector, before declining somewhat in 2011, as gross saving by the private sector decreased.

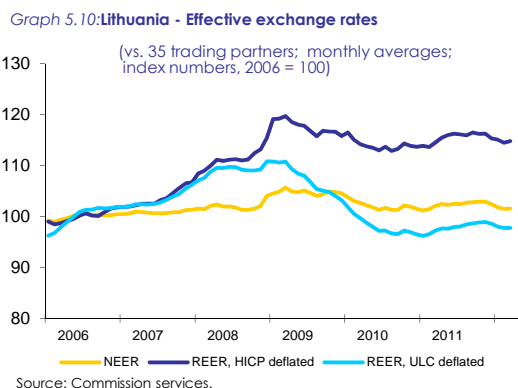


Competitiveness indicators continued to improve in recent years, albeit at a slowing pace. Lithuania succeeded in increasing its export market share in 2010 and to a lesser extent also in 2011. Mainly thanks to favourable domestic price and cost

<http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/898>

⁽⁶¹⁾ http://ec.europa.eu/economy_finance/articles/governance/2012-02-14-alert_mechanism_report_en.htm

developments, the real-effective exchange rate depreciated substantially between early 2009 and mid-2010, in particular when deflated by ULC. It appreciated again somewhat in the course of 2011 as the robust recovery in domestic demand resulted in increased cost and price pressures.



Lithuania managed to attract increasing net inflows of foreign direct investment in 2010 and 2011 while also recording substantial net portfolio investment, mainly thanks to successful sovereign external debt issuance. Although slowing down, net outflows of other investment continued in 2010 and 2011, driven by decreasing external loan liabilities in the banking sector. As a result, total gross external debt decreased to about 81% of GDP at the end of 2011 whereas the negative net international investment position also narrowed somewhat.

According to the Commission services' Spring 2012 Forecast, the external surplus is expected to broadly stabilise in 2012 and 2013 as the negative impact of weaker external demand is foreseen to be offset by a parallel decrease in domestic demand growth.

5.6.2. Product market integration

The Lithuanian economy is well integrated to the EU economy through trade and investment linkages. Trade openness further increased from some 61% in 2005 to almost 69% in 2010, well above the EU27 average (40.1%). During the crisis in 2009, Lithuania's openness indicator decreased as both imports and exports fell substantially, but it recovered quickly in 2010 on the back of rising external demand and a re-orientation of the economy from the non-tradable to the tradable sector. Around 60% of Lithuania's exports of goods are directed to the EU27, with Latvia,

Germany and Poland accounting for around one fourth of the total flow. Through its exports, Lithuania has strong ties to markets outside the EU, mainly to Russia, Belarus and Ukraine.

Low-to-medium-technology goods continue to predominate in Lithuania's exported goods, but a gradual shift to high-technology goods can be observed. Exports of high technology products increased from 3.2% of GDP in 2005 to 7.3% in 2007, but dropped to 5.8% in 2009. The increase in the share of exported capital-intensive goods recorded up to 2007 was partly due to rising re-exports of road vehicles to the CIS countries. Although the contribution of high-tech manufacturing to growth is still relatively limited compared to other non-euro area Member States, the technological trade deficit closed in 2008.

The stock of inward FDI amounted to some 34% of GDP in 2009 (up from 28% in 2008), with a constant share of around 80% of the total coming from EU Member States and one third of the total from the euro area. Despite a relatively favourable business environment and moderate taxes, Lithuania has been struggling to attract higher FDI inflows, with FDI per capita substantially below the average of comparable Central European economies. The reasons most frequently mentioned for the relatively weak attractiveness of the country with respect to FDI relate to red tape, corruption, the uncompleted land reform and the inefficiency of public administration.

Between 2001 and 2007, real house prices recorded double digit annual increases, resulting in cumulative growth of over 240%. From the peak until the third quarter of 2011, real house prices dropped by 45%. Most of the adjustment took place before the end of 2010 and since then real prices seem to have levelled off. FDI tilted towards non-tradable and real estate activities gave an additional impetus to the housing upswing. Over 2002-2008, gross fixed capital formation in dwellings grew from about 1.5% of GDP to close to 3.5% of GDP, followed by a sharp correction back to 1.9% of GDP in 2010.

Concerning the business environment, Lithuania scores broadly in line with the average of euro area Member States in international rankings⁽⁶²⁾. Actions are planned by the government to cut

⁽⁶²⁾ For instance, Lithuania ranks on 44th and 27th place according to the 2011-2012 Global Competitiveness index and the 2012 World Bank Doing Business respectively.

Table 5.5:

Lithuania - Product market integration

	2005	2006	2007	2008	2009	2010
Trade openness ¹⁾ (%)	60.9	63.9	60.5	65.5	55.1	68.9
Intra-EU trade in goods GDP ratio ²⁾ (%)	32.6	35.0	35.3	33.7	28.8	35.5
Intra-EU trade in services GDP ratio ³⁾ (%)	5.3	5.7	5.8	5.8	5.4	5.3
Extra-EU trade in goods GDP ratio ⁴⁾ (%)	19.8	20.4	17.5	23.7	18.0	25.0
Export in high technology ⁵⁾ (%)	3.2	4.7	7.3	6.5	5.8	n.a.
Technological balance ⁶⁾ (%)	-3.4	-2.3	-1.0	0.0	-0.1	n.a.
Total FDI inflows GDP ratio ⁷⁾ (%)	3.9	6.0	5.1	4.3	0.5	2.1
Intra-EU FDI inflows GDP ratio ⁸⁾ (%)	:	9.9	3.7	3.3	-0.3	1.7
FDI intensity ⁹⁾	:	5.3	2.5	1.9	0.1	0.9
Internal Market Directives ¹⁰⁾ (%)	0.4	0.3	0.6	0.6	0.2	0.5
Value of tenders in the EU Official Journal ¹¹⁾	26.3	28.1	25.6	22.2	29.0	26.9
Time to start up a new company ¹²⁾	26.0	26.0	26.0	26.0	26.0	22.0
Real house price index ¹³⁾	100.0	134.8	175.1	168.4	112.1	102.3
Residential investment ¹⁴⁾ (%)	2.2	2.5	2.8	3.4	3.3	1.9
Building permits index ¹⁵⁾	100.0	141.0	164.0	136.0	64.0	71.0

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

2) (Intra-EU-27 Imports + Exports of goods / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).

3) Intra-EU-27 trade in services (average credit and debit in % of GDP at current prices) (Balance of Payments).

4) (Extra-EU-27 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-EU-27 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) Public procurement - Value of public procurement which is openly advertised in the EU Official Journal in total public procurement.

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

13) Experimental house price index (2005=100), Eurostat.

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

15) Number of new residential buildings (2005=100), Eurostat.

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

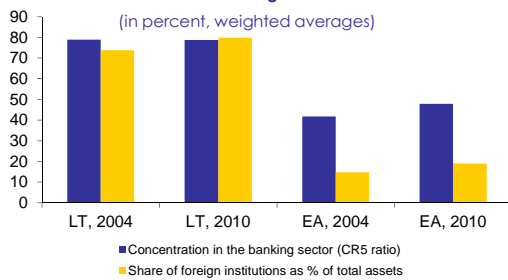
administrative burden, and some progress was made as reflected by the indicator on the time necessary to start a new company. According to the November 2011 Internal Market Scoreboard, Lithuania managed to get back under the 1.0% objective, down from 1.2% in May 2011. The number of infringement procedures open against Lithuania has decreased considerably since 2007 (-39%), so that with 11 cases Lithuania was well below the EU average of 34 cases. In recent years Lithuania has continuously shown a high value share of tenders openly advertised in the EU Official Journal ⁽⁶³⁾, with 26.9% in 2010 well above the EU27 average of 18.6%.

5.6.3. Financial market integration

Lithuania's financial sector is well integrated into the EU financial system. The share of foreign-owned banks increased to 90% in terms of total assets, following the bankruptcy of the largest domestic bank Snoras in late 2011. The banking sector is quite concentrated, with the five largest institutions accounting for almost 87% of its total assets by end-2011.

⁽⁶³⁾ The value of tenders published in the EU Official Journal may serve as a proxy of the extent to which national public procurement is open to foreign bidders.

Graph 5.11: Lithuania - Foreign ownership and concentration in the banking sector

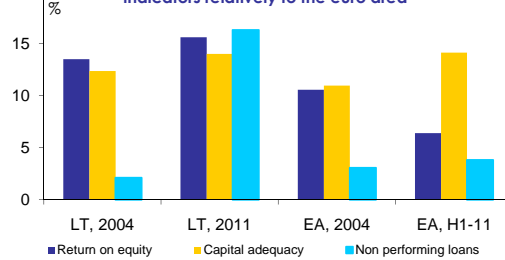


Source: ECB, Structural indicators for the EU banking sector, December 2011.

The size of Lithuania's financial system is still quite small compared to the euro area average, but financial development has progressed over recent years. Banks strongly predominate among financial intermediaries, with their total assets amounting to almost 75% of GDP by end-2011. Bank lending expanded strongly in the run-up to the 2008-09 global financial crisis but banks' loan portfolio has been falling on an annual basis since mid-2009. Credit to the non-financial private sector amounted to about 54% of GDP in 2011. Following the re-pegging of the litas to the euro in 2002, euro-denominated lending increased rapidly in both the household and the corporate sectors. Mainly due to the narrowing gap between interest rates, non-financial corporations and households recently started to borrow more in local currency, with the share of foreign-currency-denominated loans declining to 74% in the corporate and 71% in the household sector by end-2011. Nevertheless, the exposure of the private sector to exchange rate risk remains substantial.

The capital adequacy ratio (CAR) of the banking sector remained broadly stable at some 14% in 2011 with Tier 1 CAR at 12%. At the same time, the quality of loan portfolio started to improve in late 2010, with the share of non-performing loans declining to about 16% by end-2011, driven by the recovery in corporate and consumer loan portfolio quality. As a result, after two years of negative profitability, return on equity increased to above 15% in 2011, partly thanks to a decline in provisions.

Graph 5.12: Lithuania - selected banking sector soundness indicators relatively to the euro area

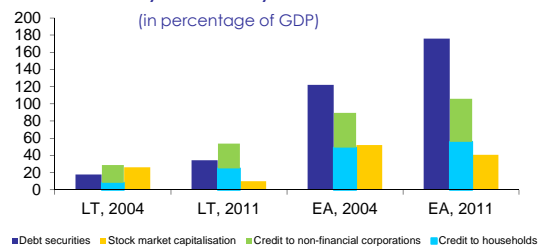


Note: For 2011, EU-27 non performing loans are a proxy for EA. Source: ECB, Bank of Lithuania, EC calculations.

Insurance companies, leasing companies and pension funds still play a relatively minor role in the local financial system. In 2011, 12 insurance companies controlled assets amounting to less than 3% of GDP, 9 leasing companies held assets worth about 6% of GDP while 39 pension funds managed assets valued at close to 4% of GDP.

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. Nevertheless, stock market capitalisation remains relatively low, amounting to some 10% of GDP in 2011. Reflecting the increasing level of central government debt, the outstanding stock of debt securities reached around 34% of GDP in 2011. Private sector debt⁽⁶⁴⁾ of about 80% of GDP in 2010 is still far below the euro area average.

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



Note: Debt Securities other than shares, excluding financial derivatives. Source: Eurostat, ECB, Bank of Lithuania, Nasdaq OMX, Reuters EcoWin.

A joint financial sector supervision department was established inside the Bank of Lithuania in January 2012, which should strengthen the ability of the national authorities to identify and address risks to the financial system. A regulation on responsible lending applicable for new credits issued to natural persons came into effect in

⁽⁶⁴⁾ Data on private sector debt are based on unconsolidated 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.

November 2011. It sets caps on loan-to-value and debt-to-income ratios as well as maximum credit maturity. It also obliges banks to provide information to their customers about probable risks in taking loans in a more comprehensive and responsible way. Moreover, in the context of the Snoras bankruptcy, new legal amendments enhancing the bank resolution framework were adopted in late 2011. Lithuania achieved full compliance with the transposition of the FSAP directives and has transposed most of the post-FSAP directives.

6. HUNGARY

6.1. LEGAL COMPATIBILITY

6.1.1. Introduction

The Magyar Nemzeti Bank (MNB – central bank of Hungary) was founded in 1924 and re-established as a central bank in 1987. The Act LVIII of 2001 on the MNB was amended several times and replaced recently by Act CCVIII of 2011 (hereafter: MNB Act) which entered into force on 1 January 2012. On the same date "Transitional Arrangements" to the Fundamental Law on Hungary and concerning the MNB entered into force. With a view to the central bank independence under Article 130 TFEU, Hungary has announced changes to the MNB Act and the "Transitional Arrangements" to the Fundamental Law recently.⁽⁶⁵⁾

6.1.2. Central bank independence

Pursuant to Article 34(1) and (2) of the MNB Act, the MNB shall submit the agenda of the meetings of the Monetary Council to the government with the latter being represented at the meetings of the Monetary Council by the Minister or a person duly authorised by the Minister. 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 when the latter is adopting decisions for which its independence is protected by the Treaty. The active participation of the Minister, even without voting right, to discussions where monetary policy is set would structurally offer to the government the possibility to influence the central bank when taking its key decisions. The obligation to submit the agenda of the Monetary Council to the government and the systematic participation of the Minister limit also the possibility for the central bank to hold confidential discussions and offer the possibility for the government to seek to influence them. Therefore,

Article 34(1) and (2) is incompatible with Article 130 of the TFEU, as Member States must undertake not to seek to influence the members of the decision-making bodies of the national central bank.

According to Article 46(7) Monetary Council members – including the Governor – must swear an oath in front of the Hungarian President (Governor) or the Hungarian Parliament (other members of the Monetary Council). Compared to the 2010 Convergence Report the text of the oath has been amended and is no longer deemed incompatible with the TFEU. However, the oath is still considered as an imperfection, as it does not contain an explicit reference to the central bank independence enshrined in Article 130 TFEU. Since the Monetary Council members 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.

Further to Article 46 (17) of the MNB Act, the Monetary Council shall cease to exist on the day of entry into force of the termination of the derogation pursuant to Article 140 TFEU. Given that the Governor is a member of the Monetary Council, it must be guaranteed that with the abolition of the Monetary Council and its inherent ending of the members' functions, the term of office of the Governor does not end automatically, but only at the end of his regular mandate, in line with 130 TFEU. This imperfection of Article 46(17) should be remedied.

Article 51(1) of the MNB Act provides for a remuneration scheme of the Governor to be applied pursuant to Article 66(1) as of entering into force of the MNB Act (1 January 2012). The MNB Act provides for a cap on the salary to be calculated in relation to the Hungarian average monthly gross salary as introduced as a salary adjustment in the Hungarian public sector under Law XC of 2010. The MNB Act entered into force during the term of office of the incumbent Governor. The capped remuneration is significantly lower compared to the remuneration paid at the beginning of the term of office of the Governor. The new remuneration scheme applying to the incumbent Governor can be considered as not being a means of pressure prohibited by Article 130 of the TFEU to the extent that the

⁽⁶⁵⁾ On 7 March 2012, Hungary submitted a draft law amending the MNB act law for consultation of the ECB pursuant to Article 127(4) TFEU. The draft law provides for repealing Articles 34, 46(10) and (17) of the MNB act as well as of Article 30 of Transitional arrangements to the Hungarian Fundamental Law. If adopted this law will remedy the legal problems identified in this document.

remuneration cap under Law XC of 2010 as perpetuated in Article 51 (1) of the MNB act was a part of a general review of the remuneration regime of the public function in Hungary and not solely targeting the Governor.

Article 30 of the "Transitional Arrangement" to the Fundamental Law allows placing the Governor under hierarchical responsibility of the new President of a merged body composed of the MNB and the Financial Supervisory Authority, the effect of which would be to negate the Governor's independence. This provision is incompatible with Article 130 of the TFEU.

6.1.3. Prohibition of monetary financing and privileged access

Under Article 12(4) of the Act on the MNB, the central bank is allowed, subject to the prohibition of monetary financing to extend emergency loans to credit institutions in the event of circumstances which jeopardize the stability of the financial systems. In order to comply with the prohibition on monetary financing of Article 123 of the TFEU– it should be clearly specified that the loan is granted against adequate collateral to ensure that the MNB would not suffer any loss in case of debtor's default.

Pursuant to Article 13, the MNB may grant loans to the National Deposit Insurance Fund in emergency cases, subject to prohibition of monetary financing under Article 15 of the Act. Though the Act adequately reflects the 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, it constitutes therefore an incompatibility with the prohibition on monetary financing, as foreseen by the Article 123 of the TFEU.

6.1.4. Integration in the ESCB

Objectives

The secondary objective of the MNB (Article 3(2)) refers to the general economic policy of the government, while it should make a reference to the general economic policies in the Union, with the latter taking precedence over the former, as it is provided under Article 127 of the TFEU.

Tasks

The incompatibilities in the Act derive from the following ESCB/ECB tasks:

- definition of monetary policy and the monetary functions, operations and instruments of the ESCB (Articles 4 to, 9, 11, 13, 46, 59 and 65); Article 41 of the Fundamental Law of Hungary;
- conduct of foreign exchange operations and the definition of foreign exchange policy (Articles 4(3) and (4), 10, 16 and 59(2));
- competences of the ECB and of the Council for banknotes and coins (Articles 4(2), 27 to 30 and 65(1));

There are also some imperfections in the Act regarding:

- non recognition of the role of the ECB for the functioning of the payment systems (Articles 4(5)(a-b), 19 and 20, 23(b) and 65(2-3));
- non recognition of the role of the ECB and of the EU for the collection of statistics (Articles 4(6), 21, 65(1));
- non recognition of the role of the ECB in the field of international cooperation (Article 36(4));
- absence of an obligation to comply with the Eurosystem's regime for the financial reporting of NCB operations (Article 49(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 for the appointment of external auditors (Articles 41, 43(1)(b)).

6.1.5. Assessment of compatibility

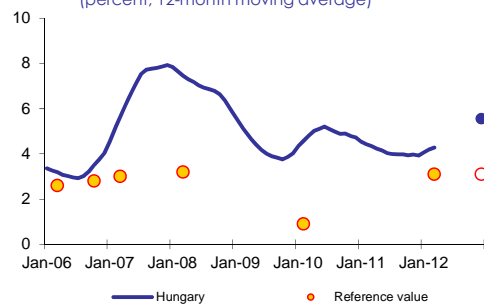
As regards central bank integration into the ESCB at the time of euro adoption, independence as well as the prohibition on monetary financing, existing Hungarian legislations, in particular the Act on the MNB and the Transitional Provisions to the Fundamental Law of Hungary, are not fully compatible with the compliance obligations under 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 each convergence assessment since EU accession. After increasing from 3.8% in October 2009 to 5.2% in June 2010, average annual inflation declined gradually to just below 4% in July 2011. It then remained stable in the second half of 2011 before rising again in early 2012. In March 2012, the reference value was 3.1%, calculated as the average of the 12-month average inflation rates in Ireland, Sweden and Slovenia plus 1.5 percentage points. The corresponding inflation rate in Hungary was 4.3%, i.e. 1.2 percentage points above the reference value. The 12-month average inflation rate is projected to move well above the reference value in the months ahead.

Graph 6.1: Hungary - Inflation criterion since 2006
(percent, 12-month moving average)



Note: The dots in December 2012 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2012 Forecast.

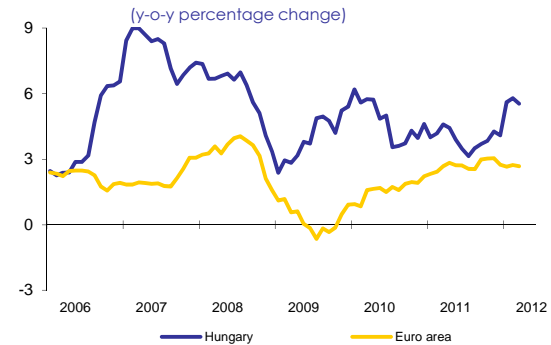
6.2.2. Recent inflation developments

Inflation has been rather volatile in Hungary in recent years, mainly as a reflection of the evolution of energy and food prices, which together represent more than 40% of the HICP basket, with processed food having the largest impact. Changes in administered prices and taxation further amplified inflation volatility.

Annual HICP inflation peaked at above 6% in January 2010, pushed up by indirect tax hikes adopted in 2009 and a pass-through from a weaker exchange rate. Amid substantial volatility, consumer price inflation broadly followed a downward trend, declining to close to 3% in July 2011, as the inflationary impact of one-off measures faded and the exchange rate strengthened. Annual inflation increased again in

the second half of 2011, driven mainly by energy price increases reflecting higher commodity prices and a weaker exchange rate. In early 2012, a new round of indirect tax hikes induced a further jump in consumer prices.

Graph 6.2: Hungary - HICP inflation



Source: Eurostat.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) broadly mirrored the evolution of HICP inflation, recording a large decline in mid-2010 and then slowly increasing again throughout 2011. Processed food prices were the main driver of core inflation recently, reflecting both unprocessed food price developments and indirect tax hikes. Inflation contributions of services and non-energy industrial goods decreased substantially in mid-2010 as the inflationary effect of the July 2009 VAT hike faded and the sluggish pace of economic recovery limited further price increases. Although increases in non-energy industrial goods and services prices picked up somewhat during 2011, they remained far below the headline inflation rate. Another increase in the higher VAT rate in January 2012 pushed up all main components of core inflation. Annual producer price inflation for total industry averaged around 6% in 2011, indicating significant cost price pressures related to commodity price increases.

6.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and cyclical stance

Having contracted by almost 7% in 2009, the Hungarian economy expanded by 1.3% in 2010 and 1.7% in 2011. The sluggish pace of economic recovery was mainly caused by the contraction in bank lending constraining household consumption and corporate investment, leaving net exports as

Table 6.1:

Hungary - Components of inflation	(percentage change) ¹⁾							weights
	2006	2007	2008	2009	2010	2011	Mar-12	in total
HICP	4.0	7.9	6.0	4.0	4.7	3.9	4.3	1000
Non-energy industrial goods	-0.4	3.7	1.3	3.5	1.9	1.3	1.9	231
Energy	7.1	13.6	12.1	2.1	11.8	9.3	9.3	168
Unprocessed food	15.7	11.5	4.5	6.3	5.9	2.8	0.3	74
Processed food	4.1	10.3	10.9	4.4	4.0	6.1	7.1	199
Services	4.3	7.1	5.1	4.5	3.9	2.1	2.7	329
HICP excl. energy and unproc. food	2.5	6.7	5.1	4.1	3.3	3.0	3.7	759
HICP at constant taxes ²⁾	5.3	6.6	5.9	2.2	2.5	3.7	3.7	1000
Administered prices HICP	6.5	19.1	10.2	7.2	6.7	4.8	4.9	170

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.

2) Last observation for HICP at constant taxes is February 2012.

Sources: Eurostat, Commission services.

the only significant driver of growth. As a result, actual output remained a couple of percentage points below potential. According to the Commission services' Spring 2012 Forecast, real GDP growth is expected to come to a standstill in 2012, reflecting the slow-down in the country's main export markets, before recovering back to around 1% in 2013.

The fiscal policy stance, as measured by changes in the structural balance, was loosened in recent years. After a counter-cyclical tightening in 2009, the structural balance deteriorated in 2010 and 2011. During 2009, significant fiscal adjustment measures were adopted in the context of the EU-IMF balance of payments assistance programme to restore investor confidence in the Hungarian economy. However, once the financial market situation stabilised, fiscal policy was deployed to support the economic recovery. The fiscal stance is expected to be tightened again in 2012.

Monetary policy, conducted within an inflation targeting framework⁽⁶⁶⁾, was relatively tight in the recent period mainly to contain excessive financial market volatility. As a result, real short-term interest rates remained positive between mid-2010 and early 2012 despite the slow pace of economic recovery. In October 2008, the MNB increased its main policy rate by 300 basis points to 11% in an attempt to stabilise the exchange rate in the midst of the financial market turmoil. Following the granting of balance-of-payments assistance by international institutions and subsequent gradual improvements in the financial market situation, the

policy rate was gradually decreased by 625 basis points to 5.25% by April 2010. Faced with accelerating energy and food price inflation, the MNB then increased its main policy rate again in three successive 25bp steps between November 2010 and January 2011. Thereafter, it kept the main policy rate on hold until late 2011 when in view of escalating financial market tensions, the monetary policy stance was tightened by two successive 50 basis point hikes in November and December, bringing the policy rate to 7%.

Wages and labour costs

The Hungarian labour market is relatively flexible, with a decentralized wage setting and a low coverage of collective agreements. Large increases in unit labour costs prior to the 2008 crisis were mainly driven by wage settlements in the public sector, which also influenced private sector behaviour, as well as by sizeable minimum wage hikes. The labour market reacted rather swiftly to the sharp economic downturn, with compensation per employee declining over 2009 and 2010 reflecting wage cuts in the public sector as well as surging unemployment. However, as the downward adjustment initially did not fully match the drop in labour productivity, unit labour costs only fell in 2010 when labour productivity had already recovered somewhat. Compensation per employee started to increase in 2011, again outpacing labour productivity growth. Unit labour costs are expected to rise further in 2012 and 2013, as increases in compensation per employee, also pushed up by a substantial increase in the minimum wage in 2012, are foreseen to exceed labour productivity growth, which is likely to be negative.

⁽⁶⁶⁾ Following a decision in August 2005, the MNB has pursued 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:

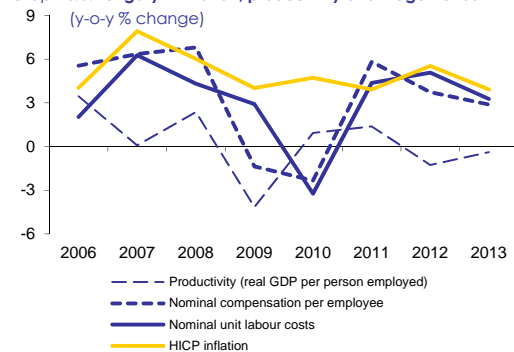
Hungary - Other inflation and cost indicators	(annual percentage change)							
	2006	2007	2008	2009	2010	2011 ¹⁾	2012 ²⁾	2013 ²⁾
HICP inflation								
Hungary	4.0	7.9	6.0	4.0	4.7	3.9	5.5	3.9
Euro area	2.2	2.1	3.3	0.3	1.6	2.7	2.4	1.8
Private consumption deflator								
Hungary	3.5	6.9	5.3	3.7	4.2	4.4	5.5	3.9
Euro area	2.2	2.2	2.7	-0.4	1.7	2.5	2.2	1.7
Nominal compensation per employee								
Hungary	5.6	6.4	6.8	-1.4	-2.3	5.8	3.7	2.9
Euro area	2.5	2.6	3.4	1.8	1.7	2.2	1.9	1.9
Labour productivity								
Hungary	3.5	0.1	2.4	-4.2	0.9	1.4	-1.3	-0.4
Euro area	1.9	1.3	-0.3	-2.4	2.5	1.2	0.1	1.0
Nominal unit labour costs								
Hungary	2.0	6.3	4.3	2.9	-3.2	4.4	5.1	3.3
Euro area	0.8	1.4	3.8	4.2	-0.8	0.8	1.6	0.8
Imports of goods deflator								
Hungary	8.0	-4.4	1.7	1.1	1.9	5.1	7.8	1.4
Euro area	3.9	1.0	4.2	-7.7	5.7	6.9	3.6	1.3

1) 2011 data (except HICP inflation) are estimates.

2) Commission services' Spring 2012 Forecast.

Source: Eurostat, Commission services.

Graph 6.3: Hungary - Inflation, productivity and wage trends



Source: Eurostat, Commission services' Spring 2012 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. Growth of import prices, as measured by the imports of goods deflator in the national accounts, had an inflationary impact in recent years. Import price dynamics have been significantly influenced by exchange rate fluctuations. Having depreciated by more than 8% in 2009, the nominal effective exchange rate stabilised in 2010 before depreciating sharply in the second half of 2011. At the same time, following a substantial fall in 2009, prices of primary commodities, including crude oil, surged

in 2010 and 2011. The impact of higher energy prices on headline inflation was accentuated by their relatively high weight in the HICP basket. Growth of import prices thus accelerated in recent years and is expected to increase further in 2012, reflecting the recent substantial exchange rate depreciation.

Administered prices and taxes

The share of administered prices⁽⁶⁷⁾ in the Hungarian HICP is around 17%. From 2004 to 2011, the growth rate of administered prices was significantly higher than headline inflation, reaching on average almost 10%. Sectors that contributed the most to administered price inflation were energy, services related to housing as well as transportation. This was mainly the consequence of global commodity price increases, reductions in subsidies as well as substantial investment needs in certain regulated sectors. The average annual increase in administered prices declined from 6.7% in 2010 to below 5% in 2011, driven by higher prices of gas, heat energy, postal services as well

⁽⁶⁷⁾ 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/met_hodology/administered_prices

as refuse and sewerage collection. Administered price inflation is expected to increase somewhat in 2012 as a result of the increase in the main VAT rate.

Changes in taxation related to fiscal adjustment measures have also had a substantial impact on inflation since 2009. In July 2009, the VAT rate for around 85% of the consumer basket increased from 20% to 25%, while the VAT rate for approximately 8% of the basket declined from 20% to 18%. From January 2012, the upper VAT rate was raised again to 27%. Due to weak demand conditions, retailers were not immediately able to pass through to consumers the full extent of these VAT increases. Excise duties have also been increased gradually to support fiscal consolidation efforts and to comply with the minimum level of excise duties on cigarettes required in the EU. Having exceeded 1½ percentage points in 2010, the inflation contribution of indirect tax increases is estimated to have been only marginal in 2011. However, indirect tax increases are expected to contribute about 2 percentage points to average consumer price inflation in 2012.

Medium-term prospects

Inflation is currently driven by the pass-through from the substantially weaker exchange rate as well as by indirect tax increases adopted in late 2011. As a result, if the exchange rate stabilises, a significant disinflation process could arise in 2013 when the inflationary impact of one-off measures is expected to fade. At the same time, the substantial negative output gap should constrain underlying inflationary pressures and potential second round effects. According to the Commission services' Spring 2012 Forecast, HICP inflation is thus projected to average 5.5% in 2012 and just below 4% in 2013.

Risks to inflation appear to be broadly balanced. A negative external shock leading to a lower-than-expected output growth and higher unemployment would likely heighten the disinflationary impact of the negative output gap. On the other hand, higher commodity price increases would likely be rapidly reflected in final consumption prices, with the overall impact amplified by the relatively large weight of commodities in the consumption basket.

The level of consumer prices in Hungary was at some 62% of the euro area average in 2010. As in other new Member States, the remaining gap vis-à-

vis the euro area is larger for services than goods. This suggests potential for further price level convergence in the long term, as income levels (around 60% of the euro area average in PPS in 2010) 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 to prevent skill mismatches, in particular for the low-skilled. Further fiscal consolidation will also be important to stem inflationary risks, especially when cyclical conditions improve.

6.3. PUBLIC FINANCES

6.3.1. The excessive deficit procedure for Hungary

Hungary is in EDP since the year of its accession to the EU. The Council decided on 5 July 2004 that an excessive deficit existed and made recommendations under Article 104(7) of the Treaty establishing the European Community (TEC) with a view to bringing the excessive deficit situation to an end by 2008. After deciding twice, in January and November 2005, in accordance with Article 104(8) TEC, that Hungary had not taken effective action, the Council issued for the third time a recommendation on October 2006, this time postponing the deadline to 2009. In July 2009, the Council concluded that the Hungarian authorities could be considered to have taken effective action and, against the background of the economic and financial crisis, postponed the deadline by two years to 2011. On 27 January 2010 the Commission concluded that Hungary had taken effective action within the given six-month period, but warned of considerable risks. On 24 January 2012, the Council established that Hungary had not taken effective action in response to the latest Council Recommendations of July 2009, as compliance with the 3% of GDP reference value by Hungary in 2011 was not based on a structural and sustainable correction. Specifically, a structural deterioration of 2¼ percentage points of GDP over 2010-2011 was estimated by the Commission services against the 0.5 percentage points of GDP cumulative adjustment recommended by the Council. Moreover, the 2013 deficit was projected by the Commission services to surpass the reference value again (at 3¼% of GDP) even after taking

Table 6.3:

Hungary - Budgetary developments and projections (as % of GDP unless indicated otherwise)

Outturn and forecast¹⁾	2006	2007	2008	2009	2010	2011	2012	2013	
General government balance	-9.4	-5.1	-3.7	-4.6	-4.2	4.3	-2.5	-2.9	
- Total revenues	42.7	45.6	45.5	46.9	45.2	52.9	46.1	44.6	
- Total expenditure	52.2	50.7	49.2	51.4	49.5	48.7	48.7	47.7	
of which:									
- Interest expenditure	3.9	4.2	4.2	4.7	4.1	4.1	4.1	4.2	
p.m.: Tax burden	37.4	40.5	40.4	40.2	37.8	36.9	38.3	37.4	
Primary balance	-5.5	-1.0	0.5	0.1	-0.1	8.3	1.5	1.2	
Cyclically-adjusted balance	-11.4	-6.4	-4.8	-2.2	-2.4	5.3	-1.3	-2.0	
One-off and temporary measures	-0.3	-0.9	-0.4	-0.1	1.2	9.6	0.8	0.0	
Structural balance ²⁾	-11.1	-5.5	-4.4	-2.2	-3.6	-4.3	-2.1	-2.0	
Government gross debt	65.9	67.1	73.0	79.8	81.4	80.6	78.5	78.0	
p.m.: Real GDP growth (%)	3.9	0.1	0.9	-6.8	1.3	1.7	-0.3	1.0	
p.m.: Output gap	4.5	2.8	2.3	-5.1	-3.9	-2.3	-2.7	-2.0	
Convergence programme						2012	2013	2014	2015
General government balance						-2.5	-2.2	-1.9	-1.5
Structural balance ²⁾³⁾						-1.9	-1.2	-1.1	-0.9
Government gross debt						78.4	77.0	73.7	72.7
p.m. Real GDP (% change)						0.1	1.6	2.5	2.5

1) Commission services' Spring 2012 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 (9.4% of GDP in 2011, deficit-reducing; 0.8% of GDP in 2012, deficit-reducing; 0.2% of GDP in 2013, deficit-reducing; 0.0% in 2014-2015).

Sources: Commission services, the 2012 Convergence Programme of Hungary.

into account additional measures announced in mid-December 2011. A new (the fifth) recommendation under Article 126(7) has been issued by the Council on 13 March 2012. The Council also endorsed the Commission proposal of 22 February 2012 to partially suspend commitments of the EU Cohesion Fund for 2013, because of non-compliance with the previous Council recommendation to correct its excessive deficit⁽⁶⁸⁾.

6.3.2. Recent fiscal developments

Despite the major contraction of the economy of in 2009, the fiscal adjustment programme supported by EU-IMF financial assistance managed to stabilise the headline deficit at around 4-4.5% of GDP in 2008 and 2009 as well as to improve the structural balance in 2009 by more than 2% of GDP; this was based on important consolidation efforts carried out from a very high starting level of over 9% of GDP in 2006. In 2010, the general government deficit was 4.2 % of GDP, exceeding somewhat the target of 3.8 % of GDP. Although

the economic recovery was faster than expected, it did not result in higher revenues since the structure of GDP turned out to be less tax-rich. This overrun was the result of a combination of important expenditure slippages and revenue shortfalls (partly related to some within-the-year tax cuts of around 0.3% of GDP) amounting to over 3% of GDP. On the other hand, this overrun was almost counterbalanced by the introduction of extraordinary taxes on selected sectors amounting to 1¼% of GDP and other expenditure savings measures, including notably the elimination of the extraordinary reserves of 0.6% of GDP. Given the nature of the budgetary correction package (one-off revenues compensated for the excess deficit), the structural deficit deteriorated by 1½% of GDP.

In the 2011 Convergence Programme, the government target was a surplus of 2% of GDP for 2011, despite significant tax cuts of 2½% of GDP in the second half of 2010 and in 2011. The budgetary surplus was foreseen to be achieved primarily due to huge one-off revenues (the transfer of the accumulated assets estimated at some 9¾% of GDP) linked to the elimination of the obligatory private pension scheme. This also resulted in a permanent increase in revenues of

⁽⁶⁸⁾ 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

around 1.3% of GDP since the pension contributions of the switched back employees (97% of all members) are to be paid into the public pillar instead of the private one. In June 2011, the budget was amended to integrate additional permanent saving measures of close to 1% of GDP at the line ministries which was primarily needed to compensate for the lower than originally expected economic growth (3% vs 1.7%). The 2011 outturn was 4.3% of GDP, i.e. more than 2 percentage points improvement compared to the target. This is chiefly due to the fact that some originally foreseen one-off operations were not (or only partially) implemented: (i) instead of the planned full takeover of the 1.3% of GDP debt stock of public transport companies, only 0.2% of GDP was assumed by the state, and (ii) the government decided to abort its 0.7% of GDP programme to buy-out PPP projects. The 2011 deficit net of one-off effects is estimated to be around 5¼% of GDP.

Gross public debt increased from 79.7% of GDP in 2009 to 81.3% in 2010, which primarily reflects an adverse denominator effect due to low nominal growth. In 2011, gross public debt declined slightly to 80.6% of GDP. This small improvement is the result of a sizeable primary surplus of 8.3% of GDP (generated by one-off revenues), which is to a large extent offset by the significant depreciation of the forint by over 10% compared to its end-2010 level.

6.3.3. Medium-term prospects

The 2012 budget was adopted by Parliament on 20 December 2011. It targets a deficit of 2.5% of GDP in line with the latest Convergence Programme. On the revenue side, the budget contains revenue increasing measures of around 2% of GDP, including notably a 2 percentage points hike in the standard VAT rate and increases in the excise duties; it also contains the continuation of temporary sectoral levies of 0.9% of GDP. On the expenditure side, it incorporates several structural measures, mainly in line with the Széll Kálmán Plan, in particular savings in unemployment benefits, disability pensions and pharmaceutical subsidies. Moreover, additional measures of around 1% of GDP are also budgeted, such as the nominal wage freeze in the public sector. In order to counterbalance the negative budgetary effect of potential unforeseen adverse developments, a substantial extraordinary budgetary reserve of 1.1% of GDP was established

(on top of the standard general reserve of 0.3% of GDP). In the context of the 2012 Convergence Programme, the government announced further saving measures with a budgetary impact of 0.3% of GDP in 2012, including a levy on the telecommunication services.

The Commission services' Spring 2012 Forecast projects the 2012 deficit to reach 2.5% of GDP. On the basis of the usual no-policy change assumption, it forecasts a deficit of 2.9% of GDP for 2013. Following a cumulative deterioration of more than 2% of GDP in 2010 and 2011, the structural balance is expected to improve by over 2% of GDP to around 2% of GDP by 2012, and improve slightly further in 2013. Assuming that no public assets will be sold throughout the forecast horizon, the gross public debt is expected to decrease to around 78% of GDP in 2013.

The 2012 Convergence Programme was submitted on 23 April. It confirmed the deficit path laid down in the 2011 Convergence Programme for the 2012-2015 period, targeting deficits of 2.5%, 2.2%, 1.9% and 1.5% of GDP, respectively. As regards 2012, the Commission services' Spring 2012 Forecast of 2.5% of GDP is identical with the official target. However, while the authorities' forecast presented in the 2012 Convergence Programme calculates with a still remaining extraordinary reserve of close to 0.4% of GDP, the Commission services currently project that no further reserve will be left.⁽⁶⁹⁾ This difference is explained by expenditure slippages of this magnitude projected by the Commission services, mainly related to the pharmaceutical subsidies, the transport sector and budgetary institutions. For 2013, the difference between the two deficit projections is 0.7% of GDP. This is chiefly explained by the fact that slightly over half of the additional saving measures (including tax increases, the introduction of new taxes such as the financial transaction tax, and expenditure cuts) could not be incorporated in the forecast due to the lack of specification and implementation risks. In addition, the Commission services project weaker economic growth for both 2012 and 2013.

Further details on the assessment of the 2012 Convergence Programme for Hungary can be found in the forthcoming Commission Staff Working Document, which accompanies the

⁽⁶⁹⁾ This approach is based on a specific governing regulation contained in the budget bill which is assumed to ensure the cancellation of this reserve in case of slippages.

Commission Recommendation for a Council Recommendation on the 2012 National Reform Programme of Hungary and delivering a Council Opinion on the 2012 Convergence Programme of Hungary ⁽⁷⁰⁾.

In March 2012, Hungary signed the Treaty on Stability, Coordination and Governance in the EMU. This implies an additional commitment to conduct stability-oriented and sustainable fiscal policies. This Treaty will apply to contracting Member States with a derogation which have ratified the Treaty as from the date when the decision abrogating that derogation will come into force unless they declare their intention to be bound at an earlier date by some or all of the provisions on the fiscal compact and on economic policy coordination and convergence.

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. 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 exhibited high volatility in recent years. After having enjoyed a period of relative stability between August 2009 and April 2010 in the context of the EU-IMF balance of payments assistance programme, the forint depreciated sharply in May 2010 and remained weaker throughout the summer reflecting increased uncertainty about the future course of economic policy following parliamentary elections and the formation of a new government in spring 2010. The forint exchange rate against the euro followed a mild appreciating trend from September 2010 until April 2011 and then broadly stabilised for another three months, as the government proclaimed a strong commitment to public debt

reduction while the monetary policy stance was also tightened somewhat in late 2010 and early 2011.

Subsequently, mounting financial market tensions in weaker euro area economies started to negatively affect local FX markets in central and eastern Europe. The forint suffered the largest losses, weakening by some 12% against the euro between July and December 2011, also due to some controversial domestic economic policy measures, such as the possibility to repay FX mortgage loans at historical exchange rates. It recovered somewhat in early 2012 amid a pick-up in global risk appetite accentuated by expectations that an agreement on precautionary balance of payments assistance by the EU and the IMF would be reached soon. During the two years before this assessment, the forint depreciated against the euro by 6.5%.

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



The stock of international reserves jumped by some EUR 5 billion in November 2008 and then gradually increased to above EUR 30 billion in summer 2009, reflecting successive disbursements of balance of payments assistance from international institutions. International reserves continued to follow an upward trend until mid-2010, benefiting from the sharp improvement in the external balance which turned into surplus in the second quarter of 2009. The reserve level thereafter temporarily stabilised, before recording further increases in spring 2011 as a result of successful international sovereign bond issuance. International reserves peaked at above EUR 38bn in October 2011 before sovereign external debt redemptions and accelerated deleveraging in the banking sector led to a decline in the reserve level to below EUR 35bn by March 2012. At the end of 2011, international reserves covered about 155% of short-term external debt at original maturity.

⁽⁷⁰⁾ http://ec.europa.eu/economy_finance/economic_governance/sgp/convergence/programmes/2012_en.htm

Short-term interest rate differentials vis-à-vis the euro area declined gradually from above 800 basis points in July 2009 to below 450 basis points in summer 2010, reflecting successive domestic monetary policy rate cuts, which were mainly enabled by the improving local financial market situation. They increased to around 500 basis points in early 2011, as domestic monetary policy was tightened somewhat, before declining marginally in spring 2011 due to rising short-term rates in the euro area. In late 2011, rapidly deteriorating financial market sentiment and the associated re-launching of the domestic rate-hiking cycle combined with monetary policy loosening in the euro area set spreads on a steep upward trajectory. At the cut-off date of this report, the 3-month spread vis-à-vis the euro area reached some 640 basis points.

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

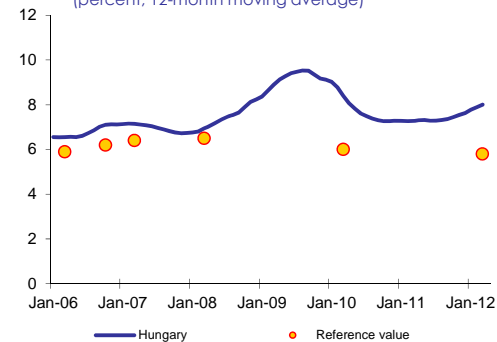


6.5. LONG-TERM INTEREST RATES

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 of close to 10 years.

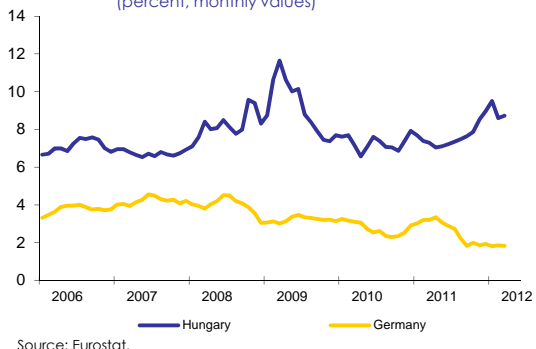
The Hungarian 12-month moving average long-term interest rate relevant for the assessment of convergence has been above the reference value at the time of each convergence assessment since EU accession. It followed a downward trend since August 2009, falling to below 7.3% in late 2010, starting to increase again in the second half of 2011. In March 2012, the reference value, defined by the average of long-term interest rates in Sweden and Slovenia plus 2 percentage points, stood at 5.8%. In that month, the twelve-month moving average of the yield on the Hungarian benchmark bond had reached 8.0%, 2.2 percentage points above the reference value.

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



Between September 2009 and September 2011 long-term interest rates mainly oscillated between 6.5% and 8%. Afterwards, they followed a steep upward trend exceeding 9% in January 2012 as a number of controversial policy measures adopted by the Hungarian authorities raised investors' concerns regarding local financial stability. Long-term spreads vis-à-vis the German benchmark bond ⁽⁷¹⁾ stood at some 690 basis points in March 2012.

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



6.6. ADDITIONAL FACTORS

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

⁽⁷¹⁾ 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)					
	2006	2007	2008	2009	2010	2011
Current account	-7.4	-7.3	-7.3	-0.1	1.2	1.4
of which: Balance of trade in goods	-2.7	-0.7	-1.1	2.6	3.3	4.0
Balance of trade in services	1.6	1.3	1.4	2.2	3.0	3.2
Income balance	-5.9	-7.4	-7.1	-5.3	-5.5	-6.3
Balance of current transfers	-0.3	-0.5	-0.5	0.5	0.4	0.5
Capital account	0.8	0.7	1.0	1.2	1.8	2.1
External balance ¹⁾	-6.6	-6.6	-6.4	1.1	3.0	3.6
Financial account	8.8	6.6	8.5	-0.7	-1.4	-1.8
of which: Net FDI	2.6	0.2	2.6	0.1	0.7	-0.1
Net portfolio inflows	5.8	-1.6	-2.4	-4.1	-0.2	6.5
Net other inflows ²⁾	1.5	8.1	15.7	9.4	1.2	-4.3
Of which International financial assistance			6.6	8.0	0.0	-2.0
Change in reserves (+ is a decrease)	-1.1	-0.1	-7.3	-6.1	-3.1	-3.9
Financial account without reserves	9.9	6.7	15.9	5.4	1.8	2.1
Errors and omissions	-2.2	0.0	-2.2	-0.4	-1.7	-1.8
Gross capital formation	24.1	22.4	23.5	17.9	18.4	19.1
Gross saving	16.6	15.0	16.6	17.8	19.4	20.1
External debt	96.8	104.6	117.0	150.0	142.4	130.5
International investment position	-107.7	-104.2	-100.7	-122.0	-111.4	-94.5

1) The combined current and capital account.

2) Including financial derivatives.

Sources: Eurostat, Commission services, Magyar Nemzeti Bank.

The section on additional factors makes reference *inter alia* to 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. Related to this, in February 2012, following the adoption of the legislation establishing the new procedure for surveillance and correction of macroeconomic imbalances (the Macroeconomic Imbalances Procedure - MIP) ⁽⁷²⁾, the Commission published its first Alert Mechanism Report (AMR) ⁽⁷³⁾. The AMR scoreboard showed that Hungary exceeded the indicative threshold for two out of ten indicators (namely the international investment position and public sector debt). In line with the conclusion of the AMR, Hungary was subject to an in-depth review in the context of the MIP.

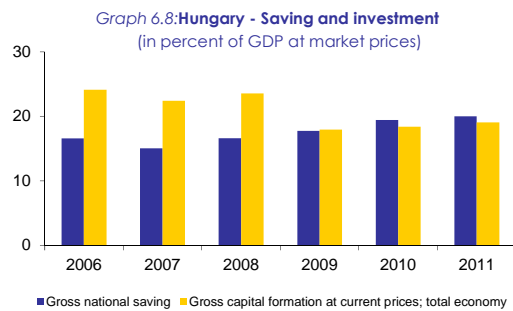
6.6.1. Developments of the balance of payments

After turning into surplus in 2009, Hungary's external balance (i.e. the combined current and capital account) improved further in 2010 before broadly stabilising in 2011. The adjustment was driven by falling domestic demand, dampening import growth, combined with a robust export performance. The improvement in the current account balance resulted from an increased trade surplus, while the balance of primary incomes and net current transfers deteriorated. The surplus in the capital account also increased due to higher absorption of EU funds.

The improvement in the external balance in 2010 mainly resulted from a further increase in private sector savings whereas gross saving by the general government continued to decline. At the same time, after increasing somewhat in 2010, domestic investment activity (as a percentage of GDP) dropped again in 2011.

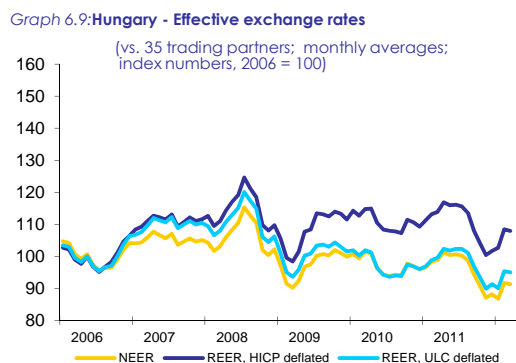
⁽⁷²⁾ The package of six legislative proposals to strengthen the economic governance of the EU entered into force in December 2011.
<http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/898>

⁽⁷³⁾ http://ec.europa.eu/economy_finance/articles/governance/2012-02-14-alert_mechanism_report_en.htm



Source: Eurostat, Commission services.

Competitiveness indicators show an improving picture. Hungary has continued to record increases in its export market share in recent years. The real effective exchange rate, measured by HICP or ULC, remained broadly stable between mid-2009 and mid-2011 before depreciating significantly in the second half of 2011, largely as a result of the evolution of the nominal exchange rate.



Source: Commission services.

Net foreign direct investment inflows remained relatively small in 2010 before ceasing entirely in 2011, as larger direct investments by residents abroad offset increased foreign direct investments in Hungary. However, after not having played a significant role in 2010, net portfolio inflows increased substantially in 2011, mainly thanks to successful sovereign external debt issuance. This was partly offset by net outflows of other investment in 2011 which had recorded a marginal surplus in 2010. Total gross external debt declined to some 130% of GDP in 2011 and the net international investment position also improved considerably, while remaining negative and elevated.

The balance of payments assistance granted to Hungary by the EU and the IMF in autumn 2008 expired in late 2010 with no disbursements from the pre-committed official funding taking place

after mid-2009. However, facing a deteriorating financial market situation, Hungary asked for precautionary balance of payments assistance by the EU and the IMF in November 2011. No agreement on a possible assistance programme was reached by the end of April 2012.

The external surplus is expected to further increase in 2012 and 2013 due to both a larger trade surplus and a higher inflow of EU funds.

6.6.2. Product market integration

The Hungarian economy is highly integrated to the EU economy through trade and investment linkages. Its degree of trade openness has increased rapidly since EU accession, from 67% in 2005 to above 83% in 2010, reflecting mainly the further integration of the Hungarian economy into continental and global supply chains. Intra-EU flows dominate both directions of trade. The EU accounted for 77% of Hungary's exports and 68% of its imports in 2010, with Germany alone accounting for almost 25% of total external trade. The successful extension of export markets to the fast growing economies of Eastern Europe and Asia has supported the further opening-up of the economy as reflected by steady growth in intra- and extra-EU trade in goods. Russia and China are the main non-EU trade partners, with respective shares of 8% and 7% of total imports.

Hungary's export of goods is heavily tilted towards high- and medium-high technology products. High technology goods account for over 22% of total exports in 2010, one of the highest shares in the EU27. This strength is confirmed by a significant technological trade surplus (2.4% of GDP in 2009) and an increasing revealed comparative advantage vis-à-vis the euro area in products such as electrical machinery, radio, TV and communication equipment.

The major share of the stock of inward FDI (amounting to 69% of GDP in 2010) originates from the EU27, with Germany, the Netherlands, and Austria accounting for about half of the total FDI stock. About 25% of the total FDI inflows went to the manufacturing sector, with an increasing share going to the automotive industry, suggesting that FDI plays a pivotal role in enhancing Hungary's export capacity. FDI inflows also contribute significantly to the integration of Hungary's financial and product markets in the EU

Table 6.5:

Hungary - Product market integration

	2005	2006	2007	2008	2009	2010
Trade openness ¹⁾ (%)	67.0	78.2	80.9	81.4	75.2	83.3
Intra-EU trade in goods GDP ratio ²⁾ (%)	44.1	50.9	52.0	51.3	46.6	51.8
Intra-EU trade in services GDP ratio ³⁾ (%)	7.2	7.8	8.2	8.5	9.5	9.3
Extra-EU trade in goods GDP ratio ⁴⁾ (%)	14.5	17.3	18.1	18.8	16.5	19.5
Export in high technology ⁵⁾ (%)	19.7	20.3	21.4	20.2	22.3	n.a.
Technological balance ⁶⁾ (%)	-0.9	1.5	1.6	2.1	2.4	n.a.
Total FDI inflows GDP ratio ⁷⁾ (%)	7.0	6.5	2.9	4.8	1.6	1.4
Intra-EU FDI inflows GDP ratio ⁸⁾ (%)	6.7	5.6	2.4	4.8	-3.5	0.5
FDI intensity ⁹⁾	3.7	3.5	2.1	1.9	-1.7	-0.1
Internal Market Directives ¹⁰⁾ (%)	0.7	0.9	1.2	0.6	0.4	1.4
Value of tenders in the EU Official Journal ¹¹⁾	36.9	30.3	22.3	25.4	27.7	24.5
Time to start up a new company ¹²⁾	38.0	38.0	16.0	5.0	4.0	4.0
Real house price index ¹³⁾	100.0	101.6	99.6	95.6	86.5	80.7
Residential investment ¹⁴⁾ (%)	4.6	3.8	4.1	3.6	3.3	2.5
Building permits index ¹⁵⁾	100.0	87.0	86.0	86.0	57.0	35.0

1) $(\text{Imports} + \text{Exports of goods and services} / (2 \times \text{GDP at current market prices})) \times 100$ (Foreign Trade Statistics, Balance of Payments).

2) $(\text{Intra-EU-27 Imports} + \text{Exports of goods} / (2 \times \text{GDP at current market prices})) \times 100$ (Foreign Trade Statistics).

3) Intra-EU-27 trade in services (average credit and debit in % of GDP at current prices) (Balance of Payments).

4) $(\text{Extra-EU-27 Imports} + \text{Exports of goods} / (2 \times \text{GDP at current market prices})) \times 100$ (Foreign Trade Statistics).

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

6) $(\text{Exports} - \text{imports in high tech}) / \text{GDP at current prices} \times 100$, 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-EU-27 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) Public procurement - Value of public procurement which is openly advertised in the EU Official Journal in total public procurement.

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

13) Experimental house price index (2005=100), Eurostat.

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

15) Number of new residential buildings (2005=100), Eurostat.

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

as both financial intermediation and the retail sector make up close to 15% of total FDI inflows.

The pre-crisis period in the Hungarian real estate market was characterised by a cumulative real price increase of over 130% from the beginning of 1998 to the peak in the fourth quarter of 2004. This implied a high average growth rate during the upswing. Since their peak, house prices in real terms have been moderately declining. Between 2005 and the third quarter of 2011, the cumulative real house price decrease amounted to 27%. During the recent period of house price decline, residential construction adjusted as well, with its value falling from slightly above 5 % of GDP in 2003 to about 2% in 2011. The decline in building permits has not bottomed yet, making it difficult to determine whether construction activity will stabilise in the coming quarters.

Concerning the business environment, Hungary scores below the average of euro area Member

States in international rankings⁽⁷⁴⁾. It performs particularly poorly in terms of legal and regulatory framework, which is complex and unstable due to frequent and sometimes ad-hoc modifications.⁽⁷⁵⁾ To address these shortcomings, a large-scale government programme was launched in 2011 with the aim of reducing the administrative costs for businesses. The value share of tenders openly advertised in the EU Official Journal⁽⁷⁶⁾ has decreased recently, but it is still higher than the EU average. Finally, according to the November 2011 Internal Market Scoreboard, the transposition deficit of EU Directives went above the threshold

⁽⁷⁴⁾ For instance, Hungary ranks on 48th and 52nd place according to the 2011-2012 Global Competitiveness index and the 2012 World Bank Doing Business respectively.

⁽⁷⁵⁾ In the World Bank 2012 Doing Business Hungary ranked far behind its regional peers for the indicator "protecting investors".

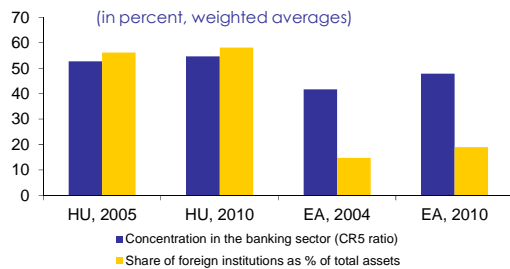
⁽⁷⁶⁾ The value of tenders published in the EU Official Journal may serve as a proxy of the extent to which national public procurement is open to foreign bidders.

in recent years. The most problematic areas in this respect are transport and energy.

6.6.3. Financial market integration

Hungary's financial sector is well integrated into the EU financial system. This integration is visible 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. The share of bank assets owned by foreign institutions through branches and subsidiaries reached 58% at the end of 2010, remaining broadly unchanged compared to the 2004 level. The Hungarian banking system is not highly concentrated with the largest five credit institutions accounting for about 55% of its total assets. This moderate concentration ratio has been rather stable since EU entry.

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



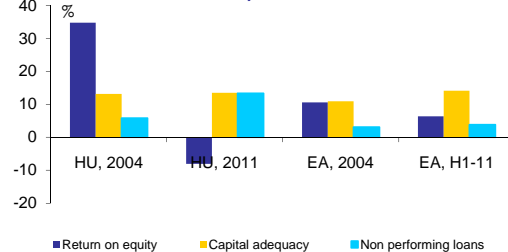
Source: ECB, Structural indicators for the EU banking sector, December 2011.

Hungary has one of the better developed financial sectors among the new EU Member States. Indirect intermediation is predominant, with domestic bank credit amounting to almost 67% of GDP in 2011. 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. In the last two years, bank lending to the non-financial private sector has fallen compared to early 2009. Nevertheless, 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 will remain substantial in the years to come.

The Hungarian banking system remains well-capitalized, with a capital adequacy ratio of some 13.5% at the end of 2011. However, the return on equity was negative at the sector level in 2011 due to losses related to the early-FX-mortgage-repayment scheme and the need to pay the special bank levy. Moreover, the level of non-performing loans has been continuously increasing since the

2008-09 crisis, reaching some 13% for household loans and more than 17% for corporate loans by the end of 2011.

Graph 6.11: Hungary - selected banking sector soundness indicators relatively to the euro area

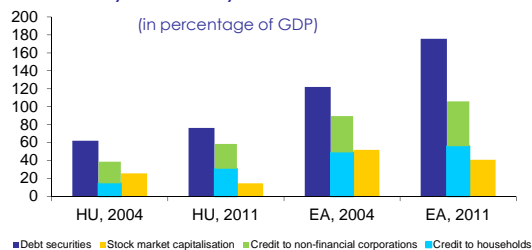


Note: For 2011, EU-27 non performing loans are a proxy for EA.
Source: ECB, National Bank of Hungary, Hungarian FSA, EC calculations.

The share of financial intermediaries other than banks and credit cooperatives in total assets of the Hungarian financial system has declined recently. Following the outbreak of the financial crisis investment funds were hit by losses suffered on the capital market and by withdrawals of capital. The pension funds industry suffered a major setback in 2011 after most second-pillar pension funds were transferred to the state social security system.

The Budapest Stock Exchange (BSE) does not play a decisive role in the financing of the economy. Moreover, falling stock prices decreased the total market capitalisation of the BSE to below 15% of GDP in 2011, which is substantially lower than the 2004 level of almost 26%. As a result of high central government issuance, the total value of outstanding fixed income securities amounted to some 76% of GDP in 2011. Private sector debt⁽⁷⁾ of around 155% of GDP in 2010 is still below the euro area average.

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



Note: Debt Securities other than shares, excluding financial derivatives.
Source: Eurostat, ECB, National Bank of Hungary, FESE, Reuters EcoWin.

⁽⁷⁾ Data on private sector debt are based on unconsolidated 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.

7. POLAND

7.1. LEGAL COMPATIBILITY

7.1.1. Introduction

The Act on the Narodowy Bank Polski (the Act on the NBP – central bank of Poland) was adopted in 1997 and was last amended in 2010 and 2011.

7.1.2. Central bank independence

In this area, several incompatibilities and imperfections exist.

The Act on the NBP does not 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. This constitutes an incompatibility with 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 for the opportunity 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 Act on the NBP foresees that the President of the NBP shall assume his/her duties after taking an oath before the Parliament. In this oath it is referred 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 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. What is more, the oath does not contain a reference to the central bank independence enshrined in Article 130 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 grounds for dismissal of the NBP's President, according to Articles 9(5) are going beyond those of Article 14.2 ESCB/ECB Statute, setting up additional grounds for dismissal. Moreover, the Law on the State Tribunal (Article 25(3) in conjunction with Article 3 and Article 1(1)(3)) provides for grounds for NBP's President removal from the office, if he or she violates the Constitution or a law. While Article 9(5) of the Act provides for an imperfection with regard to the grounds for dismissal, the provision of the Law on the State Tribunal are incompatible with Article 14.2 of the ESCB/ECB Statute.

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 respecting Article 130 of the Treaty and Article 7 of the ECB/ESCB Statute. The provision of the Constitution is therefore, incompatible and needs to be therefore adapted in order to respects the later.

7.1.3. Prohibition of monetary financing and privileged access

Article 42 of the NBP Act in conjunction with relevant provisions of the Law on banking, allow to 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. The current wording of those provisions could be interpreted as allowing for an extension of refinancing loans to banks experiencing rehabilitation proceedings leading to, in some cases, insolvency. Thus, effective preventive measures and explicit safeguards should be provided in the law, in particular, in Article 42 of the Act to avoid incompatibility with Article 123 of the TFEU.

7.1.4. Integration in the ESCB

Objectives

Article 3(1) of the NBP Law sets the objectives of the NBP. It refers only to the economic policies of the Government while it should also 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 Act on the NBP);
- holding and management of foreign exchange operations and the definition of foreign exchange policy (Articles 3(2)(2), 3(2)(3), 17(4)(2), 24, and 52);
- 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 of the Act on NBP). 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 independent auditors. The 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 for the functioning of the payment systems (Articles 3(2)(1));
- non recognition of the role of the ECB and of the EU for the collection of statistics (Article 3(2)(7) and 23);

- non recognition of the role of the ECB in the field of international cooperation (Article 5(1) and 11(3));

7.1.5. Assessment of compatibility

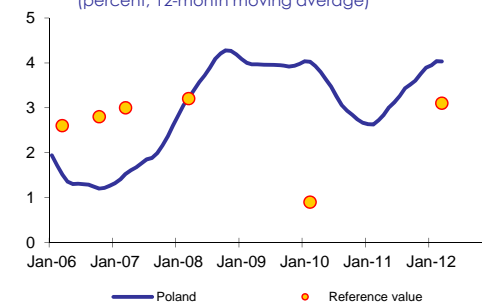
As regards the independence of the central bank, the prohibition on monetary financing and the central bank integration into the ESCB at the time of euro adoption, the legislation in Poland, in particular the Act on the NBP and the Constitution of the Republic of Poland are not fully compatible with 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 in 2010. Average annual inflation declined from above 4% in early 2010 to 2.7% in December 2010, before increasing gradually again in the course of 2011. In March 2012, the reference value was 3.1%, calculated as the average of the 12-month average inflation rates in Ireland, Sweden and Slovenia, plus 1.5 percentage points. The corresponding inflation rate in Poland was 4.0%, i.e. 0.9 percentage points above the reference value. The 12-month average inflation rate is likely to stay above the reference value in the months ahead.

Graph 7.1: Poland - Inflation criterion since 2006
(percent, 12-month moving average)



Note: The dots in December 2012 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2012 Forecast.

7.2.2. Recent inflation developments

Inflation in Poland has been relatively stable in recent years. Food and energy prices, which have a large weight (of almost 30% and about 15%

Table 7.1:

Poland - Components of inflation	(percentage change) ¹⁾							weights
	2006	2007	2008	2009	2010	2011	Mar-12	in total
HICP	1.3	2.6	4.2	4.0	2.7	3.9	4.0	1000
Non-energy industrial goods	-1.7	0.0	-0.3	0.2	0.0	1.1	1.3	271
Energy	4.8	4.3	8.5	5.9	6.2	9.2	9.4	154
Unprocessed food	0.8	4.4	2.8	7.1	3.1	2.7	1.7	91
Processed food	0.9	4.3	7.9	5.7	4.0	6.2	6.2	194
Services	2.8	2.7	4.4	4.5	2.5	3.0	3.4	290
HICP excl. energy and unproc. food	0.6	2.0	3.6	3.3	2.0	3.1	3.4	755
HICP at constant taxes ²⁾	1.1	2.1	3.5	3.2	2.5	3.1	3.3	1000
Administered prices HICP	4.9	3.7	6.4	6.9	3.9	5.3	5.3	138

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.

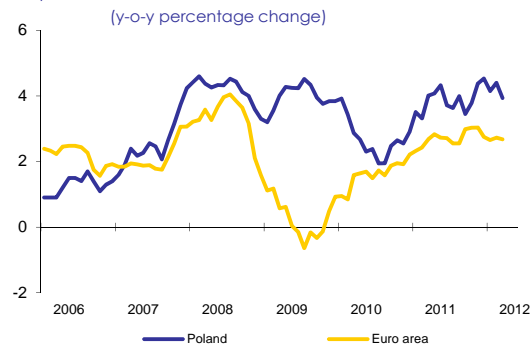
2) Last observation for HICP at constant taxes is February 2012.

Sources: Eurostat, Commission services.

respectively) in the Polish HICP index, were the main source of variation. Strong exchange rate fluctuations and changes in administered prices further amplified inflation volatility.

Annual HICP inflation declined gradually from 4.5% to below 2% between July 2009 and July 2010, mainly reflecting lower food and service price increases, as the slowdown in economic activity and a stronger exchange rate contained further upward pressure on prices. Afterwards, inflation started to increase again, driven by rising commodity prices and a VAT hike effective from the beginning of 2011. Although it declined temporarily between May and September, largely due to a favourable evolution of unprocessed food prices, the considerable weakening of the exchange rate in late 2011 pushed annual inflation up to 4.5% in December 2011. Annual inflation declined somewhat in early 2012, mainly due to favourable base effects.

Graph 7.2: Poland - HICP inflation



Source: Eurostat.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) evolved broadly in line with HICP inflation, albeit at a

lower level. It declined gradually from 3.8% in July 2009 to 1.3% in July 2010, before slowly rising to 3.9% by end-2011. The increase was mainly induced by higher prices of services. However, the inflation contributions of non-energy industrial goods and processed food also rose significantly, reflecting strong growth of private demand as well as indirect tax increases, which were further amplified by a substantial exchange rate depreciation in late 2011. Core inflation declined in early 2012, as the inflationary impact of one-off measures faded. Annual average producer price inflation for total industry increased to almost 8% in 2011, indicating elevated cost price pressures.

7.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy-mix and cyclical stance

Real GDP growth fell to below 2% in 2009 before recovering to 3.9% in 2010 and 4.3% in 2011. It was mainly driven by domestic demand which, compared to its regional peers, plays a more important role in a relatively closed Polish economy, resulting in a higher resilience vis-à-vis external shocks. The output gap turned negative in 2009 and, after remaining broadly stable in 2010, it is estimated to have narrowed in 2011. According to the Commission services' Spring 2012 Forecast, real GDP growth is projected to decrease somewhat to 2.7% in 2012 and 2.6% in 2013, leading to some widening of the negative output gap.

After a counter-cyclical fiscal expansion in 2009, the fiscal stance, as measured by changes in the

Table 7.2:

Poland - Other inflation and cost indicators		(annual percentage change)						
	2006	2007	2008	2009	2010	2011 ¹⁾	2012 ²⁾	2013 ²⁾
HICP inflation								
Poland	1.3	2.6	4.2	4.0	2.7	3.9	3.7	2.9
Euro area	2.2	2.1	3.3	0.3	1.6	2.7	2.4	1.8
Private consumption deflator								
Poland	1.2	2.4	4.3	2.5	2.5	4.3	3.7	3.0
Euro area	2.2	2.2	2.7	-0.4	1.7	2.5	2.2	1.7
Nominal compensation per employee								
Poland	1.9	4.9	8.9	3.5	5.7	5.1	4.7	5.1
Euro area	2.5	2.6	3.4	1.8	1.7	2.2	1.9	1.9
Labour productivity								
Poland	3.0	2.2	1.2	1.2	3.4	3.3	2.4	2.2
Euro area	1.9	1.3	-0.3	-2.4	2.5	1.2	0.1	1.0
Nominal unit labour costs								
Poland	-1.0	2.6	7.5	2.2	2.2	1.7	2.2	2.8
Euro area	0.8	1.4	3.8	4.2	-0.8	0.8	1.6	0.8
Imports of goods deflator								
Poland	2.8	0.8	0.3	8.7	1.8	8.0	5.0	2.0
Euro area	3.9	1.0	4.2	-7.7	5.7	6.9	3.6	1.3

1) 2011 data (except HICP inflation) are estimates.

2) Commission services' Spring 2012 Forecast.

Source: Eurostat, Commission services.

structural balance, remained broadly neutral in 2010. It was tightened considerably in 2011 in view of a continued robust expansion of domestic economic activity. Nevertheless, the structural deficit is estimated at about 5% of GDP in 2011. A further substantial tightening of the fiscal stance is foreseen for 2012.

Monetary policy, conducted within an inflation targeting framework⁽⁷⁸⁾, was loosened significantly between November 2008 and July 2009, as the NBP gradually cut its main policy rate by a total of 250 basis points to 3.5% amid a rapid deterioration in the economic outlook. The NBP then kept the policy rate unchanged throughout 2010 as inflation dropped to within the permissible fluctuation band around the inflation target. Faced with rapidly increasing inflation, the NBP increased its main policy rate by 100bp in the first half of 2011. It then kept the main rate unchanged as the economic outlook deteriorated again.

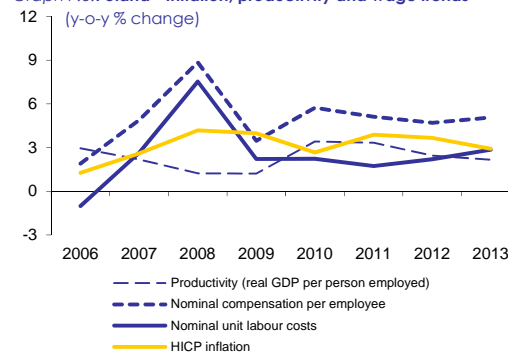
Wages and labour costs

Wage negotiations in the private sector are rather decentralised and flexible, with wage setting mostly at the enterprise level, although collective

⁽⁷⁸⁾ 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.

bargaining has a stronger impact on wage formation in sectors dominated by state enterprises, such as mining.

Graph 7.3: Poland - Inflation, productivity and wage trends



Source: Eurostat, Commission services' Spring 2012 Forecast.

The economic slowdown in 2009 resulted in higher unemployment. Consequently, the gap between increases in compensation per employee and productivity growth narrowed significantly. Growth of nominal unit labour costs (ULC) thus moderated from some 7.5% in 2008 to around 2% in 2011 even though increases in compensation per employee recovered somewhat in 2010-11 despite a wage freeze for central government employees (excluding teachers). ULC growth is expected to accelerate somewhat in 2012 and 2013 as lower labour productivity growth might not be fully

reflected in the evolution of employee compensation.

External factors

Although external trade represents a lower share of GDP in Poland than for its regional peers, prices of imported goods and services play an important role in domestic price formation. Import prices, as measured by the imports of goods deflator in the national accounts, surged in 2009, driven by a substantial nominal effective exchange rate depreciation. Growth of import prices moderated in 2010, when the exchange rate partially recovered, but it accelerated again in 2011, reflecting a somewhat weaker exchange rate as well as rapidly increasing prices of primary commodities, including crude oil. Growth of import prices is expected to decline again in 2012, mainly as the result of the more favourable outlook for primary commodity price developments.

Administered prices and taxes

Increases in administered prices⁽⁷⁹⁾, with a weight of around 14% in the HICP basket, significantly exceeded HICP inflation in recent years. The average annual increase in administered prices declined to below 4% in 2010 from almost 7% in 2009, before increasing again to above 5% in 2011, driven by rising prices of gas, electricity, water supply and sewage collection. The rate of increase in administered prices should decline somewhat in 2012, mainly due to smaller increases in electricity and gas prices.

In line with the need to reach the minimum level required by the EU, excise duties on tobacco have increased continuously in recent years but their impact on the overall inflation rate was marginal in 2010 and 2011. To support fiscal consolidation efforts, the main VAT rate was raised by 2 percentage points to 23% in 2011, while the VAT rate on unprocessed food was lowered to 5%. Due to an incomplete pass-through to consumer prices, the overall impact of VAT changes on the average inflation rate in 2011 is estimated to have remained below half a percentage point. A marginal inflation contribution from higher excise duties on tobacco and diesel is expected in 2012.

⁽⁷⁹⁾ According to the Eurostat definition, administered prices in Poland include *inter alia* water supply, 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/met_hodology/administered_prices

Medium-term prospects

Price increases are currently constrained by the negative output gap and the declining pace of output growth, hampering further improvements in the labour market situation. In addition, the inflationary impact of one-off measures effective in 2011 should largely fade in 2012. The Commission services' Spring 2012 Forecast thus projects HICP inflation to average 3.7% in 2012 and just below 3% in 2013.

Risks to inflation appear to be broadly balanced. A stronger inflation pass-through from the recent exchange rate depreciation, especially if it turns out to be persistent, could result in higher consumer price growth. On the other hand, if external shocks result in slower-than-expected GDP growth, a possible further deterioration in the labour market situation would have disinflationary effects.

The level of consumer prices in Poland was close to 60% of the euro area average in 2010. This suggests potential for further price level convergence in the long term, as income levels (about 58% of the euro area average in PPS in 2010) 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 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. On product markets, there is scope to enhance the competitive environment, especially in the services and energy sector. At the macro level, a prudent fiscal stance will be essential to contain inflationary pressures.

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. In particular, the Council recommended that the

Polish authorities should: (a) implement the fiscal stimulus measures in 2009 as planned, in particular the public investment plan, while structuring a supplementary budget in such a way that any further deterioration in public finances is avoided; (b) ensure an average annual fiscal effort of at least 1¼% of GDP starting in 2010; (c) spell out the detailed measures that are necessary to bring the deficit below the reference value by 2012, and reforms to contain primary current expenditure over the coming years. On 3 February 2010, the Commission concluded that Poland had taken action towards the correction of the excessive deficit within the time limits set by the Council, while emphasising the need for further sizeable consolidation measures. On 2 March 2011, following a request from Commissioner Rehn, the Polish authorities announced a list of consolidation measures to be implemented in 2011 and 2012. The Commission considered these measures to be sufficient to ensure a correction of the excessive deficit by 2012 and decided to maintain the excessive deficit procedure (EDP) in abeyance.

On 21 December 2011, the Polish authorities announced further consolidation measures which complemented the 2012 budget. On the basis of information available on 11 January 2011, the Commission considered that the Polish authorities have taken effective action towards a timely and sustainable correction of the excessive deficit, and no further steps in the excessive deficit procedure of Poland are needed at present ⁽⁸⁰⁾.

7.3.2. Recent fiscal developments

In 2009, as part of the European Economic Recovery Plan (EERP), the Polish authorities implemented a fiscal stimulus programme to cushion the impact of the global economic slowdown on the Polish economy. As a consequence, the general government deficit widened sharply from 3.7% in 2008 to 7.4% of GDP in 2009. Despite a considerable acceleration in the real GDP growth rate from 1.6% in 2009 to 3.9% in 2010, the deficit widened further to 7.8% amid lower-than-expected revenues from Corporate Income Tax (CIT), higher consumption and investment expenditure and higher-than-expected interest expenditure.

The general government deficit began to decline in 2011 to reach 5.1% of GDP, as a result of continued economic growth and ambitious consolidation efforts by the government. On the revenue side, a number of measures, including a change in the pension system that retains part of the contribution in the public first pillar, changes in rates and exemption rules of VAT and excise duties as well as a freeze in Personal Income Tax (PIT) thresholds, led to an increase in revenues (from 37.5% to 38.5% of GDP). Growth in government spending has been constrained by the expenditure rule limiting increases in all newly enacted and existing discretionary expenditure items to 1 percentage point over the rate of inflation, a freeze of the wage fund of public sector employees and additional minor cuts in social spending, resulting in a significant decline in the expenditure-to-GDP ratio (from 45.4% to 43.6%). All the above measures are considered as structural, although some of them are temporary and will expire in the coming years. As a consequence, the structural deficit fell from about 7.5% of GDP in 2010 to some 5% of GDP in 2011. The reduction in the headline deficit was larger than expected in the 2011 Convergence Programme, while the composition of the budgetary adjustment turned out to be considerably more expenditure-driven (with both revenue and expenditure ratio to GDP lower than expected one year before).

While remaining below 60%, the debt-to-GDP ratio rose significantly from 50.9% in 2009 to 54.8% in 2010 and 56.3% in 2011 as a result of the still high government deficit, unfavourable effects from the implicit interest rate and, especially in the second half of 2011, a strong depreciation of the national currency.

7.3.3. Medium-term prospects

The main consolidation measures introduced in 2011 continue to apply in 2012. The 2012 Budget Law, adopted on 2 March 2012, includes also additional measures, mainly on the revenue side e.g. an introduction of a tax on minerals extraction and increases in social security contributions and some excise duties. Additionally, the strong economic growth in 2011 is expected to result in higher dividend payments from state-owned enterprises. The only significant new measure aimed at reducing public expenditure is a reduction in complementary national direct payments to landowners.

⁽⁸⁰⁾ 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 7.3:

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

Outturn and forecast¹⁾	2006	2007	2008	2009	2010	2011	2012	2013		
General government balance	-3.6	-1.9	-3.7	-7.4	-7.8	-5.1	-3.0	-2.5		
- Total revenues	40.2	40.3	39.5	37.2	37.5	38.5	40.1	39.8		
- Total expenditure	43.9	42.2	43.2	44.5	45.4	43.6	43.1	42.4		
of which:										
- Interest expenditure	2.7	2.3	2.2	2.6	2.7	2.7	2.7	2.7		
p.m.: Tax burden	34.1	34.8	34.3	31.8	31.8	32.3	33.8	33.9		
Primary balance	-1.0	0.4	-1.5	-4.7	-5.2	-2.4	-0.3	0.2		
Cyclically-adjusted balance	-4.0	-2.8	-4.6	-7.1	-7.5	-5.0	-2.7	-1.9		
One-off and temporary measures	0.0	0.0	0.0	0.3	0.0	0.0	0.1	-0.1		
Structural balance ²⁾	-4.0	-2.8	-4.6	-7.4	-7.5	-5.0	-2.8	-1.9		
Government gross debt	47.7	45.0	47.1	50.9	54.8	56.3	55.0	53.7		
p.m.: Real GDP growth (%)	6.2	6.8	5.1	1.6	3.9	4.3	2.7	2.6		
p.m.: Output gap	1.0	2.4	2.2	-0.7	-0.8	-0.2	-0.9	-1.5		
Convergence programme							2012	2013	2014	2015
General government balance							-2.9	-2.2	-1.6	-0.9
Structural balance ²⁾³⁾							-2.5	-1.7	-1.1	-0.7
Government gross debt							53.7	52.5	50.6	49.7
p.m. Real GDP (% change)							2.5	2.9	3.2	3.8

1) Commission services' Spring 2012 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 2012 Convergence Programme of Poland.

As a consequence, the general government deficit is expected to decrease further in 2012 and 2013, according to the Commission services' Spring 2012 Forecast. In 2012, reduction in the nominal deficit to 3.0% of GDP is expected to be achieved on the back of the implemented budgetary measures supported by GDP growth. In 2013, given the lack of significant additional measures, the consolidation process is forecast to slow down with deficit reaching 2.5%, driven mainly by sharp reduction in public investment. Given the structural character of most implemented reforms and a negative but relatively stable output gap, the structural deficit is set to follow the evolution of the headline deficit, falling from about 5% of GDP to some 2.8% in 2012 and 1.9% in 2013.

The 2012 Convergence Programme was submitted on 25 April 2012. It confirms the government's commitment to bring the deficit below 3% of GDP in 2012, as recommended by the Council under the Excessive Deficit Procedure, and sets up a 2015 deadline to achieve the Medium Term Objective of the structural deficit not exceeding 1% of GDP. To reach this target, the Programme establishes a consolidation path, based mainly on significant reductions in public expenditure. The nominal

deficit is expected to fall from 5.1% of GDP in 2011 to 2.9% in 2012, 2.2% in 2013, 1.6% in 2014 and 0.9% of GDP in 2015. These projections are slightly more optimistic than the Commission services' Spring 2012 Forecast. The difference of 0.1 percentage points in 2012 and 0.3 percentage points in 2013 results mainly from different assumptions on the public investment expenditure and corresponding inflow of the EU funds towards the end of the current EU budgetary perspective.

Further details on the assessment of the 2012 Convergence Programme for Poland can be found in the forthcoming Commission Staff Working Document, which accompanies the Commission Recommendation for a Council Recommendation on the 2012 National Reform Programme of Poland and delivering a Council Opinion on the 2012 Convergence Programme of Poland⁽⁸¹⁾.

In March 2012, Poland signed the Treaty on Stability, Coordination and Governance in the EMU. This implies an additional commitment to conduct stability-oriented and sustainable fiscal

⁽⁸¹⁾ http://ec.europa.eu/economy_finance/economic_governance/sgp/convergence/programmes/2012_en.htm

policies. This Treaty will apply to contracting Member States with a derogation which have ratified the Treaty as from the date when the decision abrogating that derogation will come into force unless they declare their intention to be bound at an earlier date by some or all of the provisions on the fiscal compact and on economic policy coordination and convergence.

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.

The zloty exchange rate against the euro has displayed higher volatility recently. From January 2010 until July 2011, the zloty mainly oscillated in a relatively wide range between some 3.85 and 4.15 PLN/EUR. In this context, the Polish Treasury and the NBP jointly announced on 21 April 2011 that incoming EU funds would in future be primarily converted from euro on the open market to counteract excess zloty liquidity. In August 2011 rising financial market tensions in the euro area began to also negatively affect local FX markets in central and eastern Europe. As a result, the Polish zloty weakened by some 11% against the euro between July and December 2011. In October 2011, the NBP publicly acknowledged FX intervention in favour of the zloty. In early 2012, the zloty exchange rate against the euro partially recovered earlier losses. During the two years before this assessment, the zloty depreciated against the euro by 6.1%.

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



International reserves increased by some EUR 20bn between Q4-2009 and Q1-2011, mainly due

to large inflows of portfolio and other investment from abroad. Afterwards, the reserve level remained broadly stable at around EUR 75bn until the end of 2011, as financial market sentiment towards emerging markets deteriorated again. As a result, foreign exchange reserves covered some 136% of short-term external debt at original maturity by the end of 2011.

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



Short-term interest rate differentials vis-à-vis the euro area declined from above 350 basis points in January 2010 to below 300 basis points in July 2010 as the liquidity situation in the Polish banking sector improved gradually. They increased again to above 300 basis points in early 2011, reflecting faster monetary policy tightening in Poland relative to the euro area. Short-term spreads widened by some 90 basis points in late 2011 and early 2012 as the ECB loosened its policy stance while rates on the Polish money market increased somewhat. At the cut-off date of this report, the 3-month spread vis-à-vis the euro area reached almost 410 basis points.

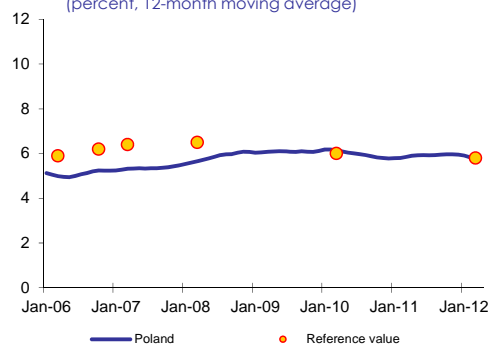
7.5. LONG-TERM INTEREST RATES

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 below but close to 10 years.

The Polish 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion was above the reference value at the time of the last convergence assessment in 2010. It declined slowly from some 6.2% in early 2010 to about 5.8% by end-2010 before increasing marginally again throughout 2011. In March 2012, the latest month for which data are available, the

reference value, given by the average of long-term interest rates in Sweden and Slovenia plus 2 percentage points, stood at 5.8%. In that month, the 12-month moving average of the yield on the Polish benchmark bond stood at 5.8%, i.e. at the reference value.

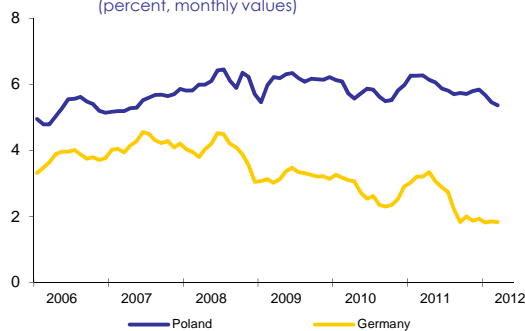
Graph 7.6: Poland - Long-term interest rate criterion
(percent, 12-month moving average)



Source: Commission services.

Long-term interest rates decreased from above 6% in early 2010 to below 5.5% in September 2010, reflecting a substantial fall in domestic inflation. They returned to above 6% by early 2011, as rising inflation necessitated a gradual monetary policy tightening. Long-term interest rates declined again to below 6% by mid-2011 and then to below 5.5% in early 2012, benefiting from improved investors' sentiment towards the country. As a result, long-term interest rate spreads vis-à-vis the German benchmark bond⁽⁸²⁾ decreased to about 350 basis points in March 2012.

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 – is an important indication that the integration of a Member State into the euro area would proceed without difficulties.

The section on additional factors makes reference *inter alia* to 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. Related to this, in February 2012, following the adoption of the legislation establishing the new procedure for surveillance and correction of macroeconomic imbalances (the Macroeconomic Imbalances Procedure - MIP)⁽⁸³⁾, the Commission published its first Alert Mechanism Report (AMR)⁽⁸⁴⁾. The AMR scoreboard showed that Poland exceeded the indicative threshold for three out of ten indicators, all in the area of external imbalances and competitiveness (namely the current account balance, the international investment position and the nominal ULC). In line with the conclusion of the AMR, Poland was not subject to an in-depth review in the context of the MIP.

7.6.1. Developments of the balance of payments

While remaining in deficit, Poland's external balance (i.e. the combined current and capital account) improved considerably in 2009. Although it worsened somewhat in 2010 due to a higher current account deficit, it improved again in 2011, on the back of a rapidly increasing surplus on the capital account, induced by higher absorption of EU funds, and a lower current account deficit. After having increased in 2010, the external trade deficit declined somewhat in 2011, as strong export performance was only partially outweighed by rising imports, driven by robust domestic

⁽⁸²⁾ The reference to the German benchmark bond is included for illustrative purposes, as a proxy of the euro area long-term AAA yield.

⁽⁸³⁾ The package of six legislative proposals to strengthen the economic governance of the EU entered into force in December 2011.
<http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/898>

⁽⁸⁴⁾ http://ec.europa.eu/economy_finance/articles/governance/2012-02-14-alert_mechanism_report_en.htm

Table 7.4:

Poland - Balance of payments	(percentage of GDP)					
	2006	2007	2008	2009	2010	2011
Current account	-3.8	-6.2	-6.6	-3.9	-4.6	-4.3
of which: Balance of trade in goods	-2.1	-4.4	-5.8	-1.7	-2.5	-2.7
Balance of trade in services	0.2	1.1	1.0	1.1	0.7	1.2
Income balance	-2.8	-3.8	-2.4	-3.8	-3.6	-3.9
Balance of current transfers	0.9	1.0	0.6	0.5	0.8	1.2
Capital account	0.6	1.1	1.1	1.6	1.8	2.2
External balance ¹⁾	-3.2	-5.1	-5.4	-2.2	-2.8	-2.1
Financial account	3.1	5.9	7.8	5.1	4.8	4.1
of which: Net FDI	3.2	4.3	1.9	1.9	0.7	1.8
Net portfolio inflows	-0.8	-1.5	-0.5	3.9	5.4	3.1
Net other inflows ²⁾	1.5	6.1	5.7	2.7	1.9	0.5
Change in reserves (+ is a decrease)	-0.7	-3.0	0.7	-3.4	-3.2	-1.3
Financial account without reserves	3.9	8.9	7.1	8.5	8.0	5.4
Errors and omissions	0.1	-0.8	-2.4	-2.8	-2.0	-2.0
Gross capital formation	21.1	24.4	23.9	20.3	20.9	21.7
Gross saving	18.0	19.4	19.1	17.3	17.2	17.7
External debt	49.7	54.8	45.9	64.8	67.1	62.5
International investment position	-46.4	-52.8	-47.4	-62.0	-64.5	-59.2

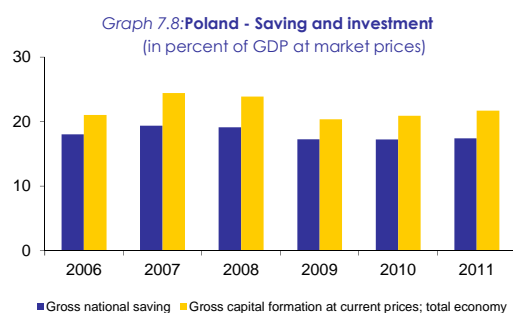
1) The combined current and capital account.

2) Including financial derivatives.

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

demand growth. At the same time, the negative balance of primary incomes and net current transfers remained broadly stable.

As far as the saving-investment balance is concerned, gross national saving (as a percentage of GDP) followed a declining trend between 2007 and 2010, driven by falling gross saving by the general government, which was only partially offset by higher private sector saving. Gross national saving increased somewhat in 2011, due to the improved position of the general government. At the same time, after decreasing in 2008 and 2009, domestic investment activity (as a percentage of GDP) increased again in 2010 and 2011.

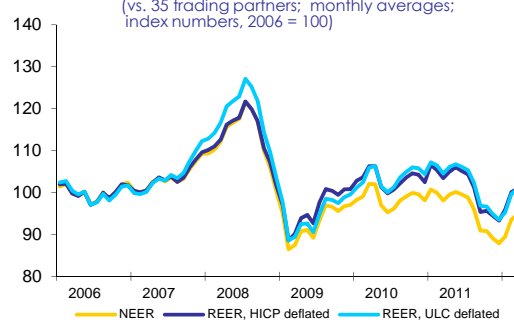


Source: Eurostat, Commission services.

External competitiveness appears to have remained solid, with Poland continuing to gain export market shares in 2010 and 2011, albeit at a slower pace. After a substantial depreciation in 2008, the real effective exchange rate strengthened to some extent throughout 2009 and then remained broadly stable until mid-2011, largely in line with nominal exchange rate developments. The real effective exchange rate depreciated substantially in the second half of 2011, again as a result of the nominal exchange rate evolution, as inflation rates remained relatively close to those of trading partners.

Graph 7.9: Poland - Effective exchange rates

(vs. 35 trading partners; monthly averages; index numbers, 2006 = 100)



Source: Commission services.

Net inflows of foreign direct investment (FDI), which covered almost 50% of the current account deficit in 2009, declined substantially in 2010, mostly as a result of lower direct investment in Poland, before recovering again in 2011, when they accounted for some 40% of the current account deficit. Due to rapidly increasing holdings of government debt securities by non-residents, net inflows of portfolio investment have been the main source of foreign financing since 2009. After peaking in 2007, net inflows of other investment and financial derivatives have gradually declined in recent years, mainly due to lower external borrowing by the private sector. Total gross external debt declined to 62.5% of GDP in 2011 while the negative net international investment position also narrowed considerably. Balance of payments stability was supported by the IMF's Flexible Credit Line arrangement, which was initially granted in May 2009 and then renewed in July 2010 and in January 2011, when it was increased and extended for another two years.

According to the Commission services' Spring 2012 Forecast, the external balance is expected to improve somewhat in 2012, due to weaker domestic demand and thus lower import growth, before deteriorating again in 2013.

7.6.2. Product market integration

The Polish economy is well integrated to the EU economy through trade and investment linkages. Trade openness increased between 2005 and 2010, with an average share of exports and imports of more than 40% of GDP in recent years, comparable to that of EU countries of similar size. The rebound of extra-EU trade in goods in 2010 was much weaker (apart from rising imports from China and increasing imports of commodities from Russia) than in the case of intra-EU trade (driven by strong demand from Germany). Polish trade is mainly oriented towards manufacturing. The small further growth of intra-EU trade in services, up to 4.7% of GDP in 2010, was mainly driven by a growing importance of the business process outsourcing sector, which increased its share within services exports from 14% in 2004 to 29% in 2010.

The composition of Polish goods exports 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 2010, the

export structure was dominated by motor transport equipment (16.4%) radio, TV and communication equipment (7.3%) and electrical equipment (5.6%), reflecting the presence of multinational corporations in these sectors and significant technology transfers following large FDI inflows. In the medium term, the competitiveness of the Polish economy will largely depend on its capacity to further upgrade the export structure of the country, shifting towards capital-intensive and high-technology industries. So far, the technological trade deficit has stabilised around $-2\frac{1}{2}\%$ of GDP since early 2000s. This is related to the relatively limited inflow of FDI into high-technology sectors and its slow absorption, which is partly due to low domestic R&D spending, weak links between research institutes and private sector and relatively low quality of research institutional framework.

Poland seems to be well integrated into international production chains. Intermediate goods constitute about 55% of all Polish imports and this share remained fairly stable since 1999, while the import content of Polish exports is relatively high. Foreign investors in the manufacturing sector, including the largest multinational corporations with extensive cross-border production and distribution chains, are mainly export-oriented. The stock of inward FDI from EU27 reached 35% of GDP in the recent years compared with 6% of GDP for FDI from non-EU countries. Domestic market size and growth as well as access to large regional markets are pointed out as main reasons for the attractiveness of the country for FDI.

From the beginning of 2005 until the third quarter of 2007, real house prices cumulatively increased by 104%. Since 2008, there has been a gradual fall in prices of flats on the primary and secondary market in most large cities. The total decline in the prices of flats in the period 2008–2011 was 15% to 25% in large cities. The fall in the prices of flats was mainly driven by the growth of their supply on the primary market in 2011. Nevertheless, the value of the housing stock increased from 170% of GDP in 2002 to about 200% in 2009. This was mainly the result of a higher relative price level and did not reflect a substantial rise in the volume of housing. This observation is in line with the smooth evolution of residential investment around 3% of GDP. Concerning the rental market, the formal rental segment is underdeveloped, with

Table 7.5:

Poland - Product market integration

	2005	2006	2007	2008	2009	2010
Trade openness ¹⁾ (%)	37.5	41.3	42.2	41.9	39.4	42.9
Intra-EU trade in goods GDP ratio ²⁾ (%)	24.2	26.4	27.2	26.5	25.1	26.9
Intra-EU trade in services GDP ratio ³⁾ (%)	3.9	4.4	4.7	4.6	4.6	4.7
Extra-EU trade in goods GDP ratio ⁴⁾ (%)	7.3	8.4	8.7	9.0	7.9	9.1
Export in high technology ⁵⁾ (%)	3.2	3.1	3.0	4.3	5.7	n.a.
Technological balance ⁶⁾ (%)	-2.5	-2.4	-2.6	-2.5	-2.3	n.a.
Total FDI inflows GDP ratio ⁷⁾ (%)	3.4	5.7	5.5	2.8	3.2	1.9
Intra-EU FDI inflows GDP ratio ⁸⁾ (%)	2.8	5.0	4.6	2.7	2.6	1.6
FDI intensity ⁹⁾	1.6	3.6	2.6	1.5	1.7	1.3
Internal Market Directives ¹⁰⁾ (%)	0.9	0.9	1.7	2.0	1.4	1.7
Value of tenders in the EU Official Journal ¹¹⁾	47.7	28.6	32.2	38.9	41.2	42.6
Time to start up a new company ¹²⁾	31.0	31.0	31.0	31.0	32.0	32.0
Real house price index ¹³⁾	100.0	135.0	196.1	187.5	178.6	167.6
Residential investment ¹⁴⁾ (%)	2.2	2.5	2.8	3.4	3.3	1.9
Building permits index ¹⁵⁾	100.1	138.8	204.6	190.2	145.4	142.6

1) $(\text{Imports} + \text{Exports of goods and services} / (2 \times \text{GDP at current market prices})) \times 100$ (Foreign Trade Statistics, Balance of Payments).

2) $(\text{Intra-EU-27 Imports} + \text{Exports of goods} / (2 \times \text{GDP at current market prices})) \times 100$ (Foreign Trade Statistics).

3) Intra-EU-27 trade in services (average credit and debit in % of GDP at current prices) (Balance of Payments).

4) $(\text{Extra-EU-27 Imports} + \text{Exports of goods} / (2 \times \text{GDP at current market prices})) \times 100$ (Foreign Trade Statistics).

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

6) $(\text{Exports} - \text{imports in high tech}) / \text{GDP at current prices} \times 100$, 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-EU-27 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) Public procurement - Value of public procurement which is openly advertised in the EU Official Journal in total public procurement.

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

13) Experimental house price index (2005=100), Eurostat.

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

15) Number of new residential buildings (2005=100), Eurostat.

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

relatively high tenant protection and controls on rent increases.

Concerning the business environment, Poland scores below the average of euro area Member States in international rankings⁽⁸⁵⁾. Two legislative packages were adopted in 2011 to reduce the number of procedures and administrative obligations imposed on businesses, including by replacing administrative certificates with declarations, and to reduce information obligations. However, the main outstanding issues remain high administrative compliance costs, slow legislative processes and unstable legislation. Some improvement in the administration of justice was achieved through the introduction of e-judiciary for small lawsuits in 2010, which slightly reduced the backlog of open court cases.

Nevertheless, there was little progress in the simplification of enforcing contracts. Finally, according to the November 2011 Internal Market Scoreboard, Poland was the country with the second highest transposition deficit and the second highest number of directives not correctly transposed. On the other hand, the share of public procurement tenders in Poland announced in the EU Official Journal⁽⁸⁶⁾ appears to be higher than the EU average.

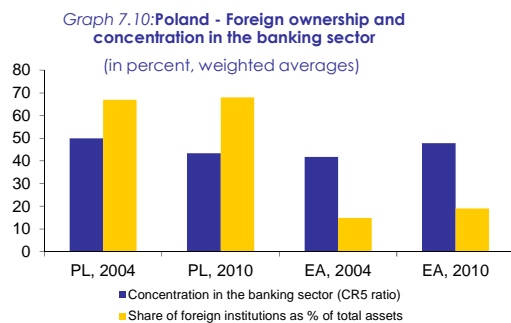
7.6.3. Financial market integration

Poland's financial sector is well integrated into the EU financial system, which is demonstrated by the high degree of foreign ownership of financial institutions and the increasingly international role of the Warsaw Stock Exchange. The share of bank

⁽⁸⁵⁾ For instance, Poland scores on 41st and 62nd place according to the 2011-2012 Global Competitiveness index and the 2012 World Bank Doing Business respectively.

⁽⁸⁶⁾ The value of tenders published in the EU Official Journal may serve as a proxy of the extent to which national public procurement is open to foreign bidders.

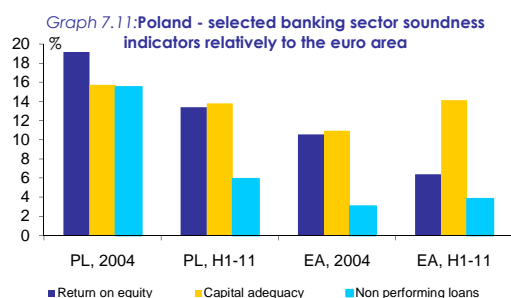
assets owned by foreign institutions through branches and subsidiaries reached almost 70% in 2010, remaining largely unchanged compared to the 2004 level. Concentration in the Polish banking sector is relatively low, as the share of total assets owned by the five largest credit institutions amounted to 43% in 2010, the lowest level among Member States with a derogation.



Source: ECB, Structural indicators for the EU banking sector, December 2011.

Poland has one of the most developed financial sectors among the non-euro area EU member countries. The share of banks in total assets of the financial sector has been decreasing in recent years. Although growth of credit to the non-financial private sector has slowed down following the 2008-09 global financial crisis, it accelerated again to about 14% in 2011. As a result, credit to the non-financial private sector reached some 52% of GDP in 2011. The share of foreign-currency-denominated lending was significant for housing loans, amounting to some 63% at the end of 2011. However, since 2009 the majority of newly-granted loans has been denominated in zloty.

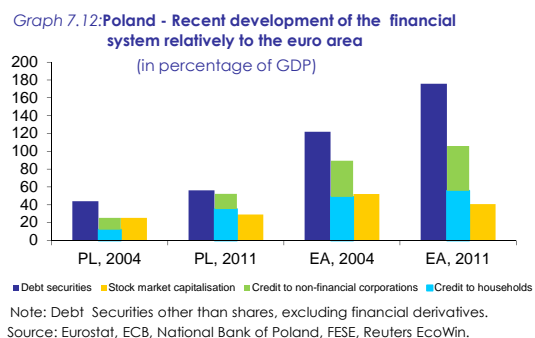
The overall capital adequacy ratio of the banking sector reached almost 14% in H1-2011 while return on equity exceeded 13%. After having deteriorated between 2008 and 2010, the quality of banks' loan portfolio started to improve in 2011, due to a recovery in the corporate loan portfolio.



Note: For 2011, EU-27 non performing loans are a proxy for EA.
Source: ECB, Polish FSA, EC calculations.

Non-banking institutions play a relatively important role in financial intermediation, accounting for roughly 30% of the total assets of Polish financial institutions by 2011. The pension funds launched in 1999 are the biggest players in this category and also belong to biggest domestic institutional investors. The insurance sector has also been growing, but its size is still far below the euro area average. Investment funds have recently also increased their assets, although they have not yet returned to the 2007 peak level. Credit unions (SKOK) have been expanding, but their total assets make up only a small part of total financial sector assets.

Following the decline in equity prices, stock market capitalisation fell to 29% of GDP in 2011 from 46% of GDP in 2007. The share of foreign investors in the capitalisation of the Warsaw Stock Exchange (WSE) exceeds 40%. The WSE has so far not taken part in the European stock exchange consolidation process. The debt securities market, amounting to some 56% of GDP in 2011, is the largest and most liquid in the region. It is dominated by government bonds (90% share); corporate bonds account only for about 4% of the outstanding amounts. Private sector debt⁽⁸⁷⁾ of close to 75% of GDP in 2010 is still far below the euro area average.



Since 2006, supervision of the financial sector has been consolidated with the Polish Financial Supervision Authority (KNF). 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 bank subsidiaries operating in Poland. While transposition of EU financial services legislation has been relatively slow,

⁽⁸⁷⁾ Data on private sector debt are based on unconsolidated 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.

Poland achieved full compliance with the FSAP directives and implemented most of the subsequent directives.

8. ROMANIA

8.1. LEGAL COMPATIBILITY

8.1.1. Introduction

Banca Națională a României (BNR – central bank of Romania) is governed by Law No. 312 of June 28, 2004 (hereinafter "the BNR Law ") which entered into force on July 30, 2004.

No amendments to the Law on BNR were introduced with regard to the incompatibilities mentioned in the Convergence Report 2010.

8.1.2. Central Bank independence

In this area, a number of incompatibilities and imperfections exist 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 when the latter is adopting decisions for which its independence is protected by the Treaty. The active participation of the Minister, even without voting right, to 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 is incompatible with Article 130 of the TFEU.

Under Article 3(1) 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. This provision is incomplete with respect to Article 130 of the TFEU and Article 7 of the ECB/ ESCB Statute given that it does not contain a reference to Union institutions, bodies, offices or agencies. Article 3(1) of the BNR Law thereby constitutes an imperfection. Further, Article 3 needs to be adapted to fully reflect Article 130 of the TFEU and Article 7 of the ESCB/EC Statute, in order to expressly prohibit third parties from giving

instructions to the BNR and the members of its decision making bodies.

Article 33(5) of the BNR Law provides that if the Board of BNR becomes incomplete, the vacancies shall be filled for the respective office following the procedure for the appointment of the members of the Board of BNR by the Parliament. Article 35(5) of the Law stipulates that in case the Governor is absent or incapacitated to act the Senior Deputy Governor shall replace the Governor. The BNR Law, in order to remove this imperfection and to ensure smooth and continuous functioning of BNR in case of expiry of the term of office, resignation, dismissal or other cause of termination of office of the Governor, needs to provide for procedures and rules regarding the successor of the Governor in such cases.

Pursuant to Article 33(9) of the BNR Law, the Governor as well as any other member of the BNR's Board can appeal against a decision to recall him from office before the Romanian High Court of Cassation and Justice. This provision constitutes an imperfection with respect to Article 14.2 of the ESCB/ECB Statute, which provides for a right of judicial review by the Court of Justice of the EU in the event of the Governor's dismissal.

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 for 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⁽⁸⁸⁾ and Law 176/2010 on the integrity in the exercise of public functions and dignities⁽⁸⁹⁾ define the conflicts of interest and incompatibilities applicable to the Governor and the other members of the Board of BNR and require them to report on their interests and wealth. For the sake of legal clarity, 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

⁽⁸⁸⁾ Published in Monitorul Oficial al României, Part One, No 279, 21.4.2003.

⁽⁸⁹⁾ Published in Monitorul Oficial al României, Part One, No 621, 2.9.2010.

to those contained in Article 33 of the Law on BNR.

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 performed 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 Statute.

Article 43 of the 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 may, in certain circumstances, be seen as an intra-year credit, which negatively impacts on the financial independence of the BNR. Consequently, a Member State may not put its central bank 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 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 foresee the prohibition of 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) 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 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) extends this prohibition to other bodies governed by public law and public undertakings of Member States. These provisions do not cover the full list of cases mentioned in the Article 123 of the TFEU (a reference to, amongst others, the Union institutions is missing) and are therefore incompatible with the TFEU.

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 in Article 7(2) 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 Law is incompatible and should be aligned 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".

As noted above in point 7.1.3., Article 43 of the 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.

The Government Emergency Ordinance 90/2008 on the statutory audit of the annual financial statements⁽⁹⁰⁾ and consolidated annual financial statements establishes rules on statutory auditors and audit entities and organises a system of public supervision of statutory audits. With this aim, it establishes the Council for the Public Supervision of Statutory Audits, which is a public autonomous institution, with legal personality and designed to carry out the public supervision of statutory audits, according to the principles specified in Directive 2006/43/EC⁽⁹¹⁾⁽⁹²⁾. The BNR contributes funds and human resources to the functioning of this Council. The provision of resources by a central bank to a supervisory authority does not give rise to monetary financing concerns insofar as the central bank will be financing the performance of a legitimate financial supervisory task under national law as part of its mandate, or as long as the central bank can contribute to and have influence on the decision-making of the supervisory authorities. However, in this case the involvement of BNR in the supervision of the statutory audit of consolidated and annual financial statements does not seem linked to the financial stability of the financial sector and thus constitutes a form of financing of obligations pertaining to the public sector which infringes the prohibition of monetary financing and is incompatible with regard to Article 123 of the TFEU. For this reason, the Government Emergency Ordinance 90/2008 should be made compliant with Article 123 of the TFEU.

8.1.4. Integration in the ESCB

Objectives

Further 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)

⁽⁹⁰⁾ Published in Monitorul Oficial al României No 481 of 30 June 2008.

⁽⁹¹⁾ Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC (OJ L 157, 9.6.2006, p. 87).

⁽⁹²⁾ From 2009 the Council is under the responsibility of the Ministry of Public Finances.

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.

Tasks

The incompatibilities in the Statute of the BNR 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));
- conduct of foreign exchange operations and the definition of foreign exchange policy (Articles 2(2)(a) and (d), 9, , and 33(1)(a));
- holding and management of foreign reserves (Articles 2(2)(e), 9(2)(c), 30 and 31);
- right to authorise the issue of banknotes and the volume of coins (Articles 2(2)(c), 12 to 18);
- non-recognition of the role of the ECB and of the Council for regulating, monitoring and controlling foreign currency transactions (Articles 10 and 11);
- the ECB's right to impose sanctions (Article 57).

There are also imperfections regarding the:

- non-recognition of the role of the ECB and the EU for the collection of statistics (Article 49);
- non-recognition of the role of the ECB and of the Council for the appointment of an external auditor (Article 36(1));
- absence of an obligation to comply with the ESCB/ECB regime for the financial reporting of NCB operations (Articles 37(3) and 40);
- lack of reference to the role of the ECB for payment systems (Articles 2(2)(b), 22 and 33(1)(b)).

8.1.5. Assessment of compatibility

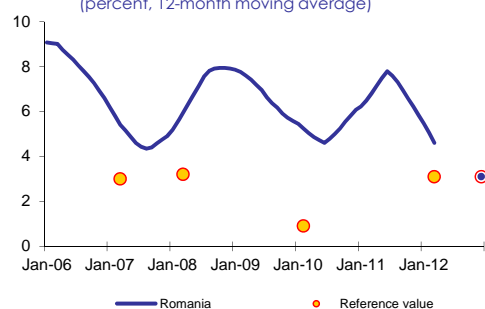
As regards the central bank integration into the ESCB at the time of euro adoption, the independence of the BNR as well as the prohibition on monetary financing, the legislation in Romania, in particular the BNR Law is not fully compatible with the compliance duty under Article 131 of the TFEU.

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, was well above the reference value at each convergence assessment since EU accession in 2007. Average annual inflation increased from below 5% in mid-2010 to a two-year high in June 2011, before decreasing sharply thereafter. In March 2012, the reference value was 3.1%, calculated as the average of the 12-month average inflation rates in Sweden, Ireland and Slovenia plus 1.5 percentage points. The corresponding inflation rate in Romania was 4.6%, i.e. 1.5 percentage points above the reference value. The 12-month average inflation is likely to approach the reference value in the months ahead.

Graph 8.1: Romania - Inflation criterion since 2006
(percent, 12-month moving average)



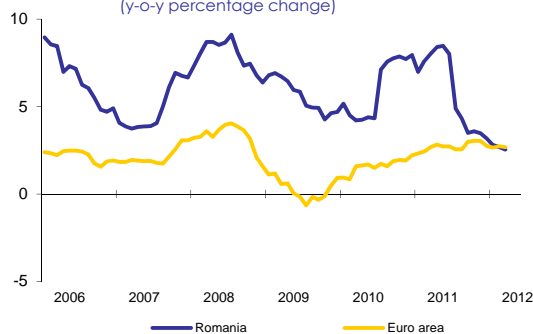
Note: The dots in December 2012 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2012 Forecast.

8.2.2. Recent inflation developments

Romania recorded volatile and, for protracted periods, very high inflation rates in recent years. After successful disinflation in 2004-2006, with annual HICP inflation bottoming out at just below 4% in early 2007, inflation spiked to around 9% by mid-2008 amid rising food and fuel prices. In 2009 and early 2010, when the impact of major cost-push factors ebbed away, the inflation rate receded somewhat but remained elevated despite the sharp

economic downturn. This was *inter alia* a result of increases in Romanian tobacco excise duties, higher energy inflation and persistently high inflation in services. In July 2010, inflation picked up due to a 5 percentage point increase in the standard VAT rate. HICP inflation, pushed even higher by significant increases in food prices, peaked at a two-year high of 8.5% in May 2011. In the second half of 2011, inflation fell sharply to an average of 3.8% amid a VAT-related base effect and easing food prices due to an exceptional agricultural harvest. Inflation continued to recede and fell close to the euro area level in the first quarter 2012, averaging 2.7%, partly on account of a favourable base effect from higher food prices a year ago.

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



Source: Eurostat.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) remained relatively high in 2009 (at 6.6% for the year as a whole), particularly due to price rises in processed food (partly relating to several tobacco excise duty increases) and services. An increase in non-energy industrial goods inflation reflected *inter alia* the lagged impact of a significant weakening of the leu in 2008. In mid-2010, core inflation spiked (in tandem with headline inflation) due to the substantial VAT rate increase. As the one-off impact of indirect tax increases faded, core inflation declined sharply to an average of around 4% in the second half of 2011. Annual average producer price inflation for total industry increased to just above 8% in 2011, indicating elevated cost price pressures related to commodity price increases.

Table 8.1:

Romania - Components of inflation	(percentage change) ¹⁾							weights
	2006	2007	2008	2009	2010	2011	Mar-12	in total
HICP	6.6	4.9	7.9	5.6	6.1	5.8	4.6	1000
Non-energy industrial goods	4.1	2.6	3.0	4.1	3.5	3.3	2.8	265
Energy	11.9	5.9	9.9	4.0	7.6	9.3	8.7	125
Unprocessed food	4.0	1.2	7.1	3.4	2.9	5.4	1.0	158
Processed food	6.6	7.9	10.9	7.3	10.4	7.5	6.6	220
Services	6.5	5.4	8.2	8.5	4.1	3.5	3.1	232
HICP excl. energy and unproc. food	5.8	5.5	7.6	6.6	6.4	5.0	4.4	717
HICP at constant taxes ²⁾	5.4	4.2	7.1	4.0	1.8	3.8	3.6	1000
Administered prices HICP	10.6	5.3	7.8	7.1	5.4	7.6	7.3	145

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.

2) Last observation for HICP at constant taxes is February 2012.

Sources: Eurostat, Commission services.

8.2.3. Underlying factors and sustainability of inflations

Macroeconomic policy-mix and cyclical stance

The Romanian economy is estimated to have been operating well below its potential during the global economic crisis. GDP contracted in both 2009 and 2010, suffering from a collapse in domestic demand. The economy gained some momentum and grew by 2.5% in 2011, due to a strong domestic harvest and solid exports. Available data and indicators for the first quarter of 2012 suggest a deterioration in economic activity, notably due to difficult weather conditions and external uncertainties. Real GDP growth is projected to decline to 1.4% in 2012, but to rebound to 2.9% in 2013, according to the Commission services' Spring 2012 Forecast, amid a gradual increase in private consumption and a recovery in public investment (benefiting from an increased absorption of EU funds). The Commission services' estimates suggest a sizeable negative output gap to remain over the medium term.

The fiscal stance, as measured by changes in the structural balance, was expansive in the period before the global crisis, as Romania followed largely pro-cyclical policies throughout the boom years around EU accession in 2007. Fiscal policy has been restrictive since 2010, as significant fiscal adjustment measures have been adopted under the international financial assistance programme to bring public finances back to a sustainable path. In view of the continued consolidation efforts of the Romanian government, a restrictive fiscal stance is planned for 2012 and 2013.

Monetary policy was loosened in 2009 and early 2010 in view of an improved inflation outlook and signs of stabilisation in the domestic financial markets. The BNR, operating within an inflation targeting framework⁽⁹³⁾, kept the key policy rate stable from June 2010 to October 2011 amid uncertainties related to a temporary spike in inflation due to the VAT increase in July 2010. Between the fourth quarter of 2011 and the first quarter of 2012, the BNR cut the key interest rate by a cumulative 100 basis points to 5.25% in view of a more benign inflation outlook. Credit growth to the private sector weakened sharply during the global crisis in the midst of unfavourable cyclical and financial conditions, though signs of a recovery in lending activity (particularly to the corporate sector) emerged in 2011.

Wages and labour costs

The labour market was considerably impacted by the economic downturn. Employment fell markedly in 2009-2010 and staged only a modest recovery in 2011. The unemployment rate increased to above 7% in 2010-2011, up from a ten-year low of 5.8% in 2008. Annual growth in nominal compensation per employee fell sharply to an average of around 3% in the period of 2009-2011, and a moderate growth is expected due to continued slack in the labour market in 2012-2013. Labour productivity growth became negative in 2009-2010 amid contracting output, before picking up slightly in 2011; it is projected to remain muted in 2012 and 2013, in line with a projected moderate recovery of economic activity. As a result, growth in nominal unit labour costs (ULC)

⁽⁹³⁾ The BNR has set inflation targets in terms of annual consumer price index growth at 3.0% (with a tolerance band of ± 1 percentage point) for end-2011 and end-2012.

Table 8.2:

Romania - Other inflation and cost indicators		(annual percentage change)						
	2006	2007	2008	2009	2010	2011 ¹⁾	2012 ²⁾	2013 ²⁾
HICP inflation								
Romania	6.6	4.9	7.9	5.6	6.1	5.8	3.1	3.4
Euro area	2.2	2.1	3.3	0.3	1.6	2.7	2.4	1.8
Private consumption deflator								
Romania	4.9	4.8	10.0	3.7	7.9	5.8	3.4	3.3
Euro area	2.2	2.2	2.7	-0.4	1.7	2.5	2.2	1.7
Nominal compensation per employee								
Romania	12.4	22.0	31.9	-1.9	7.6	3.7	3.2	4.2
Euro area	2.5	2.6	3.4	1.8	1.7	2.2	1.9	1.9
Labour productivity								
Romania	7.1	5.9	7.3	-4.7	-0.2	2.0	0.9	1.7
Euro area	1.9	1.3	-0.3	-2.4	2.5	1.2	0.1	1.0
Nominal unit labour costs								
Romania	4.9	15.2	22.9	2.9	7.9	1.7	2.3	2.5
Euro area	0.8	1.4	3.8	4.2	-0.8	0.8	1.6	0.8
Imports of goods deflator								
Romania	-1.2	-9.2	17.2	2.2	3.6	7.6	7.5	2.1
Euro area	3.9	1.0	4.2	-7.7	5.7	6.9	3.6	1.3

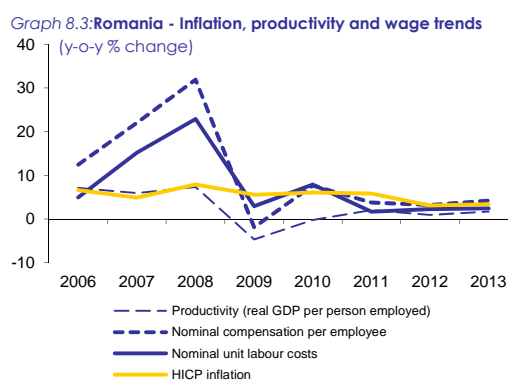
1) 2011 data (except HICP inflation) are estimates.

2) Commission services' Spring 2012 Forecast.

Source: Eurostat, Commission services.

is expected to increase moderately in the period 2012-2013.

2011, following a 25% wage cut in 2010. The budget for 2012 assumed a freeze in the public sector wage bill, including further reductions in public sector employment. In May 2011, the government implemented important reforms in the areas of labour market legislation and social dialogue.



External factors

For Romania, given the deepening integration into the world economy, developments in import prices play an important role in domestic price formation. Import price inflation (as measured by the imports of goods deflator in the national accounts) remained broadly contained in 2009-2010, but it is expected to outpace headline inflation in the period of 2011-2012. A moderation of import price inflation is projected for 2013 in line with the assumed path for commodity prices.

The wage-setting process is largely decentralised, although wage agreements in the public sector continue to play an important signalling role for private sector wages. Public wage sector restraint – after many years of poor discipline – helped to moderate wage costs for the economy as a whole in 2010 and 2011. The sharper-than-expected reduction in public sector employment allowed for a moderate increase in public sector wages in

Energy and food commodity prices have been an important determinant of import price inflation in recent years, in particular in view of the large weight of these categories in the Romanian HICP. In 2010-2011, the energy category of the consumer price basket was strongly affected by volatile, but on the whole rising, global commodity prices. The contribution of energy prices to HICP inflation increased from around 0.7 percentage points in

2009 to about 1.4 percentage points on average in 2010-2011, including significant increases in administered energy prices. Easing global food prices contributed to the sharp disinflation in Romania in the second half of 2011, although an important part of the foodstuffs is traditionally of domestic origin.

Import price dynamics have been influenced by fluctuations of the leu. After weakening by about 17% in the second half of 2008, the leu nominal effective exchange rate (measured against a group of 35 trading partners) broadly stabilised for a prolonged period between early 2009 and mid-2011. A weakening impetus set in during the second half of 2011, in the midst of a deterioration in global risk sentiment, when the leu's nominal effective exchange rate fell by about 3%. Most available estimates suggest that the pass-through of the exchange rate into inflation in Romania is substantial and fast, in particular for categories such as telecommunication services (due to the linking of tariffs to the exchange rate of the leu against the euro) and fuel prices.

Administered prices and taxes

Changes in administered prices and indirect taxes have been an important driver of inflation in Romania in recent years. In particular, changes in indirect taxes exerted a permanent upward pressure on headline inflation until mid-2011. This reflected, *inter alia*, fiscal consolidation efforts by the government as well as EU tax harmonisation of excise duties (on fuels and tobacco products). Administered prices had a comparatively large weight in the HICP basket of around 18% in 2011⁽⁹⁴⁾.

Annual inflation in administered prices increased from 5.4% in 2010 to 7.6% in 2011. The significant administered price increases in 2011 were driven by higher electricity prices, mirroring in particular the pass-through from higher commodity prices and the introduction of a tax on energy with the aim to support renewable producers. Annual increases in heat energy prices surged to 15.5% in 2011, following the elimination of heating subsidies from the state budget from August 2011. Administered utility prices (e.g. water supply, services related to dwellings)

recorded persistently high inflation, on average around 15% in 2010-2011. In the area of indirect taxes, increases in tobacco excise duties contributed particularly strongly to higher inflation in Romania in 2010. The initial pass-through of the 5 percentage points VAT standard rate increase with effect from July 2010 was substantial and implied a durable level shift in the price level, but the effect on inflation was temporary.

Medium-term prospects

Inflation is expected to remain lower in 2012 and 2013 compared to recent years, amid sluggish domestic demand and on assumption of moderate increases in administered prices. Available data indicate a recent decline in inflation expectations. Inflation will likely increase in the second half of 2012 due to an unfavourable base effect stemming from the drop in food prices a year ago, but it should remain within the upper margin of the BNR's 3%±1 percentage point target band. On this basis, the Commission services' Spring 2012 Forecast projects annual HICP inflation to average 3.1% in 2012 and 3.4% in 2013.

Risks to the inflation outlook are tilted to the upside due to yet unclear prospects of increases in administered prices, in particular in gas and electricity for retail consumers. Upside risks also relate to a possible further rise in commodity prices. No major changes in indirect taxes are foreseen going forward, although further upward adjustments cannot be excluded in the context of fiscal consolidation efforts. There are currently no apparent excessive upward wage pressures given the weak economy, but risks may appear if the public sector wage restraint was to be relaxed. Conversely, a slower-than-expected recovery of the economy would have disinflationary effects. There is also an important two-sided risk to inflation stemming from the leu's exchange rate.

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 43% of the euro area average in PPS in 2010). The level of consumer prices in Romania was at around 56% of the euro area average in 2010, with the relative price gap widest for services.

Short to medium-term inflation prospects will hinge upon productivity and wage developments as well as on developments in some categories of

⁽⁹⁴⁾ According to the Eurostat definition, administered prices in Romania include *inter alia* regulated electricity and gas prices, regulated utility prices, cultural services and part of public transport.

administered prices. The liberalization of electricity and gas markets, as agreed under the arrangements of the EU-IMF financial assistance, will imply sizeable price increases up until 2015-2017. The impact of such measures on inflation will depend on the pace of liberalization and developments in global commodity prices. Anchoring inflation expectations at a low level will be also important going forward. A prudent fiscal policy and continued structural reforms, reaffirmed by the commitments of the Romanian authorities under the joint programme supported by the EU and the IMF, should help sustain convergence going forward.

8.3. PUBLIC FINANCES

8.3.1. The excessive deficit procedure for Romania

On 7 July 2009, the Council decided that an excessive deficit existed in Romania in accordance with Article 104(6) TEC, and, on a recommendation by the Commission, it addressed recommendations to Romania in accordance with Article 104(7) TEC with a view to bringing an end to the situation of an excessive deficit by 2011. In its recommendations, the Council established a deadline of 7 January 2010 for effective action to be taken and invited the Romanian authorities to implement all fiscal measures as planned in the February 2009 budget and the April 2009 amended budget, and continue fiscal consolidation in 2010 and 2011 with an average fiscal effort of at least 1 ½% of GDP. On 16 February 2010 the Council concluded that the Romanian authorities had taken effective action to correct the excessive deficit, but it considered that unexpected adverse economic events with major unfavourable consequences for government finances had occurred, thereby justifying revised recommendations under Article 126(7) TFEU. A new deadline for correction of the excessive deficit by 2012 was given. This required an average annual fiscal effort of 1¾ of GDP over the period 2010-2012, as well as the implementation of the fiscal measures planned in the 2010 budget law and continued consolidation in 2011 and 2012. A new deadline of 16 August 2010 was established for Romania to take effective action. In its conclusions of 19 October 2010 the Council assessed that Romania was making satisfactory progress in correcting its excessive deficit and no further action under the excessive

deficit procedure was necessary, thereby putting the procedure in abeyance⁽⁹⁵⁾.

Romania is currently under a precautionary medium-term financial assistance programme with the EU worth EUR 1.4 billion decided on 12 May 2011. This assistance-provided in conjunction with an IMF Stand-By Agreement⁽⁹⁶⁾, also treated as precautionary, is subject to a number of policy conditions including continued and enhanced fiscal consolidation, fiscal governance and structural reforms. These are consistent with the Council recommendations under the EDP⁽⁹⁷⁾.

8.3.2. Recent fiscal developments

During the crisis, the headline government deficit rose from 2.9% of GDP in 2007 to 9% of GDP in 2009. In early 2010, the deteriorating balance prompted the government to implement consolidation measures worth 5% of GDP on an annual basis starting in July. The measures on the expenditure side were worth 3.9% of GDP and included *inter alia* a 25% reduction in public wages and a 15% reduction in social spending excluding pensions. On the revenue side, measures worth 1.1% of GDP included a 5 percentage point increase in the standard VAT rate. As a result, the expenditure to GDP ratio fell by 0.9 percentage points to 40.2%, while the revenue to GDP ratio increased by 1.3 percentage points to 33.4%, thereby reducing the budget deficit to 6.8% of GDP in 2010. Fiscal consolidation continued in 2011 when the deficit is estimated to have fallen to 5.2% of GDP. The expenditure-to-GDP ratio is estimated to have decreased further to 37.7% following lower spending on other transfers. The revenue-to-GDP ratio fell to 32.5%.

⁽⁹⁵⁾ 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

⁽⁹⁶⁾ The precautionary international assistance package of a total of EUR 5 billion also includes contributions from the IMF worth EUR 3.6 billion. The previous financial assistance package (available in years 2009-2011) of a total of EUR 20 billion included contributions from the IMF worth EUR 12.9 billion and the World Bank, EIB and EBRD worth EUR 1.9 billion.

⁽⁹⁷⁾ Previous to the current programme, Romania had received medium-term financial assistance from the EU in the form of a loan of up to EUR 5 billion decided on 6 May 2009. It was also provided in conjunction with an IMF Stand-by agreement and was subject to a number of policy conditions also consistent with the Council recommendations under the EDP.

Table 8.3:

Romania - Budgetary developments and projections								
(as % of GDP unless indicated otherwise)								
Outturn and forecast ¹⁾	2006	2007	2008	2009	2010	2011	2012	2013
General government balance	-2.2	-2.9	-5.7	-9.0	-6.8	-5.2	-2.8	-2.2
- Total revenues	33.3	35.3	33.6	32.1	33.4	32.5	33.4	33.2
- Total expenditure	35.5	38.2	39.3	41.1	40.2	37.7	36.2	35.4
of which:								
- Interest expenditure	0.8	0.7	0.7	1.5	1.5	1.6	1.7	1.7
p.m.: Tax burden	28.6	29.1	28.2	27.0	26.7	27.4	27.7	27.7
Primary balance	-1.4	-2.2	-5.0	-7.5	-5.3	-3.7	-1.1	-0.4
Cyclically-adjusted balance	-4.3	-5.3	-8.8	-9.1	-5.9	-4.4	-1.7	-1.2
One-off and temporary measures	-0.6	-0.1	-0.5	0.5	0.2	-1.1	0.1	0.0
Structural balance ²⁾	-3.6	-5.2	-8.3	-9.6	-6.1	-3.3	-1.8	-1.2
Government gross debt	12.4	12.8	13.4	23.6	30.5	33.3	34.6	34.6
p.m.: Real GDP growth (%)	7.9	6.3	7.3	-6.6	-1.6	2.5	1.4	2.9
p.m.: Output gap	6.8	7.9	10.3	0.4	-3.2	-2.8	-3.7	-3.3
Convergence programme					2010	2011	2012	2013
General government balance							-2.8	-2.2
Structural balance ²⁾³⁾							-1.7	-1.2
Government gross debt							34.2	33.7
p.m. Real GDP (% change)							1.7	3.1
							3.6	3.9

1) Commission services' Spring 2012 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 1.1% of GDP, all deficit increasing; 0.5% of GDP in 2009 and 0.2% of GDP in 2010, all deficit-decreasing.

Sources: Commission services, the 2012 Convergence Programme of Romania.

The 2011 budget deficit was higher than the target of 4.9% of GDP fixed in the 2011 Convergence Programme. However, this was due to a one-off measure related to court decisions⁽⁹⁸⁾. Without this one-off, the deficit would have been lower than the 4.9% target due to higher-than-expected savings on the expenditure side. The structural balance improved from a deficit of 9.6% of GDP in 2009 to a deficit of 6.1% in 2010 and deficit of 3.3% of GDP in 2011 following the implementation of the fiscal consolidation measures by the authorities. Given the need for urgent fiscal consolidation, the authorities had to implement pro-cyclical fiscal policy during the recession which in Romania lasted from the end of 2008 to the end of 2010.

While remaining well below 60% of GDP, the debt-to-GDP ratio increased to 30.5% in 2010 from 23.6% in 2009 as a result of high government deficit and unfavourable effects from the implicit interest rate and the stock-flow adjustment. The ratio increased further to 33.3% in 2011 despite the

positive contributions to debt reduction made by nominal GDP growth and the implicit interest rate.

8.3.3. Medium-term prospects

The budget for 2012 was adopted by Parliament on 15 December 2011. The measures taken to continue fiscal consolidation are mainly on the expenditure side and include: i) a freeze in wages and further employment cuts in the public sector, ii) a pension freeze, iii) the introduction of a new social assistance code which streamlines the number of social assistance programmes and targets them towards the most vulnerable, iv) the termination of pre-accession programmes following the end of the extension period for finishing them. On the revenue side the main measures are an increase in the excise rate for cigarettes and diesel and an increase in royalties paid for the use of the resources necessary to produce construction material. Fiscal consolidation is expected to decrease the deficit to 2.8% of GDP in 2012.

The fiscal consolidation measures implemented by the authorities will lead to a further decrease in the expenditure-to-GDP ratio in 2012 to 36.2% from 37.7% in 2011. This is mainly due to a fall in the

⁽⁹⁸⁾ Further details can be found in the forthcoming Commission Staff Working Document available at: http://ec.europa.eu/economy_finance/economic_governance/sgp/convergence/programmes/2012_en.htm

share in GDP of compensation of employees following the continued freeze in wages and the reduction in the size of the public sector operated in past years. Social benefits will also further decrease as a percent of GDP as a result of the application of the new pension law which tightens the eligibility criteria for early and special pensions, the pension freeze and the introduction of the new social assistance code. Finally, current expenditure will also fall as a share of GDP following the termination of the pre-accession programmes. Revenue as a percent of GDP is expected to increase in 2012 to 33.4% from 32.5% in 2011. In 2013 the deficit is expected to decrease further to 2.2% of GDP under a no-policy-change assumption, mainly as a result of a further fall in the expenditure-to-GDP ratio to 35.4%. The underlying fiscal position this year as measured by the change in the structural balance (cyclically-adjusted balance excluding one-offs and other temporary measures) in the Commission services' Spring 2012 Forecast is restrictive, following the implementation of further consolidation measures in a context of relatively weak economic growth. The structural balance will improve further to 1.2% of GDP in 2013. The debt-to-GDP ratio is expected to stabilise in 2012 and 2013, after several years of strong growth due to the economic crisis.

Romania submitted the 2012 Convergence Programme on 11 May 2012. The Programme aims to correct the excessive deficit this year, in line with the Council's recommendations to Romania under the EDP procedure, and reach the MTO in 2014. The Convergence Programme foresees a deficit of 2.8% of GDP in 2012, 2.2% of GDP in 2013, 1.2% of GDP in 2014 and 0.9% of GDP in 2015. The Commission services' Spring 2012 Forecast expects the deficit to decrease to 2.8% of GDP in 2012 and further to 2.2% of GDP in 2013 under a no-policy-change assumption.

Further details on the assessment of the 2012 Convergence Programme for Romania can be found in the forthcoming Commission Staff Working Document⁽⁹⁹⁾, which accompanies the Commission Recommendation for a Council Recommendation on the National Reform Programme 2012 of Romania and delivering a Council Opinion on the 2012 Convergence Programme of Romania.

⁽⁹⁹⁾ Available at: http://ec.europa.eu/economy_finance/economic_governance/sgp/convergence/programmes/2012_en.htm

In March 2012, Romania signed the Treaty on Stability, Coordination and Governance in the EMU. This implies an additional commitment to conduct stability-oriented and sustainable fiscal policies. This Treaty will apply to contracting Member States with a derogation which have ratified the Treaty as from the date when the decision abrogating that derogation will come into force unless they declare their intention to be bound at an earlier date by some or all of the provisions on the fiscal compact and on economic policy coordination and convergence.

8.4. EXCHANGE RATE STABILITY

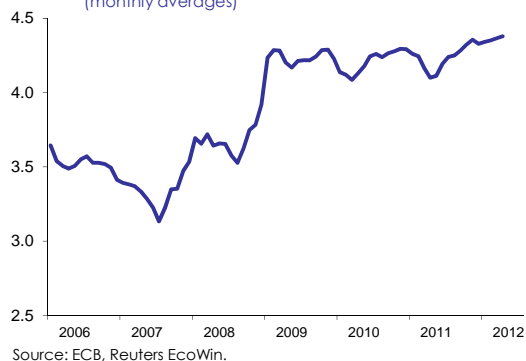
The Romanian leu does not participate in ERM II. Romania has been operating a *de jure* managed floating exchange rate regime since 1991 with no preannounced path for the exchange rate⁽¹⁰⁰⁾. *De facto*, the exchange rate regime had moved gradually from a strongly managed float – including through the use of administrative measures until 1997 – to a more flexible one. In 2004, the BNR increased the flexibility of the exchange rate and moved to a regime characterized by less frequent interventions. A further change in the monetary policy strategy followed in 2005, when Romania shifted to a direct inflation targeting framework – combined with a floating exchange rate regime. The BNR has stressed, nonetheless, that currency intervention remains available as a policy instrument.

The nominal exchange rate of the leu against the euro fluctuated in a wide range in the pre-crisis years. As of mid-2007, the leu appreciated to a five-year high amid capital inflows sparked by EU membership and economic catching-up (facilitated by full capital account liberalisation in 2006). Between mid-2007 and late 2008, the leu's exchange rate followed a broad depreciation trend in the midst of intensifying global market tensions. Country-specific factors also played a role in view of rising investors' concerns about large and widening domestic macroeconomic imbalances. In autumn 2008, Romania was downgraded by major rating agencies; CDS spreads on sovereign debt increased substantially, money market rates surged, while the leu's exchange rate recorded a particularly strong depreciation.

⁽¹⁰⁰⁾ 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.

Following agreement in early 2009 to provide Romania with a coordinated package of international financial assistance, financial market pressures eased and the leu broadly stabilised against the euro – at levels that then prevailed for most of the period from 2009 to 2011. The lower short-term volatility of the leu has reflected – in addition to the positive effects associated with international financial assistance to Romania and easing global market conditions – also operations by the BNR in the interbank market as well as in the foreign exchange market. The leu's exchange rate temporarily depreciated at times of heightened global risk aversion (in spring 2010 and autumn 2011), but the weakening was more moderate in comparison with regional peers with a floating exchange rate regime. The leu's exchange rate against the euro remained broadly stable in early 2012, though at a moderately weaker level than the 2009–2011 average. During the two years before this assessment, the leu depreciated against the euro by 6.4%.

Graph 8.4: Exchange rates - RON/EUR
(monthly averages)

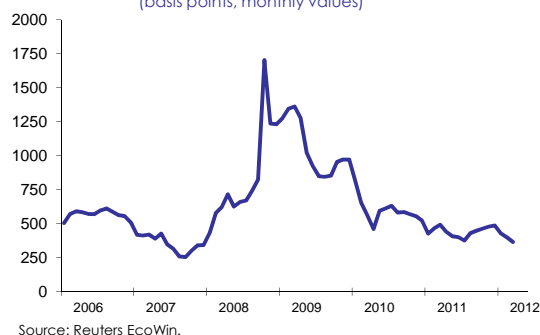


The level of gross international reserves remained robust in 2011, amounting to above 100% of short-term external debt at remaining maturity. International reserves were notably boosted by the disbursements of international financial assistance since 2009. Fluctuations in the level of gross international reserves over recent years also reflected changes in the foreign exchange reserve requirements of the credit institutions and foreign exchange operations by the government.

In autumn 2008, the market turmoil and the ensuing lack of liquidity drove up short-term interest rate differentials significantly. Short-term spreads eased markedly in 2009. This reflected lower key policy interest rates of the BNR and improved conditions on the Romanian money market. Short-term interest rates fell further in early 2010, in line with key rate cuts by the BNR

and a stabilisation of the interbank market. Between June 2010 and September 2011, the BNR maintained the key policy rate stable, though abundant liquidity conditions kept short-term interbank rates well below the policy rate for most of 2011 and early 2012. The BNR's key interest rate was lowered to 5.25% by April 2012, i.e. to 425 basis points above the ECB reference rate.

Graph 8.5: Romania - 3-M Robor spread to 3-M Euribor
(basis points, monthly values)



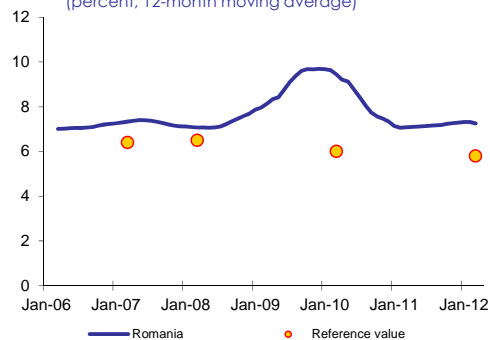
8.5. LONG-TERM INTEREST RATES

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 9 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 ⁽¹⁰¹⁾.

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 2009, but gradually declined thereafter and hovered at just above 7% since early 2011. In March 2012, the latest month for which data are available, the reference value, given by the average of long-term interest rates in Sweden and Slovenia plus 2 percentage points, stood at 5.8%. In that month, the 12-month moving average of the yield on the Romanian benchmark bond stood at 7.3%, i.e. 1.5 percentage points above the reference value.

⁽¹⁰¹⁾ The Ministry of Public Finance lengthened maturities of its debt instruments in the course of 2011, though the average remaining maturity of government debt denominated in domestic currency remains comparatively low (at 2.6 years by year-end).

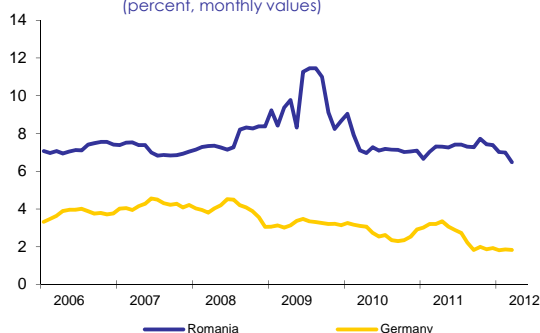
Graph 8.6: Romania - Long-term interest rate criterion
(percent, 12-month moving average)



Source: Commission services.

Long-term interest rates increased sharply as the global financial crisis intensified in late 2008. The widening spread between Romanian and euro area benchmark bonds largely reflected increasing country and currency risk premia. Long-term interest rates in Romania then declined sharply in late 2009 and remained at just above 7% for most of the period 2010-2011, before falling to the lowest level since EU accession in early 2012. A decreasing country risk premium due to a solid fiscal consolidation track record and a gradual downward adjustment in the expected path of interbank rates contributed to driving yields down. The long-term spread vis-à-vis the German benchmark bond widened sharply in the midst of the euro area turmoil in the third quarter 2011, before stabilising at around 500 basis points in early 2012⁽¹⁰²⁾.

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

⁽¹⁰²⁾ The reference to the German benchmark bond is included for illustrative purposes, as a proxy of the euro area long-term AAA yield.

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 – is an important indication that the integration of a Member State into the euro area would proceed without difficulties.

The section on additional factors makes reference *inter alia* to 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⁽¹⁰³⁾. Related to this, in February 2012, the Commission published its Alert Mechanism Report (AMR)⁽¹⁰⁴⁾. The scoreboard shows that Romania exceeds the indicative threshold in three out of ten indicators, all of them in the area of external imbalances (namely on the current account balance, international investment position and nominal unit labour costs). Romania currently benefits from a precautionary EU-IMF assistance programme totalling up to about EUR 5 billion that is made available until early 2013. In 2012, Romania – as a programme country and in order to avoid the duplication of surveillance procedures – is not examined under the macroeconomic imbalances procedure.

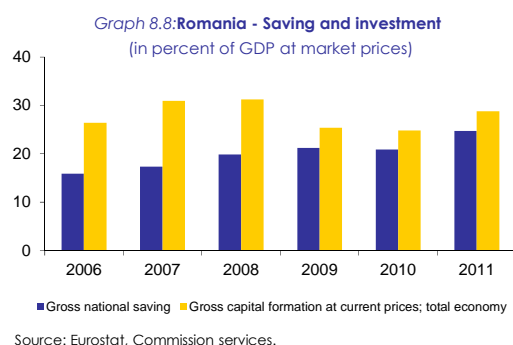
8.6.1. Developments of the balance of payments

Romania's external balance (i.e. the combined current and capital account) improved markedly during the global crisis. The external deficit declined from a peak of around 13% of GDP in 2007 to an average of around 4% of GDP in 2009-2011. The narrowing of the external shortfall over past three years reflected in particular a significantly lower merchandise trade deficit, due to a sharper decline in imports than exports amid plummeting domestic demand. Net income outflows fell amid a decline in profits related to FDI. The capital account recorded only a modest surplus, as EU funds absorption remained comparatively low in recent years.

⁽¹⁰³⁾ The package of six legislative proposals to strengthen the economic governance of the EU entered into force in December 2011.
<http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/898>

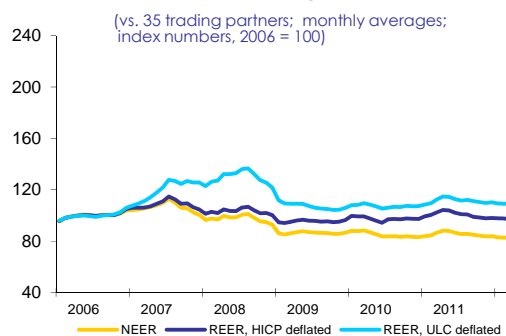
⁽¹⁰⁴⁾ http://ec.europa.eu/economy_finance/articles/governance/2012-02-14-alert_mechanism_report_en.htm

In terms of the saving-investment balance, the deterioration in the external deficit in pre-crisis years was largely accounted for by an increase in domestic investment. This notably reflected improved access to credit, partly channelled into the Romanian economy through foreign-owned banks. Part of the widening external gap mirrored an increase in the general government deficit in 2006-2008. The savings-investment gap shrunk sharply and stabilised at close to 4% of GDP during the economic crisis. In 2009, it reflected mainly plummeting domestic demand due to balance sheet adjustment in the private sector, while a widening of the fiscal gap operated against the correction of the external shortfall. In 2010-2011, the improvement in the general government balance contributed to narrowing of the external gap, while a moderate deterioration in the private saving-investment balance – amidst the signs of economic stabilisation – acted broadly as an offset.



The real effective exchange rate appreciated strongly in the period from 2006 to 2007, partly due to trend nominal appreciation of the leu. Since the onset of the financial crisis, price and cost competitiveness has improved on the back of a weakening nominal effective exchange rate of the leu – although positive differentials in relative consumer prices developments and unit labour costs vis-à-vis main trading partners acted partly as an offset. The continued gains in world export market share, driven by EU membership and export product diversification, support the view that Romania's competitiveness remains adequate.

Graph 8.9: Romania - Effective exchange rates



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. In early 2009, a co-ordinated package of international financial assistance totalling up to EUR 20 billion was provided to Romania amid tightening market conditions and growing government refinancing needs. Nearly all of the pre-committed funds were disbursed between 2009 and early 2011. In spring 2011, after the successful completion of the first balance-of-payments assistance programme, a follow-up joint EU-IMF precautionary programme (available until early 2013) totalling up to about EUR 5 billion was made available to Romania.

External financing pressures eased markedly in 2010-2011 amid the sharp improvement in the external balance, disbursements of international financial assistance and recovery in global risk appetite. Romania's financial account surplus shrank from about 13% of GDP recorded before the crisis to an average of just above 4% of GDP in 2010-2011. Net FDI fell sharply amid deteriorating investors' sentiment towards Romania. Net other inflows remained positive throughout the crisis due to disbursements of international financial assistance. The rising level of gross external debt was mainly driven by public debt, despite the marked reduction in the fiscal shortfall over the past three years; this reflects disbursements of international financial assistance and partly renewed international bond issuance⁽¹⁰⁵⁾. In 2011,

⁽¹⁰⁵⁾ The Romanian Treasury had launched its first 5-year internationally issued euro-denominated bond under the medium term notes programme in June 2011, but further issuances in autumn 2011 were postponed amid global market tensions. In January 2012, the Treasury successfully

Table 8.4:

Romania - Balance of payments		(percentage of GDP)				
	2006	2007	2008	2009	2010	2011
Current account	-10.5	-13.4	-11.6	-4.2	-4.4	-4.4
of which: Balance of trade in goods	-12.1	-14.3	-13.6	-5.8	-6.1	-5.5
Balance of trade in services	0.0	0.3	0.5	-0.2	0.3	0.3
Income balance	-3.3	-3.3	-2.7	-1.6	-1.5	-1.8
Balance of current transfers	5.0	3.9	4.3	3.5	2.9	2.6
Capital account	0.0	0.7	0.4	0.5	0.2	0.3
External balance ¹⁾	-10.5	-12.8	-11.1	-3.6	-4.2	-4.1
Financial account	9.6	13.5	12.6	4.7	4.6	3.6
of which: Net FDI	8.9	5.7	6.7	3.0	1.8	1.4
Net portfolio inflows	-0.2	0.4	-0.4	0.4	0.7	1.5
Net other inflows ²⁾	6.3	11.0	6.3	2.3	4.7	1.5
Of which International financial assistance				7.5	6.4	1.7
Change in reserves (+ is a decrease)	-5.4	-3.6	0.1	-1.0	-2.6	-0.7
Financial account without reserves	15.0	17.0	12.6	5.8	7.2	4.4
Errors and omissions	0.9	-0.7	-1.5	-1.1	-0.4	0.6
Gross capital formation	26.5	31.0	31.3	25.4	24.8	28.8
Gross saving	15.9	17.4	19.8	21.2	20.9	24.7
External debt	42.1	47.0	51.8	68.7	74.5	72.1
International investment position	-37.7	-43.5	-49.4	-62.4	-62.7	-60.5

1) The combined current and capital account.

2) Including financial derivatives.

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

total gross external debt stood at about 72% of GDP and the negative net international investment position at just above 60% of GDP.

According to the Commission services' Spring 2012 Forecast, the external deficit is expected to remain below 5% of GDP in 2012-2013. Romania's external position is expected to benefit from a higher absorption of EU funds, while supported by the precautionary EU-IMF assistance programme.

8.6.2. Product market integration

Romania's economy is well integrated to the EU economy through trade and investment linkages. The trade openness of Romania has however been lower compared to other non euro area Member States with derogation; it declined temporarily during the global crisis, but recovered in 2010 to its long-term average of just below 40% of GDP in 2010. Trade with other EU Member States is predominant (particularly with Germany, Italy and

France) and has been increasing since the EU accession in 2007.

Romania's trade specialisation is mostly in low and medium-to-low technology goods. Recently, however, the country's comparative advantage in labour-intensive goods has diminished, and the specialisation in capital-intensive goods has somewhat increased. The cumulated share of a few sectors, namely machinery, transport, optical and electrical equipment, increased significantly from 27% to 47% in 2005 and 2010 respectively. The share of high value-added goods in exports reached 8.2% of GDP in 2010, reflecting a gradual upward shift in the specialisation pattern. The technological trade deficit almost halved as a share in GDP in 2009 compared to 2005, as a result of the reduced investment, deleveraging and a significant fall in FDI inflows. The export performance of Romania would benefit from a greater technological content of exports to build up non-price competitiveness and become less dependent on labour cost advantages.

Due to its competitive wages, favourable corporate tax rates and relatively large domestic market Romania attracted substantial FDI inflows over

returned to markets with a US dollar-denominated issuance of 10-year bonds.

Table 8.5:

Romania - Product market integration

	2005	2006	2007	2008	2009	2010
Trade openness ¹⁾ (%)	38.2	38.3	36.2	37.0	33.6	38.1
Intra-EU trade in goods GDP ratio ²⁾ (%)	22.6	22.5	23.2	22.7	21.2	24.5
Intra-EU trade in services GDP ratio ³⁾ (%)	3.9	4.1	4.0	4.6	4.6	4.0
Extra-EU trade in goods GDP ratio ⁴⁾ (%)	11.7	11.6	9.2	9.7	7.6	9.4
Export in high technology ⁵⁾ (%)	3.1	3.8	3.5	5.4	8.2	n.a.
Technological balance ⁶⁾ (%)	-2.9	-2.9	-2.6	-2.2	-1.5	n.a.
Total FDI inflows GDP ratio ⁷⁾ (%)	6.5	9.2	5.8	6.8	2.9	1.8
Intra-EU FDI inflows GDP ratio ⁸⁾ (%)	6.7	8.6	5.2	6.1	3.1	1.7
FDI intensity ⁹⁾	3.3	4.4	2.6	3.1	1.5	0.9
Internal Market Directives ¹⁰⁾ (%)	:	:	0.8	0.4	0.3	0.5
Value of tenders in the EU Official Journal ¹¹⁾	:	:	32.5	31.6	25.0	23.3
Time to start up a new company ¹²⁾	11.0	11.0	9.0	9.0	9.0	9.0
Real house price index ¹³⁾	100.0	146.0	211.0	170.9	126.0	107.8
Residential investment ¹⁴⁾ (%)	2.0	1.8	2.4	3.2	3.0	n.a.
Building permits index ¹⁵⁾	100.0	118.0	130.0	140.0	112.0	97.0

1) $(\text{Imports} + \text{Exports of goods and services} / (2 \times \text{GDP at current market prices})) \times 100$ (Foreign Trade Statistics, Balance of Payments).

2) $(\text{Intra-EU-27 Imports} + \text{Exports of goods} / (2 \times \text{GDP at current market prices})) \times 100$ (Foreign Trade Statistics).

3) Intra-EU-27 trade in services (average credit and debit in % of GDP at current prices) (Balance of Payments).

4) $(\text{Extra-EU-27 Imports} + \text{Exports of goods} / (2 \times \text{GDP at current market prices})) \times 100$ (Foreign Trade Statistics).

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

6) $(\text{Exports} - \text{imports in high tech}) / \text{GDP at current prices} \times 100$, 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-EU-27 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) Public procurement - Value of public procurement which is openly advertised in the EU Official Journal in total public procurement.

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

13) Experimental house price index (2005=100), Eurostat.

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

15) Number of new residential buildings (2005=100), Eurostat.

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

past years, which supported a gradual restructuring of the economy. Romania's FDI stock reached around 43% of GDP in 2009, but it remained significantly lower as compared to EU-27 average (71%) as well as to other non-euro area Member States⁽¹⁰⁶⁾. FDI inflows mainly originate in the EU, while the Netherlands, Austria and Germany accounted for more than half of the FDI stock in 2009. The majority of FDI (55% of the total stock in 2009) was in services, while about 32% went to manufacturing – which contributed to a strengthening of the export capacity. FDI is not evenly distributed across regions in the country, as the capital region had attracted almost two thirds of the total stock by 2010.

House prices and residential construction spiked in the period around the EU accession in 2007, before

undergoing significant downward adjustment during the crisis. Real house prices increased at a cumulated rate of 142% between 2005 and the third quarter of 2007. Since the peak, real house prices have adjusted by 58%. Residential construction increased from 1% of GDP in 2000 to 3% of GDP in 2008, but adjusted to around 2% of GDP in 2009-2010. Moreover, after reaching a peak in 2008, the evolution of building permits, considered as a leading indicator for the sector, is also on a downward path and back to 2005 levels.

Concerning the business environment, Romania scores poorly compared to euro area Member States in international rankings⁽¹⁰⁷⁾. From a comparative perspective, this weak performance can be explained by particularly low scores for starting a business, trading across borders, and

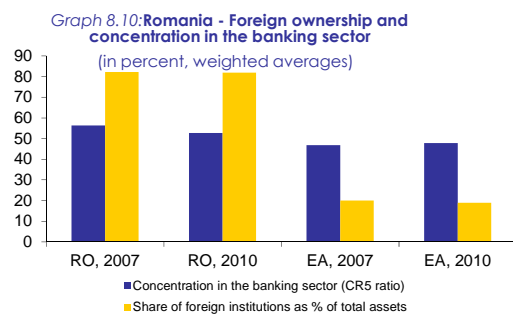
⁽¹⁰⁶⁾In 2009, a part of the FDI stock level increase has to be attributed to important valuation effects related to the exchange rate fluctuations of the leu.

⁽¹⁰⁷⁾For instance, Romania ranks on 77th and 72nd place according to the 2011-2012 Global Competitiveness index and the 2012 World Bank Doing Business respectively.

registering property. According to the November 2011 Internal Market Scoreboard, Romania equalled the EU average transposition deficit of 1.2%. The share of public procurement tenders announced in the EU Official Journal is marginally higher than the EU average⁽¹⁰⁸⁾.

8.6.3. Financial market integration

The Romanian financial sector has been well integrated into the EU financial sector, particularly through strong interbank linkages. The share of assets of foreign-owned credit institutions – mainly euro area banks – in total assets of credit institutions in Romania hovered at around 80% since EU accession. Bank concentration, as measured by the market share of the largest five credit institutions in total assets, remains somewhat above the euro area average.



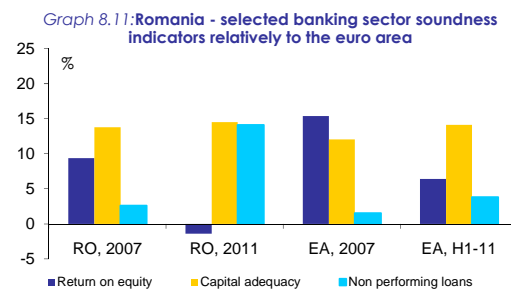
¹⁰⁸ EU banking sector, December 2011.

Financial intermediation is performed predominantly by banks, though Romania still lags considerably behind the euro area concerning the evolution of bank credit to the private non-financial sector. After a rapid financial deepening over the period 2004-2008, credit activity in Romania weakened considerably during the crisis. Annual credit growth to the private sector fell from above 50% in 2008 to about 7% by end-2011. As a result, domestic bank credit to the private sector relative to GDP stabilised below 40% of GDP in 2009-2011. These developments reflect both tightened bank lending standards and low credit demand due to weak economic activity and debt deleveraging, while the reliance on external funding was significantly reduced in recent years. The foreign currency lending continued to play an important role in private sector lending throughout the crisis; its share in total lending increased by about 9 percentage points to around 63% over the

⁽¹⁰⁸⁾ The value of tenders published in the EU Official Journal may serve as a proxy of the extent to which national public procurement are open to foreign bidders.

period 2008-2011, though roughly half of this increase is accounted for by the depreciation of the domestic currency.

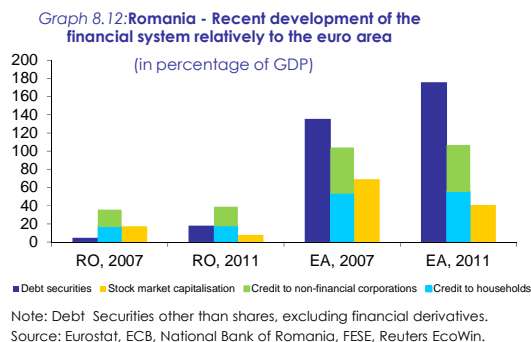
In spite of potential spill-overs from the peripheral euro area countries, the Romanian financial sector has weathered the financial crisis well and no rescue measures have been taken by the government thus far. The banking system has remained well-capitalised, with a capital adequacy ratio of around 14.2% by end-2011. Although the high share of foreign currency lending and rather severe adjustment in the housing market during the crisis may pose a threat to macro-financial stability, there seems to be no evidence of large-scale mortgage foreclosures in Romania. Nonetheless, the ongoing deterioration in asset quality and the increase in loan-loss provisions have negatively impacted profitability in 2011. Non-performing loans (90 days overdue definition) increased significantly throughout the crisis period (up to 14.1% by end-2011).



Note: For 2007 and 2011, EU-27 non performing loans are a proxy for EA. For 2007, EA RoE and CAR averages are unweighted.

Source: ECB, National Bank of Romania, EC calculations.

Market penetration rates for non-bank services are low and were also impacted by the recent economic downturn. In the insurance sector, written premiums declined by 7.5% in 2010 compared to 2009. Insurance penetration in Romania stood at about 1.5 % of GDP in 2010, which is one of the lowest levels in the EU. In 2007, Romania introduced a private pension funds system comprising two pillars: the mandatory private pension funds (pillar II) and the voluntary private pension funds (pillar III). Notwithstanding the difficult economic environment, the net assets of both pillar II and pillar III pension funds followed a positive trend in the last two years. Albeit from a low level, the assets of the second pillar increased by some 169% in 2011 compared to 2009. The assets of the third pillar went up by roughly 113% in the same period.



Romanian equity and debt markets are comparatively underdeveloped. Stock market capitalisation, despite significant increases recorded in 2006-2007, continued to be very low in comparison with the euro area. During the crisis, the stock market capitalisation gap vis-à-vis the euro area remained broadly unchanged amid high market volatility, as the Romanian market largely moved in sync with global markets. The debt securities markets have been dominated by issuances of T-bills and bonds by central government, while the issuance of corporate and municipal bonds has been traditionally very limited. Available data and indicators also suggest that non-resident holdings of domestically issued government securities remain at a low level. Private sector debt, at around 78% of GDP in 2010, stood well below the euro area average⁽¹⁰⁹⁾.

Romania has transposed all FSAP directives into national legislation, whereas the transposition rate of post-FSAP directives stood at just below 70% in January 2012. Although the transposition deadline has already passed, the Commission has not received the notification for the transposition of the amendments to the undertakings for collective investment in transferable securities (Directive 2009/65/EC) as well as of the amendments to the reporting and documentation requirements in the case of mergers and divisions (Directive 2009/109/EC). Romania partially notified to the Commission the transposition of Omnibus I (Directive 2010/78/EU).

⁽¹⁰⁹⁾ Data on private sector debt are based on unconsolidated 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.

9. SWEDEN

9.1. LEGAL COMPATIBILITY

9.1.1. Introduction

The role of the Riksbank as a central bank dates back to 1897 when the first Riksbank Act was adopted concurrently with a Law giving the Riksbank the exclusive right of issuing banknotes. The legal basis for its establishment is contained in both the Instrument of Government (Swedish Constitution) and the Sveriges Riksbank Act adopted in 1988.

No amendments to the Riksbank Act have been introduced with regard to the incompatibilities mentioned in the 2010 Convergence Report.

9.1.1.1. Central Bank Independence

In Chapter 3, Article 2 of the Riksbank Act and in Chapter 9, Article 13 of the Instrument of Government, the prohibition on the members of the Executive Board to seek or take instructions only covers monetary policy issues. As the provisions do not provide for their independence in the performance of the other ESCB related tasks, the principle of the central bank's institutional independence is not respected. Both provisions are therefore considered as incompatible with Article 130 of the TFEU and Article 7 of the ESCB/ECB Statute.

Chapter 6, Article 3 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. 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 Central Bank to independently take decisions and offers the possibility for the Government to seek to influence them. Therefore, 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 and thus should be adapted accordingly.

Chapter 1, Article 4 of the 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 cases of termination of office.

Pursuant to Chapter 10, Article 4 of the Act, the 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 right of the Parliament should be to acknowledge the Central Bank's decision on the profit allocation. The Parliament should not be involved in the relevant central bank's decision-making process.

According to Chapter 8, Article 14(2) of the Instrument of Government, the Parliament may direct the Riksbank in an act of law within its sphere of responsibility under Chapter 9 (financial power). This provision does not respect the principle of the Central Bank's independence in the performance of its tasks conferred upon by the TFEU and the ESCB/ECB Statute and is therefore considered as incompatible.

9.1.2. Prohibition of monetary financing and privileged access

Under Chapter 6, Article 8 of the 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 debtor's default. The absence of such a provision constitutes therefore, an incompatibility with the prohibition on monetary financing as foreseen by the Article 123 of the TFEU.

Pursuant to Chapter 8, Article 1 of the Act, the Riksbank shall not extend credits or purchase debt instruments directly from the State, another public body or an institution of the EU. Article 1 is

incompatible with the wording of Article 123(1) of the TFEU and 21(1) of the ESCB/ECB Statute. Thus, it should define more clearly the entities concerned. According to the same Article, fourth sentence, 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 and constitutes a further imperfection. It should be added that, in the context of the supply of reserves by central banks, these publicly owned credit institutions should receive the same treatment as private credit institutions.

As noted above under paragraph 8.1.3, Chapter 10, Article 4 of the Act sets provisions for the allocation of Riksbank's profit. These provisions are supplemented by non-statutory guidelines on profit distribution, according to which 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 Riksbank's reserve capital 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.

9.1.3. Integration in the ESCB

Objectives

Chapter 1, Article 2 of the 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, Article 14 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 for the collection of statistics (Chapter 6, Articles 4(2) and Article 9);
- non-recognition of the role of the ECB for 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 for the appointment of an external auditor;
- non-recognition of the role of the ECB in the field of international cooperation (Chapter 7, Article 6).

9.1.4. Assessment of compatibility

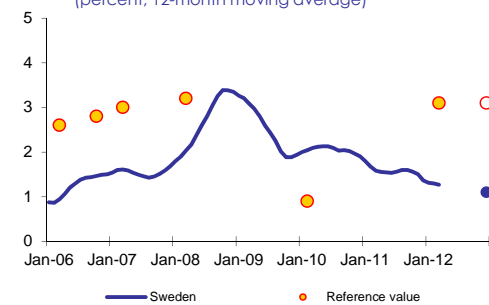
As regards the prohibition on monetary financing, the independence of the central bank as well as its integration into the ESCB at the time of euro adoption, the legislation in Sweden, in particular the Sveriges Riksbank Act, the Instrument of Government and the Law on Exchange Rate Policy, is not fully 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 for Sweden, which is used for the convergence evaluation, was above the reference value at the time of the last convergence assessment in 2010. Since then, inflation has gradually declined. In March 2012, the reference value was 3.1%, calculated as the average of the 12-month average rates in Sweden, Ireland and Slovenia plus 1.5 percentage points. The corresponding inflation rate in Sweden was 1.3%, i.e. 1.8 percentage points below the reference value. Sweden's 12-month average inflation rate is likely to remain well below the reference value in the months ahead.

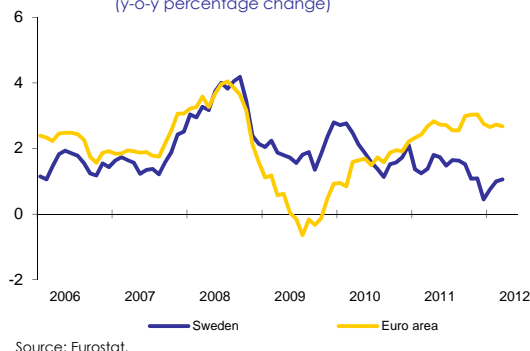
Graph 9.1: Sweden - Inflation criterion since 2006
(percent, 12-month moving average)



Note: The dots in December 2012 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2012 Forecast.

9.2.1. Recent inflation developments

Graph 9.2: Sweden - HICP inflation
(y-o-y percentage change)



Source: Eurostat.

After averaging 3.3% in 2008, inflation has been below 2% in the following years, as the stronger krona in 2010 together with subdued unit labour costs have held back inflationary pressure. Inflation temporarily picked up in the second half of 2010 amid higher energy prices (overall HICP inflation almost doubled between August and

December 2010, from 1.1% to 2.1%). In the course of 2011, inflation slowed down and averaged 1.4% in 2011. HICP inflation stood at 1.1% in March 2012.

Core inflation (measured as HICP excluding energy and unprocessed food) has hovered around 1% since mid-2010. Important factors behind this subdued underlying trend include low resource utilisation, effects relating to the strong appreciation of the krona and falling unit labour costs. This resulted in a slowdown in the rate of price increases for services and non-energy industrial goods, the latter turning negative in the second half of 2010. Processed food inflation has gradually come down from very high levels in 2008, but began to increase again in 2011.

9.2.1. Underlying factors and sustainability of inflation

Macroeconomic policy-mix and cyclical stance

The Swedish economy recovered strongly from the 2008-2009 recession, with GDP growth of 6.1% in 2010. The upturn was broad-based and covered both exports and domestic demand. Swedish exports picked up, partly driven by rapid economic growth in emerging economies. The economy continued to expand rapidly during most of 2011 but growth slowed down considerably towards the end of the year as lower external demand, falling stock prices and increased economic uncertainty made households and firms more cautious. Overall, GDP expanded by 3.9% in 2011. Although some of the negative momentum from the end of 2011 is expected to spill over into early 2012, survey data point to a return to positive economic growth already in early 2012. The recovery is, however, expected to be subdued and relatively fragile. The Commission services' Spring 2012 Forecast projects GDP growth of 0.3% in 2012 and 2.1% in 2013.

Despite the deep economic downturn in 2008 and 2009, Sweden recorded only a small budget deficit. Part of the reason was the strong initial position of public finances, with high budget surpluses and a relatively low government debt ratio. The fiscal policy framework introduced after the banking crisis in early 1990s (a budget surplus rule, central government nominal expenditure ceilings and balanced budget requirements for local governments) played an important role. The

Table 9.1:
Sweden - Components of inflation

	(percentage change) ¹⁾							weights
	2006	2007	2008	2009	2010	2011	Mar-12	in total
HICP	1.5	1.7	3.3	1.9	1.9	1.4	1.3	1000
Non-energy industrial goods	-0.4	0.6	-0.1	1.5	0.9	-0.5	-0.6	284
Energy	6.9	0.5	9.5	-0.8	5.5	4.8	3.9	117
Unprocessed food	2.6	2.2	6.5	3.3	0.9	-1.8	-1.7	58
Processed food	0.1	3.7	7.6	2.7	1.8	2.7	2.8	135
Services	1.3	2.1	2.2	2.6	1.8	1.7	1.7	406
HICP excl. energy and unproc. food	0.5	1.8	2.3	2.3	1.5	1.1	1.1	825
HICP at constant taxes ²⁾	1.4	1.3	2.7	1.8	1.9	1.4	1.4	1000
Administered prices HICP	1.1	2.2	1.8	2.6	1.9	1.9	2.3	158

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.

2) Last observation for HICP at constant taxes is February 2012.

Sources: Eurostat, Commission services.

fiscal policy stance (measured by the change in structural balance) has been expansionary since 2010 and is likely to tighten in 2012, as some previous measures expire.

Since 1995, the Riksbank has targeted the domestic CPI with the aim to keep inflation at 2%. In 2010, the Riksbank removed the tolerance interval of ± 1 percentage points that had been in place since 1995 from its specification of the inflation target. While there have been long periods when inflation deviated significantly from the target, long-term inflation expectations have remained well anchored since the late 1990s. ⁽¹¹⁰⁾

The non-conventional monetary policy measures adapted by the Riksbank following the financial crisis in 2008 were phased out during 2010 as the funding situation for Swedish banks improved. After cutting the repo rate to 0.25% during the crisis, the Riksbank embarked on a tightening cycle in July 2010. The repo rate was gradually raised from 0.25% to 2.0% one year later amid growing inflationary pressure and concerns about strong household credit growth. Appreciation of the krona since early 2011 has also contributed to tightening monetary conditions. In December 2011 and February 2012, the Riksbank cut its repo rate in two steps by 50 basis points to 1.50% as a deteriorating outlook for global growth and a slowdown in the Swedish economy was expected to keep inflationary pressure low in the period ahead.

Wages and labour costs

The Swedish labour market fared relatively well during the crisis as labour hoarding dampened the increase in unemployment. Unemployment increased by around 3 percentage points from August 2008 to a peak of 9.1% in April 2010. Unemployment has since then gradually declined and stabilised at around 7.5% since mid-2011. Annual growth of nominal compensation per employee slowed down markedly during 2008 and 2009, largely due to reductions in overtime pay and other variable supplements. In 2010, growth in compensation per employee picked up as the labour market improved, although remaining below pre-crisis levels. The following year, growth in compensation slowed down considerably due to historically low wage agreements made in 2010. A large drop in output per worker caused nominal unit labour costs (ULC) to surge in 2009 before becoming negative in 2010 as output per worker recovered sharply. In 2011, nominal unit labour costs increased modestly. Public sector wages increased at a slightly higher pace than in the private sector during 2010 and for most of 2011. According to the Commission services' Spring 2012 Forecast, the growth of nominal compensation per employee is expected to increase to 2.9% in 2012 and 3.1% in 2013. This, together with a weakening of productivity growth, implies an increase in nominal unit labour costs (ULC) of 2.8% in 2012. The following year, growth in ULC is expected to slow down to 1.4%.

⁽¹¹⁰⁾ The difference between HICP and domestic CPI can occasionally be relatively large, reflecting above all the non-inclusion of interest costs for owner-occupied homes. This was the case in 2009 when drastic repo rate cuts implemented during the crisis contributed to a rapid fall of CPI inflation, which became negative.

Table 9.2:

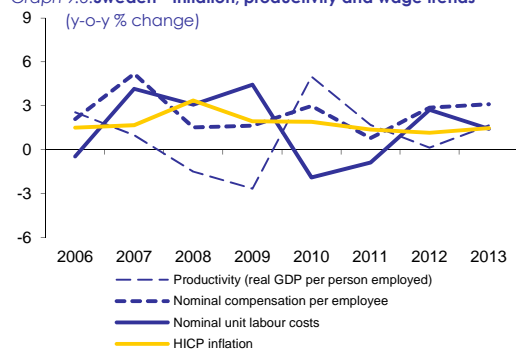
Sweden - Other inflation and cost indicators	(annual percentage change)							
	2006	2007	2008	2009	2010	2011 ¹⁾	2012 ²⁾	2013 ²⁾
HICP inflation								
Sweden	1.5	1.7	3.3	1.9	1.9	1.4	1.1	1.5
Euro area	2.2	2.1	3.3	0.3	1.6	2.7	2.4	1.8
Private consumption deflator								
Sweden	1.2	1.4	3.1	2.1	1.4	1.3	1.1	1.3
Euro area	2.2	2.2	2.7	-0.4	1.7	2.5	2.2	1.7
Nominal compensation per employee								
Sweden	2.1	5.2	1.5	1.6	3.0	0.8	2.9	3.1
Euro area	2.5	2.6	3.4	1.8	1.7	2.2	1.9	1.9
Labour productivity								
Sweden	2.6	1.0	-1.5	-2.7	5.0	1.7	0.1	1.7
Euro area	1.9	1.3	-0.3	-2.4	2.5	1.2	0.1	1.0
Nominal unit labour costs								
Sweden	-0.5	4.2	3.1	4.4	-1.9	-0.9	2.7	1.4
Euro area	0.8	1.4	3.8	4.2	-0.8	0.8	1.6	0.8
Imports of goods deflator								
Sweden	3.9	0.2	4.3	-1.0	-0.2	-0.4	1.5	1.5
Euro area	3.9	1.0	4.2	-7.7	5.7	6.9	3.6	1.3

1) 2011 data (except HICP inflation) are estimates.

2) Commission services' Spring 2012 Forecast.

Source: Eurostat, Commission services.

Graph 9.3: Sweden - Inflation, productivity and wage trends
(y-o-y % change)



Source: Eurostat, Commission services' Spring 2012 Forecast.

The Swedish wage formation system is based on collective bargaining, both in the public and private sector. The social partners are responsible for wage formation themselves, and in principle engage in it without any interference from the political authorities. The majority of wage bargaining takes place at company or establishment level, within the framework of a sectoral agreement. The Industrial Agreement has played a prominent role since 1997, confirming the role of the industry as wage leader. The 2010 wage bargaining round (covering over 3.3 million employees) was strongly influenced by the economic crisis and uncertainty about the outlook.

This resulted in lower centrally-agreed wage increases than in previous bargaining rounds during the 2000s. Wage agreements for 2.7 million employees are being renegotiated during the 12-month period until September 2012. The first agreement within the manufacturing industry was signed in December 2011 and contained wage increases of 3% over a period of 14 months (2.6% annually). The agreements signed subsequently have so far followed the norm set by the manufacturing industry.

External factors

Import price growth, as measured by the imports of goods deflator in the national accounts, has been negative since 2009. The decline in 2009 was mainly due to rapidly falling international commodity prices, and when these prices recovered in 2010, a stronger krona pushed down import prices. In 2011, the krona's appreciation came to a halt but import prices continued to fall due to a reversal of the commodity price trend. In 2012, import prices are expected to rise somewhat as higher oil prices are not expected to be offset by further strengthening of the krona.

Following the deep drop in global oil prices after the financial crisis, energy prices in HICP fell by 0.8% in 2009 but gradually increased as oil prices

recovered. In 2010 and 2011, energy prices in the HICP index increased by around 5% on average. Easing global food inflation since early 2010 contributed to a marked decline in annual unprocessed food price inflation in 2010 (from 3.3% in 2009 to 0.9% in 2010). The following year, unprocessed food price inflation turned negative, with prices falling by 1.8% on average in 2011.

The krona's nominal effective exchange rate (measured against a group of 35 trading partners) lost 13% in the six months following the intensification of the financial crisis in September 2008. The downward trend reversed in the spring 2009 and the krona's nominal exchange rate appreciated by close to 20% in the period up to March 2011 before levelling off.

Administrative prices and taxes

Administrative prices account for 16% of the total HICP basket⁽¹¹⁾. The most important item is rents (9% of total HICP), which are substantially regulated in Sweden.

Administrative price inflation has outpaced the increase in total HICP inflation in recent years. Administrative price inflation picked up during the second half of 2009, mainly because of the base effect from an increase in dental subsidies one year earlier. In 2010, administrative price inflation subsided in response to broad-based declines across subgroups. A gradual increase in actual rents during 2011 was offset by lower municipal charges on refuse collection, pharmaceutical products, hospital and dental services. As a result, administered price inflation was stable at 1.9% in 2011.

The changes in indirect taxes foreseen for 2012 are expected to have a neutral effect on inflation. The VAT reduction for restaurant and catering services from 25% to 12% is estimated to reduce headline inflation by 0.2 percentage points. This effect will be counterbalanced by an increase in the excise duty on tobacco and the indexing of energy taxes.

⁽¹¹⁾ According to the Eurostat definition, administered prices *inter alia* include actual rents for housing, combined passenger transports, medical and dental services. For details, see http://epp.eurostat.ec.europa.eu/portal/page/portal/hicp/methodology/administered_prices

Medium-term prospects

HICP inflation is expected to slow down in 2012, mainly due to a stable commodity prices outlook and strong carry-over effects from the last quarter of 2011, when inflation dropped much more than expected across most categories of the consumer basket. Although the ongoing wage bargaining round has so far resulted in moderate wage increases, the expected dip in output per worker in 2012 is likely to raise unit labour costs significantly. Underlying inflation is however expected to remain subdued throughout 2012 as low demand and capacity utilisation restrain the inflationary impact. In the second half of 2012, as the recovery gains some traction and employment growth resumes, cost pressures are expected to re-emerge and inflation to pick up gradually. The Commission services' Spring 2012 Forecast projects annual HICP inflation to average 1.1% in 2012 and 1.5% in 2013. Inflation expectations are well anchored around the Riksbank's inflation target.

The Swedish relative price level has gradually decreased since Sweden joined the EU in 1995. In 2010, the Swedish price level increased to some 120% of the EU-27 average compared to close to 110% the previous year. The increase likely reflects the significant strengthening of the krona in 2010.

9.3. PUBLIC FINANCES

9.3.1. Recent fiscal developments

Swedish public finances were strong in the run-up to the global financial crisis, with the general government surplus amounting to 3.6% and 2.2% in 2007 and 2008, respectively. The strong result was achieved due to a long-standing commitment to respecting the fiscal rules requiring a 1% surplus over the cycle and a cap on expenditure. Due to the impact of the recession and the discretionary stimulus measures that the government undertook to counteract its effects, the balance briefly turned into a small deficit in 2009. As the economic recovery got underway, the balance swung back into a surplus in 2010, despite further stimulus measures being taken. The government balance remained in surplus in 2011, as economic growth remained robust until the third quarter. The gyrations in the government balance observed over the last couple of years have been driven by cyclical swings in both revenues and expenditures,

Table 9.3:

Sweden - Budgetary developments and projections		(as % of GDP unless indicated otherwise)								
Outturn and forecast ¹⁾	2006	2007	2008	2009	2010	2011	2012	2013		
General government balance	2.3	3.6	2.2	-0.7	0.3	0.3	-0.3	0.1		
- Total revenues	54.9	54.5	53.9	54.0	52.4	51.4	51.8	51.8		
- Total expenditure	52.7	51.0	51.7	54.9	52.5	51.3	52.3	51.9		
of which:										
- Interest expenditure	1.6	1.7	1.7	1.0	0.8	1.0	1.1	1.1		
p.m.: Tax burden	48.7	47.8	46.9	47.1	46.0	44.9	45.2	45.3		
Primary balance	3.9	5.3	3.8	0.2	1.1	1.3	0.8	1.2		
Cyclically-adjusted balance	0.7	1.7	1.8	2.5	1.1	0.0	0.3	0.4		
One-off and temporary measures	0.0	0.0	0.3	0.0	0.0	0.0	0.0	0.0		
Structural balance ²⁾	0.7	1.7	1.5	2.5	1.1	0.0	0.3	0.4		
Government gross debt	45.3	40.2	38.8	42.6	39.4	38.4	35.6	34.2		
p.m.: Real GDP growth (%)	4.3	3.3	-0.6	-5.0	6.1	3.9	0.3	2.1		
p.m.: Output gap	2.8	3.4	0.6	-5.6	-1.4	0.4	-1.0	-0.6		
Convergence programme							2012	2013	2014	2015
General government balance							-0.1	0.5	1.7	3.0
Structural balance ²⁾³⁾							1.0	1.6	2.4	3.4
Government gross debt							37.7	35.4	31.8	27.5
p.m. Real GDP (% change)							0.4	3.3	3.7	3.6

1) Commission services' Spring 2012 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 2012 Convergence Programme of Sweden.

as employment and unemployment were changing with the cycle.

The budgetary outcome in 2011 was somewhat weaker than targeted in the Convergence Programme of 2011, with the general government budget showing a surplus of 0.3% of GDP, compared with an initial target of 0.6% of GDP. The structural balance shrank by 1.4% and 1.1% of potential GDP in 2010 and 2011, respectively. At least for 2010 this reflects active discretionary measures being taken, such as a fourth step in the so called in-work tax credit, active labour market policy initiatives and additional state transfers to local governments to counteract the effects of the crisis.

With the economic recovery and the improvement in the budgetary balance, the debt ratio resumed its previous downward trend, only briefly interrupted by the 2008/09 recession, and fell to 38.4% of GDP in 2011. The substantial stock-flow adjustments in the form of privatisation proceeds observed until 2009 have been more modest in the 2010-11 period, both due to adverse market conditions and weaker support in parliament for further ambitious privatisations.

9.3.1. Medium-term prospects

The 2012 Budget Bill, which was adopted on 20 December 2011, includes discretionary measures of about SEK 15 billion (around ½% of GDP), including a reduction of the VAT rate for restaurant and catering services, which entered into force on 1 January 2012 and some further spending on infrastructure and training.

The Commission services' Spring 2012 Forecast projects that the general government balance will record a deficit of around 0.3% of GDP in 2012 and then return to a small surplus of 0.1% of GDP in 2013 reflecting the economic slowdown in 2012 and the subsequent expected muted recovery. Rather subdued employment growth limits the improvement. The structural balance is expected to improve slightly from 0% in 2011 to 0.3% and 0.4% in 2012 and 2013 respectively. Gross debt as a share of GDP is expected to continue its downward trend and amount to 34.2% of GDP in 2013, mostly due to nominal GDP growth, but also to some expected privatisation receipts.

The medium-term budgetary strategy of the 2012 Convergence Programme, which was submitted on 16 April 2012, aims at achieving government's

target of a general government surplus of 1% of GDP over the cycle. Until 2011, this target coincided with Sweden's Medium-Term Objective (MTO). However, as from 2012, the MTO will be -1% of GDP, i.e. the minimum required according to Commission services' calculations. The Convergence Programme explains the change with a wish to separate the minimum requirements following from the fact that Sweden is an EU member from its own more ambitious surplus target. The authorities rely on a number of indicators to measure target fulfilment. The programme foresees a general government deficit of 0.1% of GDP in 2012 and a surplus of 0.5% of GDP in 2013. With a general government structural balance of 0.0% in 2011, the MTO was not fulfilled, but is expected to be so in 2012 and 2013, when the recalculated balance is 1.0% and 1.6%, respectively. Based on a no-policy change scenario, the target is expected to be fulfilled with increasing margin as from 2014.

Further details on the assessment of the 2012 Convergence Programme for Sweden can be found in the forthcoming Commission Staff Working Document ⁽¹¹²⁾, which accompanies the Commission Recommendation for a Council Recommendation on the 2012 National Reform Programme of Sweden and delivering a Council Opinion on the 2012 Convergence Programme of Sweden.

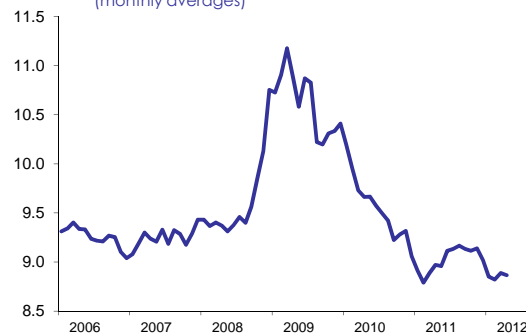
In March 2012, Sweden signed the Treaty on Stability, Coordination and Governance in the EMU. This implies an additional commitment to conduct stability-oriented and sustainable fiscal policies. This Treaty will apply to contracting Member States with a derogation which have ratified the Treaty as from the date when the decision abrogating that derogation will come into force unless they declare their intention to be bound at an earlier date by some or all of the provisions on the fiscal compact and on economic policy coordination and convergence.

9.4. EXCHANGE RATE STABILITY

The Swedish krona does not participate in ERM II. Sweden pursues a floating exchange rate regime and inflation targeting since the early 1990s.

The krona depreciated strongly vis-à-vis the euro at the onset of the financial crisis in September 2008 but then quickly recovered. The krona reached a ten-year high against the euro in February 2011, strengthening by some 20% since March 2009. Unlike in previous periods of severe financial market stress, the krona remained broadly stable when the euro area sovereign debt crisis intensified in the third quarter of 2011. After some weakening in the first half of 2011, the krona stabilised just above 9.1 SEK/EUR before strengthening to on average 8.8 SEK/EUR in the first four months of 2012 as Sweden's strong public finances triggered safe-haven flows into krona. Overall, the krona has appreciated against the euro by 8% during the two years before this assessment.

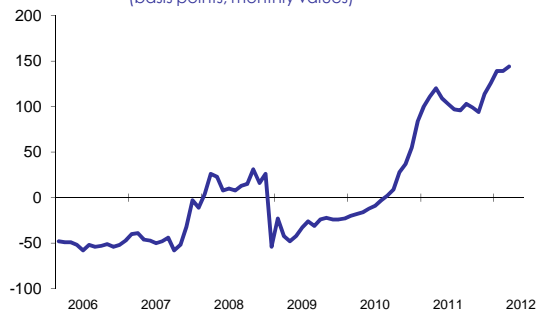
Graph 9.4: Exchange rates - SEK/EUR
(monthly averages)



Sweden's strong public finances triggered safe-haven flows into SEK. The krona was also supported by a significant widening of short-term interest rate differentials vis-à-vis the euro area after the Riksbank embarked on a monetary policy tightening cycle in July 2010. The spread temporarily narrowed in spring 2011 as the ECB increased its benchmark rate in two steps from 1% to 1.50%, but widened again after the ECB reversed the increases towards the end of 2011. The Riksbank also cut its repo rate in two steps by a total of 50 basis points in December 2011 and February 2012. In 2012, the spread has widened significantly as euro area short-term interest rates have declined significantly in the wake of the increase in excess liquidity following the two 3-year longer-term refinancing operations carried out by the ECB in December 2011 and February 2012. On April 30, the spread was 1.5 percentage points.

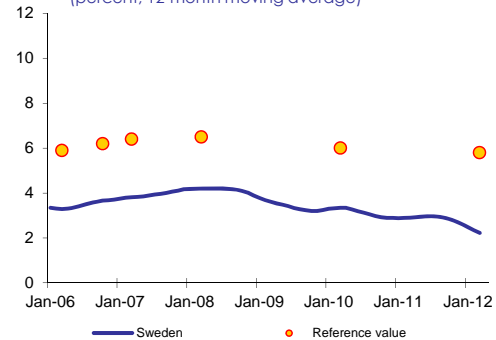
⁽¹¹²⁾ Available at: http://ec.europa.eu/economy_finance/economic_governance/sgp/convergence/programmes/2012_en.htm

Graph 9.5: Sweden - 3-M Slibor spread to 3-M Euribor
(basis points, monthly values)



Source: Eurostat.

Graph 9.5: Sweden - Long-term interest rate criterion
(percent, 12-month moving average)



Source: Commission services.

The Riksbank replenished its foreign currency reserves in 2009 by borrowing the equivalent of SEK 100 billion from the Swedish National Debt Office. Hence, the level of foreign currency reserves increased to SEK 338 billion in 2009 from close to SEK 200 billion in the years preceding the crisis. The Riksbank's participation in the IMF's various loan arrangements has increased in scope in recent years and prompted the central bank to reinforce its foreign currency reserves by an additional SEK 10 billion in February 2012.

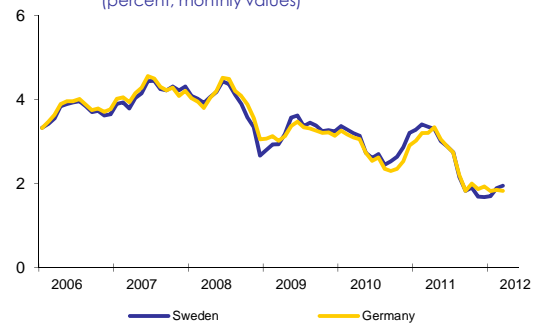
9.5. LONG-TERM INTEREST RATES

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 just over 10 years.

The Swedish 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion has gradually declined since 2008. In March 2012, the latest month for which data are available, the reference value, given by the average of long-term interest rates in Sweden and Slovenia plus 2 percentage points, stood at 5.8%. In that month, the 12-month average of the yield on the Swedish benchmark bond stood at 2.2%, i.e. 3.6 percentage points below the reference value.

After steady declines since the beginning of 2009, long-term interest rates in Sweden and abroad started to drift higher in 2010 on the back of an improved economic outlook and higher inflation. The upward trend was reversed in 2011 and Swedish long-term interest rates reached historically low levels in the second half of the year. Sweden's strong macroeconomic performance and stable public finances have increased the interest of foreign investors in Swedish government bonds. These safe haven flows accelerated towards the end of 2011, pushing down yields. Sweden has issued government bonds at record-low yields, facing very high demand from investors. Swedish long-term interest rates have closely followed German long-term benchmark yields⁽¹¹³⁾. Yield spreads vis-à-vis German long-term benchmark bonds widened to around 30 basis points towards the end of 2010 but turned negative during the course of 2011. Spreads stood at 12 basis points at end-March 2012.

Graph 9.7: Sweden - Long-term interest rates
(percent, monthly values)



Source: Eurostat.

⁽¹¹³⁾ The reference to the German benchmark bond is included for illustrative purposes, as a proxy of the euro area long-term AAA yield.

Table 9.4:

Sweden - Balance of payments	(percentage of GDP)					
	2006	2007	2008	2009	2010	2011
Current account	8.4	9.2	8.8	7.0	6.9	7.2
of which: Balance of trade in goods	5.4	3.8	3.2	3.2	2.5	2.4
Balance of trade in services	2.4	3.4	3.4	3.3	3.9	3.8
Income balance	1.9	3.1	3.5	1.8	1.9	2.3
Balance of current transfers	-1.3	-1.1	-1.3	-1.3	-1.4	-1.3
Capital account	-0.7	-0.1	-0.2	-0.1	-0.1	-0.1
External balance ¹⁾	7.8	9.2	8.6	6.9	6.7	7.1
Financial account	-8.2	-2.5	4.8	-2.6	-7.7	-8.4
of which: Net FDI	0.6	-2.4	1.2	-3.9	-4.2	-3.0
Net portfolio inflows	-5.0	3.2	-6.1	15.6	4.2	4.7
Net other inflows ²⁾	-3.5	-3.3	9.7	-10.5	-7.7	-10.1
Change in reserves (+ is a decrease)	-0.4	0.1	0.0	-3.7	0.1	-0.1
Financial account without reserves	-7.8	-2.5	4.9	1.1	-7.8	-8.3
Errors and omissions	0.5	-6.7	-13.5	-4.3	0.9	1.3
Gross capital formation	18.7	20.3	20.2	16.5	18.6	19.6
Gross saving	26.6	28.9	29.0	23.3	25.4	26.7
External debt	164.3	172.7	181.9	218.0	203.5	197.3
International investment position	-13.2	-1.1	-9.3	-11.8	-9.0	-6.9

1) The combined current and capital account.

2) Including financial derivatives.

Sources: Eurostat, Commission services.

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 – is an important indication that the integration of a Member State into the euro area would proceed without difficulties.

The section on additional factors makes reference *inter alia* to 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. Related to this, in February 2012, following the adoption of the legislation establishing the new procedure for surveillance and correction of macroeconomic imbalances (the Macroeconomic Imbalances Procedure - MIP) ⁽¹¹⁴⁾, the

Commission published its first Alert Mechanism Report (AMR) ⁽¹¹⁵⁾. The AMR scoreboard showed that Sweden exceeded the indicative threshold in the case of four out of ten indicators, linked to both external and internal imbalances (namely the current account balance, export market shares, house prices and private sector debt). In line with the conclusion of the AMR, Sweden was subject to an in-depth review in the context of the MIP.

9.6.1. Developments of the balance of payments

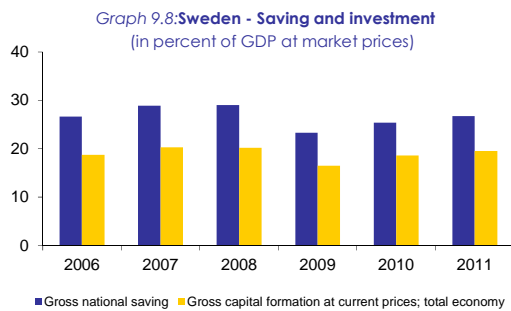
Sweden has had a substantial and growing external surplus (i.e. on the combined current and capital account) since the economic crisis at the beginning of the 1990s, driven by high net exports in goods and recently also in services. Prior to that, Sweden usually had external deficits for extended periods. The external surplus hovered around 8-9% of GDP in the years prior to the financial crisis, increasing from around 4% in the early 2000s. The surplus

⁽¹¹⁴⁾ The package of six legislative proposals to strengthen the economic governance of the EU entered into force in December 2011.

<http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/898>
⁽¹¹⁵⁾ http://ec.europa.eu/economy_finance/articles/governance/2012-02-14-alert_mechanism_report_en.htm

decreased somewhat in the period 2009 to 2011, averaging around 7% of GDP.

The surpluses after the 1990s economic crisis reflected a high level of domestic saving. These savings are to a large extent channelled abroad rather than being used for domestic investments. Sweden has had a lower investment ratio (as a percentage of GDP) than the EU average since the 1990s. The difference is almost entirely explained by lower investment in the construction sector.



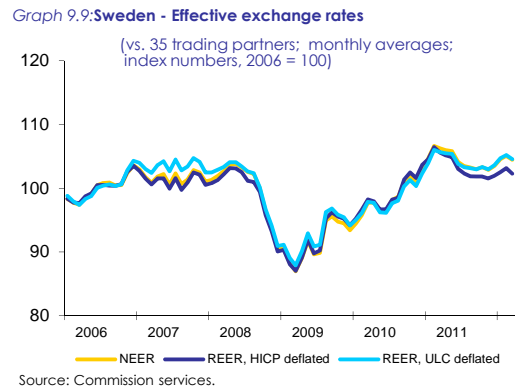
The financial account deficit picked up in 2010-2011 to stand at around 8% of GDP, down from a deficit of 2.6% in 2009. The increase in the financial account deficit was driven by lower foreign direct investment inflows (FDI) and net portfolio inflows. Foreign holdings of Swedish government debt have increased steadily since March 2011 and the pace of increase accelerated in the fourth quarter of 2011.

Despite the sizeable current account surplus, Sweden has a negative net international investment position. This can be explained by the large expansion of cross-border capital flows during the last decade, resulting in large gross stocks in the international investment position. Hence, changes in the Swedish krona exchange rate, equity prices and the value of direct investment companies have a large impact on the investment position. The strong appreciation of the krona in 2009-2011 had a negative effect on Sweden's net international investment position. Total gross external debt continued to increase rapidly during the financial crisis, peaking at 218% of GDP in 2009, before falling below 200% again in 2011.

The real effective exchange rate, measured both by consumer prices (HICP) and unit labour costs (ULC), weakened substantially at the onset of the financial crisis but has since then recovered. Some improvement in external price competitiveness

occurred in 2011 as Swedish consumer prices increased at a slower pace than the EU average.

According to the Commission services' Spring 2012 Forecast, the external balance is expected to remain in surplus in 2012-2013.



9.6.1. Product market integration

Sweden's economy is highly integrated to the EU economy through trade and investment linkages. The openness and level of integration with the EU of the Swedish economy has continued to increase steadily since 2005 and this trend was only temporarily interrupted by the economic crisis in 2008-2009. This process was induced by trade globalisation in general and strengthened trade links with the countries of Central and Eastern Europe after their EU accession in 2004. Sweden's main trading partners are other EU-27 Member States, particularly Germany and its Scandinavian neighbours. Between 2005 and 2010, services accounted for a larger share of intra-EU trade as a result of the increasing role of outsourcing services in the industry. As regards extra-EU trade, the importance of the United States has declined since 2005 while the importance of the BRICs has increased.

The composition of trade in goods reflects the main features of Sweden's manufacturing industries, which are mainly concentrated in capital-intensive sectors, particularly in high and medium-high technology industries, despite the declining technological balance since 2005. The increased share of high-technology exports in 2009 is due to exports of electronic and telecommunication equipment, which were hit less than other exported products during the global crisis. Looking at the import content of exports, about one third of Swedish exports consist of

Table 9.5:

Sweden - Product market integration

	2005	2006	2007	2008	2009	2010
Trade openness ¹⁾ (%)	44.5	47.1	48.1	50.2	44.7	46.6
Intra-EU trade in goods GDP ratio ²⁾ (%)	21.0	22.2	22.9	23.1	19.4	20.6
Intra-EU trade in services GDP ratio ³⁾ (%)	5.8	6.2	6.6	6.9	7.2	7.0
Extra-EU trade in goods GDP ratio ⁴⁾ (%)	11.7	12.2	11.9	12.8	11.4	12.6
Export in high technology ⁵⁾ (%)	14.2	13.4	13.6	13.4	14.8	n.a.
Technological balance ⁶⁾ (%)	0.8	0.8	0.6	0.6	0.4	n.a.
Total FDI inflows GDP ratio ⁷⁾ (%)	3.2	7.2	5.9	7.9	2.9	-0.3
Intra-EU FDI inflows GDP ratio ⁸⁾ (%)	2.9	4.1	4.8	8.2	3.6	1.2
FDI intensity ⁹⁾	4.0	3.9	3.3	6.3	4.6	0.4
Internal Market Directives ¹⁰⁾ (%)	0.9	1.3	1.0	0.9	0.4	0.9
Value of tenders in the EU Official Journal ¹¹⁾	17.8	17.1	17.2	19.3	21.0	24.5
Time to start up a new company ¹²⁾	15.0	15.0	15.0	15.0	15.0	15.0
Real house price index ¹³⁾	100.0	110.4	120.0	120.3	120.2	128.3
Residential investment ¹⁴⁾ (%)	3.2	3.6	3.9	3.5	2.8	3.2
Building permits index ¹⁵⁾	100.0	139.0	91.0	77.0	69.0	89.0

1) $(\text{Imports} + \text{Exports of goods and services} / (2 \times \text{GDP at current market prices})) \times 100$ (Foreign Trade Statistics, Balance of Payments).

2) $(\text{Intra-EU-27 Imports} + \text{Exports of goods} / (2 \times \text{GDP at current market prices})) \times 100$ (Foreign Trade Statistics).

3) Intra-EU-27 trade in services (average credit and debit in % of GDP at current prices) (Balance of Payments).

4) $(\text{Extra-EU-27 Imports} + \text{Exports of goods} / (2 \times \text{GDP at current market prices})) \times 100$ (Foreign Trade Statistics).

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

6) $(\text{Exports} - \text{imports in high tech}) / \text{GDP at current prices} \times 100$, 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-EU-27 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) Public procurement - Value of public procurement which is openly advertised in the EU Official Journal in total public procurement.

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

13) Experimental house price index (2005=100), Eurostat.

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

15) Number of new residential buildings (2005=100), Eurostat.

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

imported goods: raw materials, input goods and intermediate services from sub-contractors around the world. This share has increased slightly over the last decade in line with the global trend towards a fragmentation of manufacturing operations in various countries.

Total FDI inflows have been generally increasing over the period. Almost half of the inward FDI stock is in the manufacturing sector, particularly in the chemical and pharmaceutical industry, which is clearly export-oriented. The other main prominent sectors for FDI in 2010 were financial services, the utilities sector, and goods trade. Approximately 80% of total FDI emanates from other EU Member States but the main source is from the euro area with 60% of the total coming from there.⁽¹¹⁶⁾ The

attractiveness of Sweden for FDI can be attributed to a business-friendly climate, a transparent legal and regulatory framework, skilled labour force, and a stability-oriented macroeconomic framework.

House prices in Sweden rose very sharply over the last 15 years. From the trough of 1996 to the pre-crisis peak of 2007, Swedish house prices had climbed by over 130% in real terms. In contrast to other countries, house prices reacted to the 2008-2009 crisis with only a temporary dip and soon resumed their upward trend. In 2011, house prices stabilised and in the second half of the year even declined in both real and nominal terms.

Regarding the business environment, Sweden scores well above the average of euro area

⁽¹¹⁶⁾ However, the data is somewhat biased, and the high share of Luxembourg and the Netherlands is probably due to the fact that many companies choose to register holding companies in these two countries.

Member States in international rankings⁽¹¹⁷⁾, particularly due to the high level of technological adoptions, innovations, internet access, higher education and quality of public and private institutions. The Swedish government has adopted a large number of measures in 2011 to reach its target of 25% reduction in administrative burden by 2012. These measures include a simplification programme for 2011-2014, a series of actions to improve and assess the interactions between businesses and local authorities.

The mandate of the Swedish Better Regulation Council, set up in 2009 to promote reduction of administrative burden, has been extended until 2014. Transaction costs related to starting or closing a business are relatively low in Sweden. However, additional efforts could be made to further simplify procedures for new firms.

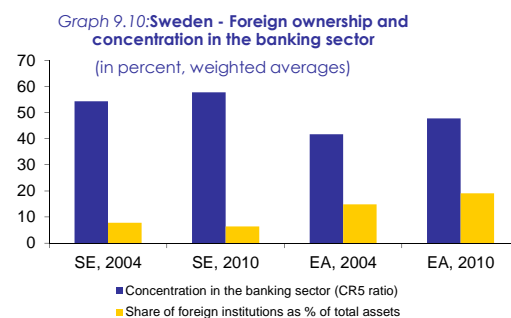
The time to start a business in Sweden (15 days) is slightly longer than the EU average. While the EU directives on public procurement have been transposed in national legislation, there are nevertheless indications that there remains room for improvement. Progress has been made in recent years to open national procurement markets to international competition. The value of tenders published in the EU Official Journal has increased from 17.2% in 2007 to 24.5% in 2010, which is higher than the EU average.⁽¹¹⁸⁾

Finally, according to the November 2011 Internal Market Scoreboard, the transposition of EU Internal Market directives has been improving over the period under review and Sweden has again a transposition deficit below the 1% EU target and below the EU average.

9.6.1. Financial market integration

Sweden's financial sector is well integrated into the EU financial system. The integration of Sweden's financial sector into the broader EU sector relates mainly to links with other Nordic countries and the Baltic States. The main channels of integration have been the ownership of financial intermediaries in the Nordic/Baltic region and the

transformation of the Swedish stock exchange into the OMX Group of Nordic stock exchanges, which was subsequently bought by Nasdaq. The share of assets of foreign banks stood at 6% in 2010 but has increased compared to the early 2000s. The Swedish banking sector is dominated by four large banks and bank concentration, as measured by the market share of the largest five credit organisations in total assets, is considerably higher than the euro area average. Mortgage institutions play a relatively important role in the Swedish banking system, providing about 45% of the total lending in 2010.

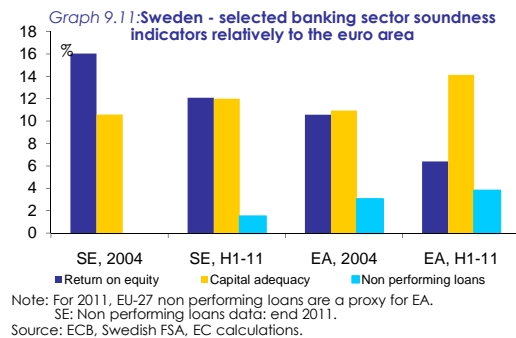


Source: ECB, Structural indicators for the EU banking sector, December 2011.

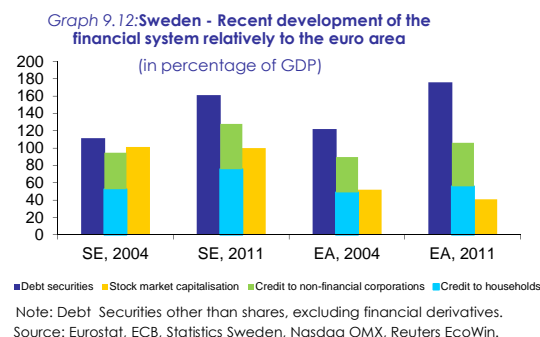
The Swedish banks have managed the euro area sovereign debt crisis relatively well. They are well-capitalised and have small direct exposure to the countries affected by the sovereign debt crisis. The banks have benefitted from the strong growth in the Swedish economy, which together with the stabilisation in the Baltics have increased their resilience. The profitability of the major banks, measured as return on equity, has increased from just above 5% in 2009 to 12% in 2011, supported by volume increases, low credit losses and higher earnings after the Riksbank's interest rate hikes. All Swedish banks passed the 2011 European Banking Authority (EBA) EU-wide stress tests with a margin, the result is also in line with the tests conducted by the Swedish Financial Supervisory Authority. The banks in Sweden have traditionally been funded largely by deposits from bank customers, but in recent years the share of market funding has increased. The major Swedish banks currently receive around half of their funding from financial markets. Of this, almost half is in foreign currency (split equally between US dollars and euro).

⁽¹¹⁷⁾ For instance, Sweden ranks on 3rd and 14th place according to the 2011-2012 Global Competitiveness index and the 2012 World Bank Doing Business index respectively.

⁽¹¹⁸⁾ The value of tenders published in the EU Official Journal may serve as a proxy of the extent to which national public procurement are open to foreign bidders.



Developments in the Swedish housing market have prompted concerns about sustainability and implications for financial stability. Swedish house prices continued to increase almost continuously throughout the financial crisis. Also, the rate of household lending remained high, supported by historically low interest rates. The loan-to-value ratio was relatively high for new borrowers and amortisation payments have been small. To curb lending, the Swedish Financial Supervisory Authority in October 2010 imposed a cap on mortgage borrowing (85% of the market value of the house). The stricter lending mortgage regulations in combination with rising mortgage rates contributed to a slowdown of lending to households in 2011. House prices levelled off at high levels in late 2010 and started to fall back towards the end of 2011. The stock of private debt increased to 237% of GDP in 2010⁽¹¹⁹⁾. The Alert Mechanism Report from February 2012 showed that Sweden, *inter alia*, exceeded the indicative thresholds for house prices and private sector debt. As a result, Sweden was subject to an in-depth review in the context of the Macroeconomic Imbalance Procedure.



The Swedish equity market is comparatively large and liquid. The main trading activity takes place at the Stockholmsbörsen, but the investor base has significantly expanded via the OMX group. Stock market capitalisation is high compared to the euro area. Debt securities markets are dominated by issuances of bonds by mortgage institutions and central government. The market for corporate debt is relatively small and bank loans are the primary source of funding for firms. Issuance of bonds by municipals and county councils is also limited.

The assets of non-bank financial intermediaries account for about 40% of the total assets of financial institutions. Sweden has a developed and relatively large insurance sector, including more than 300 domestic companies and over 30 foreign branches.⁽¹²⁰⁾ The total premium signed in 2010 corresponded to 8.2% of GDP, with the life business accounting for about three quarters of the total.⁽¹²¹⁾ The insurance companies managed assets amounting to around 90% of GDP. The assets under management of Swedish investment funds corresponded to about 60% of GDP, while the state pension funds (AP Funds) total assets⁽¹²¹⁾ accounted for about 30% GDP.

Since 1991, the Finansinspektionen (Swedish Financial Supervisory Authority) has been a single supervisor for the banking, securities and insurance sectors. Cooperation with other authorities responsible for financial stability and crisis management is ensured, in particular by the Memorandum of Understanding signed in 2009 between the Finansinspektionen, the Sveriges Riksbank, the Ministry of Finance and the Swedish National Debt Office. Sweden has a good track record in implementing EU financial services legislation and has transposed most of the post-FSAP directives.

⁽¹¹⁹⁾ Data on private sector debt are based on unconsolidated 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.

⁽¹²⁰⁾ As at the end of 2010. Sveriges Riksbank (2011) *The Swedish Financial Market*

⁽¹²¹⁾ Swiss Re Sigma (2011) World Insurance in 2010