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CONVERGENCE REPORT 2020

Accompanying the document

REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

CONVERGENCE REPORT 2020

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

{COM(2020) 237 final}

ABBREVIATIONS

Member States

BG Bulgaria
CZ Czechia
HR Croatia
HU Hungary
PL Poland
RO Romania
SE Sweden
EA Euro area
EA-19 Euro area, 19 Member States
EA-18 Euro area, 18 Member States before 2015
EA-17 Euro area, 17 Member States before 2014
EU-28 European Union, 28 Member States
EU-27 European Union, 27 Member States before July 2013 (i.e. EU-28 excl. HR) and from February 2020 (i.e. EU-28 excl. UK)
EU-25 European Union, 25 Member States before 2007 (i.e. EU-28 excl. BG, RO and HR)
EU-15 European Union, 15 Member States before 2004

Currencies

EUR Euro
BGN Bulgarian lev
CZK Czech koruna
HRK Croatian kuna
HUF Hungarian forint
PLN Polish zloty
RON Romanian leu (ROL until 30 June 2005)
SEK Swedish krona
USD United States dollar

Central Banks

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

Other abbreviations

AMR Alert Mechanism Report
BoP Balance of Payments
CAR Capital adequacy ratio
CBA Currency board arrangement
CEE Central and Eastern Europe
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
EMU Economic and monetary union

ERM II	Exchange rate mechanism II
ESA	European System of Accounts
ESCB	European System of Central Banks
EU	European Union
Eurostat	Statistical Office of the European Union
FDI	Foreign direct investment
FGS	Funding for Growth Scheme
FSA	Financial Supervisory Authority
GDP	Gross domestic product
HICP	Harmonised index of consumer prices
HFSA	Hungarian Financial Supervisory Authority
IDR	In-Depth Review
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
REER	Real effective exchange rate
SGP	Stability and Growth Pact
TFEU	Treaty on the Functioning of the European Union
ULC	Unit labour costs
VAT	Value added tax

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1. INTRODUCTION

1.1. ROLE OF THE REPORT

The euro was introduced on 1 January 1999 by eleven Member States. Since then, Greece (2001), Slovenia (2007), Cyprus and Malta (2008), Slovakia (2009), Estonia (2011), Latvia (2014) and Lithuania (2015) have also adopted the euro.

Member States for which the Council has not yet decided that they fulfil 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 convergence situation of Member States with a derogation (Box 1.1). At least once every two years, or at the request of a Member State with a derogation, the Commission and the European Central Bank (ECB) prepare Convergence Reports for such Member States. Denmark negotiated an opt-out arrangement before the adoption of the Maastricht Treaty ([1]) and does not participate in the third stage of EMU. Until Denmark indicates that it wishes to participate in the third stage and adopt the euro, it is not the subject of an assessment as to whether it fulfils the necessary conditions for such a participation.

In 2018, the Commission and the ECB adopted their latest regular Convergence Reports ([2]). None of the Member States assessed in those reports was deemed to meet the necessary conditions for adopting the euro.

In 2020, two years will have elapsed since the last regular reports were prepared. Denmark has not expressed a wish to enter the third stage of EMU ([3]). Therefore, this convergence assessment covers Bulgaria, Czechia, Croatia, Hungary, Poland, Romania and Sweden. This Commission Staff Working Document is a Technical Annex to the Convergence Report 2020 and includes a detailed assessment of the progress with convergence, as required by Article 140(1) of the Treaty.

The 2008-2009 financial and economic crisis, along with the euro-area sovereign debt crisis, had revealed certain gaps in the economic governance system of the Economic and Monetary Union (EMU) and showed that its instruments need to be strengthened and used more comprehensively. With the aim of ensuring a sustainable functioning of EMU, an overall strengthening of economic governance in the Union has been undertaken. Accordingly, this Commission Staff Working Document makes references where appropriate to procedures that help to strengthen the assessment of each Member States' convergence process and its sustainability. In particular, it incorporates references to the strengthened surveillance of macroeconomic imbalances (see sub-section 1.2.6.).

The COVID-19 pandemic represents a severe shock that fundamentally disrupts the economy of the EU and of its Member States. Accordingly, it could have a significant impact on economic convergence indicators going forward, making it more difficult to assess the sustainability of convergence. However, the impact of the COVID-19 pandemic on the historical data used in the 2020 Convergence Report is limited. This is mainly due to the constraints imposed by its cut-off date, which together with the Treaty-defined calculation methods of the price stability and long-term interest rate criteria (i.e. one year averages have to be used), mean that the corresponding data still largely reflect the situation prior to the COVID-19 pandemic. Furthermore, the latest Commission assessment of macroeconomic imbalances has also taken place before the pandemic (see Box 1.6).

The implications of the COVID-19 pandemic for the forward-looking elements of this Report are taken into account through inputs from the Commission services’ Spring 2020 Forecast, i.e. using the latest available Commission forecast. This forecast is the first comprehensive assessment from the Commission of the likely economic effects of the COVID-19 crisis in 2020 and 2021, and as such, it is surrounded by higher than usual uncertainty.

The remainder of the first chapter presents the methodology used for the application of the assessment criteria. Chapters 2 to 8 examine, on a

([1]) Protocol (No 16) on certain provisions relating to Denmark.
([2]) European Commission, Convergence Report 2018, COM(2018) 370 final, 23 May 2018; European Central Bank, Convergence Report 2018, May 2018.
([3]) The United Kingdom has withdrew from the EU since the May 2018 Convergence Report.

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."

country-by-country basis, the fulfilment of the convergence criteria and other requirements in the order in which they appear in Article 140(1) (see Box 1.1). The cut-off date for the statistical data included in this Convergence Report was 23 April 2020.

1.2. APPLICATION OF THE CRITERIA

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

1.2.1. Compatibility of legislation

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

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

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

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

1.2.2. Price stability

The price stability criterion is defined in the first indent of Article 140(1) of the Treaty: "the achievement of a high degree of price stability; 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".

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 ([4]) 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.

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 EU Member States in terms of price stability' plus 1.5 percentage points (see Box 1.2).

([4]) Council Regulation (EC) No 2494/95 of 23 October 1995 concerning harmonised indices of consumer prices (OJ L 257, 27.10.1995, pp. 1-4), amended by Regulations (EC) No 1882/2003 and No 596/2009 of the European Parliament and of the Council, and repealed by Regulation (EU) 2016/792 of the European Parliament and of the Council.

Box 1.2: Assessment of price stability and the reference value

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

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

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

As Article 140(1) of the Treaty refers to 'Member States' and does not make a distinction between euro-area and other Member States, the Convergence Reports select the three best performers from all Member States – EU-15 for the Convergence Reports before 2004, EU-25 for the reports between 2004 and 2006, EU-27 for reports between 2007 and 2013, EU-28 for reports between 2014 and 2018 and EU-27 for the 2020 report.

The notion of '**best performer in terms of price stability**' is not defined explicitly in the Treaty. It is appropriate to interpret this notion in a non-mechanical manner, taking into account the state of the economic environment at the time of the assessment. In previous Convergence Reports, when all Member States had a positive rate of inflation, the group of best performers in terms of price stability naturally consisted of those Member States which had the lowest positive average rate of inflation. In the 2004 report, Lithuania was not taken into account in the calculation of the reference value because its negative rate of inflation, which was due to country-specific economic circumstances, was significantly diverging from that of the other Member States, making Lithuania a de facto outlier that could not be considered as 'best performer' in terms of price stability. In 2010, in an environment characterised by exceptionally large common shocks (the global economic and financial crisis and the associated sharp fall in commodity prices), a significant number of countries faced episodes of negative inflation rates (the euro-area average inflation rate in March 2010 was only slightly positive, at 0.3%). In this context, Ireland was excluded from the best performers, i.e. the only Member State whose average inflation rate deviated by a wide margin from that of the euro area and other Member States, mainly due to the severe economic downturn in that country. Outliers were also identified in 2013 (Greece), 2014 (Greece, Bulgaria and Cyprus) and 2016 (Cyprus and Romania), as their inflation rates deviated by a wide margin from the euro-area average, driven by country-specific factors that limited their scope to act as meaningful benchmarks for other Member States. Table 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, France, Luxembourg 5)	3.3	2.4
2004	August 2004	Finland, Denmark, Sweden	2.4	2.1
2006 May	March 2006	Sweden, Finland, Poland	2.6	2.3
2006 December	October 2006	Poland, Finland, Sweden	2.8	2.2
2007	March 2007	Finland, Poland, Sweden	3.0	2.1
2008	March 2008	Malta, Netherlands, Denmark	3.2	2.5
2010	March 2010	Portugal, Estonia, Belgium	1.0	0.3
2012	March 2012	Sweden, Ireland, Slovenia	3.1	2.8
2013	April 2013	Sweden, Latvia, Ireland	2.7	2.2
2014	April 2014	Latvia, Portugal, Ireland	1.7	1.0
2016	April 2016	Bulgaria, Slovenia, Spain	0.7	0.1
2018	March 2018	Cyprus, Ireland, Finland	1.9	1.4
2020	March 2020	Portugal, Cyprus, Italy	1.8	1.1

1) EU15 until April 2004; EU25 between May 2004 and December 2006; EU27 between January 2007 and June 2013; EU28 between July 2013 and January 2020; EU27 (without UK) from February 2020 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 arthmetic average of the latest 12 monthly indices relative to the arithmetic average of the 12 monthly indices of the previous period.
5) Based on revised data, Germany would replace Luxembourg as one of the three Member States with the lowest 12-month average inflation in April 2002. This change would not affect the price and long-term interest rate reference values in April 2002.

Sources: Eurostat and Commission services.

Accordingly, the reference value is currently 1.8%, based on the data of Portugal (0.2%), Cyprus (0.4%), and Italy (0.4%) over the 12-month period covering April 2019-March 2020.

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 as the Global Financial Crisis exposed unsustainable price developments in many EU Member States, including euro area countries, in the pre-crisis period.

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

From a forward-looking 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 ([5]). Medium-term inflation prospects are also assessed by reference to the economies' key structural characteristics, including the functioning of the labour and product markets.

([5]) Based on the Commission services' Spring 2020 Forecast, the inflation reference value is forecast to stand at 1.1% in December 2020.

Box 1.3: **Excessive deficit procedure**

The excessive deficit procedure (EDP) 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]). Together, these determine the steps to be followed to reach a Council decision on the existence and correction of an excessive deficit, which forms the basis for the assessment of compliance with the convergence criterion on the government budgetary position. The debt criterion in Article 126(2) of the Treaty was operationalised in the 2011 amendment of Council Regulation (EC) No 1467/97.

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

- whether the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value, specified in the Protocol on the EDP as 3% of GDP, unless:
  - 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 exceptional and temporary and the ratio remains close to the reference value;
- whether the ratio of government debt to gross domestic product exceeds a reference value, specified in the Protocol on the EDP as 60% of GDP, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

According to the EDP Protocol, the Commission provides the statistical data for the implementation of the procedure. Member States have to provide data on government deficits, government debt, nominal GDP and other associated variables twice a year, before 1 April and before 1 October ([2]). Eurostat validates the submitted data subject to its compliance with ESA2010 ([3]) rules and related Eurostat decisions.

Under Article 126(3), the Commission prepares a report if a Member State does not fulfil the requirements under one or both of the above criteria. The report takes into account whether the government deficit exceeds government investment expenditure and all other relevant factors. These include developments related to the medium-term economic position ([4]), the medium-term budgetary position ([5]), the medium-term government debt position ([6]), and other factors which, in the opinion of the Member State concerned, are relevant and which the Member State has put forward.

The Council and the Commission make a balanced overall assessment of 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

([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), as amended.
([3]) Regulation (EU) No 549/2013 of the European Parliament and of the Council of 21 May 2013 on the European system of national and regional accounts in the European Union, OJ L 174, 26.6.2013, p 1–727).
([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, debt dynamics and sustainability, including risk factors, 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 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)

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.

In the next step of the procedure, the Economic and Financial Committee (EFC) formulates an opinion on the Commission report within two weeks of its publication (Article 126(4), Article 3.1 of Regulation 1467/97). If the Commission 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 the Commission's proposal and the overall assessment the Council decides whether an excessive deficit exists (Article 126(6)).

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

If effective action has been taken in compliance with a recommendation under Article 126(7) and, compared with the economic forecasts underlying the recommendation, unexpected adverse economic events with major unfavourable consequences for government finances occur subsequent to its adoption, the Council may decide, on a recommendation from the Commission, to adopt a revised recommendation under the same article. The revised recommendation may extend the deadline for the correction of the excessive deficit. 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.

If the Council establishes lack of 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 expiration 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 sanctions in case of non-compliance, as well as the enforcement mechanisms introduced in 2011, are not applicable to Member States with a derogation (that is, those that have not yet adopted the euro), which is the case of the Member State considered in this report. Following a Council decision establishing, under Article 126(8), that the Member State did not take effective action in response to a Council recommendation under Article 126(7), 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)).

More information about the EU fiscal surveillance framework can be found in the *Vade Mecum on the Stability and Growth Pact*, European Economy Institutional Paper 101, April 2019: https://ec.europa.eu/info/publications/vade-mecum-stability-and-growth-pact-2019-edition_en

1.2.3. Public finances

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

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

1.2.4. Exchange rate stability

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

Article 3 of the Protocol on the convergence criteria stipulates: "The criterion on participation in the exchange rate mechanism of the European Monetary System […] shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against the euro on its own initiative for the same period" ([7]). Based on the Council Resolution on the establishment of the ERM II ([8]), 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, and international financial assistance wherever relevant, in maintaining exchange rate stability.

In principle, the assessment of this criterion verifies the participation in ERM II and examines exchange rate behaviour within the mechanism. As currently none of the Member States assessed in this Convergence Report participates in ERM II, de facto exchange rate stability is reviewed for analytical purposes (see Box 1.4 for further information on ERM II participation). The relevant period for assessing exchange rate stability in this Technical Annex is 24 April 2018 to 23 April 2020.

1.2.5. Long-term interest rates

The fourth indent of Article 140(1) of the Treaty requires that "the durability of convergence achieved by the Member State with a derogation and of its participation in the exchange rate mechanism" is "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 1.5).

([6]) The definitions of the government deficit and debt used in this report are in accordance with the excessive deficit procedure, as was the case in previous convergence reports. These definitions are laid out in the amended Council Regulation (EC) No 479/2009. In particular, government debt is general government consolidated gross debt at nominal value. 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.

([7]) 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 ERM II by the Informal ECOFIN Council, Athens, 5 April 2003.

([8]) 97/C 236/03 of 16 June 1997, OJ C 236, 2.8.1997, p.5.

Box 1.4: A reinforced approach to ERM II participation by means of upfront policy commitments by the applicant Member States

Participating in ERM II is an essential step for a Member State with a derogation on the way to fulfil the exchange rate criterion and to euro adoption. Fulfilling the exchange rate criterion through the smooth participation in ERM II is provided for in Article 140 of the TFEU, Protocol No 13 to the TFEU on the convergence criteria and the Resolution of the European Council on the establishment of an exchange-rate mechanism in the third stage of economic and monetary union adopted in Amsterdam on 16 June 1997 ([1]). In accordance with this framework, ERM II entry of a Member State with a derogation requires a mutual agreement of all 'ERM II parties'. These include the finance ministers of euro area Member States, the European Central Bank, and the finance ministers and the central bank governors of the non-euro area Member States participating in ERM II. At the time of writing this report, Denmark was the only non-euro-area Member State participating in ERM II. The European Commission provides analytical support to the ERM II process, but has no voting right and no right of initiative in the ERM II entry process.

In July 2018, learning from past episodes of economic overheating in ERM II and the euro-area crisis, the ERM II parties clarified the modalities of a reinforced approach for future ERM II participation with a view of ensuring a smooth transition to, and participation in, ERM II, in their statement on Bulgaria's path towards ERM II, stating that this approach would apply to all Member States wishing to join ERM II from then onwards ([2]). The reinforced approach was confirmed in the later statement of the ERM II parties of July 2019 on Croatia's path towards ERM II participation ([3]).

According to this reinforced approach, the applicant Member State and ERM II parties agree on a number of policy commitments to be implemented by the former before joining ERM II. This package of so called prior policy commitments aims at maximising the country's chances to operate smoothly in ERM II. It is country-specific, targeted and covers policy areas that are highly relevant for a smooth transition to and participation in ERM II including, for instance institutional quality, governance, the financial sector, fiscal policy, or the business environment.

In particular, as being part of the euro area now also implies for a Member State to be part of the Banking Union's pillars of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM), the applicant Member State is expected to enter into 'close cooperation' with the ECB for banking supervision purposes at the latest by the time of its participation in ERM II. A Member State with a derogation can join the Banking Union before its euro adoption via an arrangement called 'close cooperation'. Entering in close cooperation with the ECB means that the significant credit institutions established in the country concerned are supervised by the ECB via the involvement of the domestic national supervisor. Entering in close cooperation also implies participation in the Single Resolution Mechanism, including the Single Resolution Fund ([4]).

In addition to establishing close cooperation with the ECB, the two Member States currently intending to participate in ERM II have taken a number of other prior policy commitments. The Bulgarian authorities have taken prior-commitments in the following areas: the macroprudential framework, the supervision of the non-banking financial sector, the insolvency framework, the anti money-laundering framework and the governance of state-owned enterprises ([5]). Besides close cooperation, the prior-commitments of Croatian authorities cover measures related to the macroprudential framework, the anti money-laundering framework, the collection, production and dissemination of statistic, public sector governance and firms' administrative and financial burden ([6]).

([1]) See: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A31997Y0802%2803%29
([2]) See: https://www.consilium.europa.eu/en/press/press-releases/2018/07/12/statement-on-bulgaria-s-path-towards-erm-ii-participation/
([3]) See: https://www.consilium.europa.eu/en/press/press-releases/2019/07/08/statement-on-croatia-s-path-towards-erm-ii-participation/
([4]) See: https://www.bankingsupervision.europa.eu/press/publications/newsletter/2018/html/ssm.nl181114_1.en.html, and see also: https://www.bankingsupervision.europa.eu/ecb/legal/pdf/celex_32014d000501_en_txt.pdf
([5]) For more details on the prior-commitments taken by Bulgarian authorities see: https://www.consilium.europa.eu/media/36125/st11119-en18.pdf
([6]) For more details on the prior-commitments taken by Croatian authorities see: https://www.consilium.europa.eu/media/40282/letter-of-intent.pdf

(Continued on the next page)

Box (continued)

In terms of process, the ECB and the Commission monitor the fulfilment of the prior-commitments undertaken by the applicant Member States in the respective areas of competence of the ECB and the Union and in close cooperation with the Member State concerned. The two institutions regularly inform ERM II parties on the progress made with the prior-commitments. A comprehensive assessment of the applicants' banking sector is carried out by the ECB as part of the process of establishing close cooperation with the ECB. This includes an asset quality review and a stress test that aims at assessing whether banks are fundamentally sound. The results of the comprehensive assessment are made public on the ECB's website ([7]).

In line with the long-standing ERM II practice, ERM II parties also expect applicant Member States to take further policy commitments at the moment of joining ERM II with the aim of achieving a high degree of sustainable economic convergence by the time the euro will be adopted.

([7]) The results of the comprehensive assessment of six Bulgarian banks are available at: https://www.bankingsupervision.europa.eu/press/pr/date/2019/html/ssm.pr190726~1b474e3467.en.html

Box 1.5: **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 10-year benchmark bond yields on behalf of Eurostat and collects the data from the central banks. The selection of bonds for inclusion in this series is based on the following criteria:

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

For ten Member States, the residual maturity of the benchmark bond is at least 9.5 years. For seventeen Member States, the residual maturity of the benchmark bond is below 9.5 years, in particular for Lithuania and Luxembourg with residual maturity below 5 and 7 years respectively. All yields are calculated on the basis of secondary market rates, where available. For Czechia, Germany and Malta 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*.L.L40.CI.0000.*Currency Code*.N.Z) and in a dedicated page in the ECB website with additional information: http://www.ecb.europa.eu/stats/financial_markets_and_interest_rates/long_term_interest_rates/html/index.en.html.

For the assessment of the criterion on the convergence of interest rates, yields on benchmark long-term bonds have been taken, using an average rate over the latest 12 months. The reference value for March 2020 is calculated as the simple average of the average long-term interest rates in Portugal (0.5%), Cyprus (0.8%) and Italy (1.6%), plus 2 percentage points, yielding a reference value of 2.9%.

1.2.6. Additional factors

Article 140(1) TFEU also requires that the reports take into account other factors relevant to economic integration and convergence. These additional factors include financial, product and labour market integration and the development of the balance of payments. The analysis 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 price stability section.

The assessment of additional factors gives an important indication of a Member State's ability to integrate into the euro area without difficulties. As regards the balance of payments, the focus is on the situation and development of the external balance ([9]). Market integration is assessed through trade, foreign direct investment and a smooth functioning of the internal market. Moreover, progress in financial integration is examined, together with the main characteristics, structures and trends of the financial sector. Given that Member States which adopt the euro also participate in the banking union, developments in national banking sectors are specifically looked at as well.

Starting with the 2012 Convergence Report, the convergence assessment is aligned with the broader European Semester approach which takes an integrated look at the economic policy challenges facing EMU in ensuring fiscal sustainability, competitiveness, financial market stability and economic growth ([10]).

The section on additional factors makes reference to the surveillance of macroeconomic imbalances under the Macroeconomic Imbalance Procedure, which was adopted in December 2011 as one of the key elements of the legislative package (the "Six-Pack") to enhance the governance structures in EMU, and integrates its results into the assessment (see Box 1.6).

([9]) 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.

([10]) In line with the statistical data cut-off date of this Convergence Report (23 April 2020), an assessment of the 2020 updates of the Convergence Programmes is not included in this Staff Working Document. Moreover, on 19 March 2020 the Commission set out its view that the conditions allowing the Union institutions to activate the general escape clause of the EU fiscal framework were fulfilled, to which the Finance Ministers of the Member States reacted favourably on 23 March 2020, which facilitates the necessary budgetary response to the economic consequences of the COVID-19 crisis. The activation of the general escape clause allows for a temporary departure from the adjustment path towards the medium-term budgetary objective, provided that this does not endanger fiscal sustainability in the medium term.

Box 1.6: The Macroeconomic Imbalance Procedure (MIP)

The Macroeconomic Imbalance Procedure (MIP): key elements

A key lesson from the economic and financial crisis was that the economic governance framework in the EMU needed to be further strengthened to better support macroeconomic stability, including in aspects beyond fiscal policy. The Macroeconomic Imbalance Procedure (MIP) responds to that need by aiming at the detection, prevention and correction of macroeconomic imbalances that could harm economic stability in an EU country, the euro area, or the EU as a whole. It was a key element of the legislative package (the "Six-Pack") to enhance the governance structures in EMU adopted in 2011.

No simple and mechanistic criteria are available for the identification of macroeconomic imbalances because drivers of macroeconomic instability are multi-dimensional phenomena whose severity needs to be assessed along several aspects and taking into account also country-specific features, notably linked to the adjustment capacity of the economy. Instead, the MIP relies on a two-step approach for the identification of imbalances.

In a first step for the identification of imbalances under the MIP, the Alert Mechanism Report (AMR) identifies the Member States that require more in-depth investigation on whether they may be affected by macroeconomic imbalances. The AMR builds on an economic reading of a scoreboard of economic and financial indicators with indicative thresholds. The scoreboard aims at covering the different challenges facing the Member States and comprises fourteen indicators of external imbalances and competitiveness developments, internal imbalances and the employment situation ([1]). The scoreboard encompasses variables that the economic literature and recent experiences suggest anticipating or associated with crisis episodes. The scoreboard is a starting point for the analysis in the AMR, which also takes into account additional information and assessment tools and previous in-depth assessments at country level.

In a second step, the analysis carried out in the in-depth reviews (IDRs) for the selected Member States provides the basis for the identification of imbalances by the Commission. IDR analysis makes use of updated and specific information and analytical tools developed by the Commission services and is integrated in the Country Reports published in the European Semester context on annual basis.

If imbalances have been identified, a difference is made between "imbalances" and "excessive imbalances", both implying possible recommendations by the Council upon Commission proposal, which have so far been integrated in the single package of Country-Specific Recommendations (CSRs) under the European Semester. The identification of "excessive imbalances" implies a stronger surveillance process, possibly leading to the launch of the Excessive Imbalance Procedure. The latter provides a framework underpinned by an articulated corrective action plan designed by the concerned Member State, endorsed by the Commission and the Council and monitored by the Commission, and including the possibility of sanctions for euro-area Member States in case of reiterated lack of compliance. The Excessive Imbalance Procedure has never been launched for countries with excessive imbalances, but the Commission has issued prescriptive recommendations and put in place a system of specific monitoring to assess the implementation of policy commitments in these countries.

The 2020 Alert Mechanism Report (AMR) and In-Depth Reviews (IDR)

The Commission published its latest AMR in December 2019 concluding that IDRs were warranted for 13 Member States, which coincided with the ones that had already been identified with imbalances or excessive imbalances in the previous annual round of application of the MIP. Four of the Member States for which IDRs were prepared are covered in this Convergence Report (Bulgaria, Croatia, Romania and Sweden). On the basis of this year's IDRs, in February 2020, the Commission concluded that Croatia, Romania and Sweden are experiencing imbalances, as last year. Instead, Bulgaria was found to no longer experience imbalances.

([1]) The variables are: current account, net international investment position, real effective exchange rates, unit labour cost, and export market shares; private sector debt, general government debt, private sector credit flow, change in total financial sector liabilities, house prices; unemployment rate, activity rate, long-term and youth unemployment.

2. BULGARIA

2.1. LEGAL COMPATIBILITY

2.1.1. Introduction

The legal basis for the Bulgarska Narodna Banka (BNB – central bank of Bulgaria), the Law on the Bulgarian National Bank (the BNB Law) of 1997, has been amended since the 2018 Convergence Report. Bulgarian authorities have amended the BNB Law to remedy certain incompatibilities highlighted in the Commission's 2018 Convergence Report([11]). In particular, it concerns issues flagged in previous convergence reports in the section on central bank independence. Other issues remain unresolved. Therefore, certain comments provided in the 2018report are repeated also in this year's assessment.

2.1.2. Central Bank independence

Regarding the rules on a possible removal of the Governor from office, Article 14(1) of the BNB Law has been amended. It now provides that the competent authority may only remove a member of the Governing Council from office if he no longer fulfils the conditions required for the performance of his duties or if he has been found guilty of serious misconduct. This provision is compatible with Article 14.2 of the ESCB/ECB Statute.

The Conflict of Interest Prevention and Ascertainment Act of 2008, which regarding the possibility to dismiss the Governor of the BNB had to be brought in line with Article 14.2 of the ESCB/ECB Statute, was fully repealed and replaced by the Act on Corruption Counteraction and Eviction of Illegally Acquired Property of 2018 ([12]). However, similar to the repealed Act, Article 80(1) in conjunction with Article 6(1)(12) of the new Act provides that the ascertainment of a conflict of interest is a ground for dismissal of the Governor of the BNB. Thus, an incompatibility remains. It should be specified that a dismissal of the Governor is only admissible if, as set out in Article 14.2 of the ESCB/ECB Statute, the ascertainment of a conflict of interest corresponds to a lack of fulfilment of the conditions required for the performance of the Governor's duties or a serious misconduct of which the Governor has been guilty within the meaning of Article 14 (1) of the BNB Law.

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

Article 13(2) of the BNB Law foresees that the Governor of the BNB shall swear an oath before the Parliament. The content of the oath laid down in paragraph one of the same provision refers inter alia to abiding by law and to contribute to the performance of the functions of the BNB. The Governor of the BNB acts in dual capacity as a member of BNB’s decision-making bodies and of the relevant decision-making bodies of the ECB. Article 13 of the BNB Law needs to be adapted to reflect the status and the obligations and duties of the Governor of the BNB as member of the relevant decision-making bodies of the ECB. Moreover, the oath does not contain a reference to central bank independence as enshrined in Article 130 of the TFEU. The oath as it stands now is an imperfection and should be remedied.

Article 44 of the BNB Law has been amended since the 2018 Convergence Report with a view to achieving compatibility with Article 130 of the TFEU and Article 7 of the ESCB/ECB Statute. The amended Article 44 of the BNB Law now also encompasses a reference, as suggested in the previous report, that the BNB and members of the Governing Council, in the performance of their tasks, shall be independent and shall not seek or take any instructions from foreign and EU

([11]) SG No 106/21 21.12.2018; SG No 37/7.05.2019; SG No 83/22.10.2019; SG No 14/18.02.2020.
([12]) SG No. 7/19.01.2018.

institutions or bodies. However, an imperfection remains in the second sentence of Article 44 of the BNB Law where it refers to the public institutions and bodies not having the right to influence the BNB, the Governor and the members of the Governing Council. The wording should be further improved by referring to the wording of Article 130 of the TFEU, which states that public authorities may not seek to influence the members of national central banks' decision-making bodies.

In this context, it is also noted that Article 3 of the BNB Law provides that "in the formulation of the general outlines of the monetary policy, the BNB and the Council of Ministers shall inform each other". This procedure provides for the opportunity for the government to exert ex ante influence on the monetary policy of the BNB. As from the date of the formal adoption of the euro in Bulgaria or after the currency board has been suspended this might constitute an incompatibility in the area of independence, with Article 130 of the TFEU and Article 7 of the ESCB/ECB.

2.1.3. Prohibition of monetary financing and privileged access

Since the 2018 Convergence Report, Article 45(1) and (2) of the BNB Law, which were not fully consistent with Article 123 of the TFEU and Article 21.1 of the ESCB/ECB Statute have been amended with a view to including all European and other national public entities mentioned in Article 123(1) of the TFEU and Article 21.1 of the ESCB/ECB Statute. However, an imperfection remains given the original list of national entities referred to in Article 45(1) was maintained. The imperfection in the latter provision referred to in the 2018 Convergence Report regarding the scope of public sector debt that can be purchased by a national central bank has been solved.

In addition, Article 45(3) of the BNB Law was amended since the 2018 Convergence Report. It provides that the BNB shall not purchase in the primary and secondary markets public debt instruments. This paragraph is inconsistent with the amended Article 45(1) of the BNB Law and with Article 123 of the TFEU given the word 'direct' refers to the prohibition to purchase debt instruments on the primary market only. Purchases on the secondary market are not prohibited unless they qualify as a circumvention of the objective of Article 123 of the TFEU. For this reason, the wording 'and secondary" in Article 45(3) should be removed. In addition, since the first paragraph of Article 45 of the BNB Law already covers the prohibition to buy directly debt instruments, i.e. on the primary market, the third paragraph's content becomes redundant after adjustment.

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

2.1.4. Integration in the ESCB

Objectives

The secondary objective of the BNB (Article 2(2) of the BNB Law) is compatible with the Treaty on the Functioning of the European Union.

Article 2(1) of the BNB Law correctly reflects that the primary objective of the BNB is to maintain price stability. However, as from the day that Bulgaria adopts the euro, the latter will replace the national currency (lev) in accordance with Article 140 (3) of the TFEU. The reference to the wording 'through ensuring the stability of the national currency' will become obsolete as from that day.

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

- absence of a general reference to the BNB as an integral part of the ESCB (Article 1(1) of the BNB Law) and to its subordination to the ECB's legal acts (Articles 16 (1) and (2) and 60 of the BNB Law);
- definition of monetary policy and monetary functions, operations and instruments of the ESCB (Articles 2(1) and (3), 16(4) and (5), 28, 29, 30, 31, 32, 33, 35, 38, 41 and 61 of the BNB Law);
- conduct of foreign exchange operations and the definition of foreign exchange rate policy (Articles 20(1), 28, 29, 30, 31, 32 of the BNB Law);
- right to authorise the issue of banknotes and the volume of coins (Articles 2(5), 16(9), 24 to 27 of the BNB Law);

- non-recognition of the role of the ECB in the field of international cooperation (Articles 5, 16(12) and 37(4) of the BNB Law);

- ECB's right to impose sanctions (Article 61, 62 of the BNB Law).

There are also numerous imperfections regarding:

- non-recognition of the role of the ECB in the functioning of the payment systems (Articles 2(4) and 40(1) of the BNB Law);

- non-recognition of the role of the ECB and the EU in the collection of statistics (Article 4(1) and 42 of the BNB Law);

- non-recognition of the role of the ECB and of the Council in the appointment of the external auditor (Article 49(4) of the BNB Law);

- absence of an obligation to comply with the Eurosystem's regime for the financial reporting of NCB operations (Article 16(11), 46 and 49 of the BNB Law).

2.1.5. Assessment of compatibility

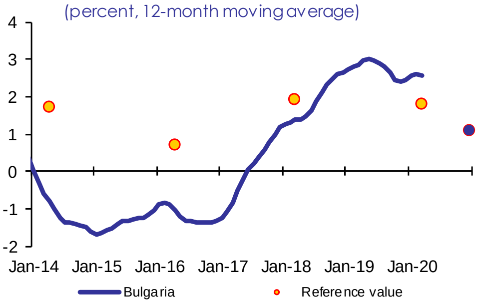
The Commission welcomes the efforts of Bulgarian authorities to remedy the incompatibilities and imperfections in comparison to its previous 2018 Convergence Report. However, the BNB Law and the Conflict of Interest Prevention and Ascertainment Act are not yet fully compatible with Article 131 of the TFEU as regards central bank independence, the prohibition of monetary financing and the integration in the ESCB at the time of euro adoption.

2.2. PRICE STABILITY

2.2.1. Respect of the reference value

The 12-month average inflation rate, which is used for the convergence assessment, was below the reference value at the time of the last convergence assessment of Bulgaria in 2018. It then increased to 3.0% by April 2019, before decreasing to 2.4% by November 2019. In March 2020, the reference value was 1.8%, calculated as the average of the 12-month average inflation rates in Portugal, Cyprus and Italy plus 1.5 percentage points. The corresponding inflation rate in Bulgaria was 2.6%, i.e. 0.8 percentage points above the reference value. The 12-month average inflation rate is projected to approach the reference value in the months ahead.

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



Note: The dots in December 2020 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2020 Forecast.

2.2.2. Recent inflation developments

The annual HICP inflation rose from 1.7% in April 2018 to 3.7% by August and returned to 2.3% by end-2018. It then increased to 3.1% by April 2019, before falling back to 1.6% by September. Inflation then started to rise again, reaching 3.4% in January 2020 and then fell to 2.4% in March. The fluctuation of inflation was mainly driven by energy and unprocessed food prices. Fuel price increases propped up inflation between May and November 2018, in the first five months of 2019 and then again in the end of 2019 and the two months of 2020. Their contribution turned negative, following the depressed oil prices in the second half of 2019 and again in March 2020. Unprocessed food prices spiked in 2018 due to a bad harvest and higher international grain prices. High unprocessed food inflation continued in 2019, following the outbreak of the African swine fever in April and higher import prices of meat. Inflation rates in Bulgaria have exceeded those of the euro area over the past two years.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) hovered around 2.5% over the last two years. It remained below headline inflation in most of 2018. In 2019, core inflation was close to the headline figure and remained below overall inflation between December 2019 and February 2020. Inflation in processed food gathered pace over the last two years, reflecting both higher international food prices and domestic factors, such as higher prices of unprocessed food. Inflation in services also picked up in 2018 and 2019, reaching 6.1% in August 2018 and 4.3% in July 2019. The cyclical upturn and the convergence process sustained the

Table 2.1:
Bulgaria - Components of inflation

	2014	2015	2016	2017	2018	2019	Mar-20	weights in total 2020
	(percentage change) 1)							
HICP	-1.6	-1.1	-1.3	1.2	2.6	2.5	2.6	1000
Non-energy industrial goods	-2.2	-1.6	-1.6	-1.1	-0.5	0.2	0.2	268
Energy	-3.8	-6.7	-7.0	5.8	6.4	1.4	1.6	122
Unprocessed food	-0.8	0.6	-1.1	5.9	1.3	5.3	6.1	54
Processed food	-0.4	0.6	1.2	2.3	2.3	4.0	4.5	236
Services	-1.3	0.1	-0.6	0.0	4.3	3.2	3.0	320
HICP excl. energy and unproc. food	-1.3	-0.3	-0.4	0.3	2.1	2.5	2.5	824
HICP at constant tax rates	-1.6	-1.1	-1.5	1.0	2.4	2.4	2.6	1000
Administered prices HICP	-1.0	1.5	0.1	1.7	2.2	2.6	2.6	157

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

Sources: Eurostat, Commission services.

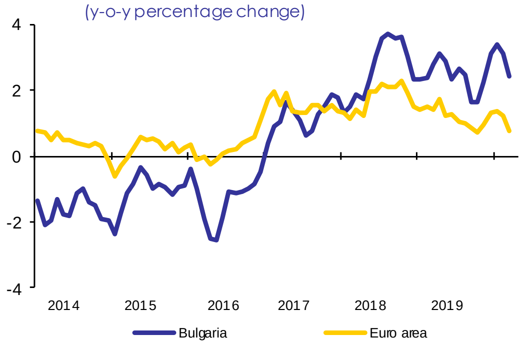
dynamics in prices of services over those two years. Specific factors have also contributed to services inflation. Higher food prices fed into higher prices for catering services. Statistical effects and a more pronounced seasonality pushed up prices of accommodation services during the summer months of 2018 and 2019. Sharp increases in car insurance premiums in mid-2018 also added to annual inflation in 2018 and early 2019. Prices of non-energy industrial goods had a negligible effect on overall price movements.

2.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and cyclical stance

Real GDP growth accelerated from 3.1% in 2018 to 3.4% in 2019, despite relatively weaker external demand and higher uncertainty abroad. Private consumption was the main driving force of economic growth on the back of rapid wage growth and high employment. Overall investment growth was moderate, although favourable financing conditions and high capacity utilisation were in place. Export growth slowed in 2018, mainly in relation with the external trade slowdown with major trading partners and temporary one-off factors (i.e. closure of oil refinery) and became volatile in the course of 2019. Net exports had a sizable negative contribution to GDP growth in 2018, while in 2019 the contribution was less negative at -0.3%. According to the Commission services' Spring 2020 Forecast, real GDP is expected to contract sharply by 7.2% in 2020 due to the coronavirus pandemic and then to recover by 6% in 2021 on the back of a relatively swift rebound in private consumption and exports. Output gap is projected to turn deeply negative in 2020 and then recover only partially, remaining below zero in 2021.

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



Source: Eurostat.

The fiscal stance, as measured by the change in the structural balance, was tightened in 2018 and loosened in 2019, but was overall broadly neutral over the two years. According to the Commission services' Spring 2020 Forecast, the fiscal stance is set to be expansionary in the current and next year.

The BNB pursues its primary objective of price stability through an exchange rate anchor in the context of a currency board arrangement (CBA) with the lev pegged to the euro. The CBA serves as a key macroeconomic policy anchor.

Wages and labour costs

Employment rates continued to increase in 2018 and 2019. The improved prospects for employment and higher wages attracted more working age population to the labour market, thus increasing the activity rates. The unemployment rate continued its downward trend, reaching historically low levels of 5.2% in 2018 and 4.2% in 2019. However, the imposition of containment

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

	2014	2015	2016	2017	2018	2019	2020 1)	2021 1)
HICP inflation								
Bulgaria	-1.6	-1.1	-1.3	1.2	2.6	2.5	1.1	1.1
Euro area	0.4	0.2	0.2	1.5	1.8	1.2	0.2	1.1
Private consumption deflator								
Bulgaria	0.0	1.6	0.4	3.2	2.0	2.0	0.0	2.0
Euro area	0.5	0.3	0.4	1.3	1.4	1.2	0.3	1.2
Nominal compensation per employee								
Bulgaria	5.6	5.6	5.8	10.5	9.7	6.1	3.4	2.3
Euro area	1.4	1.3	1.2	1.7	2.2	2.1	1.1	0.4
Labour productivity								
Bulgaria	1.5	3.6	3.3	1.7	3.2	3.0	-4.8	5.6
Euro area	0.8	1.0	0.5	1.0	0.4	0.1	-3.2	2.4
Nominal unit labour costs								
Bulgaria	4.0	1.9	2.4	8.7	6.3	3.0	8.6	-3.1
Euro area	0.6	0.5	0.7	0.7	1.8	2.1	4.3	-1.9
Imports of goods deflator								
Bulgaria	-2.9	-2.9	-6.0	7.5	2.2	0.4	-3.0	2.8
Euro area	-2.4	-3.3	-3.3	3.4	2.7	-0.6	-3.6	1.1

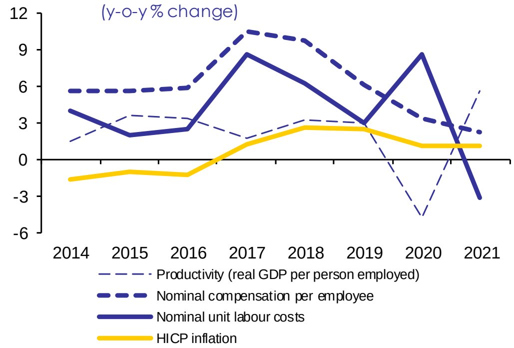
1) Commission services' Spring 2020 Forecast.

Source: Eurostat, Commission services.

measures against the COVID-19 pandemic already caused job losses in the first months of 2020. Job losses are set to be most pronounced in the services sector (which accounts for more than 60% of employment), where the disruption is likely to last longest. According to the Commission services' Spring 2020 Forecast, the unemployment rate is expected to jump to 7% in 2020, after having declined to historic lows of around 4% in 2019. Government measures to support employment in hard-hit sectors are expected to cushion the impact of the crisis on the labour market. The government has taken measures to protect employment, notably a new short-time work scheme according to which the State will cover 60% of the wages of employees in companies with a proven impact from the crisis. Nominal compensation per employee increased by 9.7% in 2018 and 7.8% in 2019, owing to the tight labour market and wage convergence pressures.

Labour productivity growth hovered around 3% in 2018 and 2019. It is projected to decrease by 4.8% in 2020 due to partial labour hoarding and recover in 2021. Nominal unit labour cost (ULC) growth remained high at 6.3% in 2018 and then decelerated to 3.0% in 2019 while labour market tightness and skill shortages persisted. According to the Commission services' Spring 2020 Forecast, ULC growth is expected to strongly increase in 2020 as labour hoarding would cause a sharp drop in productivity. ULC dynamics are projected to slow down somewhat in 2021 alongside the recovery.

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



Source: Eurostat, Commission services' Spring 2020 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 of mineral fuels, food and other manufactured articles, including clothing and footwear, are particularly relevant for inflation in Bulgaria, due to the high energy intensity of the Bulgarian economy and the relatively large share of manufactured goods in the consumer basket. In 2018, growth in the import deflator stood at 2.2%, pushed up by higher oil and gas prices as well as prices of some non-durable consumer products. In 2019, growth in the import deflator was close to zero, as prices of mineral fuels dropped sharply and inflation in imported consumer goods decelerated.

Over the last two years, the appreciating nominal effective exchange rate (NEER) decreased import price dynamics. The lev's NEER (measured against a group of 36 trading partners), which is determined by the price of the lev (and therefore the euro) vis-à-vis the currencies of major trade partners, appreciated by 3.4% in 2018 and by 0.6% in 2019. The appreciation in 2018 was strongly influenced by the depreciation of the Turkish lira against the euro. Turkey is the most important trading partner for Bulgaria outside the EU, with 8% of total exports and 6% of total imports.

Administered prices and taxes

The growth rate of administered prices accelerated in 2019, reaching 2.6% on the back of increases in utilities prices and (tertiary) education fees. Administered prices inflation remained below overall HICP in 2018 and slightly surpassed headline consumer price inflation in 2019. The share of administered prices in the HICP basket is relatively high at around 16%, compared to 12% in the euro area. Regulated prices of electricity, heat and water follow a seasonal pattern, as they are usually updated at the beginning of the year or in the summer months.

Indirect tax changes had only a small positive effect on inflation over the last two years. Annual constant-tax HICP was thus slightly below headline inflation during the assessment period.

Medium-term prospects

Annual HICP inflation is expected to decline significantly in 2020 before stabilizing at a low level in 2021. Following the oil price collapse at the beginning of 2020, energy prices are set to push inflation downwards substantially in 2020 and the beginning of 2021. In 2020, services inflation is projected to decline given the demand reduction in sectors that are affected by the imposed lockdown due to the COVID-19 outbreak as well as by the negative cyclical position of the economy. Inflation of processed and unprocessed food prices is forecast to gradually decelerate, as price pressures in the beginning of 2020 are expected to abate. Average annual inflation is projected at 1.1% for both 2020 and 2021.

Risks to the inflation outlook appear broadly balanced. However, the interplay between supply and demand constraints related to the COVID-19 pandemic presents additional uncertainty to the inflation forecast.

The level of consumer prices in Bulgaria stood at about 49% of the euro area average in 2018. This suggests that there is a significant potential for price level convergence in the long term, as GDP per capita in PPS (about 48% of the euro-area average in 2018) increases towards the euro-area average.

Medium-term inflation prospects will depend on wage and productivity developments as well as on the functioning of product and services markets. These developments may be substantially affected by the COVID-19 crisis. Given the openness of the Bulgarian economy and its limited resource base, commodity prices and other external price shocks will continue to exercise significant influence on domestic inflation.

2.3. PUBLIC FINANCES

2.3.1. Recent fiscal developments

The general government budget registered surpluses of 2% of GDP in 2018 and 2019. The overall improvement in budget surpluses relative to the previous years was mostly driven by higher revenue. Total public revenue increased by more than 2 percentage points of GDP between 2017 and 2019, to 38.4%. This increase reflects improvements in tax collection and higher transfers from the EU. Moreover, a large part of the increase in the level of total revenue (by around 1 percentage point of GDP) was due to the introduction of a fee on electricity supply in favour of the national energy security fund in 2018. This change, however, does not affect the government balance as it is matched with an equal increase in expenditure through subsidies. In this context, the expenditure-to-GDP ratio increase by 1.4 percentage points between 2017 and 2019 to 36.3%, mainly due to wage increases in education and a recovery in public investment from a very low level in 2017. The main driving forces of public investment were the picking up in EU funded projects and some investment in road infrastructure and defence.

The general government balance was 2.1% of GDP in 2019, overshooting the target of -0.3% of GDP in the 2019 Convergence Programme. The better

Table 2.3:

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

Outturn and forecast [1]	2014	2015	2016	2017	2018	2019	2020	2021
General government balance	-5.4	-1.7	0.1	1.1	2.0	2.1	-2.8	-1.8
- Total revenues	37.9	38.7	35.1	36.0	38.5	38.4	39.3	38.3
- Total expenditure	43.3	40.4	35.0	34.9	36.6	36.3	42.0	40.2
of which:								
- Interest expenditure	0.9	0.9	0.9	0.8	0.7	0.6	0.6	0.7
p.m.: Tax burden	28.4	29.1	29.1	29.4	29.9	30.9	31.3	30.1
Primary balance	-4.6	-0.8	1.0	1.9	2.6	2.6	-2.2	-1.2
Cyclically-adjusted balance [2]	-4.8	-1.5	-0.1	0.7	1.3	1.1	-1.3	-1.6
One-off and temporary measures [3]	-3.2	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Structural balance [2)4)]	-1.6	-1.4	-0.1	0.7	1.3	1.1	-1.3	-1.6
Government gross debt	27.1	26.0	29.3	25.3	22.3	20.4	25.5	25.4
p.m: Real GDP growth (%)	1.9	4.0	3.8	3.5	3.1	3.4	-7.2	6.0
p.m: Output gap [2]	-2.0	-0.8	0.5	1.5	2.2	3.4	-5.0	-0.7

1) Commission services' Spring 2020 Forecast.

2) Due to the COVID-19 pandemic, these estimates are surrounded by an unusually high level of uncertainty.

3) COVID-19-related measures were not classified as one-offs in the Commission services' Spring 2020 Forecast, due to the activation of the general escape clause of the SGP.

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

Source: Commission services.

outcome is mainly due to better than projected revenue and lower than planned public investment. In structural terms, after the peak of 2018 at around 1.3% of GDP the surplus returned to 1% of GDP in 2019. The general government debt declined from around 25% of GDP in 2017 to close to 20% of GDP in in 2019.

2.3.2. Medium-term prospects

The 2020 budget was originally adopted by Parliament in December 2019 and aimed at a balanced general government budget in cash terms, corresponding to a close to balanced budget in ESA terms. The budget envisaged an increase in all public wages by 10% and for some categories of teaching staff by 17% and no new measures on the revenue side. The medium term plan of the government up to 2022 was to maintain a balanced budget and to continue decreasing debt.

In April 2020, the Parliament amended the budget law to take into account a deteriorated economic outlook and the new budgetary plans of the government in response to the COVID-19 pandemic. The updated 2020 budget envisages a deficit slightly over 3% of GDP in cash terms, as the overall impact of the pandemic on the budget is estimated to be close to 5 percentage points of GDP relative to the previous year. This is mainly due to the deteriorated macroeconomic outlook, which is expected to lead to lower revenues from taxes and social security contributions and a higher spending on unemployment and social benefits. Moreover, as part of the package of measures to contain the pandemic and its impact, the government announced a higher spending on medical equipment and wage bonuses and increases for the medical and security staff, as well as subsidies, tax deferrals, state guarantees and a reallocation of investment funds to support the economy.

According to the Commission services' Spring 2020 Forecast, the deficit of the general government balance in ESA terms is set to reach 2.8% of GDP in 2020 and to slightly diminish to 1.8% of GDP in 2021 (assuming unchanged policies), mainly due to the positive impact of higher economic growth on revenues and the fading impact of some expenditure measures. Taking into account the estimated positive output gap, the structural deficit is projected to be in the neighbourhood of -1.5% of GDP in both 2020 and 2021. The public-debt-to-GDP ratio is forecast to increase to 25.5% of GDP in 2020 and remain at that level in 2021. The rise in general government debt is mainly driven by a return to primary deficits, the contraction in GDP and certain measures to support liquidity in the economy (e.g. the capital strengthening of the Bulgarian Development Bank to provide state guaranteed loans) that do not affect the deficit but do weigh on debt.

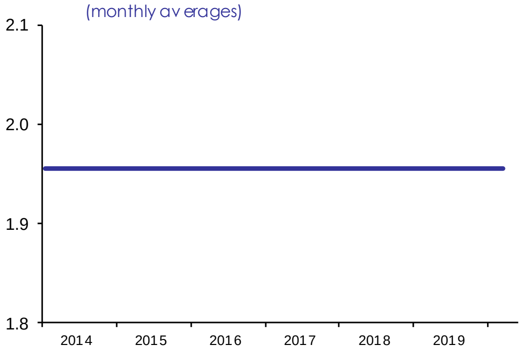
The Bulgarian fiscal framework has been strengthened over the recent years. It should be recalled that Bulgaria is bound (based on its own declaration of intention) by the Fiscal Compact provisions of the intergovernmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG)([13]) and has transposed those requirements in the national legal order. Based on the Commission's Fiscal Governance Database, Bulgaria has in place no less than nine domestic numerical rules (highest number in the EU), with a recently improving trend of compliance. Based on its broad remit, the Fiscal Council has gradually established its system for releasing its mandatory monitoring reports on the annual and medium-term fiscal plans and compliance with all the numerical rules laid down in the Public Finance Act. The mandate of the Council was further extended in 2019 to include regular and comprehensive *ex post* evaluations of the government's macroeconomic and budgetary forecasts (the first evaluation is yet to be released).

2.4. EXCHANGE RATE STABILITY

The Bulgarian lev does not participate in ERM II. In July 2018, Bulgaria announced its intention to put in place the necessary elements for a successful entry into ERM II. In order to ensure a smooth transition to, and participation in, ERM II, Bulgaria committed to implement before joining the ERM II a number of measures (i.e. prior-commitments) in the following six policy areas: banking supervision, macro-prudential framework, supervision of non-banking financial sector, insolvency framework, anti-money laundering framework, governance of state-owned enterprises. Bulgaria is currently working towards the completion of these prior-commitments, in close liaison with the Commission and the ECB who monitor their progress.

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.

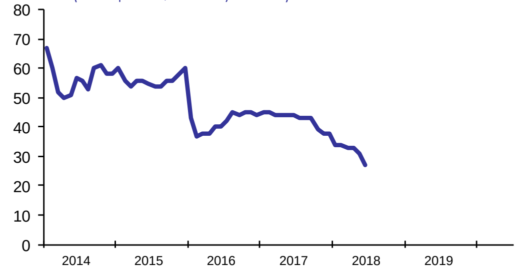
Graph 2.4: **Bulgaria - BGN/EUR exchange rate**
(monthly averages)



Source: ECB.

Bulgaria's international reserves hovered around EUR 25 billion in 2019, after having increased from EUR 22.6 billion at the beginning of 2018 to around EUR 25 billion at the end of the same year. International reserves increased in the course of 2018 on account of inflows of EU funds and the related net purchases of euros by the BNB. As international reserves were broadly stable in 2019 compared to 2018, their share as a percentage of GDP declined slightly to below 41% from around 45% at the end of 2017.

Graph 2.5: **Bulgaria - 3-M Sofibor(1) spread to 3-M Euribor**
(basis points, monthly values)



(1) The production of SOFIBOR reference rate was discontinued by the National Bank of Bulgaria as of 1 July 2018. An equivalent rate is not currently available.

Source: Eurostat and National Bank of Bulgaria.

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. The BNB discontinued the production of short-term reference rates (e.g. SOFIBOR) as of 1 July 2018.([14])

([13]) Fiscal Compact is Title III of the intergovernmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG).

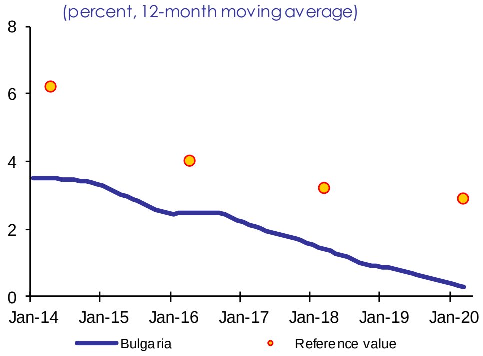
([14]) The BNB continues to calculate and publish the LEONIA Plus, which is a reference rate of concluded and effected

2.5. LONG-TERM INTEREST RATES

Long-term interest rates used for the convergence examination reflect the secondary market yield on a single benchmark Bulgarian government bond with a residual maturity of around 10 years.

The Bulgarian 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion was below the reference value in the 2018 convergence assessment of Bulgaria. It further declined to below 1% at the end of 2018 and to below 0.50% by the end-2019. In March 2019, the reference value, given by the average of long-term interest rates in Portugal, Cyprus, and Italy plus 2 percentage points, stood at 2.9%. In that month, the 12-month moving average of the yield on the Bulgarian benchmark bond stood at 0.3%, i.e. 2.6 percentage points below the reference value.

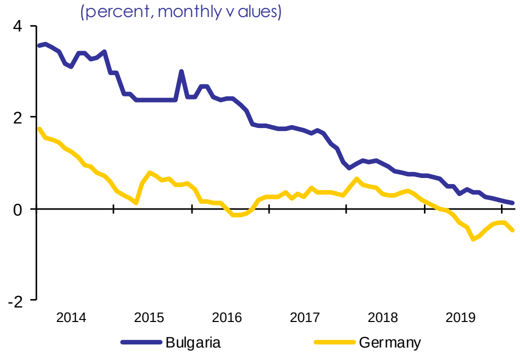
Graph 2.6: **Bulgaria - Long-term interest rate criterion**
(percent, 12-month moving average)



Source: Commission services.

The long-term interest rate of Bulgaria has been on a downward path since the beginning of 2018, declining from close to 1% to below 0.20% in the first three months of 2020. Bulgarian benchmark bond yields fell throughout 2018-19, supported by local market conditions and continuing strong demand for government securities while their supply remained subdued. Falling long-term interest rates were supported also by external forces, i.e. expectations of loose monetary policy in the euro area for an extended period of time. After falling sharply to below 50 basis points at the beginning of 2018, the spread to German long-term benchmark bond increased somewhat, while remaining below 100 basis points, between mid-2018 and mid-2019, reflecting a sharp drop in the German long-term interest rates. The spread declined again to close to 50 basis points by end 2019, before widening only moderately to close to 70 basis points in March 2020, mainly reflecting developments in German long-term government bond yields.

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



Source: Eurostat.

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, as well as product, labour and financial market integration – gives an important indication of a Member State's ability to integrate into the euro area without difficulties.

In December 2019, the Commission published its ninth Alert Mechanism Report (AMR 2020) under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.6), which concluded that an In-Depth Review (IDR) was warranted for Bulgaria. In February 2020, the Commission published its annual country report on Bulgaria, including an In-Depth Review (IDR). The report concluded that Bulgaria is experiencing no imbalances. In the past years, vulnerabilities in the financial sector were coupled with high indebtedness and non-performing loans in the corporate sector. Consistent policy action and a favourable macroeconomic environment have reduced risk and vulnerabilities further. Progress has been made in strengthening financial sector governance and addressing outstanding regulatory issues. The insolvency framework reform has been advancing. Robust economic growth has supported the reduction of corporate debt and non-performing loan ratios.

overnight deposit transactions in Bulgarian levs on the interbank market in Bulgaria.

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

	2014	2015	2016	2017	2018	2019
Current account	1.2	0.1	3.2	3.5	1.4	4.0
of which: Balance of trade in goods	-6.5	-5.7	-2.0	-1.5	-3.3	-2.8
Balance of trade in services	5.9	6.7	7.0	5.8	5.9	6.2
Primary income balance	-2.0	-4.5	-5.1	-4.4	-4.4	-2.8
Secondary income balance	3.8	3.6	3.3	3.5	3.2	3.4
Capital account	2.2	3.1	2.2	1.0	1.1	1.5
External balance [1)]	3.5	3.2	5.4	4.5	2.5	5.5
Financial account	1.0	7.9	9.1	4.4	5.4	4.2
of which: Direct investment	-0.3	-4.1	-1.1	-2.5	-1.3	-1.3
Portfolio investment	-2.8	-1.3	-1.3	5.0	2.6	2.6
Other investment [2)]	0.0	5.1	4.5	2.1	1.7	3.9
Change in reserves	4.2	8.2	7.1	-0.2	2.4	-0.9
Financial account without reserves	-3.2	-0.2	2.0	4.6	3.0	5.1
Errors and omissions	-2.4	4.7	3.8	-0.1	2.9	-1.3
Gross capital formation	21.6	21.1	19.0	19.9	21.3	19.5
Gross saving	21.8	21.6	24.0	25.5	25.9	24.7
Gross external debt	97.1	80.6	78.5	71.8	65.9	62.2
International investment position	-72.2	-62.5	-48.7	-44.2	-36.8	-31.6

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

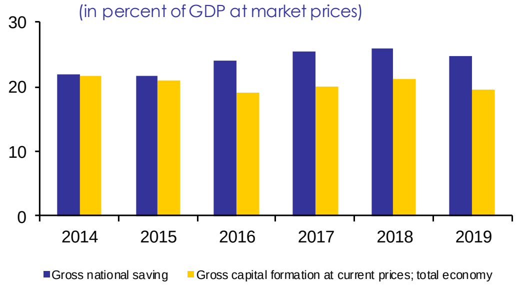
Sources: Eurostat, Commission services, Bulgarian National Bank.

2.6.1. Developments of the balance of payments

Bulgaria's external balance (i.e. the combined current and capital accounts) continued to record surpluses in both 2018 and 2019, with the surplus rising from 2.5% of GDP in 2018 to 5.5% of GDP in 2019. This improvement was mostly driven by a substantial increase in the current account surplus, which rose to 4% in 2019 from 1.4% in 2018, on account of declining deficits of goods and primary income balances while the surplus of the balance of trade services continued to increase for the third consecutive year. The balance of goods strengthened in 2019, as nominal exports expanded faster than nominal imports. The terms of trade have also improved, supporting Bulgaria's external position. The balance of services remained positive and strengthened further in 2019 due to lower imports of other services. Declining profits from FDI in 2019 led to improved balance of primary income. Given the high share of FDI revenues in income outflow and their volatility, they determine to a large extent the evolution of primary income balance. The surplus in secondary income increased in 2019, as the income outflow returned to normal levels following an increase in 2018. Capital account also improved on the back of higher inflows from EU funds transfers.

The saving-investment gap of the Bulgarian economy increased in 2019 compared to 2018, reaching 5.5% of GDP. The higher surplus was driven by higher net savings in the private sector. The somewhat depressed investment rate in 2019, influenced by the increased uncertainty abroad, accounted for the widening of the saving-investment gap. Aggregate savings rate remained roughly constant.

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

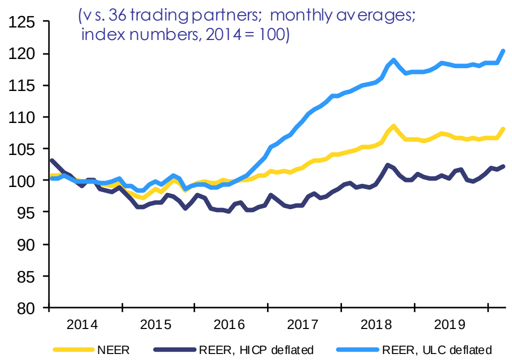


Source: Eurostat, Commission services.

The financial account continued to show net outflow of capital. Increasing net deposits of commercial banks abroad, coupled with more foreign currency held domestically, account for the largest part of the financial account balance. Correspondingly, the negative Net International Investment Position (NIIP), continued to decrease rapidly. The net external liabilities consist mostly of FDI equity, which have been rather stable as a share of GDP after the crisis of 2009.

The measures of price and cost competitiveness worsened somewhat in 2018 and were kept broadly unchanged in 2019. In 2018, the pace of appreciation of the real effective exchange rate (REER), deflated by ULC, slowed to 3.2% and in 2019 its level stayed roughly constant. The REER deflated by HICP appreciated moderately in 2018. By the end of 2018, it was 1.6% higher than a year earlier. It then remained at that level in 2019.

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



Source: Commission services.

The long-term trend of growing export market share continued in 2018 and 2019, suggesting that Bulgaria's external competitiveness has been preserved so far. Productivity gains, expansion in production capacity and improvement in product sophistication indicate that non-price competitiveness factors compensated for price and cost increases.

According to the Commission services' Spring 2020 Forecast, the current account surplus is expected to deteriorate as an external demand slump is set to drive exports down in 2020. Nevertheless, the current account is projected to remain in surplus in 2020, and to improve further in 2021 on the back of a rebound in exports.

2.6.2. Market integration

The economy is well integrated with the euro area through trade and investment linkages. Although the ratio of trade openness declined to close to 64% in 2019 from above 68% in 2017, Bulgaria remained a relatively open economy. Trade with the euro area was about 29% of total trade in 2019. Outside the EU, Bulgaria's main trading partners are Turkey and Russia (especially for imports).

FDI inflows remained low at about 1% of GDP in 2018 and 2019. The stock of FDI amounted to some 78% of GDP in 2018 and 76% in 2019, with FDI mainly coming from the Netherlands, Austria, Germany and Italy. 27% of all FDI stock is directed to industry (excluding construction), 23% are invested in real estate, while the trade sector attracted 14% of total FDI stock.

Concerning the business environment, Bulgaria performs relatively worse than many euro-area Member States in international rankings (WEF's Global Competitiveness Index, the World Bank's Ease of Doing Business). The slow pace of improvement and the lack of substantial reforms dragged Bulgaria down from the 50th place in 2017 to 61st place in the 2019 'Ease of Doing Business' ranking. The major challenges relate to the institutional framework, including fighting corruption, improving the functioning of the judicial system, reducing the administrative burden on corporations, and improving the quality of public services. Shortcomings in the functioning of institutions are a significant obstacle to the economic and social potential of the country. However, action is being taken to improve the business environment, in particular regarding the insolvency framework and governance of state-owned enterprises. Bulgaria ranks low in the World Bank's Worldwide Governance Indicators and the European Quality of Government Index. Bulgaria's transposition deficit of EU Directives has decreased by 0.6 percentage points since December 2017 (the second highest decrease amongst all Member States) to 0.7%, according to the 2019 Internal Market Scoreboard. Bulgaria now equals the EU average, but it is still above the target (0.5%) proposed by the European Commission in the Single Market Act (2011).

The 4th Anti-Money Laundering Directive imposed transposition by 26 June 2017. Bulgaria communicated to the Commission several measures adopted to transpose the directive between April 2018 and November 2019. The Commission is analysing the communicated measures to assess their completeness and conformity with the directive and also in light of the prior ERM II commitments. As regards the 5th Anti-Money Laundering Directive, whose transposition deadline elapsed on 10 January 2020,

Table 2.5:
Bulgaria - Market integration

	2014	2015	2016	2017	2018	2019
Trade openness [1] (%)	69.0	66.0	64.6	68.3	67.3	64.4
Trade with EA in goods & services [2]+[3] (%)	30.6	30.0	29.5	30.3	30.5	29.0
Export performance (% change) [4]	-0.7	3.3	4.6	-0.8	-1.6	-0.4
World Bank's Ease of Doing Business Index rankings [5]	36	37	39	50	59	61
WEF's Global Competitiveness Index rankings [6]	54	54	50	49	51	49
Internal Market Transposition Deficit [7] (%)	0.7	0.9	0.6	1.7	1.3	0.7
Real house price index [8]	98.8	100.0	106.6	112.2	117.3	121.9
Residential investment [9] (%)	1.6	1.4	2.7	2.9	2.7	2.6

1) (Imports + Exports of goods and services / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics, Balance of Payments).
2) (Imports + Exports of goods with EA-19 / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).
3) Trade in services with EA-19 (average credit and debit in % of GDP at current prices) (Balance of Payments).
4) Index for exports of goods and services divided by an index for growth of markets (percentage change on preceding year).
5) New methodology as of 2014 (World Bank).
6) (World Economic Forum)
7) Percentage of internal market directives not yet communicated as having been transposed, relative to the total.
(November data, as of 2016 date refers to the year of publication).
8) Deflated house price index (2015=100) (Eurostat).
9) Gross capital formation in residential buildings (in % of GDP) (Eurostat).

Sources: Eurostat, World Bank, World Economic Forum, Commission services.

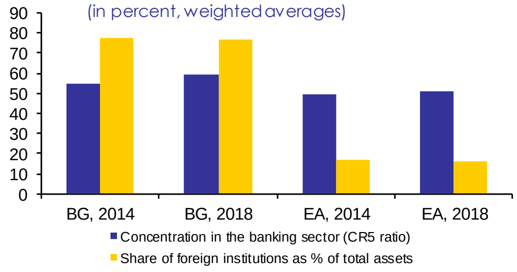
Bulgaria has notified national transposition measures and declared a complete transposition. The Commission is analysing the communicated measures to assess their completeness and conformity with the directive. Beyond the transposition of the latest anti-money laundering directives, the recently completed National Risk Assessment shows weaknesses that need urgent mitigation to prevent money laundering and terrorist financing. Actions need to be designed and implemented to deliver an effective application of the anti-money laundering framework by obliged entities.

The employment rate increased steadily in the past 5 years, reaching 75% in 2019 and the unemployment rate reached 3.8 % in the last quarter of 2019. However, Bulgaria’s labour market suffers from a number of vulnerabilities, such as regional disparities, skills mismatches and still high levels of inactivity in some population groups (e.g. NEETs, Roma). In a context of worsening demographics, the supply of labour has been negatively affected by high emigration and brain drain.

Demographic developments strongly affect the labour market, and may constrain future economic growth. The population decreased by 50,000 in 2018, to reach nearly 7 million in January 2019. Bulgaria’s labour force is expected to decrease by 10% by 2030. The age cohort 25-49 (with a labour market participation rate of 86% on average) is expected to decline the most. Such a reduction in the available labour force might jeopardise sustainable future growth.

Bulgaria's financial sector is well integrated into the EU financial sector, in particular through a high level of foreign ownership in its banking system. The share of foreign-owned institutions in total bank assets stood at 77% in 2018. Bank concentration, as measured by the market share of the five largest credit institutions in total assets, reached almost 60%, some 10 percentage points above the euro area average in 2018.

Graph 2.10: **Bulgaria - Foreign ownership and concentration in the banking sector**
(in percent, weighted averages)

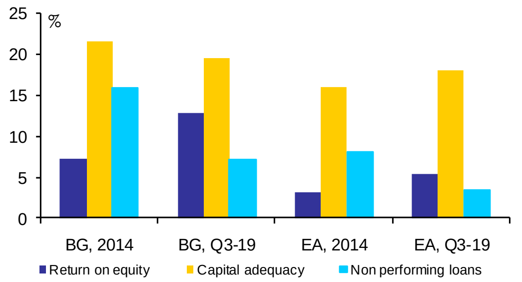


Source: ECB, Structural financial indicators.

Based on the available data, the capital adequacy of the banking sector is somewhat higher than in the euro area. The average capital adequacy ratio stood at 19.5% in the third quarter of 2019, which was some 1.4 percentage points higher than in the euro area. However, according to the results of the ECB comprehensive assessment of six Bulgarian banks published on 26 July 2019 and which included an asset quality review (AQR) and a stress test, two banks faced capital shortfalls, as their capital adequacy ratios fell below some of the relevant thresholds used in the AQR and the stress test.([15]) The ratio of NPLs to the loan portfolio held by the banking sector has fallen substantially over the last two years, but at 7.2% in the third quarter of 2019, was still more the double of the euro-area average of 3.4%. The profitability of the domestic banking sector remained well above the euro-area level, with an average return on equity (RoE) close to 13% in the third quarter of 2019. The COVID-19 pandemic could have a significant impact on the indicators analysed in this paragraph over the coming months.

House prices continued to grow at a rather rapid pace of about 5% yearly in real terms, reaching 121.9% of its 2015 level in 2019. Residential investment grew at much more moderated rates of around 2.5% both in 2018 and 2109. The stock of loans for house purchases increased annually by 12.5% at the end of 2018 and by 15.1% at the end of 2019. Although growth in household debt increased due to intensified mortgage lending, it still remains among the lowest in the EU.([16])

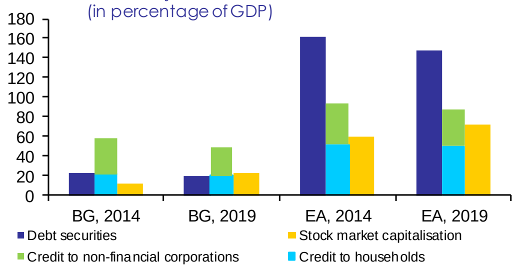
Graph 2.11: **Bulgaria - Selected banking sector soundness indicators**



Note: Q3-19 Return on equity is calculated over the last four quarters.
Source: ECB, EC calculations.

Relative to GDP, the financial system is much smaller in Bulgaria than in the euro area. Domestic bank credit stood at below 50% of GDP in 2019 compared to almost 90% of GDP in the euro area. The capitalization of the stock market increased to around 23% of GDP in 2019, but remained well below the euro-area average of over 70%. The debt securities market remained small in comparison with the euro area average (just over 19% vs. 148% of GDP). According to available data, the consolidated stock of private sector debt stood at 95% of GDP in 2018 and was below the euro-area average of 135%.

Graph 2.12: **Bulgaria - Recent development of the financial system relative to the euro area**
(in percentage of GDP)



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

([15]) https://www.bankingsupervision.europa.eu/press/pr/date/2019/html/ssm.pr190726~1b474e3467.en.html
([16]) Growth rates of loans are calculated from notional stocks, which reflect only changes that arise from financial transactions.

3. CZECHIA

3.1. LEGAL COMPATIBILITY

3.1.1. Introduction

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

Following the Commission's 2018 Convergence Report, the ČNB Law was only slightly amended ([17]). However, since there have been no amendments as regards the incompatibilities highlighted in the Commission's 2018 Convergence Report, the comments made in the latter report are largely repeated in this year's assessment.

3.1.2. Central Bank independence

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

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

The power for the Chamber of Deputies of the Parliament to impose modifications to the annual financial report, which was previously submitted and rejected (Article 47(5) of the ČNB Law) could hamper the ČNB's institutional independence. Moreover, it is formulated in a very general manner, which could create situations where the Parliament requests changes affecting the financial independence of the ČNB. Thus, the current wording of Article 47(5) of the ČNB Law constitutes an incompatibility, which should be removed from the Act.

Article 6(10) of the ČNB Law provides that members of the Bank Board, which also includes the Governor of the ČNB, may be relieved from office only if they no longer fulfil the conditions required for the performance of their duties or if they have been guilty of serious misconduct. Although Article 6(10) of the ČNB Law extends the protection offered by Article 14.2 of the ESCB/ECB Statute to Governors against arbitrary dismissal to all Bank Board members of the ČNB, it remains silent on the Governor's right in case of dismissal to seek a remedy before the Court of Justice of the European Union. However, pursuant to footnote 22, the Commission understands that the possibility to seek legal redress by the Governor before the Court of Justice of the European Union, as enshrined in Article 14.2 of the ESCB/ECB Statute, would apply. However, the ČNB Law would benefit from a more explicit clarification.

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

([17]) Act No 89/2018 Coll. provides for the right of the ČNB to issue commemorative banknotes and trade coins. Act No 111/2019 Coll. implements data protection rules..

3.1.3. Prohibition of monetary financing and privileged access

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

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

3.1.4. Integration in the ESCB

Objectives

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

Tasks

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

- definition of monetary policy and monetary functions, operations and instruments of the ECB/ESCB (Articles 2(2)(a), 5(1) and 23 to 26, 28, 29, 32, 33 of the ČNB Law);
- conduct of exchange rate operations and the definition of exchange rate policy (Articles 35 and 36 of the ČNB Law);
- holding and management of foreign reserves (Articles 35(c), 36 and 47a of the ČNB Law);
- non-recognition of the competences of the ECB and of the Council on the banknotes and coins (Article 2(2)(b), Articles 12 to 22 of the ČNB Law);
- ECB's right to impose sanctions (Article 46a of the ČNB Law);
- the possibility for Parliament to demand amendments to the report of the ČNB on monetary policy developments and to determine the content/scope of the extraordinary report in view of the absence of a specification regarding the non-forward looking nature of the reports (Article 3 of the ČNB Law).
- There are also some imperfections regarding:
- the partial absence of reference to the role of the ECB and of the EU in the collection of statistics (Article 41);
- non-recognition of the role of the ECB in the functioning of the payment systems (Articles 2.2 c), 38 and 38a of the ČNB Law);
- non-recognition of the role of the ECB and of the Council in the appointment of the external audit of the ČNB (Article 48(2) of the ČNB Law);
- absence of an obligation to comply with the Eurosystem's regime for the financial reporting of NCB operations (Article 48 of the ČNB Law);
- non-recognition of the role of the ECB in the field of international cooperation (Article 2(3) of the ČNB Law).

3.1.5. Assessment of compatibility

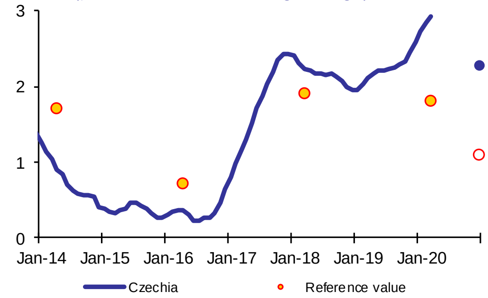
As regards the independence of the central bank, the prohibition of monetary financing and the integration of the central bank in the ESCB at the time of euro adoption, the ČNB Law is not fully compatible with the compliance duty under Article 131 of the TFEU. The Czech authorities are invited to remedy the abovementioned incompatibilities.

3.2. PRICE STABILITY

3.2.1. Respect of the reference value

The 12-month average inflation rate, which is used for the convergence assessment, was above (2.2%) the reference value (1.8%) at the time of the last convergence assessment of Czechia in 2018. It declined gradually to 2% in November 2018 and then steadily increased up to 2.6% by end-2019. In March 2020, the reference value was 1.8%, calculated as the average of the 12-month average inflation rates in Portugal, Cyprus and Italy plus 1.5 percentage points. The corresponding inflation rate in Czechia was 2.9%, i.e. 1.4 percentage points above the reference value. According to the Commission Service's 2020 Spring Forecast, the 12-month average inflation rate is projected to remain well above the reference value in the months ahead.

Graph 3.1: **Czechia - Inflation criterion**
(percent, 12-month moving average)

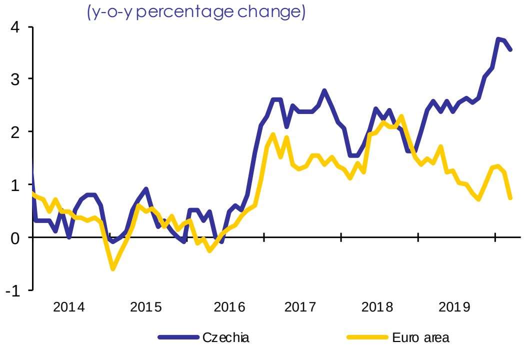


Note: The dots in December 2020 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2020 Forecast.

3.2.2. Recent inflation developments

The annual HICP inflation rate was broadly on an upward path during the last two years. In 2018, it fluctuated between 1.6% and 2.4%. After dropping at the end of 2018, mainly due to declining food prices, HICP inflation increased steadily from 2.0% to 3.2% in 2019, exceeding the central bank's tolerance band of 3.0% in both November and December ([18]). This resulted mainly from a rapid hike in food prices, as well as a sustained rise in services and energy prices throughout 2019. In annual terms, the inflation rate dropped to 2.0% in 2018 (vs. 2.4% in 2017), before rising again to 2.6% in 2019. The acceleration is explained by a combination of high wage growth and strong domestic demand in an economy working at full capacity. Since end 2018, annual HICP inflation in Czechia has been higher than in the euro area with a fast increasing gap. Core inflation (measured as HICP inflation excluding energy and unprocessed food prices) remained below headline inflation in 2018 and 2019. This was mainly due to high energy inflation. Core inflation oscillated between 1.3% and 2.1% in 2018. It decreased markedly in September 2018 as a result of a drop in service prices and rose steadily up to 2.4% in March 2019. After decreasing again in April 2019 to 1.8% due to food prices, it grew strongly to 3.6% in March 2020, driven by a sustained increase in service prices and prices of processed food. Domestic producer prices increased steadily in 2018 and 2019, in line with rising prices for manufactured products and electricity.

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



Source: Eurostat.

3.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and cyclical stance

After a significant economic upswing up to 2017, the Czech economy decelerated in 2018 and 2019, mostly due to a more subdued external environment. Real GDP expanded by 2.8% in 2018, considerably less than in 2017 (4.4%). The economy continued its deceleration in 2019, when it grew by 2.6%. Private consumption was the main driver of GDP growth, supported by low unemployment and strong wage growth. Yet, private consumption growth moderated gradually throughout the period, falling from 3.2% in 2018 to 3% in 2019. Gross fixed capital formation increased strongly in 2018 by 7.6%, mainly driven by an influx of EU funds, investment in automation and robotisation in manufacturing, and a revival of investment in construction. As the external environment deteriorated, growth in investment in 2019 fell significantly to 2.8%.

([18]) It is important to note, however, that the CNB's tolerance band is based on CPI inflation, which stood at 3.1% in November and increased to 3.4% in March 2020.

Table 3.1:
Czechia - Components of inflation

	2014	2015	2016	2017	2018	2019	Mar-20	weights in total 2020
					(percentage change) 1)			
HICP	0.4	0.3	0.6	2.4	2.0	2.6	2.9	1000
Non-energy industrial goods	0.4	0.5	0.8	0.6	0.6	0.5	0.6	259
Energy	-3.8	-3.0	-2.5	1.2	3.2	4.8	4.5	122
Unprocessed food	1.2	0.7	0.5	2.2	2.3	1.4	4.7	50
Processed food	2.7	1.1	1.2	4.4	1.7	2.7	3.1	229
Services	0.6	0.9	1.5	2.9	2.6	3.4	3.7	340
HICP excl. energy and unproc. food	1.1	0.8	1.2	2.6	1.8	2.3	2.6	828
HICP at constant tax rates	0.3	0.1	0.4	2.6	1.9	2.6	2.9	1000
Administered prices HICP	0.4	0.5	1.4	1.1	1.5	3.7	4.2	149

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

Sources: Eurostat, Commission services.

According to the Commission services' Spring 2020 Forecast, due to the COVID-19 pandemic real GDP is expected to decrease by around 6.2% in 2020, before recovering by 5% in 2021. As a result, although the Czech economy is estimated to have been operating above its potential since 2016 the output gap will become sharply negative in 2020 due to the strong fall in the GDP.

The fiscal stance, as measured by the change in the structural balance, eased considerably in 2018 and in 2019. In particular, the structural balance decreased by 0.8 percentage points to 0.0% of GDP in 2018, and went into negative territory at -0.7% of GDP in 2019. According to the Commission services' Spring 2020 Forecast, it is expected to decrease significantly in 2020 to -5% of GDP, due to a large decline of the balance in light of the fiscal measures taken against the pandemic. It is then projected to recover partially to -3.5% of GDP in 2021.

The ČNB conducts monetary policy within an inflation targeting framework. The use of the exchange rate as an additional monetary policy instrument was discontinued in April 2017. The decision was supported by macroeconomic data and forecasting scenarios indicating a sustainable fulfilment of the 2% inflation target over the forecast horizon. Subsequently, the ČNB started in August 2017 to gradually raise its main policy rate (the 2-week repo rate) as annual inflation remained above its 2% inflation target. The rate increased from 0.75% in February 2018 to 2.0% in May 2019. Due to increasing domestic inflation pressure at end of the year 2019 and beginning 2020, the CNB Board raised the policy rate by 25 basis points to 2.25% during the February CNB Board meeting. After observing and assessing the measures taken by governments in trading partner countries, the Bank Board debased interest rates first by 50 basis point, followed by a 75 reduction rate to 1% during two monetary policy meetings in March 2020.

Growth in loans to domestic sectors slowed down during last two years. According to the Bank Lending Survey, credit standards were tightened after the ČNB tightened its macroprudential policies in June 2018 and June 2019 ([19]). This specifically led to a decline in loans for house purchase in 2019. After credit volumes to non-financial corporations expanded in 2018, firms, especially in industry and wholesale and retail trade, reduced their demand for loans in 2019. According to the latest Bank Lending Survey, this was mainly due to the increased use of internal financing and lower need to finance inventories and working capital.

Wages and labour costs

The labour market continued to perform well in 2018 and 2019. The unemployment rate dropped further in both years, to 2.9% in 2018 and 2% in 2019, making Czechia the best performer in the EU for the fourth year in a row. Nevertheless, the labour market is set to be impacted by the COVID-19 pandemic, with the unemployment rate hiking to 5% in 2020, despite temporary measures supporting self-employed and companies. The employment rate of those aged between 20 and 64 reached 80.4% in the second half of 2019, 6 percentage points above the EU average. Overall nominal wage growth accelerated sharply in 2018 and 2019, reaching 9.5% and 7.0% respectively. Although wage growth moderated slightly in end of 2019 and beginning of 2020, the still high

([19]) This mainly concerns DTI (debt-to-income) and DSTI (debt service-to-income) limits.

Table 3.2:
Czechia - Other inflation and cost indicators (annual percentage change)

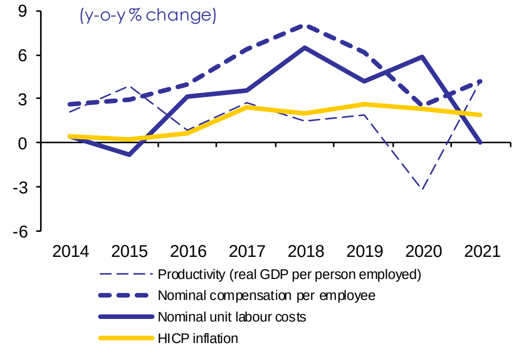
	2014	2015	2016	2017	2018	2019	2020 1)	2021 1)
HICP inflation								
Czechia	0.4	0.3	0.6	2.4	2.0	2.6	2.3	1.9
Euro area	0.4	0.2	0.2	1.5	1.8	1.2	0.2	1.1
Private consumption deflator								
Czechia	0.6	0.1	0.5	2.4	2.3	3.0	2.0	1.6
Euro area	0.5	0.3	0.4	1.3	1.4	1.2	0.3	1.2
Nominal compensation per employee								
Czechia	2.6	3.0	4.0	6.4	8.0	6.2	2.5	4.2
Euro area	1.4	1.3	1.2	1.7	2.2	2.1	1.1	0.4
Labour productivity								
Czechia	2.2	3.8	0.8	2.8	1.5	1.9	-3.2	4.2
Euro area	0.8	1.0	0.5	1.0	0.4	0.1	-3.2	2.4
Nominal unit labour costs								
Czechia	0.4	-0.8	3.1	3.6	6.5	4.2	5.9	0.0
Euro area	0.6	0.5	0.7	0.7	1.8	2.1	4.3	-1.9
Imports of goods deflator								
Czechia	2.0	-1.9	-3.8	0.7	-0.6	0.6	0.4	0.2
Euro area	-2.4	-3.3	-3.3	3.4	2.7	-0.6	-3.6	1.1

1) Commission services' Spring 2020 Forecast.

Source: Eurostat, Commission services.

growth rate is mainly attributable to persisting labour shortages, due to e.g. demographic factors, and an increase in the minimum wage ([20]). Wages in both the public and private sector showed similar growth dynamics during 2018 and 2019.

Graph 3.3: **Czechia - Inflation, productivity and wage trends**



Source: Eurostat, Commission services' Spring 2020 Forecast.

Labour productivity increased moderately in 2018 and 2019, mainly driven by manufacturing. As compensation per employee kept growing at a faster pace than productivity, nominal unit labour costs grew markedly in 2018 and 2019 (6.5% and 4.3%, respectively). According to the Commission services' Spring 2020 Forecast wage growth is expected to moderate in 2020 as the labour market eases, but growth in unit labour costs is set to increase to 5.4% due to a likely drop in labour productivity. In 2021, unit labour costs are projected to remain broadly unchanged as both labour productivity and wage growth are likely to rebound. Unit labour cost growth will also notably depend on the way labour shortages are adressed.

External factors

Given the size and openness of the Czech economy, import prices have a sizeable effect on domestic price formation. The imports of goods deflator fell by -0.6% in 2018, mainly due to lower industrial producer price inflation of trading partners in the euro area and declining oil prices. In 2019, goods' import prices increased by 0.6%, driven by prices for machinery and transport equipment.

The nominal effective exchange rate (measured against the main 36 trading partners) remained relatively stable throughout 2018 and 2019. It then appreciated end of 2019 and beginning of 2020, bringing import prices down during that period. Import prices are set to remain broadly stable in 2020 and 2021, as the expected depreciation of the koruna in 2020 and 2021 should be offset by emerging anti-inflationary pressures stemming from the COVID-19 crisis and by falling oil prices.

([20]) Despite the increase in the minimum wage, the relative value in PPS of the statutory minimum wage in Czechia is the fifth lowest in the EU, after Latvia, Bulgaria, Estonia, and Slovakia.

Table 3.3:
Czechia - Budgetary developments and projections (as % of GDP unless indicated otherwise)

Outturn and forecast [1]	2014	2015	2016	2017	2018	2019	2020	2021
General government balance	-2.1	-0.6	0.7	1.5	0.9	0.3	-6.7	-4.0
- Total revenues	40.3	41.1	40.7	41.0	42.2	42.1	41.9	41.7
- Total expenditure	42.4	41.7	40.0	39.5	41.2	41.9	48.5	45.7
of which:								
- Interest expenditure	1.3	1.1	0.9	0.7	0.8	0.7	0.9	0.9
p.m.: Tax burden	33.9	34.1	35.3	35.9	36.8	36.7	36.0	36.2
Primary balance	-0.8	0.5	1.6	2.3	1.7	1.0	-5.8	-3.1
Cyclically-adjusted balance [2]	-1.2	-0.7	0.7	0.8	0.1	-0.5	-4.6	-2.9
One-off and temporary measures [3]	-0.3	0.0	-0.1	0.0	0.0	0.0	0.0	0.0
Structural balance [2][4]	-0.9	-0.7	0.7	0.8	0.1	-0.5	-4.6	-2.9
Government gross debt	42.2	40.0	36.8	34.7	32.6	30.8	38.7	39.9
p.m: Real GDP growth (%)	2.7	5.3	2.5	4.4	2.8	2.6	-6.2	5.0
p.m: Output gap [2]	-2.2	0.2	0.1	1.8	2.1	2.0	-5.2	-2.6

1) Commission services' Spring 2020 Forecast.
2) Due to the COVID-19 pandemic, these estimates are surrounded by an unusually high level of uncertainty.
3) COVID-19-related measures were not classified as one-offs in the Commission services' Spring 2020 Forecast, due to the activation of the general escape clause of the SGP.
4) Cyclically-adjusted balance excluding one-off and other temporary measures.
Source: Commission services.

Administered prices and taxes

The share of administered prices in the HICP basket increased markedly in 2019 to 15.8%, which is significantly above the euro area average (12.2%). This came after a gradual decline in the share since 2011, from 11.2% to 9.8% in 2018. Changes in administered prices were a significant driver of inflation in 2019, as they increased by 3.8%, i.e. almost double that of headline HICP. This was not the case in 2018, where the growth in administered prices was just 1.6%, compared to 2.0% for the overall HICP. Increases in heat energy and pharmaceutical products were the main contributors to the increase in administered prices in 2019. Administered transport prices decreased considerably by roughly 6.5% on average that year. HICP at constant tax rates was somewhat below headline inflation in 2018 (1.9%) and at the same level in 2019 (2.6%).

Medium-term prospects

Annual HICP inflation remained relatively elevated in early 2020, driven by a hike in food prices, increasing administered prices, and changes to indirect taxes. It is expected to moderate substantially in the second half of 2020, as declining oil prices, falling demand, and lower wage growth bring inflation down. According to the Commission services' Spring 2020 Forecast, annual HICP inflation is projected to average 2.3% in 2020 and 1.9% in 2021.

Risks to the inflation outlook mainly stem from external developments. The main downside risk comes from a potential slower recovery in trading partners' demand. On the upside, domestic inflation pressures stemming from higher than expected wage growth could push prices up. The level of uncertainty of this inflation forecast is unusually high.

The level of consumer prices in Czechia increased to about 69% of the euro-area average in 2018, suggesting that there is still potential for further price level convergence in the long term. Since 2012, Czechia has steadily converged to the euro area average in GDP per capital in PPS, to about 86% in 2018.

3.3. PUBLIC FINANCES

3.3.1. Recent fiscal developments

Since 2016, the general government balance has been constantly in surplus, supported by a constant increase in tax revenues. In 2019, the total expenditure-to-GDP and revenue-to-GDP ratios reached 41.9% and 42.1% respectively. While the growth in revenues was marginal compared to 2018, the growth of expenditure increased more significantly. Public investment levels also grew by 4.4.% in 2019, the highest since 2016, as the current EU funds cycle is starting to close.

The 2019 general government surplus of 0.3% of GDP was in line with the target in the 2019 Convergence Programme. Similar to previous years, the surplus was supported by high growth in tax revenue on the back of a strong labour market and domestic consumption. On the back of a shrinking general balance and a positive output gap, the structural balance turned slightly negative in 2019 at -0.5% of GDP.

The general government debt further declined from 32.6% of GDP in 2018 to 30.8% of GDP in 2019, the lowest figure in the past 10 years, remaining well below the 60% threshold.

3.3.2. Medium-term prospects

The initial 2020 state budget was adopted by the Parliament in December 2019 with an envisaged headline deficit of 0.75% of GDP, similar to previous years. The budget proposed increased social expenditures, such as higher pension indexation, increased salaries for teachers and higher parental allowances, but also additional discretionary revenues such as an increase in excise duties. In order to adopt measures to contain the COVID-19 pandemic, the state budget was revised twice in March and in April 2020 and now envisages a headline deficit of 5.5% of GDP. The new measures adopted by the government to contain the crisis amount to around 4% of GDP. The most important measures foresee financial support and deferral of health and social contributions for the self-employed and a short-time subsidy working scheme for firms.

According to the Commission services' Spring 2020 Forecast, in 2020, the headline general government balance is projected to decline significantly to -6.7% of GDP, while the structural balance will reach -4.6% of GDP. The debt-to-GDP ratio is expected to increase significantly to 38.7%. This fiscal weakening is, in addition to a denominator effect, due to the combined loss in tax revenues, on the back of the economic drop, and the adopted policy measures to contain the pandemic.

According to the Commission services' Spring 2020 Forecast and based on a no-policy change scenario, the government balance is expected to improve only slightly in 2021, to -4% of GDP, while the structural balance is forecast to reach -2.9% of GDP. The debt-to-GDP ratio is expected to stabilise, reaching 39.9%.

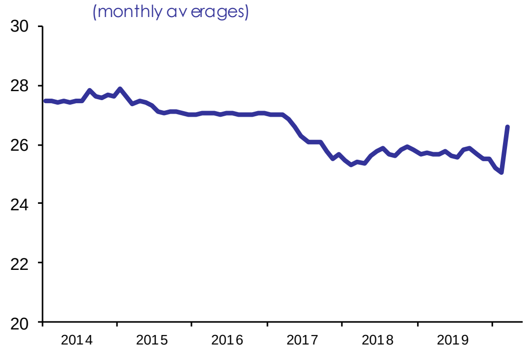
The Czech national fiscal framework is well developed, after the adoption of several legal acts in recent years. Since the appointment of its members in 2018, the Czech Fiscal Council has fulfilled its mandated tasks to assess the long-term sustainability of public finances and compliance with the national rules on budgetary responsibility. The assessment of compliance with the local government debt rule at end-2018 triggered administrative proceedings for three municipalities, which eventually took the corrective measures specified by the law on the budgetary responsibility rules within the specified timeframe. Furthermore, in all its 2019 assessments, the Committee on Budgetary Forecast confirmed the realism of the macroeconomic and budgetary forecasts. However, the assessment of budgetary forecasts only covers the revenue parameters and provides a partial picture of the underlying budgetary developments. The law on financial control in public administration amended in April 2019 entered into force on 1 January 2020, adding to the set of acts defining the Czech fiscal framework. Against the backdrop to the COVID-19 pandemic, the Parliament recently fast-tracked a legislative amendment to widen the structural deficit ceiling in 2021 from 1% to 4% of GDP and alter the adjustment path between 2022 and 2027 with an annual consolidation of at least 0.5 percentage points of GDP .

3.4. EXCHANGE RATE STABILITY

The Czech koruna does not participate in ERM II. Since the late 1990s, the ČNB has been operating an explicit inflation targeting ([21]) framework combined with a floating exchange rate regime, allowing for foreign exchange market interventions by the central bank.

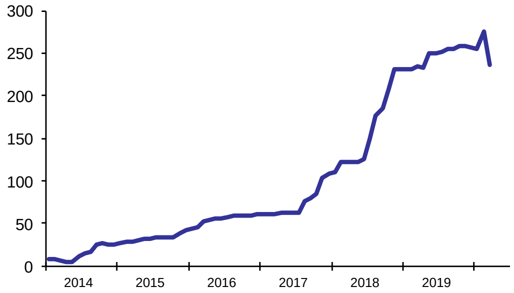
([21]) Since 2010, the inflation target is set at 2% with a tolerance band of +/- 1%.

Graph 3.4: **Czechia - CZK/EUR exchange rate**
(monthly averages)



Source: ECB.

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



Source: Eurostat and Czech National Bank.

Following the expiry of the ČNB's exchange rate commitment in April 2017, the koruna followed a gradual appreciation trend against the euro, strengthening from above 27 CZK/EUR in early April 2017 to 25.5 CZK/EUR in May 2018. It appreciated only temporarily after the CNB increased policy rates four times in the second half of 2018. Beginning 2019, it fluctuated in a relative narrow band around 25.7 CZK/EUR before slightly depreciating to 25.9 CZK/EUR in September 2019. Thereafter, the koruna appreciated steadily and reached 25.1 CZK/EUR in February. Following the lock-down measures, the koruna depreciated significantly and stood above 27 CZK/EUR at the end of March 2020.

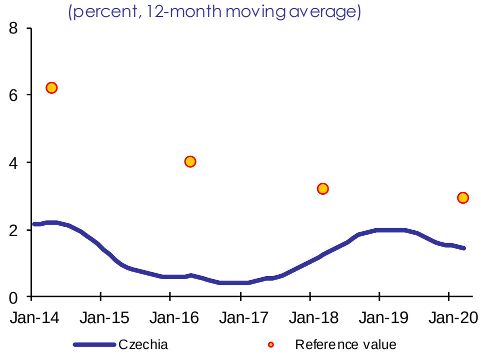
The 3-month interest rate differential vis-à-vis the euro area increased by around 120 basis points between August 2017 and May 2019, following regular policy rate hikes by 25 basis points from 0.05% in 2017 to 2% in May 2019. Afterwards, the ČNB kept its policy rates unchanged and the three-month interest rate spread relative to the euro fluctuated around 255 up to January 2020. In March 2020, the Czech 3-month rate fell in response to easing measures implemented by the ČNB, and the spread vis-à-vis the euro area reached around 240 basis points.

International reserves held by the ČNB were relatively stable and increased from EUR 121 billion beginning of 2018 (60% of GDP) to above EUR 133 billion (61% of GDP) in 2019. The level of reserve assets was mainly influenced by a rise in returns on the CNB's securities and inflows of EU funds.

3.5. LONG-TERM INTEREST RATES

Long-term interest rates in Czechia used for the convergence examination reflect secondary market yields on a basket of government bonds with the average residual maturity of close to, but below, 10 years.

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

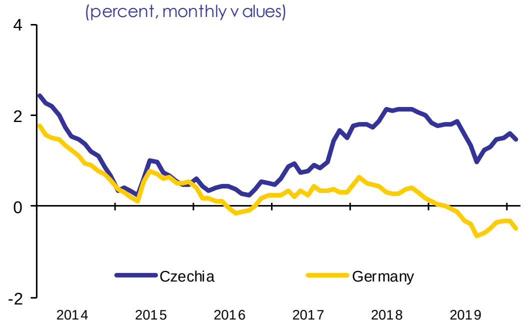


Source: Commission services.

The Czech 12-month average long-term interest rate relevant for the assessment of the Treaty criterion was well below the reference value at the time of the last convergence assessment in 2018. It followed a gradual upward trend up to December 2018 and oscillated around 2% during the first half of 2019. From June 2019, it gradually decreased to 1.5% in January. In March 2020, the reference value, given by the average of long-term interest rates in Portugal, Cyprus and Italy plus 2 percentage points, stood at 2.9%. In that month, the 12-month moving average of the yield on the Czech benchmark bond stood at 1.5%, i.e. 1.4 percentage points below the reference value.

The long-term interest rate of Czechia slowly increased to about 2.0% by end-2018 as the ČNB gradually tightened its monetary policy stance. Consequently, the spread against the German long-term benchmark bond ([22]) widened from 130 basis points in March 2018 to some 180 basis points. In 2019, the long-term interest rate stabilised around 1.8% during the first half of the year and then declined rapidly to 1% in August driven by developments abroad when the prospect of monetary easing by major central banks suppressed long-term yields. Czechia's long-term interest rate increased again and stood at 2.0% in March 2020, with a spread against the German long-term benchmark bond of around 180 basis points.

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



Source: Eurostat.

3.6. ADDITIONAL FACTORS

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

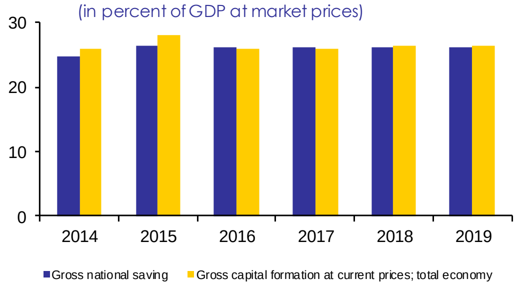
In December 2019, the Commission published its ninth Alert Mechanism Report (AMR 2020) under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.6), which highlighted issues relating to competitiveness and pressures in the housing market. However, since overall risks remained limited, no In-Depth Review (IDR) was warranted. The end of the exchange rate commitment in April 2017 led to an appreciation of the real effective exchange rate. Nominal unit labour costs have increased significantly, on the back of strong wage rises and acute labour market shortages although a deceleration is expected. At the same time, the country is exposed to risks relating to the trade policy environment and the disruption of global value chains. Real house price growth has remained high but with a deceleration in 2018 compared to 2017.

3.6.1. Developments of the balance of payments

According to balance of payments data, Czechia's external balance (i.e. the combined current and capital account) has remained in surplus until 2018. It has been declining steadily since 2016, reaching 0.7% in 2018 and turning negative, -0.1% in 2019, mainly due to a lower current account surplus. This reflected both a fall in the trade surplus in 2018 as well as a more negative income balance. The capital account balance stayed at a broadly stable level at 0.3% of GDP in both years.

According to national accounts data, the savings-investment balance has been practically negligible since 2015. This is mainly due to a strong decline in public investment in 2016 (-34%), which shrank the savings-investment gap. Savings have remained fairly stable over the reporting period, at 26.1% of GDP in 2018 and 25.7% of GDP in 2019.

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



Source: Eurostat, Commission services.

Measured by the export market share, the trade performance improved marginally in 2018. External price and cost competitiveness, as measured by ULC- and HICP-deflated real effective exchange rates, remained roughly unchanged in 2018 and 2019.

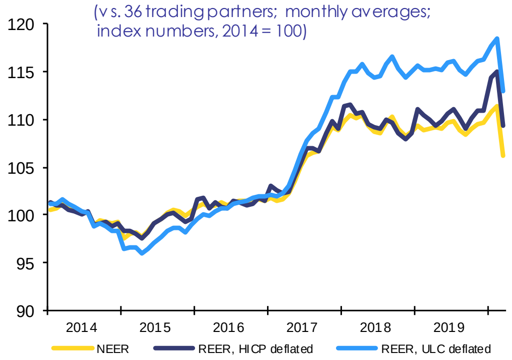
([22]) The reference to the German benchmark bond is included for illustrative purposes, as a proxy of the euro area long-term AAA yield.

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

	2014	2015	2016	2017	2018	2019
Current account	0.2	0.2	1.6	1.6	0.4	-0.4
of which: Balance of trade in goods	5.1	4.1	5.2	5.1	3.8	4.2
Balance of trade in services	1.3	1.7	2.3	2.5	2.3	1.8
Primary income balance	-6.0	-5.6	-5.3	-5.1	-4.9	-5.7
Secondary income balance	-0.2	0.0	-0.6	-0.9	-0.8	-0.7
Capital account	0.8	2.2	1.1	0.8	0.3	0.3
External balance [1]	0.9	2.4	2.7	2.4	0.7	-0.1
Financial account	1.5	3.8	2.5	2.3	1.1	0.6
of which: Direct investment	-1.9	1.1	-3.9	-0.9	-1.0	-1.1
Portfolio investment	2.1	-3.6	-3.6	-5.1	0.6	-2.1
Other investment [2]	-0.4	-1.4	-1.9	-15.7	0.6	1.8
Change in reserves	1.7	7.7	11.8	24.1	0.9	1.9
Financial account without reserves	-0.2	-3.9	-9.4	-21.7	0.2	-1.3
Errors and omissions	0.5	1.4	-0.2	-0.1	0.4	0.7
Gross capital formation	25.9	28.0	26.0	25.9	26.3	26.3
Gross saving	24.7	26.4	26.1	26.2	26.1	27.0
Gross external debt	67.8	68.5	73.4	89.1	82.7	78.3
International investment position	-36.3	-33.2	-26.9	-25.8	-24.7	-20.9

1) The combined current and capital account.
2) Including financial derivatives.
Sources: Eurostat, Commission services, Czech National Bank.

Graph 3.9: **Czechia - Effective exchange rates**
(vs. 36 trading partners; monthly averages; index numbers, 2014 = 100)



Source: Commission services.

The financial account balance of Czechia remained positive in 2018 and 2019 (0.2% and 1.4% of GDP, respectively), but decreased significantly compared to 2017 (2.3%). Although portfolio investment increased to 0.4% of GDP in 2018 (from -5.1% in 2017), it was offset by a drop in the accumulation of reserves from 24.1% of GDP in 2017 to 0.9% in 2018, following the end of the exchange rate commitment. In 2019, the accumulation of reserves increased to 1.2 % of GDP, while other investments also increased to 5.4% of GDP, leaving a more positive financial account compared to 2018.

According to the Commission services' Spring 2020 Forecast based on national accounts data, the external balance is expected to contribute negatively to GDP growth in 2020. However, as the external environment is expected to improve, the trade balance is set to increase in 2021.

3.6.2. Market integration

The Czech economy is highly integrated with the euro area through trade and investment linkages, although the related indicators decreased during the reporting period. Trade openness of Czechia remained very high at just below 90% of GDP in 2019. Its share of trade with euro area countries stood at 53% of GDP in 2019 (56% in 2018). Neighbouring euro-area countries, such as Germany, Poland and Slovakia are among its most important trade partners.

FDI inflows have grown steadily and the stock of FDI as percentage of GDP reached 64% in 2018. Belgium, Germany and the Netherlands are the biggest investor partners providing nearly two-thirds of the FDI inflows in 2019. Motor vehicle manufacturing, financial services, wholesale and retail are the main target sectors for FDI inflows. The geographical proximity to EU core markets, a relatively good infrastructure and a highly

Table 3.5:
Czechia - Market integration

	2014	2015	2016	2017	2018	2019
Trade openness 1) (%)	90.6	91.6	89.3	91.2	90.4	87.7
Trade with EA in goods & services 2)+3) (%)	55.7	56.1	55.2	56.3	55.5	53.4
Export performance (% change) 4)	4.7	1.7	0.3	0.9	0.5	-0.9
World Bank's Ease of Doing Business Index rankings 5)	33	26	27	30	35	41
WEF's Global Competitiveness Index rankings 6)	37	31	31	31	29	32
Internal Market Transposition Deficit 7) (%)	0.3	0.3	0.8	1.5	1.2	0.7
Real house price index 8)	96.3	100.0	106.6	116.3	123.5	130.9
Residential investment 9) (%)	3.4	3.6	3.7	3.9	4.0	4.2

1) (Imports + Exports of goods and services / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics, Balance of Payments).
2) (Imports + Exports of goods with EA-19 / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).
3) Trade in services with EA-19 (average credit and debit in % of GDP at current prices) (Balance of Payments).
4) Index for exports of goods and services divided by an index for growth of markets (percentage change on preceding year).
5) New methodology as of 2014 (World Bank).
6) (World Economic Forum)
7) Percentage of internal market directives not yet communicated as having been transposed, relative to the total.
(November data, as of 2016 date refers to the year of publication).
8) Deflated house price index (2015=100) (Eurostat).
9) Gross capital formation in residential buildings (in % of GDP) (Eurostat).

Sources: Eurostat, World Bank, World Economic Forum, Commission services.

educated labour force have supported the attractiveness of the country for foreign investors.

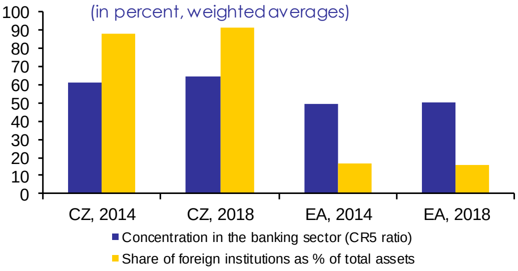
On the basis of selected indicators relating to the business environment, Czechia performs around the average of euro-area Member States. In the latest World Bank's Ease of Doing Business, Czechia lost some score points due to introducing new requirements for filing VAT control statements, which made it more difficult to do business. According to the World Bank's Worldwide Governance Indicators Czechia scores relatively poorly in terms of corruption control and government effectiveness. At the same time, Czechia's deficit in the transposition of EU internal market directives decreased to 0.7% in 2019 and equals the EU average.

The 4th Anti-Money Laundering Directive imposed transposition by 26 June 2017 and Czechia notified the Commission of the transposition measures within that deadline. However, the Commission identified a number of gaps in the transposition measures and is addressing this issue with the national authorities.

As regards the 5th Anti-Money Laundering Directive, whose transposition deadline elapsed on 10 January 2020, Czechia has notified its national transposition measures and declared a partial transposition.

The labour market performed strongly in 2018 and 2019. The unemployment rate decreased to 2.0% in 2019, the lowest in the EU. Labour shortages are pervasive in the labour market, which have hampered Czechia´s growth potential. Protection of permanent employees against collective and individual dismissals is relatively strict (as measured by the 2013 OECD employment protection indicator) whereas the duration of unemployment benefits is below the EU average. Cross-border migration flows have remained relatively subdued, although the tightening labour market has started to attract workers from both EU and non-EU countries.

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



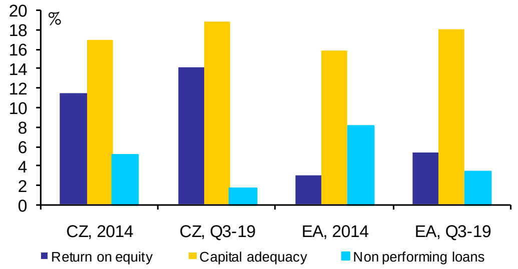
Source: ECB, Structural financial indicators.

The Czech financial sector is highly integrated into the EU financial sector. This integration is noticeable in ownership linkages of the banking system. Foreign institutions held more than 90% of banking sector's assets via their local branches and subsidiaries in 2018. Concentration in the banking sector, as measured by the market share of the largest five credit institutions in total assets, increased from 61% in 2014 to almost 65% in 2018 and thus continued to exceed the euro-area average of 51%.

The Czech banking sector is well capitalised with the average capital adequacy ratio at 19% in the third quarter of 2019, i.e. exceeding the euro-area average of about 18%. Moreover, it has performed relatively well in terms of profitability as the average annual return on equity (RoE) reached 14% in the third quarter of 2019, compared to 5.3% in the euro area. At the same time, the share of non-performing loans has been continuously declining and stood at 1.7% in the third quarter of 2019, while it was at 3.4% in the euro area. The COVID-19 pandemic could have a significant impact on the indicators analysed in this paragraph over the coming months.

The real house price index has continued the upward trend started in 2013, driven by supply constraints and strong demand. In 2019, it exceeded its 2015 level by 30%. Although increasing, household mortgage loans as a share of GDP (24%) remained below the euro-area average (38%) in 2019. The GDP share of residential investment has remained broadly stable at below 4% of GDP in recent years.

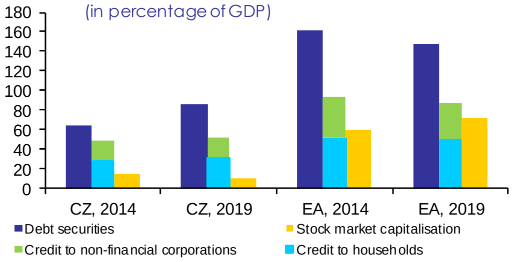
Graph 3.11: **Czechia - Selected banking sector soundness indicators**



Note: Q3-19 Return on equity is calculated over the last four quarters.
Source: ECB, IMF, EC calculations.

The financial system in Czechia is smaller relative to GDP than that of the euro area countries. In 2019, outstanding bank credit to non-financial companies and households reached 52% of GDP in Czechia, compared to almost 90% in the euro area. The valuation of quoted shares issued by Czech enterprises decreased from 15% of GDP in 2014 to 11% in 2019, while it exceeded 70% in the euro area. In 2019, the total amount of outstanding debt securities was at about 90% of GDP, i.e. far below the euro-area average of 147%. The consolidated stock of private sector debt averaged at 70% of GDP between 2017 and 2018, remaining significantly below the euro-area average of 135%.

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



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

4. CROATIA

4.1. LEGAL COMPATIBILITY

4.1.1. Introduction

The main legal rules governing the Croatian National Bank (Hrvatska narodna banka – HNB) are laid down in Article 53 of the Constitution of the Republic of Croatia ([23]) and the Act on the Croatian National Bank (the HNB Act) ([24]). The HNB Act was amended in 2013 with a view to Croatia entering the European Union on 1 July 2013. The Act provides for specific rules applying to the HNB as of EU accession of Croatia and a specific chapter for rules applying to the HNB as of the moment the euro becomes the official currency of the Republic. The Act was further amended in 2020, *inter alia* to cater for technical updates regarding the potential entry into close cooperation by Croatia with the ECB for banking supervision purposes in the context of its bid to join the Exchange Rate Mechanism II ([25]).

4.1.2. Central Bank independence

The principle of independence of the HNB is laid down in Article 53 of the Constitution and in Articles 2 (2) and 71 of the HNB Act. Article 71 of the HNB Act contains a specific reference to the principle of central bank independence as enshrined in the TFEU, stating that the HNB and members of its decision-making bodies shall be independent in achieving its objective and carrying out its tasks under the Act and relevant EU rules in accordance with Article 130 of the TFEU while adding that public authorities have to respect such independence. As regards the rules on a possible removal of the HNB Governor from office, Article 81 of the HNB Act makes a specific reference to the relevant wording of Article 14.2 of the ESCB/ECB Statute.

No incompatibilities and imperfections exist in this area.

4.1.3. Prohibition of monetary financing and privileged access

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

4.1.4. Integration in the ESCB

Objectives

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

Tasks

The provisions under chapters VIII and IX of the HNB Act define the tasks the HNB has to carry out as integral part of the European System of Central Banks pursuant to the rules of the TFEU and the ESCB/ECB Statute. No incompatibilities exist with regard to these tasks.

4.1.5. Assessment of compatibility

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

4.2. PRICE STABILITY

4.2.1. Respect of the reference value

The 12-month average inflation rate, which is used for the convergence assessment, was below the reference value at the time of the 2018 convergence assessment of Croatia. After having peaked at 1.6% in the summer of 2018, it showed a declining trend thereafter, bottoming out at 0.8% in November 2019. In March 2020, the reference value was 1.8%, calculated as the average of the 12-month average inflation rates in Portugal, Cyprus, and Italy, plus 1.5 percentage points. The corresponding inflation rate in Croatia was 0.9%, i.e. 0.9 percentage points below the reference

([23]) Constitution as amended and published in the Official Journal of the Republic of Croatia no. 56/90, 135/97, 113/2000, 123/2000, 124/2000, 28/2001, 55/2001 and 76/2010, 5/2014.

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

([25]) Official Journal of the Republic of Croatia no. 47/2020. Moreover, some technical amendments were made to further detail the euro cash rules that have been updated at EU level and the financial regime governing the HNB. The latter pertain to a mix of provisions dealing with reserve building and risk provisioning, reporting, and introduction in the HNB Act of a clear loss and profit distribution rules.

Table 4.1:
Croatia - Components of inflation

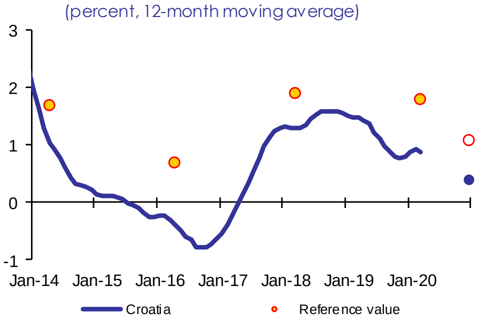
(percentage change)[1]	2014	2015	2016	2017	2018	2019	Mar-20	weights in total 2020
HICP	0.2	-0.3	-0.6	1.3	1.6	0.8	0.9	1000
Non-energy industrial goods	-1.1	0.1	0.6	0.7	0.3	-0.2	-0.2	259
Energy	0.7	-5.9	-5.7	-0.1	5.6	0.9	0.7	128
Unprocessed food	-3.6	0.8	-0.9	2.9	0.2	-4.0	-1.2	56
Processed food	0.9	0.6	0.2	2.6	1.4	2.0	1.8	219
Services	1.7	1.4	0.0	1.2	1.4	1.5	1.5	338
HICP excl. energy and unproc. food	0.6	0.8	0.2	1.4	1.1	1.1	1.0	817
HICP at constant tax rates	-0.6	-0.6	-0.8	1.2	1.5	1.4	1.5	1000
Administered prices HICP	1.7	0.4	-1.0	-0.1	1.2	1.4	1.4	120

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

Sources: Eurostat, Commission services.

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

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



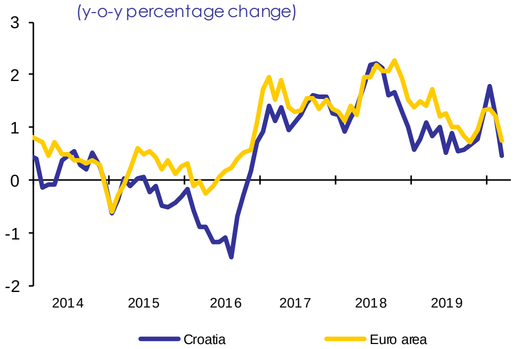
Note: The dots in December 2020 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2020 Forecast.

4.2.2. Recent inflation developments

The annual inflation rate peaked in July 2018 at 2.2% due to rising prices of energy, services and processed food. It averaged 1.6% in 2018 as it moderated in the second half of 2018 and declined further in 2019, reaching a low of 0.5% in June 2019. Average inflation stood at 0.8% in 2019. VAT reduction on selected unprocessed foods depressed HICP inflation in 2019, while energy inflation started moderating already towards the end of 2018 and remained low throughout 2019. The annual inflation rate picked up again in the last quarter of 2019. After having peaked at 1.8% in January 2020, it declined significantly due to the sharp drop in energy prices in the following two months, reaching 0.5% in March 2020.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) was stable at 1.1% on average in both 2018 and 2019. After showing a declining trend throughout 2018, processed food inflation increased moderately on average in 2019, supported by increases in the excises on alcohol and cigarettes. Services inflation remained stable while non-energy industrial goods inflation declined in 2018 and turned negative in 2019. Core inflation remained stable around 1% in the first three months of 2020.

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



Source: Eurostat.

4.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and cyclical stance

After having recorded a real GDP growth of 2.7% in 2018, Croatia experienced an increase in economic activity of 2.9% in 2019, with the volume of output reaching its pre-crisis peak. Domestic demand, in particular household consumption, was the main driver of growth in both 2018 and 2019, underpinned by rising employment and wages. Investment growth slowed in 2018, partly due to the restructuring of the Agrokor conglomerate. However, it picked up sharply in 2019 as more projects, supported by EU funds, entered implementation phase, towards the

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

	2014	2015	2016	2017	2018	2019	2020 1)	2021 1)
HICP inflation								
Croatia	0.2	-0.3	-0.6	1.3	1.6	0.8	0.4	0.9
Euro area	0.4	0.2	0.2	1.5	1.8	1.2	0.2	1.1
Private consumption deflator								
Croatia	-0.3	-0.3	-1.1	0.9	1.4	0.8	0.4	0.9
Euro area	0.5	0.3	0.4	1.3	1.4	1.2	0.3	1.2
Nominal compensation per employee								
Croatia	-5.1	0.7	0.4	0.2	2.2	3.4	-1.2	1.1
Euro area	1.4	1.3	1.2	1.7	2.2	2.1	1.1	0.4
Labour productivity								
Croatia	-2.7	1.2	3.2	0.9	0.8	1.5	-5.5	4.3
Euro area	0.8	1.0	0.5	1.0	0.4	0.1	-3.2	2.4
Nominal unit labour costs								
Croatia	-2.4	-0.5	-2.7	-0.7	1.4	1.9	4.5	-3.1
Euro area	0.6	0.5	0.7	0.7	1.8	2.1	4.3	-1.9
Imports of goods deflator								
Croatia	-0.9	-1.2	-2.5	2.6	1.1	0.2	-0.7	1.3
Euro area	-2.4	-3.3	-3.3	3.4	2.7	-0.6	-3.6	1.1

1) Commission services' Spring 2020 Forecast.

Source: Eurostat, Commission services.

end of the 2014-2020 programming period. Exports growth unexpectedly slowed in 2018 on account of smaller market share gains and uncertainties in global trade, but recovered somewhat in 2019 driven by higher exports to the EU. Due to the negative impact of the COVID-19 pandemic on the economy, real GDP is expected to contract by 9.1% in 2019 and rebound by 7.5% in 2020 according to the Commission services' Spring 2020 Forecast. Domestic demand should drive the rebound thanks to the expected fast recovery in the labour market and a strong contribution of EU funds to both private and public investment.

The fiscal stance, as measured by the change in the structural balance, turned moderately pro-cyclical in 2018-2019 partly as a result of tax cuts, but mainly due to expenditure growth, which was affected by a substantial materialisation of contingent liabilities (see Section 4.3.1). According to Commission's services' Spring Forecast, the fiscal stance is expected to be expansionary in 2020 due to the government's policy response to the COVID-19 crisis. Assuming no policy changes, the structural balance should improve significantly in 2021, implying a restrictive fiscal policy stance.

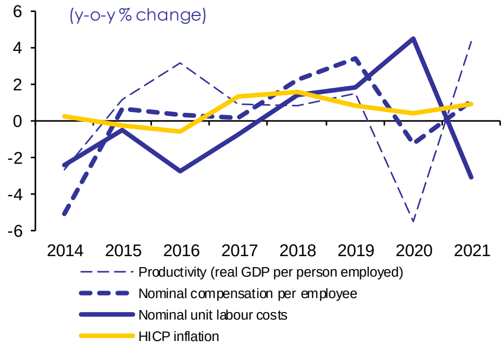
The HNB has continued to pursue accommodative monetary policy by ensuring high levels of liquidity in the banking system and simultaneously maintaining a broadly stable exchange rate of the kuna against the euro. In March 2020, the HNB undertook several measures aimed at maintaining the stability of the exchange rate and the financial sector amid the COVID-19 crisis. Notably, the HNB undertook several foreign exchange interventions to maintain the stability of the exchange rate. The HNB also conducted purchases of Croatian government bonds in the secondary market and took several measures to provide additional liquidity to the Croatian financial system.

Wages and labour costs

The labour market situation continued improving in 2018 and 2019, although both the activity and employment rates remain among the lowest in the EU. The unemployment rate dropped to 6.8% in 2019, an all-time low. Total employment has been increasing moderately but steadily in recent years, with some signs of labour market tightening in some sectors. This, coupled with wage hikes in the public sector, resulted in strong wage growth in 2018 and 2019. However, the labour market is expected to react fast to the disruption of economic activity related to the COVID-19 outbreak. Although government wage and liquidity support measures should mitigate the fall in employment in some sectors, employment is set to drop sharply in sectors that are likely to experience the longest disruption, e.g. hospitality. Employment should bottom out towards the end of the year, leaving the unemployment rate above 10% in 2020, some 3.5 percentage points above its level in 2019.

Nominal unit labour costs (ULC) growth turned positive in 2018, as nominal compensation per employee growth strengthened (based on national accounts data), while labour productivity growth stagnated. In 2019, nominal ULC growth moderated on the account of stronger productivity growth. Going forward, labour productivity growth is likely to be much more volatile than that of nominal wages, essentially reflecting the impact of the COVID-19 crisis and that of the related measures on the economic activity and wages. As a result, nominal ULC growth is expected to rise significantly in 2020 before contracting sharply in 2021.

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



Source: Eurostat, Commission services' Spring 2020 Forecast.

External factors

Import price inflation (measured by the imports of goods deflator) increased only moderately by 1.1% in 2018 and even slower by 0.2% in 2019. This mainly reflected oil price developments and the moderate appreciation of the kuna in 2018.

The exchange rate exerted a dampening impact on domestic price developments in 2018 but it remained neutral in 2019. The nominal effective exchange rate (measured against a group of 36 trading partners) appreciated by 2.5% in 2018 but remained broadly unchanged in 2019.

Administered prices and taxes

The weight of administered prices in the Croatian HICP basket amounted to 12% in 2020, in line with the euro area. In 2018, administered prices grew in line with the overall inflation. Although administered price inflation picked up only slightly in 2019, it accounted for around a quarter of the overall HICP inflation due to subdued developments in non-administered prices that year. In the first three months of 2020, administered prices grew in line with the overall inflation.

Tax changes had a strong impact on headline inflation in 2019. The VAT on fresh fruit, vegetables, meat, fish, eggs and diapers was moved from the general rate (25%) to a reduced rate of 13% as of January 2019. Excises on tobacco were raised in 2018, 2019 and again in early 2020.

Medium-term prospects

According to the Commission services' Spring 2020 Forecast, annual HICP inflation is forecast to halve to 0.4% in 2020 compared to 2019 and to remain moderate at 0.9% in 2021. Weaker demand is expected to weigh on inflation in 2020 in addition to the sharp drop in oil prices in the first months of 2020. On the other hand, dissipating effects of the VAT rate change should boost unprocessed foods inflation. Core inflation is expected to decline to 0.7% in 2020 before picking up in 2021.

Risks to the inflation outlook are broadly balanced. However, several sources of uncertainty related to the impact of the COVID-19 pandemic on the functioning of the product and services markets as well as on consumers' behaviour surround the inflation outlook.

The level of consumer prices in Croatia rose to 66% of the euro-area average in 2018. There is potential for price level convergence in the long term. Croatian GDP per capita in purchasing power standards has been increasing since 2015 and stood at 60% of the euro-area average in 2018.

Medium-term inflation prospects in Croatia will depend on wage and productivity developments as well as on global commodity price trends. These prospects will also be affected by the pace of the recovery in economic activity, following the sharp expected contraction in 2020.

4.3. PUBLIC FINANCES

4.3.1. Recent fiscal developments

After having recorded the first surplus since the EU accession in 2017 (0.8% of GDP), the

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

Outturn and forecast [1]	2014	2015	2016	2017	2018	2019	2020	2021
General government balance	-5.3	-3.3	-1.0	0.8	0.2	0.4	-7.1	-2.2
- Total revenues	43.4	45.3	46.5	46.1	46.5	47.5	46.3	47.4
- Total expenditure	48.7	48.6	47.4	45.3	46.3	47.1	53.4	49.6
of which:								
- Interest expenditure	3.4	3.4	3.1	2.7	2.3	2.2	2.3	2.3
p.m.: Tax burden	36.7	37.3	37.8	37.8	38.5	38.9	36.4	37.5
Primary balance	-1.9	0.1	2.1	3.5	2.5	2.6	-4.8	0.1
Cyclically-adjusted balance [2]	-4.0	-2.6	-1.0	0.1	-0.9	-1.2	-4.4	-1.9
One-off and temporary measures [3]	0.2	0.0	0.1	-0.1	0.0	0.0	0.0	0.0
Structural balance [2)4]	-4.2	-2.6	-1.1	0.2	-0.9	-1.2	-4.4	-1.9
Government gross debt	84.7	84.3	80.8	77.8	74.7	73.2	88.6	83.4
p.m: Real GDP growth (%)	-0.1	2.4	3.5	3.1	2.7	2.9	-9.1	7.5
p.m: Output gap [2]	-3.0	-1.6	0.1	1.5	2.5	3.7	-6.1	-0.7

1) Commission services' Spring 2020 Forecast.
2) Due to the COVID-19 pandemic, these estimates are surrounded by an unusually high level of uncertainty.
3) COVID-19-related measures were not classified as one-offs in the Commission services' Spring 2020 Forecast, due to the activation of the general escape clause of the SGP.
4) Cyclically-adjusted balance excluding one-off and other temporary measures.
Source: Commission services.

government balance remained positive also in 2018 and 2019 (0.2% and 0.4% of GDP, respectively). The recent years' surpluses were mainly the result of revenue growing more strongly than nominal GDP (most notably VAT, income taxes and contributions) in spite of tax cuts. Meanwhile, expenditure growth was overall contained, notwithstanding a substantial materialisation of contingent liabilities associated with ailing shipyards.([26]) Savings on debt servicing allowed for somewhat stronger growth in the compensation of public employees and in investment. In structural terms, the general government balance fell from a surplus of 0.2% of GDP in 2017 to a deficit of 1.2% of GDP in 2019. However, government balance surpluses and the pick-up in nominal GDP growth put the general government debt ratio on a declining path: from 77.8% of GDP in 2017 to 73.2% of GDP in 2019.

4.3.2. Medium-term prospects

The 2020 budget was adopted by the Parliament on 14 November 2019. Based on the then expected general government balance of -0.3% of GDP in 2019, the budget foresaw a surplus of 0.2% of GDP in 2020. The government's projections underpinning the 2020 budget have since become outdated because of the fundamentally changed macroeconomic outlook and sizable unanticipated fiscal measures in response to the COVID-19 pandemic. The latter most notably relate to the wage subsidy paid out to businesses for keeping workers in employment and tax cuts for the most affected companies. The government has announced that a new budget will feature a substantially more negative target.

The Commission services' Spring 2020 Forecast projects the general government balance to fall to -7.1% of GDP in 2020, driven largely by the economic slowdown resulting from the containment measures taken in the context of the COVID-19 pandemic. Assuming unchanged policies, the headline deficit should diminish to 2.2% of GDP in 2021 as revenues are expected to recover strongly on the back of the economic recovery and the base effect from 2020. Taking into account the estimated output gap, the structural balance is projected to fall significantly in 2020 before recovering towards the 2019 level in 2021. The general government debt is forecast to increase to almost 89% of GDP in 2020 before

([26]) The deterioration was mainly due to the impact of the call of the government guarantees in the Uljanik and 3. Maj shipyards.

resuming its downward trend, reaching around 83% of GDP in 2021.

The Croatian fiscal framework remains relatively weak. Following repeated delays, the new Fiscal Responsibility Act was eventually adopted by Parliament in December 2018. It aims principally at reinforcing the set-up and mandate of the Fiscal Policy Commission so as to become an independent fiscal council, as well as laying down numerical fiscal rules, including a structural budget balance rule. However, the Commission is still not operating in line with the new provisions as attempts to appoint its chair have so far been unsuccessful. In 2018, Croatia became a signatory to the TSCG, but is currently exercising its right of exemption from the TSCG's Fiscal Compact provisions. The new Budget Act, which *inter alia* should improve the medium term budgetary framework both at central and local level, is yet to be adopted.

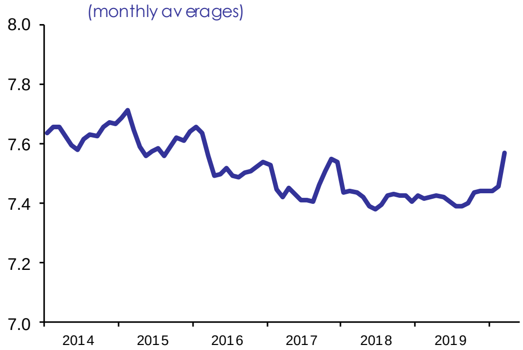
4.4. EXCHANGE RATE STABILITY

The Croatian kuna does not participate in ERM II. In July 2019, Croatia announced its intention to put in place the necessary elements for a successful entry into ERM II. In order to ensure a smooth transition to, and participation in, ERM II, Croatia committed to implement before joining the ERM II a number of measures (i.e. prior-commitments) in the following six policy areas: banking supervision, macro-prudential framework, anti-money laundering, statistics, public sector governance and business environment. Croatia is currently working towards the completion of these prior-commitments, in close liaison with the Commission and the ECB who monitor their progress.

The HNB operates a managed floating exchange rate regime, using the exchange rate against the euro as the main nominal anchor to achieve its primary objective of price stability. The HNB does not target a specific level or band for the kuna exchange rate against the euro but, through its foreign exchange transactions, it aims to prevent excessive exchange rate fluctuations. Between early 2018 and early 2020, the kuna was mostly stable against the euro, experiencing only some short-lived appreciation episodes, which necessitated foreign exchange purchases from banks by the HNB aimed at the stabilisation of its exchange rate against the euro. As the kuna exchange rate against the euro experienced some depreciation pressures in March 2020 amid the pandemic outbreak, the HNB conducted several foreign exchange interventions to maintain the stability of the exchange rate.

In recent years, the kuna's exchange against the euro has continued to exhibit a seasonal pattern of temporary appreciation in summer thanks to foreign currency inflows related to the tourism sector. While trading mostly around 7.44 HRK/EUR, it appreciated temporarily to around 7.38 HRK/EUR during the 2018 and 2019 summers. The kuna traded around 7.44 HRK/EUR in early 2020, before depreciating by some 2% in March 2020 amid the COVID-19 outbreak.

Graph 4.4: **Croatia - HRK/EUR exchange rate**
(monthly averages)



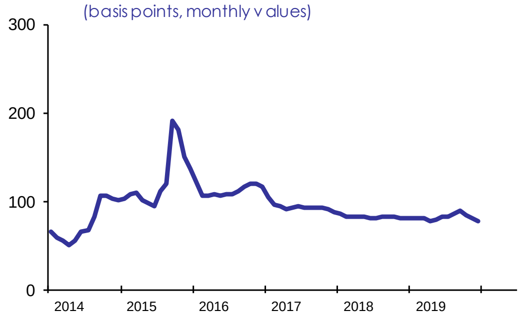
Source: ECB.

International reserves held by the HNB stood at EUR 18.5 billion (or 34% of GDP) in the last quarter of 2019. After having hovered around EUR 16.5 billion in the first three quarters of 2018, international reserves showed an upward trend thereafter, peaking at over EUR 20 billion in the third quarter of 2019, as a result of both foreign currency purchases by the HNB and increased foreign currency deposits of the government at the central bank. The NHB conducted foreign exchange interventions amounting to EUR 2.5bn in March 2020 to maintain the stability of kuna exchange rate against the euro in midst of the pandemic-induced crisis.

Given that the HNB does not frequently change interest rates on its lending and deposit facilities, the evolution of short-term rates mainly reflects changes in kuna liquidity in the banking system. The 3-month interest rate differential against the euro area was broadly flat, averaging about 80 basis points in the 2018-2019 period. The production of the ZIBOR reference rate with a maturity of three months used to measure the Croatian short-term rate was discontinued by the

NHB as of 1 January 2020. In April 2020, the HNB agreed upon establishing a precautionary currency swap line with the ECB. The currency swap line allows for the exchange of the kuna for up to EUR 2bn that could be used to provide additional euro liquidity to Croatian financial institutions without using the HNB own international reserves, if needed. The swap line will remain in place until 31 December 2020, unless it is extended.

Graph 4.5: **Croatia - 3-M Zibor(1) spread to 3-M Euribor**
(basis points, monthly values)



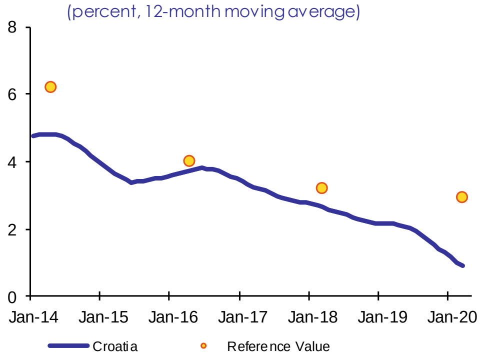
(1) The production of ZIBOR reference rate was discontinued by the national central bank as of 1 January 2020. An equivalent rate is not currently available.

Source: Eurostat and Thomson Reuters.

4.5. LONG-TERM INTEREST RATES

The long-term interest rates in Croatia used for the convergence assessment reflect the secondary market yield on a single benchmark government bond with a residual maturity of around 9 years.

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

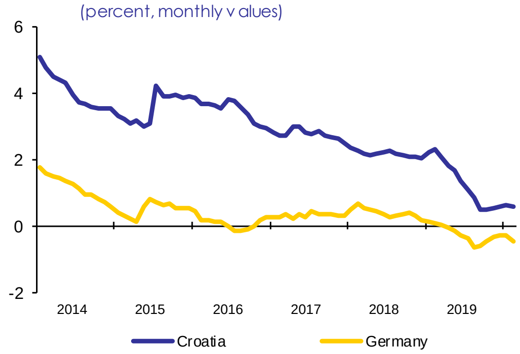


Source: Commission services.

The Croatian 12-month average long-term interest rate relevant for the assessment of the Treaty criterion was below the reference value at the time of the 2018 convergence assessment of Croatia. It was on a gradual downward trend over the last two years, declining to 2.2% at the end of 2018 and further to 1.3% at the end of 2019. In March 2020, the reference value, given by the average of long-term interest rates in Portugal, Cyprus, and Italy plus 2 percentage points, stood at 2.9%. In that month, the 12-month moving average of the yield on the Croatian benchmark bond stood at 0.9%, i.e. 2 percentage points below the reference value.

The long-term interest rate of Croatia declined gradually during 2018. It fell more sharply in the first half of 2019 dropping even slightly below 0.50% in September 2019. While the long-term interest rate had showed some stabilisation around 0.50% thereafter, it rose sharply to close to 1% in March 2020 amid the COVID-19 crisis. In order to maintain the stability of the Croatian government bond market, the HNB conducted in March 2020 purchases of Croatian government bonds in the secondary markets and accepted pension and investment funds as well as insurance companies as counterparties in its operations. The spread to the German long-term benchmark bond also widened sharply to close to 150 basis points in March 2020 after having fallen to below 100 basis points by the end of 2019, as the Croatian sovereign debt rating was raised to investment grade.

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



Source: Eurostat.

4.6. ADDITIONAL FACTORS

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

In December 2019, the Commission published its ninth Alert Mechanism Report (AMR 2020) under

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

	2014	2015	2016	2017	2018	2019
Current account	0.2	3.2	2.1	3.4	1.9	2.5
of which: Balance of trade in goods	-15.3	-16.0	-16.3	-17.2	-18.7	-19.1
Balance of trade in services	14.9	16.2	17.5	17.9	17.8	18.6
Primary income balance	-2.0	-0.6	-3.0	-1.5	-1.5	-1.5
Secondary income balance	2.6	3.6	3.9	4.2	4.2	4.5
Capital account	0.4	0.8	1.5	1.1	1.4	2.0
External balance [1)]	0.7	4.0	3.6	4.5	3.3	4.5
Financial account	1.8	4.0	3.2	4.8	3.6	4.5
of which: Direct investment	-1.6	-0.5	-4.3	-2.3	-1.4	-1.6
Portfolio investment	1.6	-0.3	2.9	0.8	1.7	1.0
Other investment [2)]	3.0	3.2	5.1	1.1	0.3	3.3
Change in reserves	-1.2	1.7	-0.6	5.3	3.0	1.8
Financial account without reserves	3.0	2.3	3.8	-0.5	0.6	2.7
Errors and omissions	1.1	0.0	-0.4	0.3	0.3	0.0
Gross capital formation	19.1	20.6	21.0	21.8	23.2	22.8
Gross saving	19.4	23.8	23.1	25.1	25.1	25.2
Gross external debt	113.2	108.0	95.9	89.8	82.8	75.8
International investment position	-86.5	-78.1	-72.2	-65.8	-57.9	-50.9

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

Sources: Eurostat, Commission services, Croatian National Bank.

the Macroeconomic Imbalance Procedure (MIP - see also Box 1.6), which concluded that an In-Depth Review (IDR) was warranted for Croatia. In February 2020, the Commission published its annual country report on Croatia([27]), including an In-Depth Review (IDR). This report led to the conclusion that Croatia continues to experience macroeconomic imbalances. Remaining vulnerabilities are linked in particular to high levels of public, private and external debt in a context of low potential growth. Stock imbalances have been narrowing over the past years, driven by resuming growth and a prudent fiscal policy. The negative net international investment position remains large, but continues improving, driven by GDP growth and the positive, albeit weakening, current account balance. Household and corporate debt decreased significantly over the last few years. However, debt remains relatively high and the pace of household debt reduction has been slowing. As a result of prudent fiscal policy in recent years, public debt is decreasing from a high level. Policy implementation has been uneven. Reforms in the education system and the business environment are progressing, with more action needed to reform the public administration and improve governance of state-owned enterprises. Key aspects of the recent pension reform aimed at lengthening working lives have been reversed.

4.6.1. Developments of the balance of payments

After having stood at 1.9% of GDP in 2018, the current account surplus increased to 2.5% of GDP in 2019. The trade balance worsened markedly in 2018 on the account of a significant slowdown in the growth of goods exports. The capital account balance improved in both 2018 and 2019 on the account of the higher uptake of EU funds. As a result, Croatia's external surplus (i.e. the combined current and capital account) increased to 4.5% of GDP in 2019 from 3.3% of GDP in 2018.

Positive external balances still reflect the continued deleveraging by the government and the corporate sector. While lending slowly picked up, especially to households, investment activity remained subdued, at more than 12% below its pre-crisis peak in real terms.

In 2018, exports growth slowed markedly after several years of strong growth following Croatia's

([27]) European Commission (2020), Country Report Croatia 2020, Commission Staff Working Document (2020) 510 final, 26.02.2020, Brussels.

Table 4.5:
Croatia - Market integration

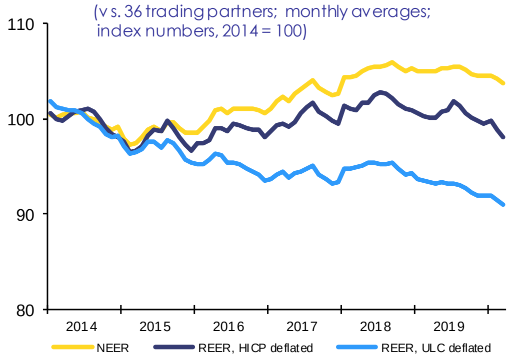
	2014	2015	2016	2017	2018	2019
Trade openness [1] (%)	46.0	49.3	51.0	54.2	55.4	56.1
Trade with EA in goods & services [2)+3)] (%)	26.1	28.3	28.9	30.0	31.0	31.7
Export performance (% change) [4]	2.9	5.4	3.0	0.6	-0.3	1.5
World Bank's Ease of Doing Business Index rankings [5]	39	39	43	51	58	51
WEF's Global Competitiveness Index rankings [6]	77	77	74	74	68	63
Internal Market Transposition Deficit [7] (%)	0.6	0.1	0.3	2.2	1.3	0.3
Real house price index [8]	102.7	100.0	102.0	105.0	109.8	118.7
Residential investment [9] (%)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

1) (Imports + Exports of goods and services / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics, Balance of Payments). Due to lack of servic
2) (Imports + Exports of goods with EA-19 / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).
3) Trade in services with EA-19 (average credit and debit in % of GDP at current prices) (Balance of Payments).
4) Index for exports of goods and services divided by an index for growth of markets (percentage change on preceding year).
5) New methodology as of 2014 (World Bank).
6) (World Economic Forum)
7) Percentage of internal market directives not yet communicated as having been transposed, relative to the total.
(November data, as of 2016 date refers to the year of publication).
8) Deflated house price index (2015=100) (Eurostat).
9) Gross capital formation in residential buildings (in % of GDP) (Eurostat).

Sources: Eurostat, World Bank, World Economic Forum, Commission services.

EU accession. The slowdown was particularly pronounced for the extra EU exports, reflecting uncertainties surrounding global trade, while intra EU exports remained strong. Exports recovered somewhat in 2019 as gains in export market shares resumed.

Graph 4.8: **Croatia - Effective exchange rates**
(vs. 36 trading partners; monthly averages; index numbers, 2014 = 100)



Source: Commission services.

Based on national accounts, external cost competitiveness, as measured by the ULC-deflated real effective exchange rate, has improved somewhat since 2017. On the other hand, the HICP-based REER indicates a slight deterioration in external price competitiveness since 2017 due to the NEER appreciation.

The financial account continued to display positive balances in 2018 and 2019. This reflected the positive net contribution of portfolio investments in 2018 and as well as other investment flows in both years. At the same time, net foreign liabilities stemming from foreign direct investment in Croatia continued to increase although at a slower pace than in previous two years. The international reserves held by the HNB increased markedly in both 2018 and 2019. The net international investment position (NIIP) thus improved substantially from about -65.8% of GDP in 2017 to -50.7% of GDP at the end of 2019 while gross external debt declined to 75.8% of GDP from 89.8% of GDP in 2017.

According to the Commission services' Spring 2020 Forecast, the current account balance is expected to deteriorate to -1.7% of GDP in 2020 amid a strong expected contraction in exports of services. A small surplus is expected in 2021 as economic activity normalises.

4.6.2. Market integration

The Croatian economy is well integrated with the euro area through trade and investment linkages. Its degree of trade openness increased gradually in recent years and stood at 56.1% of GDP in 2019 but it still remained relatively low given the small size of the Croatian economy. The trade with the euro area amounted to 22.3% of GDP in 2019 and trade with Germany, Italy, Slovenia and Austria as Croatia's largest trade partners constituted over half of its total trade.

FDI has so far been mainly directed into the banking, real estate and retail sectors, with the largest inflows originating from Austria, the Netherlands and Hungary. On the other hand, Croatia failed to attract significant FDI inflows into the tradable goods sector and it is thus weakly integrated into global supply chains. The unfavourable business environment appears to be the main obstacle to attracting more FDI.

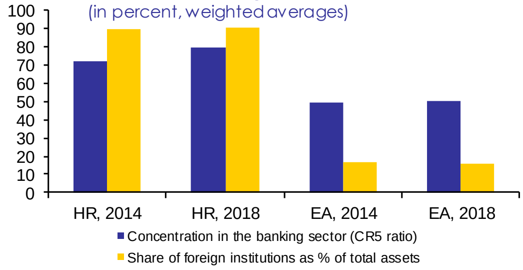
With regard to the business environment, Croatia performs worse than many euro-area Member States according to several commonly used indicators (e.g. the World Bank's Ease of Doing Business Index or the World Economic Forum's Global Competitiveness Index). In the World Bank's Ease of Doing Business, Croatia's worst rankings concern dealing with construction permits and starting a business. According to the World Bank's Worldwide Governance Indicators, Croatia performs relatively poorly in terms of rule of law and control of corruption. On the other hand, Croatia stepped up its transposition of EU internal market directives. The transposition gap decreased from 2.2% in 2017 to 0.3% in 2019. In addition, there has been renewed effort to improve the business environment, in particular to reduce the administrative burden and regulatory restrictions.

The 4th Anti-Money Laundering Directive imposed transposition by 26 June 2017 and during 2017-18 Croatia has communicated to the Commission the adoption of several transposition measures, which ensure a complete transposition of the Directive. The Commission is completing its analysis of whether the notified measures are in conformity with the Directive As regards the 5th Anti-Money Laundering Directive, whose transposition deadline elapsed on 10 January 2020, Croatia has officially notified its national transposition measures and declared a partial transposition. As a part of the prior-commitments made before joining the ERMII, Croatia is expected to fully transpose and implement the 5th Anti-Money Laundering Directive.

Activity and employment rates remain persistently low compared to the euro-area average. This is partly related to early retirement schemes and pension eligibility criteria. A pension reform package was adopted in 2018, however key elements of the reform aimed at lengthening working lives were reversed in the autumn of 2019. After the relaxation in employment protection legislation in 2013-14 resulted in a significant increase in the use of temporary contracts, the share of temporary employees has been decreasing since 2017, in the context of an overall improvement on the labour market conditions. After attaining a peak of 11% in 2013, the long-term unemployment rate has been steadily decreasing and it stood at 3.4% in 2018 (below the euro-area average of 3.8%) and at 2.4% in 2019. Still, non-harmonised wage setting frameworks in the public sector hamper the government's control over the public wage bill and may weigh on wage responsiveness in the economy.

The financial sector in Croatia is highly integrated into the EU financial sector, in particular through foreign ownership of the banking sector, as around 90% of its assets are held by subsidiaries of foreign banks. Concentration in its banking sector is high, with the largest five banking institutions accounting for close to 80% of sector's total assets, compared to 50% in the euro-area.

Graph 4.9: **Croatia - Foreign ownership and concentration in the banking sector**
(in percent, weighted averages)

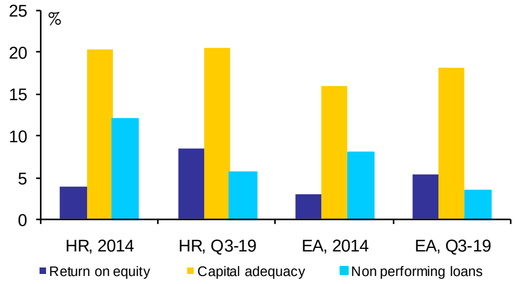


Source: ECB, Structural financial indicators and HNB Banks Bulletin.

The banking system in Croatia remains well capitalized, with the average capital adequacy ratio exceeding 20% in the third quarter of 2019, which was more than 2 percentage points above that of the euro-area banking sector. While the quality of the loan portfolio improved, with the ratio of non-performing loans (NPLs) declining to 5.6% in the third quarter of 2019, this remains still well above the NPL ratio recorded in the euro area 3.4%. At the same time, the profitability of the Croatian banking sector has improved substantially on account of larger non-interest rate income and lower expenses in impairments and provisions over the last two years, with the average annual return on equity (RoE) standing at 8.6% in the third quarter of 2019. This is well above the profitability of the euro area banking system, which stood on average at 5.3%. The COVID-19 pandemic could have a significant impact on the indicators analysed in this paragraph over the coming months.

The real house prices showed a rapid increase in 2018-2019. The real house price index rose to close to 110% of its 2015 level in 2018 and increased further to 118.7% in 2019. Over the same period, lending to households also picked up, with general-purpose loans increasing more substantially. Lending for house purchases was supported by government subsidies for first-time homeowners.

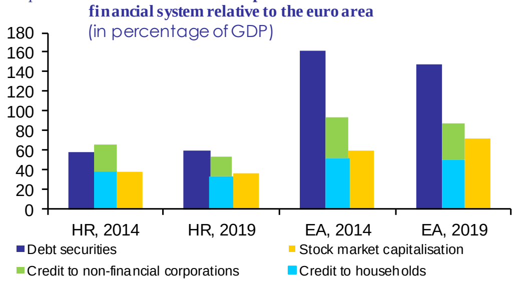
Graph 4.10: **Croatia - Selected banking sector soundness indicators**



Note: Q3-19 Return on equity is calculated over the last four quarters.
Source: ECB, EC calculations.

The financial system in Croatia is smaller relative to GDP than that of the euro area. In 2019, outstanding bank credit to Croatian non-financial corporations and households amounted to about 54% of GDP, compared to 87% in the euro area. The majority of bank loans is denominated in euro but lending to households in kuna has followed an upward trend since 2013. The valuation of quoted shares issued by Croatian enterprises amounted to 37% of GDP while this was close to 60% in the euro area. The debt securities market was largely dominated by government securities and corresponded to 60% of GDP, thus remaining far less developed that the euro-area market encompassing debt securities in the nominal value of 148% of GDP. The consolidated stock of private sector debt fell below 100% of GDP in 2017 and declined further to 94% in 2018, which was well below the euro-area average of 135%.

Graph 4.11: **Croatia - Recent development of the financial system relative to the euro area**
(in percentage of GDP)



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

5. HUNGARY

5.1. LEGAL COMPATIBILITY

5.1.1. Introduction

The main rules governing the Magyar Nemzeti Bank (MNB – Hungarian national bank, hereafter MNB) are laid down in Article 41 of the new Hungarian Fundamental Law and Act CXXXIX 2013 on the MNB (hereafter: MNB Act). The MNB Act has been subject to frequent changes including some recasts over past years. The currently applicable MNB Act took effect on 1 October 2013, providing for the MNB to become responsible for macro-prudential policy and, further to the dissolution of the Hungarian Financial Supervisory Authority, for micro-prudential supervision of the Hungarian financial sector. After this the MNB Act was amended at several occasions ([28]), including some amendments since the most recent convergence assessment of 2018 ([29]). None of these amendments are remedying the incompatibilities and imperfections referred to in the Commission's 2018 Convergence Report.

5.1.2. Central Bank independence

Frequent amendments to the Central Bank Act of a Member State can create instability in the Central Bank's operations. Therefore, a stable legal framework that provides a solid basis for a Central Bank to function is essential for ensuring central bank independence. Pursuant to Article 176 of the MNB Act, the MNB has become the legal successor of the liabilities of the former Hungarian Financial Supervisory Authority (HFSA), which ceased to exist on 1 October 2013. This legal succession also implies the transfer of all employees from the HFSA to the MNB pursuant to Article 183 of the MNB Act. The principle of central bank independence pursuant to Article 130 of the TFEU implies that the MNB must have sufficient financial resources to perform its ESCB and ECB-related tasks, in addition to its national tasks. The tasks transferred from the HFSA to the MNB must not affect its ability to carry out these tasks from an operational and financial point of view.

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

According to Article 9(7) of the MNB Act, the Governor and the Deputy Governors shall take an oath before the President of the Republic and other members of the Monetary Council before the Parliament upon taking office with the words required by Law XXVII of 2008 as amended on the oath and solemn promise of certain public officials. The Law requires making an oath with words "I, (name of the person taking the oath), hereby make an oath to be faithful to Hungary and to its Fundamental Law, to comply with its laws, and make sure others citizens comply with them too; I will fulfil the duties arising from my position as a (name of the position) for the benefit of the Hungarian nation […]". The oath does not contain a reference to the principle of central bank independence enshrined in Article 130 TFEU. What is more, the Fundamental Law contains only an indirect reference to EU law. Since the Governor and the Deputy Governors as members of the Monetary Council are involved in the

([28]) The changes relate inter alia to the MNB's resolution powers, the legal framework regarding the Financial Stability Board and financial stability measures, rules regarding the distribution and reproduction of forint and euro coins and forint and euro medals, the possibility to provide emergency liquidity assistance to the Investor Protection Fund, payment transactions, the promotion of the development and security of the financial intermediary system, out-of-court dispute settlement for financial disputes. In addition, they also relate to the implementation of EU financial legislation when carrying out supervisory tasks, the publication of certain information by the MNB, the provisions on proceedings of the MNB and the information requirements of the MNB towards the European Supervisory Authorities.

([29]) The amendments pertain inter alia to the functioning, tasks and powers of the Financial Stability Board (the body of the MNB in charge of macro-prudential policy); the expiry of the mandate of the Supervisory Board (the MNB's oversight body); procedural and data access rules in the context of criminal proceedings regarding banknotes, amendments due to EU harmonisation measures as well as technical amendments related to the reform system of the administrative jurisdiction.

performance of ESCB related tasks, any oath should make a clear reference to the central bank independence under Article 130 of the TFEU. Therefore, the oath is an imperfection as regards the institutional independence of the MNB and the wording of the oath should be adapted to be fully in line with Article 130 of the TFEU.

Article 153(6) of the MNB Act provides for the possibility for members of the Monetary Council (including the Governor) and MNB employees to take on roles in the management, boards of trustees or supervisory boards of foundations and business associations under majority ownership of the MNB established by the MNB under Article 162(2) of the MNB Act without being subject to the conflict of interest rules provided for in Article 152(1) to (5) of the MNB Act, including any formal disclosure requirement. Hence, for those activities the MNB officials involved, including the Governor, are fully shielded from any scrutiny. Moreover, Article 153(6) of the MNB Act also provides for an explicit exemption to the rule of Article 156(1) of the MNB Act, which determines that members of the Monetary Council (including the Governor) may only perform other activities, which are compatible with their central bank decision-making duties. Hence, under national law such members may undertake activities in the MNB's foundations and business associations that are incompatible with their central bank decision-making duties. The provision conflicts with Article 162(2) of the MNB Act, which provides that the MNB may only establish foundations and business associations in line with its tasks and primary objective of ensuring price stability. Moreover, central bank decision-making duties always have to be performed in compliance with Article 130 of the TFEU. The exemption therefore seems to imply that the latter principles of primary Union law may be disregarded by members of the Monetary Council when acting in the context of the foundations and business associations under MNB ownership. Therefore, the incompatibility needs to be removed.

In addition, Article 156(7) read in conjunction with Article 152(1) of the MNB Act, extends the application of conflict of interests provisions to Monetary Council members to six months following termination of their employment relationship with the MNB. However, an exemption is granted as regards organisations covered by acts enumerated in Article 39 in which the Hungarian State or the MNB has a majority stake. Such an exemption could create situations where the privileged position of Monetary Council members could give them an unfair advantage in obtaining nominations or posts in other organisations, putting them in a position of conflict of interest while still in employment at the MNB.

Moreover, Article 157 of the MNB Act provides for an obligation for members of the Monetary Council, including the Governor and the Deputy Governors, to file declarations of wealth in the same manner as Members of Parliament, pursuant to the provisions of Article 90 of the Law XXXVI of 2012 on the Parliament. According to Article 157(1) of the MNB Act and Article 90(2) of the Law XXXVI of 2012, the obligation to submit a wealth declaration extends to close family members (spouse, domestic partner, and children). Pursuant to Article 90(3) of the Law XXXVI of 2012, members of the Monetary Council who fail to submit a wealth declaration will not be allowed to exercise their functions and will receive no remuneration until compliance with the obligation. This provision allows for the temporary removal from office of inter alia the Governor which seems to automatically fall into place once the failure to submit a wealth declaration as required by the above provisions is established by the Parliament. Such an automatism may lead to situations where the removal from office would result from an unintentional action that could not be qualified as a serious misconduct under Article 14.2 of the ESCB/ECB Statute. In order to preserve fully the principle of central bank independence, this incompatibility should be removed by an amendment of Article 157 of the MNB Act, which would provide for an exception for such kind of unintentional omission.

5.1.3. Prohibition of monetary financing and privileged access

Pursuant to Article 36 of the MNB Act and subject to the prohibition of monetary financing set out under Article 146 of the MNB Act, the MNB can provide an emergency loan to credit institutions in the event of any circumstance arising in which the operation of a credit institution jeopardizes the stability of the financial system. In order to comply with the prohibition on monetary 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 37 the MNB may grant loans to the National Deposit Insurance Fund and Investor Protection Fund in emergency cases, subject to prohibition of monetary financing under Article 146 of the Act. Though the Act adequately reflects conditions for central bank financing provided to a deposit guarantee scheme a specific requirement should be included to ensure that the loans granted to the National Deposit Insurance Fund are provided against adequate collateral (e.g. a claim on future cash contributions, government securities, etc.) to secure the repayment of the loan. Therefore, Article 37 is incompatible with the prohibition on monetary financing as laid down in Article 123 of the TFEU.

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

Article 162(3) and (4) of the MNB Act lay down the conditions of disclosure of data by a company related to the MNB ([30]) ([31]). Furthermore, Article 162(5) provides for supervision of the State Audit Office of the operations of foundations established by the MNB. Notwithstanding the limitations regarding access to data of MNB companies, it is noted that pursuant to the principle of sincere cooperation (Article 4 TEU) a Member State is required, in full mutual respect, to assist the Commission and the European Central Bank in carrying out tasks which flow from the Treaties, such as providing the information necessary for monitoring the application of EU law.

Pursuant to Article 162(2) of the MNB Act, the MNB may establish business associations under majority of MNB ownership, or foundations. In order to dispel any concerns from the perspective of Article 123 of the TFEU, the provision should be amended by providing for a clear framework delimiting the operations of such foundations and the volumes or resources which the MNB could endow them with, enabling them to purchase large volumes of Hungarian government securities ([32]). Moreover, the exemption provided under Article 153(6) of the MNB Act to the rule of Article 156(1) of the MNB Act which determines that members of the Monetary Council (including the Governor) may only perform other activities which are compatible with their central bank decision-making duties is incompatible with Article 123 of the TFEU. The exemption provided for in national law seems to imply that the prohibition of monetary financing enshrined in Article 123 of the TFEU may be disregarded by members of the Monetary Council (including the Governor) when acting in the context of the foundations and

([30]) Data relating to any task of the MNB and processed by company mostly or entirely owned by the MNB shall not be public until published by the company, but at most ten years from the time it was generated, if such disclosure would compromise the central economic or monetary policy. Furthermore, data relating to business activities and processed by companies mostly or entirely owned by the MNB or a company directly or indirectly managed by such a company shall not be disclosed if it would cause disproportionate harm to the company's business activity. Disproportionate harm is defined as providing an undue advantage to any competitor of such MNB company.

([31]) Article 162(3) and (4) of the MNB Act were adopted in order to remedy a law which was previously found unconstitutional by the Hungarian Constitutional Court (Decision Hungarian Constitutional Court – No 8/2016 of 31 March 2016). The original amendment to the MNB Act which was found unconstitutional inter alia provided that regarding foundations established by the MNB only data relating to the founder including the charter as well as information regarding the financial contribution required for the foundation’s purpose as set out in the charter, should be public; any other data managed by the foundation should be accessible exclusively in accordance with the law on civil associations instead of laws on access to information of public interest.

([32]) In line with their articles of association the MNB foundations have to invest their endowment in low-risk securities such as government bonds and Treasury bills, property, art, and cash and then use the proceeds from those investments to fund themselves and provide financing for achieving their goals.

business associations under MNB ownership. This incompatibility needs to be removed.

5.1.4. Integration in the ESCB

Objectives

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

Tasks

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

- definition of monetary policy and the monetary functions, operations and instruments of the ESCB (Articles 1 (2), 4(1), 9, 16 – 21, 159 and 171 of the MNB Act);
- conduct of foreign exchange operations (Articles 1(2), 4(3), (4) and (12), 9 and 159(2) of the MNB Act) and the definition of foreign exchange policy (Articles 1(2), 4(4) and (12), 9, 22 and 147 of the MNB Act);
- competences of the ECB and of the Council for banknotes and coins (Article K of the Fundamental Law and Articles 1(2), 4(2) and (12), 9, 23, 26 and 171(1) of the MNB Act).

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

- non-accurate reflection of the principle of central bank independence in the MNB Act (Article 1(2) and (3) of the MNB Act);
- non-recognition of the role of the ECB in the functioning of the payment systems (Articles 1(2), 4(5) and (12), 9, 27-28, and 159(2), 171 (2) of the MNB Act);
- non-recognition of the role of the ECB and of the EU in the collection of statistics (Article 1(2), 30(1) and 171(1) of the MNB Act);
- non-recognition of the role of the ECB in the field of international cooperation (Article 135(5) of the MNB Act));
- absence of an obligation to comply with the Eurosystem's regime for the financial reporting of NCB operations (Article 12(4)(b) and Law C of 2000/95 (IX.21.) in conjunction with Government Decree 221/2000 (XII.19.));
- non-recognition of the role of the ECB and the Council in the appointment of external auditors (Articles 6(1) (b), 15 and 144 of the MNB Act).

5.1.5. Assessment of compatibility

As regards central bank independence of the MNB, the prohibition on monetary financing and the integration of the MNB into the ESCB at the time of euro adoption, existing Hungarian legislation is not fully compatible with the Treaties and the Statute of the ESCB and the ECB pursuant to Article 131 of the TFEU. The Hungarian authorities are invited to remedy the abovementioned incompatibilities. Finally, it is understood that the Hungarian authorities have enacted an Emergency Act to deal with the state of danger due to the COVID-19 outbreak ([33]). It enables the Government to suspend by decree the application of Acts, derogate from the provisions of Acts and take other extraordinary measures inter alia to guarantee the stability of the economy. In the absence of an exception applicable to the MNB Act, Government decrees under the Emergency Act could have a bearing on the MNB Act or on the functioning of the MNB. In such a context, the principle of independence and the prohibitions of monetary financing and privileged access deriving from EU law should be fully respected.

5.2. PRICE STABILITY

5.2.1. Respect of the reference value

The 12-month average inflation rate, which is used for the convergence assessment, was above the reference value at the time of the last convergence assessment of Hungary in 2018. It increased further to 3.5% by June 2019 and stayed close to that level in the rest of 2019. In March 2020, the

([33]) Act XII of 2020 on the containment of coronavirus SG No. 58/2020 30 March 2020.

Table 5.1:
Hungary - Components of inflation

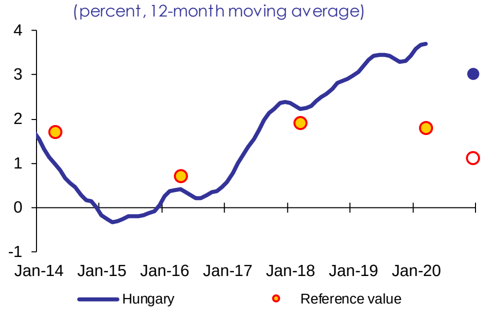
	2014	2015	2016	2017	2018	2019	Mar-20	weights in total 2020
					(percentage change)[1]			
HICP	0.0	0.1	0.4	2.4	2.9	3.4	3.7	1000
Non-energy industrial goods	0.0	0.8	1.0	0.4	0.4	1.1	1.0	231
Energy	-6.6	-7.4	-3.7	4.2	4.8	0.5	1.3	123
Unprocessed food	-1.9	3.6	0.0	1.4	6.4	7.0	9.0	56
Processed food	2.4	0.5	1.0	4.0	4.1	5.7	5.8	241
Services	2.3	2.2	1.8	1.9	2.4	4.0	4.2	348
HICP excl. energy and unproc. food	1.6	1.3	1.4	2.1	2.3	3.7	3.8	820
HICP at constant tax rates	0.0	0.0	0.6	2.9	3.4	3.2	3.6	1000
Administered prices HICP	-6.6	-0.8	0.3	0.6	0.3	1.0	0.9	140

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

Sources: Eurostat, Commission services.

reference value was 1.8%, calculated as the average of the 12-month average inflation rates in Portugal, Cyprus and Italy plus 1.5 percentage points. The corresponding inflation rate in Hungary was 3.7%, i.e. 1.9 percentage points above the reference value. The 12-month average inflation rate is projected to remain well above the reference value in the months ahead.

Graph 5.1: **Hungary - Inflation criterion**
(percent, 12-month moving average)

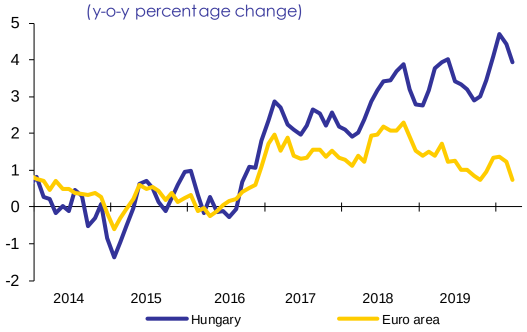


Note: The dots in December 2020 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2020 Forecast.

5.2.2. Recent inflation developments

Over the last two years, HICP inflation was on an upward path in Hungary, with unprocessed food and energy prices adding volatility to the headline figure. Annual HICP inflation rose to 2.9% in 2018 and further to 3.4% in 2019, on the back of broad-based price increases, reflecting strong demand growth and rapidly rising unit labour cost. Value added tax cuts for selected food and services items reduced inflation in 2018, but rising excise duties on tobacco added to inflation in 2019. Inflation peaked at 4.7% in January 2020, due to a rapid increase of unprocessed food and energy prices. It decreased to 3.9% in March 2020, thanks to the falling price of fuels. During the last two years, annual HICP inflation in Hungary was higher than in the euro area, with an increasing gap.

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



Source: Eurostat.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) rose from 2.3% in May 2018 to 3.9% in March 2019 and stabilized around that level thereafter, reaching 4.0% in March 2020. Non-core items had mixed effects on HICP inflation over the past two years. Energy price inflation was volatile and moderated from 2018 to 2019, in line with global oil prices. Unprocessed food inflation was also volatile and it increased markedly in late-2019, partly due to the African swine flu epidemic. Processed food inflation surpassed headline inflation from late-2018, but it then stabilized at around 6%. Non-energy industrial goods inflation has remained modest. Services inflation gradually increased from 2.4% in May 2018 to 4.4% by early 2020, partly reflecting the tightening labour market. Domestic producer price inflation rose in early 2020 for industries producing consumption and investment goods, reflecting strong underlying demand before COVID-19 hit the economy.

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

	2014	2015	2016	2017	2018	2019	2020 1)	2021 1)
HICP inflation								
Hungary	0.0	0.1	0.4	2.4	2.9	3.4	3.0	2.7
Euro area	0.4	0.2	0.2	1.5	1.8	1.2	0.2	1.1
Private consumption deflator								
Hungary	1.1	-0.1	0.2	2.7	3.1	3.6	3.0	2.7
Euro area	0.5	0.3	0.4	1.3	1.4	1.2	0.3	1.2
Nominal compensation per employee								
Hungary	0.6	2.0	2.4	7.0	6.2	9.4	5.0	4.4
Euro area	1.4	1.3	1.2	1.7	2.2	2.1	1.1	0.4
Labour productivity								
Hungary	-0.4	1.6	-1.5	2.4	2.7	3.2	-3.4	4.8
Euro area	0.8	1.0	0.5	1.0	0.4	0.1	-3.2	2.4
Nominal unit labour costs								
Hungary	1.0	0.4	4.0	4.5	3.4	6.0	8.6	-0.4
Euro area	0.6	0.5	0.7	0.7	1.8	2.1	4.3	-1.9
Imports of goods deflator								
Hungary	0.1	-1.1	-2.5	1.9	4.0	1.1	2.8	2.5
Euro area	-2.4	-3.3	-3.3	3.4	2.7	-0.6	-3.6	1.1

1) Commission services' Spring 2020 Forecast.

Source: Eurostat, Commission services.

5.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and cyclical stance

Hungary's real GDP increased rapidly in recent years. Economic growth peaked at 5.0% in 2018 and remained at 4.9% in 2019. While the external environment became less supportive, domestic policies remained accommodative. Private consumption was boosted by rapid wage rises and continued employment growth. The share of gross fixed capital formation in GDP reached a record level by 2019. Public investment rose due to the rising absorption of EU funds and higher investment activity around the 2018-2019 elections. Business investment was spurred by favourable demand, low financing costs and the recovery of the commercial real estate sector.

The COVID-19 pandemic is expected to result in a deep recession, followed by a gradual recovery. Although the sanitary measures implemented by Hungary are less restrictive to business activity in international comparison, exports are strongly exposed to the global downturn due to the strong integration of Hungarian exporters in global value chains, and their specialisation in cyclical industries (e.g. automotive) and tourism and transport services. Furthermore, fiscal policy has so far provided limited cushion against the downturn. According to the Commission services' Spring 2020 Forecast, GDP is projected to decrease by 7% in 2020 and recover by 6% in 2021. The positive output gap widened further, to 4.1% by 2019. However, it is estimated to turn negative in 2020-2021 as a result of the large recession.

The fiscal stance, as measured by the change in the structural balance was neutral in 2018 and slightly expansionary in 2019. According to the Commission services' Spring 2020 Forecast, which is based on a no-policy change assumption, the fiscal stance is expected to be restrictive in 2020 and expansionary in 2021.

Monetary policy, conducted within an inflation targeting framework ([34]), has remained loose. The MNB has kept its policy rate unchanged at 0.9% since May 2016, but it increased its overnight deposit rate from minus 15 basis points to minus 5 basis points in March 2019. The central bank endeavoured to fine-tune monetary conditions, as measured i.a. in the BUBOR interbank rates, through regulating the level of excess liquidity of the banking sector via FX swap tenders. In January 2019, the MNB launched a new round of its SME-

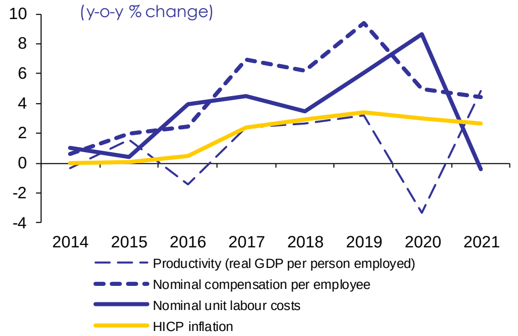
([34]) Since August 2005, the MNB pursues a continuous medium-term inflation target of 3% with a permissible fluctuation band of +/- 1 percentage point (which was changed from 'ex post' to 'ex ante' in March 2015).

financing Funding for Growth Scheme (FGS) and in July 2019 it started the Bond Funding for Growth Scheme for large corporates, for which the original total amount was raised from January 2020 onwards. In response to the COVID-19 crisis, the MNB took several measures to stabilize the financial sector and the economy. These included the introduction of a one-week deposit facility (effectively increasing the short-term market rate) and of an unlimited collateralized lending facility, the extension of its collateral framework, the expanding of the FGS and the announcement that it intends to buy government bonds on the secondary market. Net credit to the private sector has been growing at double-digit rates since mid-2018 in an environment of negative real interest rates.

Wages and labour costs

Employment continued to expand to reach a historically high 70.1% in 2019. The unemployment rate fell to 3.4% in 2019. However, growth in labour demand eased in the second half of 2019, in anticipation of slowing economic growth. Labour shortages and administrative wage increases generated strong wage growth, with wages and salaries per employee rising by close to 10% on average in 2018-2019.

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



Source: Eurostat, Commission services' Spring 2020 Forecast.

The effect of high wage growth on production costs was mitigated by large successive cuts in employers' social contributions. Labour productivity growth also picked up to around 3% in 2018-2019, although the level of productivity is lagging behind regional peers. Still, nominal unit labour costs rose by 3.4% and 6.0% in 2018 and 2019 respectively, well above the euro area average. Looking ahead, the large recession caused by the COVID-19 pandemic is projected to raise unemployment to 7% in 2020, despite temporary job protection measures offered to companies, and reduce wage growth. Labour productivity is set to decline in 2020 but recover in 2021, following its typical pattern around recessions. Employers' social contributions will be further reduced in 2020. Nominal ULC is projected to grow by 8.6% in 2020, but decrease by 0.4% in 2021 as the labour market gradually adjusts to the contraction of output.

External factors

Due to 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 (measured by the imports of goods deflator) increased consumer price inflation in 2018, mainly as a result of higher oil prices. From 2019, external disinflationary effects took hold, due to slowing global economic growth and lower commodity prices.

Over the last two years, the depreciating exchange rate contributed to the increase of import prices. The forint's nominal effective exchange rate (measured against a group of 36 trading partners) depreciated on average by 1.5% in 2018 and by a further 2.1% in 2019. The change of the nominal effective exchange rate would suggest inflationary pressures, but the pass-through of the exchange rate changes to consumer prices appears much smaller than in the past. Looking ahead, imported inflation is expected to increase, following significant depreciation of the forint since the beginning of this year.

Administered prices and taxes

The share of administered prices in the Hungarian HICP basket (14%) is somewhat above the euro area average. Administered prices increased by 0.3% in 2018 and 1.0% in 2019. Regulated energy and other utility prices practically did not change in 2018 and 2019. Overall, administered prices had a minor effect on headline inflation, contributing around 0.1 pp. in both 2018 and 2019.

Changes in indirect taxation lowered headline inflation by 0.5 pp. in 2018 and increased it by 0.2 pp. in 2019. Starting from 2018, the VAT rate was reduced on internet and restaurant services, milk, fish and pork offal. The financial transaction duty for households' smaller transactions was also abolished. At the same time, the excise duty on tobacco has been continuously increasing, and it is also expected to add to inflation in 2020-2021.

Medium-term prospects

Inflation is projected to ease after peaking at 3.4% in 2019. The recession caused by the COVID-19 shock is expected to reduce core inflation. Food price inflation is set to decrease as the temporary impact of the African swine flu fades. Energy price inflation is projected to remain low, in line with oil market developments. According to the Commission services's Spring 2020 Forecast, inflation is set to remain around the central bank's target of 3%, with an average 3.0% in 2020 and 2.7% in 2021.

There are both upside and downside risks to the inflation outlook. The large currency depreciation could result in a large one-time repricing of imported goods, while food price inflation could remain high due to supply shortages. On the other hand, a deeper or longer economic contraction could further reduce core inflation.

The level of consumer prices in Hungary stood at about 61% of the euro area average in 2018, with the relative price gap larger for services than for goods. This suggests that there is potential for price level convergence in the long term, as GDP per capita in PPS (around 67% of the euro area average in 2018) increases towards the euro area average.

Medium-term inflation prospects will depend strongly on wage and productivity developments, notably in the non-traded sector and on the success with anchoring inflation expectations at the central bank's 3% target. These elements may be substantially affected by the COVID-19 crisis.

5.3. PUBLIC FINANCES

5.3.1. Recent fiscal developments

The improvement in public finances remained limited over the 2018-2019 period, with the general government deficit reaching 2.0% of GDP in 2019, down from 2.5% of GDP in 2017.

Revenues as a share of GDP remained unchanged in 2018 at 44.5% and then dropped to 44.0% in 2019. Nominal tax revenues grew relatively fast thanks to the high growth of the main tax bases, including nominal income and consumption, and to measures to improve tax compliance. The increase was, however, below nominal GDP growth, reflecting the reduction, in both 2018 and 2019, in employers' social contribution rate. Revenues from EU funds continued to increase, reaching a peak in 2019. The moderation in the expenditure-to-GDP ratio was slightly more pronounced, from 47.0% in 2017 to 46.7% in 2018 and then further to 46.1% in 2019. This was driven by the moderate increase in current expenditure compared to GDP, in particular public wages, social transfers and interest expenditure. However, these savings were partially absorbed by rising capital expenditure, following the increased absorption of EU funds and the implementation of the measures under the 'demography programme' in 2019.

The 2019 budgetary outturn was worse than the 1.8% of GDP deficit target set in the 2019 Convergence Programme. This was explained by higher-than-planned expenditure, especially at the end of the year. The higher-than-expected revenues, thanks to high income and consumption growth, were offset by higher-than-projected expenditure, especially on intermediate consumption and subsidies. Public investment continued growing also on the back of increased EU funds absorption, while capital transfers were boosted by the take-up of the prenatal funding scheme of the 'demography programme'. The structural balance remained unchanged at -3.6% of GDP in 2018 and worsened marginally to -3.8% in 2019, well below the country's MTO (i.e. -1.5% of GDP).

Since 2017, the structural balance significantly deviated from the adjustment path towards the Medium-Term budgetary Objective (a structural deficit of 1.5% of GDP) as required by the Council in regulation 1466/97. As a consequence, Hungary has been under consecutive Significant Deviation Procedures since June 2018. Since then, the Council has issued bi-annual recommendations to which Hungary has not responded with effective action.

The government debt-to-GDP ratio decreased from 72.9% in 2017 to 66.3% by the end of 2019. The decline since 2017 was driven mainly by the high nominal economic growth, which was partly offset by the fiscal deficit and, especially in 2018, by a debt-increasing stock-flow adjustment related to the pre-financing needs of EU-funded projects.

5.3.2. Medium-term prospects

The 2020 budget was adopted by the Hungarian Parliament on 12 July 2019. It targeted a headline deficit of 1.0% of GDP, and included significant

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

Outturn and forecast [1]	2014	2015	2016	2017	2018	2019	2020	2021
General government balance	-2.8	-2.0	-1.8	-2.5	-2.1	-2.0	-5.2	-4.0
- Total revenues	47.4	48.6	45.4	44.5	44.5	44.0	45.1	43.6
- Total expenditure	50.2	50.6	47.2	47.0	46.7	46.1	50.3	47.7
of which:								
- Interest expenditure	4.0	3.5	3.1	2.7	2.4	2.3	2.5	2.4
p.m.: Tax burden	38.7	39.1	39.6	38.4	37.6	37.1	37.7	36.5
Primary balance	1.2	1.4	1.3	0.2	0.2	0.2	-2.6	-1.6
Cyclically-adjusted balance [2]	-2.6	-2.4	-2.1	-3.3	-3.6	-3.9	-2.8	-3.1
One-off and temporary measures [3]	-0.1	0.0	-0.1	0.4	0.0	-0.2	-0.2	0.0
Structural balance [2)4)]	-2.5	-2.3	-2.0	-3.6	-3.6	-3.8	-2.6	-3.1
Government gross debt	76.8	76.2	75.5	72.9	70.2	66.3	75.0	73.5
p.m: Real GDP growth (%)	4.2	3.8	2.2	4.3	5.1	4.9	-7.0	6.0
p.m: Output gap [2]	-0.4	0.8	0.6	1.8	3.1	4.1	-5.2	-2.1

1) Commission services' Spring 2020 Forecast.
2) Due to the COVID-19 pandemic, these estimates are surrounded by an unusually high level of uncertainty.
3) COVID-19-related measures were not classified as one-offs in the Commission services' Spring 2020 Forecast, due to the activation of the general escape clause of the SGP.
4) Cyclically-adjusted balance excluding one-off and other temporary measures.
Source: Commission services.

free reserves (1% of GDP) to cover potential slippages under the risk scenario. The 2020 budget included some deficit-increasing spending measures (i.e. those under the 'demography programme' and the expansion of subsidies for home building) and some tax cuts, among which a further reduction of employers' social contribution rate by 2 pp. as of October the reduction of the rates of certain taxes and some measures to simplify taxation. Following the outbreak of the COVID-19 pandemic, the authorities adopted fiscal policy measures aimed at containing its economic impact, with a net budgetary impact of 0.2% of GDP. Expansionary measures amount to 1% of GDP and include some temporary tax cuts in the most affected sectors such as tourism and services; the anticipation of the planned 2 pp. cut to employers' social contributions from October to July; a job protection scheme that covers part of lost wages for three months under certain conditions; a wage subsidy scheme for R&D jobs; and a one-off bonus for health workers. Moreover, medical emergency expenditures have amounted to 0.8% of GDP until now. Overall, these measures are financed largely from the reshuffling of existing budgetary chapters and reserves as well as new taxes on banks and retail companies. Additional measures to support the recovery have been announced: those are planned to be financed through further budgetary reallocations and their details are yet to be specified. As a result, the headline deficit target was revised to 2.7% of GDP in 2020.

The Commission services' Spring 2020 Forecast projects the current year's general government deficit at 5.2% of GDP, well above the official target. Based on a no-policy-change assumption, the deficit is projected to decrease to 4.0% of GDP in 2021. In structural terms, the deficit is overall estimated to improve over 2020-2021, reaching 3.1% by 2021. The debt-to-GDP ratio is expected to increase to 75.0% in 2020 and to decline to 73.5% by the end of 2021.

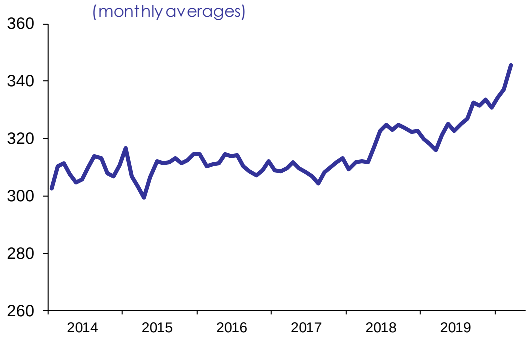
The fiscal framework in Hungary is well-developed, after the wide-ranging revamp launched in 2011 has resulted in a set of rules and procedures to control debt accumulation. There had been a number of recent legislative steps to reinforce and clarify some elements of the national framework. First, the Fiscal Council's monitoring mandate was extended in mid-2018 to cover all domestic fiscal rules. Second, the system of domestic rules was streamlined in late 2019, including by removing the discrepancy in the calculation of the public debt ratio between the ‘Maastricht’ definition and the domestic one. Nonetheless, the role of the Council in scrutinizing and shaping fiscal policies is still weak, in contrast to its constitutionally-enshrined veto power over the annual budget bill.

5.4. 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%. On 26 February 2008, the exchange rate band was abolished and a free-floating exchange rate regime was adopted that however allows for foreign exchange interventions by MNB. In March 2015, a +/-1 percentage point ex ante tolerance band was designated around the continuous medium-term inflation target of 3 percent (that is in place since 2005).

The forint fluctuated around 320 HUF/EUR for most part of 2018 and the first half of 2019. It was weaker for a few months from July 2018, before it appreciated against the euro till March 2019. Thereafter the forint depreciated to the euro, as the MNB signalled its intent to keep loose monetary conditions longer than other regional central banks and inflation rose above its target. The forint weakened to 337 HUF/EUR in February 2020, before the COVID-19 crisis set in. Inter-day exchange rate volatility was generally moderate during the past two years, with the notable exception of March 2020, when it sharply increased. In that month, the forint traded against the euro on average at about 346 HUF/EUR.

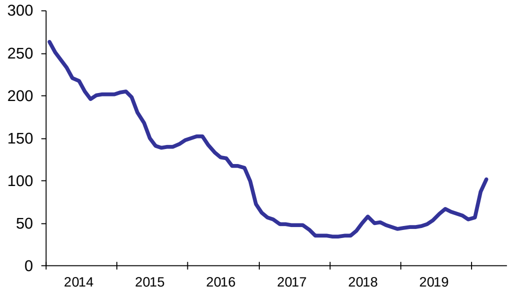
Graph 5.4: **Hungary - HUF/EUR exchange rate**
(monthly averages)



Source: ECB.

International reserves held by the MNB reached around EUR 23bn both at end-2017 and at end-April 2018. They increased from late 2018, as the positive effect of EU fund inflows and the liquidity providing FX swaps tenders exceeded the foreign currency demand by the Government Debt Management Agency and the Treasury. International reserves reached around EUR 28bn at end-2019, which corresponded to about 20% of GDP.

Graph 5.5: **Hungary - 3-M Bubor spread to 3-M Euribor**
(basis points, monthly values)



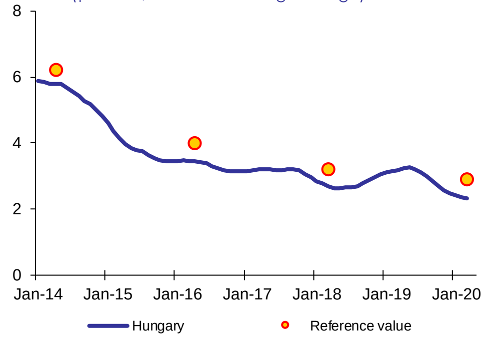
Source: National Bank of Hungary.

Short-term interest rate differentials vis-à-vis the euro area increased from around 40 basis points in May 2018 to around 60 basis points in July 2018, before falling back to about 40 basis points by end-2018. Short-term interest rate differentials then increased to 70 basis points by August 2019, before rising further to 90 basis points in February 2020. The MNB influenced forint short-term money market rates mainly via its FX swap tenders, while markets priced in a 10 basis points policy rate cut by the ECB during summer 2019. In April 2020, the MNB activated its one-week deposit instrument at the policy rate to increase the effective short-term rates. In March 2020, the 3-month spread vis-à-vis the euro area reached around 100 basis points.

5.5. 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 about 10 years.

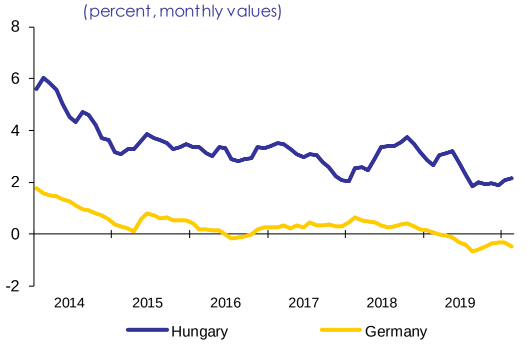
Graph 5.6: **Hungary - Long-term interest rate criterion**
(percent, 12-month moving average)



Source: Commission services.

The Hungarian 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion was below the reference value at the time of the 2018 convergence assessment of Hungary. It increased to 3.3% by May 2019 and then started to decrease again. In March 2020, the latest month for which data are available, the reference value, given by the average of long-term interest rates in Portugal, Cyprus and Italy plus 2 percentage points, stood at 2.9%. In that month, the 12-month moving average of the yield on the Hungarian benchmark bond stood at 2.3%, i.e. 0.6 percentage points below the reference value.

Graph 5.7: **Hungary - Long-term interest rates**
(percent, monthly values)



Source: Eurostat.

The long-term interest rate of Hungary increased from around 2.9% in May 2018 to about 3.7% by October 2018, as the market priced in a higher exchange rate risk of the forint. It then started to decrease again and reached 1.9% in December 2019, reflecting a renewed international search for yield, as major central banks embarked on further monetary easing. Hungary's long-term interest rate increased to 2.4% by March 2020, amidst the unfolding COVID-19 crisis. The long-term spread vis-à-vis the German benchmark bond peaked around 330 basis points in October 2018 and it stood at around 300 basis points in March 2020.

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, as well as product, labour and financial market integration – gives an important indication of a Member State's ability to integrate into the euro area without difficulties.

In December 2019, the Commission published its ninth Alert Mechanism Report (AMR 2020) under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.6), which highlighted issues related to unit labour costs, the housing market and possible risks from the exposure to the automotive industry. However, since overall risks remained limited, no In-Depth Review (IDR) was warranted. Risks from domestic demand pressures warrant attention. Unit labour cost growth has been very dynamic, as productivity growth lags behind substantial wage rises, driven by the tight labour market and administrative measures. The large role of the automotive industry may represent a risk over the longer term. Real house prices continued to grow rapidly. New lending volumes are increasing, but private debt as a percentage of GDP continued to decrease, because of the gradual amortisation of previously accumulated stocks.

5.6.1. Developments of the balance of payments

According to balance of payments data, the surplus of Hungary’s external balance (i.e. the combined current and capital account) declined to 2.1% of GDP in 2018 and to 1.0% of GDP in 2019. The current account decreased from previous surpluses to a deficit of 0.8% in 2019. Export growth slowed in line with the weaker economic growth of the main trading partners, while imports grew dynamically on the back of soaring domestic consumption and investment. The primary income balance improved with the reduction of external debt. The capital account surplus was higher in 2018-2019 than in 2017, due to the increased absorption of EU funds from the 2014-2020 Multiannual Financial Framework.

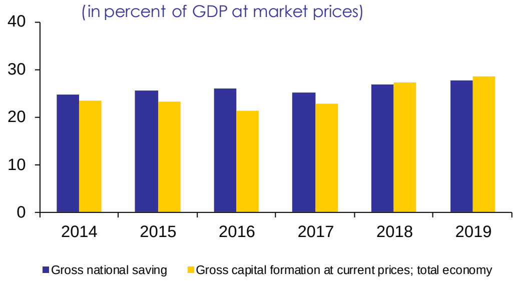
Table 5.4:
Hungary - Balance of payments **(percentage of GDP)**

	2014	2015	2016	2017	2018	2019
Current account	1.2	2.3	4.6	2.4	0.0	-0.8
of which: Balance of trade in goods	2.0	3.6	3.4	1.5	-1.3	-1.9
Balance of trade in services	4.3	4.4	5.3	5.8	5.8	5.6
Primary income balance	-4.3	-4.5	-2.6	-4.0	-3.8	-3.6
Secondary income balance	-0.9	-1.1	-1.5	-1.0	-0.6	-0.9
Capital account	3.7	4.6	0.0	0.9	2.3	1.8
External balance [1]	4.9	6.9	4.5	3.2	2.3	1.0
Financial account	4.2	5.9	3.0	1.4	0.7	-0.4
of which: Direct investment	-2.8	-2.3	-2.4	-1.6	-2.0	-1.3
Portfolio investment	3.1	5.0	4.2	3.0	-0.1	1.1
Other investment [2]	3.2	7.5	6.5	0.0	0.2	-0.4
Of which International financial assistance	1.9	0.0	1.3	n.a.	n.a.	n.a.
Change in reserves	0.7	-4.4	-5.3	0.0	2.7	0.2
Financial account without reserves	8.1	12.6	12.0	3.0	0.1	0.7
Errors and omissions	-0.7	-1.1	-1.5	-1.8	-1.6	-1.4
Gross capital formation	23.4	23.3	21.3	22.8	27.2	28.6
Gross saving	24.7	25.6	26.0	25.1	26.9	27.7
Gross external debt	144.0	128.4	120.8	102.2	100.4	88.8
International investment position	-78.6	-66.6	-59.9	-54.9	-51.3	-47.2

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

Sources: Eurostat, Commission services, Magyar Nemzeti Bank.

Graph 5.8: **Hungary - Saving and investment**
(in percent of GDP at market prices)

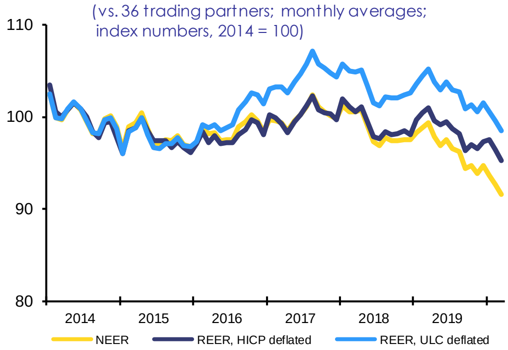


Source: Eurostat, Commission services.

Hungary's savings-investment surplus decreased in recent years as gross fixed capital formation rose markedly. The investment rate rose to a record high 28.6% in 2019. The rise in private investment was due to the favourable economic cycle, including the recovery in the real estate sector. Public investment also rose markedly until 2019, fuelled by increasing absorption of EU funds. At the same time, the saving rate increased further from already high levels.

Price and cost competitiveness indicators of Hungary deteriorated in 2018, but improved in 2019. The real-effective exchange rate deflated by ULC appreciated markedly until 2018, driven by high domestic wage growth. Since 2018, the depreciating nominal effective exchange rate also led to the depreciation of the real-effective exchange rates, offsetting some of the decline in cost competitiveness of earlier years. Hungary's export performance stagnated in 2018, but improved in 2019.

Graph 5.9: **Hungary - Effective exchange rates**
(vs. 36 trading partners; monthly averages; index numbers, 2014 = 100)



Source: Commission services.

Mirroring the development of the external balance, the surplus of the financial account melted by 2019. Direct investment continued to register net inflows in both 2018 and 2019. Large outflows of portfolio investment ended by 2018, as non-residents' forint-denominated bondholdings started to increase, in line with the yield premium on Hungarian assets. Other investment flows were close to balance over the past two years. The

Table 5.5:
Hungary - Market integration

	2014	2015	2016	2017	2018	2019
Trade openness 1) (%)	92.2	92.2	92.7	94.3	94.9	91.9
Trade with EA in goods & services 2)+3) (%)	52.9	53.1	53.6	53.7	53.7	52.0
Export performance (% change) 4)	5.1	2.8	-0.6	0.8	0.1	3.5
World Bank's Ease of Doing Business Index rankings 5)	40	40	41	48	53	52
WEF's Global Competitiveness Index rankings 6)	60	63	69	60	48	47
Internal Market Transposition Deficit 7) (%)	0.7	0.6	0.4	0.8	0.3	0.9
Real house price index 8)	88.3	100.0	113.1	123.6	137.1	151.9
Residential investment 9) (%)	1.9	2.2	2.4	2.7	3.0	3.2

1) (Imports + Exports of goods and services / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics, Balance of Payments).
2) (Imports + Exports of goods with EA-19 / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).
3) Trade in services with EA-19 (average credit and debit in % of GDP at current prices) (Balance of Payments).
4) Index for exports of goods and services divided by an index for growth of markets (percentage change on preceding year).
5) New methodology as of 2014 (World Bank).
6) (World Economic Forum)
7) Percentage of internal market directives not yet communicated as having been transposed, relative to the total.
(November data, as of 2016 date refers to the year of publication).
8) Deflated house price index (2015=100) (Eurostat).
9) Gross capital formation in residential buildings (in % of GDP) (Eurostat).

Sources: Eurostat, World Bank, World Economic Forum, Commission services.

decrease of gross external debt proceeded in 2018 and 2019 at a fast pace, falling to around 89% of GDP at the end of this period. The net international investment position improved from its low of -113.4% of GDP in 2009 to -47.2% by end-2019.

According to the Commission services' Spring 2020 Forecast, which is based on national accounts data, the external surplus is expected to increase above 3% of GDP in both 2020 and 2021, due to the contraction of domestic demand and falling imports.

5.6.2. Market integration

The Hungarian economy is highly integrated with the euro area through trade and investment linkages. Trade openness remains high at around 92% in 2019, reflecting the deep integration of the Hungarian economy into continental and global supply chains. Flows with the euro area dominate trade, accounting for more than half of the total trade in goods and services. The main goods trading partners in 2019 were Germany, Austria, Slovakia and Poland.

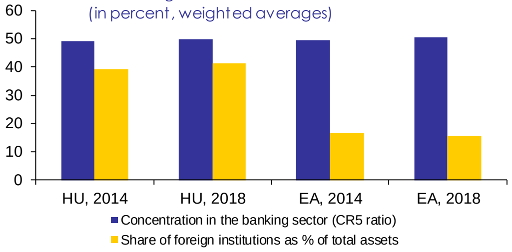
The stock of FDI in Hungary amounted to about 63% of GDP in 2018 (excluding SPEs), with FDI mainly originating from Germany, the Netherlands and Austria. The main recipient sectors of FDI were services (mostly financial services, trade and real estate activities) and manufacturing (39% of the total), suggesting that FDI plays an important role in enhancing Hungary's export capacity and contributes significantly to economic integration with the euro area.

Concerning the business environment, Hungary performs in general worse than many euro-area Member States in international rankings. In the World Bank's Ease of Doing Business Hungary scores particularly poorly with regards getting electricity and dealing with construction permits. In the World Bank's Worldwide Governance Indicators Hungary performs relatively worse in terms of "voice and accountability" and control of corruption. According to the latest data, Hungary's transposition deficit of EU Directives was at 0.9% which is above the target (0.5%) proposed by the European Commission in the Single Market Act (2011).

The 4th Anti-Money Laundering Directive imposed transposition by 26 June 2017, and Hungary notified the Commission of the adopted measures within that deadline. New measures were notified during 2019 and 2020. The Commission is analysing the communicated measures to assess their completeness and conformity with the directive. As regards the 5th Anti-Money Laundering Directive, whose transposition deadline elapsed on 10 January 2020, Hungary has notified national transposition measures and declared a partial transposition.

The Hungarian labour market can be considered as rather flexible in terms of employment protection (as measured by the 2013 OECD employment protection indicator for permanent workers). Policies on social transfers, early retirement and increasing statutory retirement age have strengthened labour supply. The regulation of working hours has also become more flexible from 2019. Both domestic and international labour mobility is rather low in Hungary, although outward migration from the country has increased since the financial crisis.

Graph 5.10: **Hungary - Foreign ownership and concentration in the banking sector**

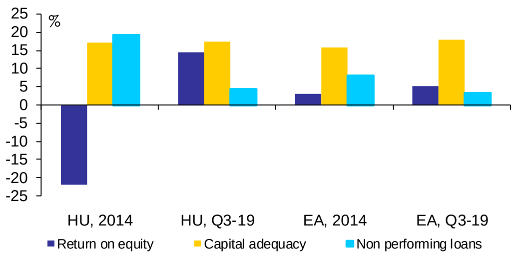


Source: ECB, Structural financial indicators.

Hungary's financial sector remains well integrated into the EU's financial system. This integration is noticeable in ownership and other cross-border linkages of the banking system. Foreign ownership in total assets of the Hungarian banking sector increased from 39.3% in 2014 to 41.2% in 2018. Bank concentration, as measured by the market share of the largest five credit institutions in total assets, reached 50% in 2018, which is close to the euro-area average.

The Hungarian banking system remains well-capitalized, with a capital adequacy ratio of 17.4% at end-September 2019, which is somewhat below that of the euro area. Banks' profitability has recovered after a large loss in 2014, which was due to provisioning for the settlement of FX mortgage loans. The sector's return on equity reached around 14% in the year to end-September 2019, well above the approximately 5% average of the euro area. Profitability was supported by dynamic lending to both household and corporate clients, as the potential to write back NPL provisions diminished. The improvement of the loan portfolio quality continued and the NPL ratio reached 4.5% in September 2019, which is somewhat above the average of the euro area. The COVID-19 pandemic could have a significant impact on the indicators analysed in this paragraph over the coming months.

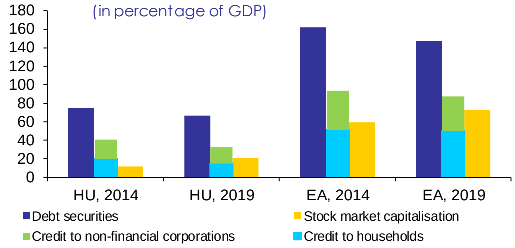
Graph 5.11: **Hungary - Selected banking sector soundness indicators**



Note: Q3-19 Return on equity is calculated over the last four quarters.
Source: ECB, EC calculations.

The rapid increase of real house prices continued in 2018-2019, supported by favourable financing conditions, the improving financial situation of households and expanding government subsidies. Homebuilding was slow to respond to rising house prices, partly due to capacity constraints. Investment in residential buildings remained at around 3% of GDP in 2019. The stock of forint-denominated housing loans increased quite dynamically, reaching an annual growth rate of around 10% at end-2019.

Graph 5.12: **Hungary - Recent development of the financial system relative to the euro area**



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

The financial system in Hungary is smaller relative to GDP than that of the euro area countries. Domestic bank credit amounted to 33% of GDP at the end-2019, split broadly evenly between households and non-financial corporations. The total capitalization of the Budapest Stock Exchange amounted to about 20% of GDP in 2019, well below the stock-market capitalization of the euro-area. The central bank continues to have a controlling ownership of the Budapest Stock Exchange, which may generate conflict of interests. The debt securities market remains small in comparison with the euro area average (67% against 148% of GDP) and is mainly used for re-financing public debt. The consolidated stock of private sector debt fell from around 92% in 2014 to around 67% of GDP in 2019, which is significantly below the private debt level of the euro area.

6. POLAND

6.1. LEGAL COMPATIBILITY

6.1.1. Introduction

The main rules governing the Narodowy Bank Polski (NBP – Polish national bank, hereafter NBP) are laid down in the Act on the Narodowy Bank Polski (the NBP Act) which was adopted on 29 August 1997. The consolidated version that includes all amendments to the NBP Act was published in Dziennik Ustaw of 2019, item 1810. The NBP Act has been slightly amended since the Commission's 2018 Convergence Report [35]. In absence of any legislative action regarding the issues mentioned in the Commission's 2018 Convergence Report, the comments provided in the latter report are largely repeated in the 2020 assessment.

6.1.2. Central Bank independence

The Polish Constitution and the NBP Act do not explicitly prohibit the NBP and members of its decision-making bodies from seeking or taking outside instructions; they also do not expressly prohibit the Government from seeking to influence members of NBP decision-making bodies in situations where this may have an impact on NBP's fulfilment of its ESCB related tasks. The absence of such an explicit reference to Article 130 of the TFEU and Article 7 of the ESCB/ECB Statute or its content constitutes an incompatibility. However, the Polish Constitutional Court has recognised that the central bank's independence is based on Article 227(1) of the Constitution. In this respect, it is noted that at the occasion of a future amendment to the Polish Constitution the Polish authorities should seize the opportunity to clarify in the Constitution that the principle of central bank independence as enshrined in Article 130 of the TFEU and Article 7 of the ESCB/ECB Statute applies. Alternatively, or in addition, the NBP Act could also be amended to ensure full compatibility with the principle of central bank independence.

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

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

The wording of Article 9(5) of the NBP Act containing grounds for dismissal of the NBP's Governor could lead to interpretative issues and is an imperfection. The provision would benefit from a clarification that these grounds correspond to a lack of fulfilment of conditions required for the performance of the Governor's duties or a serious misconduct of which the Governor has been guilty, as set out in Article 14.2 of the ESCB/ECB Statute.

The State Tribunal Act [36] provides for the suspension of the Governor from his/her duties following a procedure, which raises questions regarding its compatibility with the principle of central bank independence and Article 14.2 of the ESCB/ECB Statute. Pursuant to the second sentence of Article 11(1) of the State Tribunal Act read in conjunction with its Articles 3 and 1.1(3),

(35) The amendments stem from the Law of 9 November 2018 regarding the strengthening of financial market supervision and investor protection (Dziennik Ustaw of 2019, item 2243), the Act of 22 February 2019 restricting the pursuit of business activities by persons exercising public functions and the NBP Act (Dziennik Ustaw of 2019, item 371) and Union data protection legislation (Dziennik Ustaw of 2019, item 730).

(36) State Tribunal Act, Dziennik Ustaw of 2019, item 2122.

the Governor of the NBP can be suspended as a result of an indictment by the Parliament for violating the Constitution or an act of law when performing his/her duties even before the State Tribunal has delivered its judgment on the removal from the office. While suspending a Governor for the purpose of a (criminal) investigation may be necessary, the Governor concerned should be able to bring an action for annulment of a temporary measure before the Court of Justice of the European Union (CJEU) pursuant to Article 14.2 of the ESCB/ECB Statute. The purpose of such action is to enable the CJEU to verify that a temporary prohibition of performing a Governor's duties is taken only if there are sufficient indications that he/she has engaged in serious misconduct capable of justifying such a measure ([37]). Such a guarantee is a reflection of the principle of central bank independence and of great importance, especially in case of a suspension from office on grounds of serious misconduct further to an indictment by a parliamentary body depriving the Governor of the possibility to continue exercising the duties. In the absence of any clear reference in the NBP Act or Constitution to the principle of central bank independence the NBP Act would benefit from an explicit clarification that the Governor of the NBP has the possibility to seek legal redress against his/her dismissal, including suspension before the CJEU, as enshrined in Article 14.2 of the ESCB/ECB Statute.

According to Article 203(1) of Poland's Constitution, the Supreme Audit Office (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 for legal certainty reasons be clearly defined so as to respect Article 130 of the TFEU and Article 7 of the ESCB/ECB Statute. Furthermore, the provision's relationship with Article 69.1 of the NBP Act is also unclear. The relevant provision of the Constitution is therefore incompatible and needs to be adapted in order to comply with Article 130 of the TFEU and Article 7 of the ESCB/ECB Statute.

([37]) Judgment of the Court of Justice of the EU (Grand Chamber) of 26 February 2019 Ilmārs Rimšēvičs and European Central Bank v Republic of Latvia, Joined Cases C-202/18 and C-238/18, ECLI:EU:C:2019:139. In this ruling, the CJEU declared it has jurisdiction to hear and determine an action of annulment brought against a temporary measure like a suspension of performing duties as a Governor under Article 14.2 of the ESCB/ECB Statute.

6.1.3. Prohibition of monetary financing and privileged access

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

As such, there is also no direct reference to the prohibition on monetary financing in the NBP Act. While Article 220(2) of the Polish Constitution provides that the budget shall not provide for covering a budget deficit by way of contracting credit obligations to the State's central bank, and this could be interpreted as a reference to the rationale of Article 123 of the TFEU, this provision is not compatible with Article 123 TFEU. At the occasion of a future amendment to the Polish Constitution the Polish authorities should seize the opportunity to clarify in the Constitution that the prohibition on monetary financing as enshrined in Article 123 of the TFEU and Article 21 of the ESCB/ECB Statute applies. Alternatively, or in addition, the NBP Act could be amended to ensure full compatibility with the aforementioned principle.

6.1.4. Integration in the ESCB

Objectives

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

Tasks

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

- limitation of the NPB's activities to the territory of the Republic of Poland (Article 2(3) of the NBP Act) and absence of a general reference to the BNB as an integral part of the ESCB (Article 227(1) of the Constitution and Article 1 of the NBP Act);
- definition and implementation of monetary policy (Articles 227(1) and (6) of the Constitution, Articles 3(2)(5), 12, 23, 38-50a, and 53 of the NBP Act);
- holding of foreign reserves; management of foreign exchange and the definition of foreign exchange policy (Articles 3(2)(2), 3(2)(3), 17(4)(2), 24 and 52 of the NBP Act);
- competences of the ECB and of the EU for banknotes and coins (Article 227(1), second sentence of the Constitution and Articles 4, 31-37 of the NBP Act). The NBP shall exercise its responsibility for issuing currency as part of the ESCB/Eurosystem;
- appointment of independent auditors - Article 69(1) of the NBP Act foresees that NBP accounts are examined by external auditors. The NBP Act does not take into account that the auditing of a central bank has to be carried out by independent external auditors recommended by the Governing Council and approved by the Council. It is incompatible with Article 27.1 of the ESCB/ECB Statute.

There are also some imperfections regarding:

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

6.1.5. Assessment of compatibility

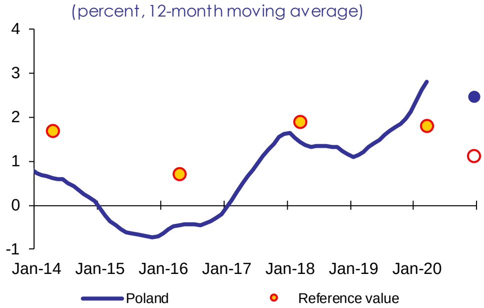
As regards the independence of the central bank, the prohibition on monetary financing and the central bank integration into the ESCB at the time of euro adoption, the legislation in Poland, in particular the NBP Act and the Constitution of the Republic of Poland are not fully compatible with the compliance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

6.2. PRICE STABILITY

6.2.1. Respect of the reference value

The 12-month average inflation rate, which is used for the convergence assessment, was below the reference value at the time of the last convergence assessment of Poland in 2018. It decreased to 1.1% by early 2019 and then increased gradually to 2.1% by end-2019. In March 2020, the reference value was 1.8%, calculated as the average of the 12-month average inflation rates in Portugal, Cyprus, Italy plus 1.5 percentage points. The corresponding inflation rate in Poland was 2.8%, i.e. 1.0 percentage points above the reference value. The 12-month average inflation rate is projected to remain well above the reference value in the months ahead.

Graph 6.1: **Poland - Inflation criterion**
(percent, 12-month moving average)



Note: The dots in December 2020 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring Forecast.

6.2.2. Recent inflation developments

Poland recorded an increase in annual HICP inflation over the past two years, backed by rising core inflation, boosted mainly by higher service price growth. Annual inflation rose to 1.5% by September 2018, before dipping back to 0.6% by January 2019. It moved to 2.1% by April 2019 and increased further to 2.4% by November. Annual inflation increased sharply further at end-2019 and early 2020, driven up by rising food and services

Table 6.1:
Poland - Components of inflation

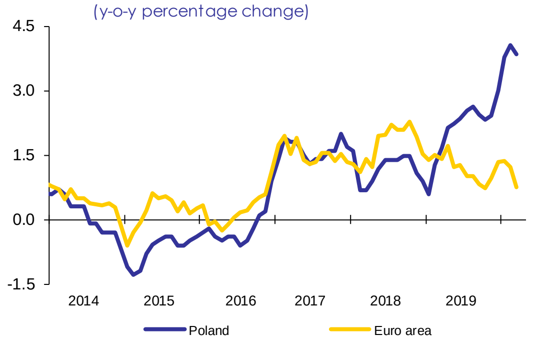
	2014	2015	2016	2017	2018	2019	Mar-20	weights in total 2020
						(percentage change)[1]		
HICP	0.1	-0.7	-0.2	1.6	1.2	2.1	2.8	1000
Non-energy industrial goods	-0.9	-0.8	-1.5	-1.0	-0.3	0.4	0.5	323
Energy	-1.2	-4.9	-3.7	2.9	3.7	0.0	0.4	131
Unprocessed food	-1.7	-1.7	1.6	5.6	3.0	5.4	9.4	46
Processed food	1.6	-0.3	0.7	2.7	1.8	3.7	4.3	195
Services	1.3	1.7	1.8	2.4	0.8	3.5	4.4	305
HICP excl. energy and unproc. food	0.6	0.3	0.3	1.2	0.6	2.3	2.8	824
HICP at constant tax rates	-0.3	-0.7	-0.2	1.6	1.2	2.1	2.7	1000
Administered prices HICP	1.2	1.0	2.1	1.2	0.8	1.2	2.8	123

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

Sources: Eurostat, Commission services.

prices. Overall, headline inflation reached 1.2% in 2018 and 2.1% in 2019. During the last two years, annual HICP inflation in Poland was lower than in the euro area until March 2019 and higher thereafter.

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



Source: Eurostat.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) increased gradually from 0.4% in May 2018 to 3.7% by March 2020. It was below headline inflation in 2018, when oil prices were high, but fluctuated around the headline figure in 2019, as the impact of spiking unprocessed food prices was then counterbalanced by falling energy prices. The upward trend of core inflation in the past two years was spread over a wide range of HICP categories, driven in particular by processed food and services. Processed food inflation increased from 1.3% in June 2018 to 5.4% by March 2020. Demand and supply factors such as rising wages, higher input prices and a strong increase in private consumption were the main contributors to this increase. Strongly rising domestic demand and difficulties in hiring adequately skilled workers leading to rising wages also played a role for services inflation, which increased from 0.4% in April 2018 to 5.6% in March 2020. Following six consecutive years of a decline, prices of non-energy industrial goods increased by 0.4% in 2019.

6.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and cyclical stance

Poland's real GDP growth reached 5.1% in 2018, the fastest growth rate for the last ten years. It then slowed to 4.1% in 2019, closer to estimates of potential output growth of around 3.5%. As in previous years, growth was mainly driven by domestic demand, in particular strong private consumption and public investment. Private consumption was supported by an excellent labour market situation, increased social transfers, lowering of direct taxes, low interest rates and ensuing consumer confidence. Investment recovered in 2018 and 2019, mainly driven by its public part, but its share in GDP remained well below the EU average. According to the Commission services' Spring 2020 Forecast, GDP is projected to decline by 4.3% in 2020, due to a disruption in economic activity and an unprecedented fall in external demand caused by the COVID-19 pandemic. In 2021, GDP is expected to bounce back by 4.1% driven mainly by a strong recovery in household consumption. The sizeable positive output gaps of 2018 and 2019 are expected to reverse strongly in 2020-2021.

The fiscal stance, as measured by the change in the structural balance, was slightly tightened in 2018. In 2019 a pro-cyclical fiscal expansion was observed. According to the Commission services' Spring 2020 Forecast, the fiscal stance is expected to be expansionary in 2020, driven mainly by the

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

	2014	2015	2016	2017	2018	2019	2020 1)	2021 1)
HICP inflation								
Poland	0.1	-0.7	-0.2	1.6	1.2	2.1	2.5	2.8
Euro area	0.4	0.2	0.2	1.5	1.8	1.2	0.2	1.1
Private consumption deflator								
Poland	-0.1	-1.1	-0.4	2.0	1.6	1.9	2.4	2.6
Euro area	0.5	0.3	0.4	1.3	1.4	1.2	0.3	1.2
Nominal compensation per employee								
Poland	2.2	1.7	4.8	5.8	7.9	7.3	3.8	2.6
Euro area	1.4	1.3	1.2	1.7	2.2	2.1	1.1	0.4
Labour productivity								
Poland	1.6	2.3	2.2	3.6	4.8	4.4	0.3	1.8
Euro area	0.8	1.0	0.5	1.0	0.4	0.1	-3.2	2.4
Nominal unit labour costs								
Poland	0.6	-0.6	2.5	2.2	3.0	2.8	3.5	0.7
Euro area	0.6	0.5	0.7	0.7	1.8	2.1	4.3	-1.9
Imports of goods deflator								
Poland	-2.2	-1.3	-0.3	1.3	2.9	1.2	0.0	0.1
Euro area	-2.4	-3.3	-3.3	3.4	2.7	-0.6	-3.6	1.1

1) Commission services' Spring 2020 Forecast.

Source: Eurostat, Commission services.

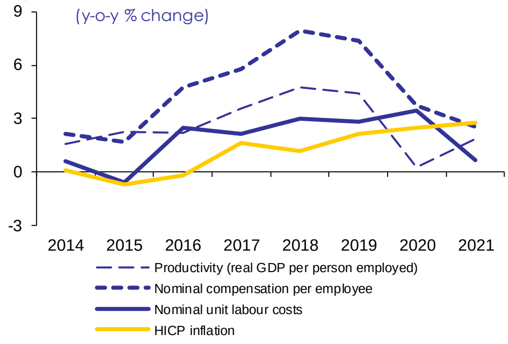
measures to contain the pandemic and support the economy, and restrictive in 2021.

Monetary policy, conducted within an inflation targeting framework ([38]) remained accommodative over the past two years. The Monetary Policy Council (MPC) kept the policy rate unchanged at 1.5% between March 2015 and March 2020. It decided to cut the policy rate in two 50 basis points steps in March and April to 0.5%, in response to the COVID-19 crisis. In addition, the MPC launched the purchase of government securities and government-guaranteed debt securities on the secondary market. It also started the provisioning of additional liquidity to the banking sector through repo operations and a discount facility. The growth rate of net bank credit to the non-financial private sector remained moderate, despite the historically low interest rates.

Wages and labour costs

Employment has been consistently on the rise reaching the highest level since comparable data are available at the end of 2019 (both in terms of absolute numbers and of the employment rate). In line with this, the unemployment rate has declined steadily, reaching a record low of 2.9% in December 2019. The labour market is set to be impacted by the COVID-19 pandemic, with the unemployment rate hiking to around 7.5% in 2020.

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



Source: Eurostat, Commission services' Spring 2020 Forecast.

Labour productivity growth rose significantly and reached its peak of 4.8% in 2018 before it somewhat declined to 4.4% in 2019. Compensation per employee increased nearly 8% in 2018 and above 7% in 2019. This translated into nominal ULC growth of 3.0% in 2018 and 2.8% in 2019. The COVID-19 pandemic is expected to lead to a moderation of the rapid increase in compensation per employee to 3.8% in 2020 and 2.6% in 2021. Labour productivity growth is to slow down considerably to 0.3% in 2020 and 1.8% in 2021, resulting in nominal ULC growth of 3.5%

([38]) 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.

in 2020 and 0.7% in 2021, according to the Commission services' Spring 2020 Forecast.

External factors

Although external trade represents a lower share of GDP in Poland than in regional peers, prices of imported goods and services play an important role in domestic price formation. Higher oil prices led to the imports of goods deflator rising to 3% in 2018, despite some appreciation of the zloty.

The zloty's nominal effective exchange rate (measured against a group of 36 trading partners) appreciated on average by 1.5% in 2018 and depreciated by 1.0% in 2019. The relative stability of the euro-zloty exchange rate overall in 2018-2019 and the slow price growth in Poland's trade partners weighed on import price increase. Imported inflation is forecast to decrease strongly during 2020-2021, due to the COVID-19 pandemic impact.

Administered prices and taxes

The increase in administered prices, with a weight of around 12% in the HICP basket (similar to that of the euro area), was below HICP inflation both in 2018 and 2019. The average annual increase in administered prices was 0.8% in 2018 and 1.2% in 2019. The faster growth of administered prices in 2019 was mainly related to dynamics of refuse collection and the gas price, but was moderated with the regulatory capping of the electricity prices.

The impact of tax measures on overall consumer price developments has been close to zero as constant tax inflation was in line with headline inflation.

Medium-term prospects

Looking ahead, inflation is expected to moderate over the course of 2020 after reaching a peak in February. Processed and unprocessed food are expected to be the product groups with high inflation dynamics, but the sharp drop of oil prices is to counterbalance their impact. Pressures from wage increases are expected to moderate strongly due to the COVID-19 pandemic's impact on the labour market. The Commission services' Spring 2020 Forecast projects annual HICP inflation to average 2.5% in 2020 and 2.8% in 2021.

The inflation outlook remains highly uncertain, with risks appearing to be broadly balanced. Wage growth is expected to moderate, but this will depend on the effectiveness of government measures and how the labour market evolves. On the other hand, even though it is expected that the zloty will keep depreciating over the forecast horizon, a less-than-expected depreciation could contain upward dynamics in 2021. Coupled with decreasing oil prices, this could bring down the inflation outlook substantially.

The level of consumer prices in Poland was at around 56% of the euro-area average in 2018. This suggests a significant potential for price level convergence in the long term, as GDP per capita in PPS (about 67% of the euro-area average in 2018) increases 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, to make better use of increased labour immigration and to facilitate the effective allocation of labour market resources will play an important role in limiting wage pressures, resulting inter alia from negative demographic developments. As to product markets, there is scope to enhance the competitive environment, especially in the services and energy sectors. At the macro level, an appropriate monetary policy response to macroeconomic developments and a prudent fiscal stance will be essential to contain inflationary pressures.

6.3. PUBLIC FINANCES

6.3.1. Recent fiscal developments

The general government deficit – following a continuous downward evolution between 2014 and 2018 – increased in 2019 to 0.7% of GDP. Total government revenue reached 41.3% of GDP in 2018 and 2019, the highest level in the last decade. The revenue evolution until 2018 was driven mainly by a robust macroeconomic environment and higher tax collection, in particular of indirect taxes. At the same time, a very good situation on the labour market supported higher revenues from income taxes and social security contributions. Several changes to direct taxes introduced in 2019 impacted revenue negatively. The ratio of total government expenditure to GDP, after six years of continuous decline from 45.8% in 2010 to 41.1% in 2016, has been increasing since 2017. It reached 42% in 2019. This resulted mainly from an

Table 6.3:

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

Outturn and forecast [1]	2014	2015	2016	2017	2018	2019	2020	2021
General government balance	-3.6	-2.6	-2.4	-1.5	-0.2	-0.7	-9.5	-3.8
- Total revenues	38.7	39.1	38.7	39.8	41.3	41.3	40.8	40.3
- Total expenditure	42.4	41.7	41.1	41.2	41.5	42.0	50.3	44.1
of which:								
- Interest expenditure	2.0	1.8	1.7	1.6	1.4	1.4	1.4	1.4
p.m.: Tax burden	32.9	33.4	34.4	35.0	36.0	36.1	35.3	35.2
Primary balance	-1.7	-0.9	-0.7	0.1	1.2	0.6	-8.1	-2.4
Cyclically-adjusted balance [2]	-2.8	-2.1	-2.1	-2.1	-1.9	-2.7	-8.3	-2.9
One-off and temporary measures [3]	-0.2	0.0	0.0	0.0	0.0	0.0	0.3	0.2
Structural balance [2)4]	-2.6	-2.1	-2.1	-2.1	-1.9	-2.7	-8.5	-3.1
Government gross debt	50.8	51.3	54.3	50.6	48.8	46.0	58.5	58.3
p.m: Real GDP growth (%)	3.3	3.8	3.1	4.9	5.3	4.1	-4.3	4.1
p.m: Output gap [2]	-1.6	-1.0	-0.6	1.3	3.4	4.0	-2.5	-1.8

1) Commission services' Spring 2020 Forecast.

2) Due to the COVID-19 pandemic, these estimates are surrounded by an unusually high level of uncertainty.

3) COVID-19-related measures were not classified as one-offs in the Commission services' Spring 2020 Forecast, due to the activation of the general escape clause of the SGP.

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

Source: Commission services.

increase in social transfers to pensioners and middle- and high-income families with children.

The 2019 headline deficit (0.7% of GDP) turned out to be lower than forecast in the 2019 edition of the Convergence Programme (1.7% of GDP). This difference stemmed mainly from a lower than expected expenditure. In turn, the structural deficit turned out to be broadly in line with the forecast. Poland has not used its favourable economic situation in the recent years to pursue structural consolidation and build up fiscal buffers.

Thanks to strong nominal economic growth and relatively low headline deficits, the general government debt continued its descending path and reached 46% of GDP in 2019. The decline in the general government debt in 2018 and 2019 resulted mainly from falling nominal fiscal deficits and strong nominal growth. The role of valuation effects has been diminishing, as the share of Polish government debt denominated in foreign currencies has been gradually decreasing and the złoty was relatively stable, in particular to the euro.

6.3.2. Medium-term prospects

The 2020 budget was adopted on 14 February 2020. It targeted a deficit of 1.2% of GDP. It broadly assumed a continuation of major policies carried out in previous years. On the revenue side, a full-year impact of measures implemented in 2019 in the area of direct taxes was assumed to weigh on public finances. This concerned in particular the lowering of the first personal income tax rate from 18% to 17%, the increase of the tax-free allowance and the exemption of young taxpayers from the personal income tax. On the expenditure side, social spending was expected to rise further. This was due mainly to a full-year impact of the removal of means testing in the universal child benefit, which entered into force in mid-2019, and a decision to pay all pensioners once per year an allowance equalling to one month minimum pension benefit. Afterwards Poland implemented a number of measures to contain the COVID-19 pandemic and to support the economy. They covered amongst others: subsidies to social contributions of employees, subsidies to salaries, (cancellable) loans and guarantees to companies, and benefits to parents who needed to take care of their children. The 2020 fiscal impact of those measures is expected to exceed 5.5% of GDP. In particular, this estimate includes loans to companies to be granted by the Polish Development Fund. In line with the authorities announcements that about 60% of loans will not have to be repaid, it is assumed that the amount of loans to become grants impacts the 2020 deficit (by some 2¾ pp. of GDP).

The Commission services' Spring 2020 forecast, projects the general government headline deficit in 2020 at 9.5% of GDP. The deficit is set to decrease to 3.8% of GDP in 2021. At the same time, amid the recession caused by the COVID-19 pandemic and a negative output gap, the structural general government deficit is forecast to increase from around 2¾% of potential GDP in 2019 to some 8½% of potential GDP in 2020 and then to decline to around 3% of potential GDP in 2021. The ratio of general government debt to GDP is set to strongly increase to over 58% in 2021. However, as above a quarter of the sovereign debt is denominated in foreign currencies, the debt projections are subject to uncertainty due to possible valuation effects.

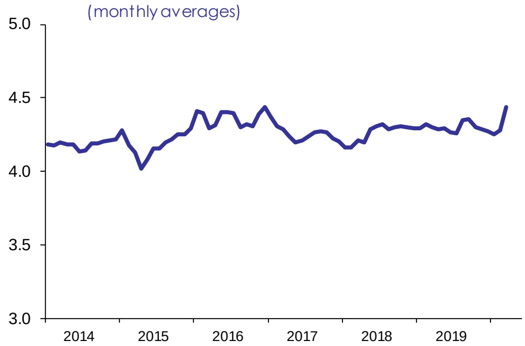
The fiscal framework in Poland is overall strong, but it has shown some weaknesses recently. Numerical fiscal rules are at the centre of the framework. First, debt ceilings anchored in the Constitution cover the general government, while a separate debt rule concerns local governments. Second, since 2015 most of the general government sector is subject to the stabilising expenditure rule, which plays an important role in preventing overspending. However, recently several new expenditure items have been channelled through newly created funds that do not fall under the rule. Medium-term budgetary planning is based on the four-year Multiannual State Financial Plan, which serves as a basis for the preparation of annual budgets but does not provide targets for them. A reform of the budget system has been ongoing, with no end date established so far. Poland does not have a fully-fledged fiscal council and activities related to the control and monitoring of domestic fiscal rules are scattered among several bodies.

6.4. EXCHANGE RATE STABILITY

The Polish zloty does not participate in ERM II. Since April 2000, Poland has been operating 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 traded against the euro in a quite narrow range at around 4.3 over the past two years, up until the outbreak of the COVID-19 crisis in March 2020. There was a short period of relative zloty weakness in July 2018 and another one from August 2019, amidst signs of an economic slowdown. This was followed by a period of strength from late 2019, after some monetary easing took place in major advanced economies. Inter-day exchange rate volatility increased in those two weaker periods, but spiked even higher, when the COVID-19 crisis set in. In March 2020, the zloty's exchange rate against the euro reached on average about 4.4 PLN/EUR.

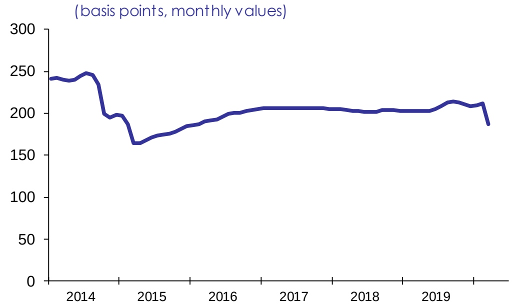
Graph 6.4: **Poland - PLN/EUR exchange rate**
(monthly averages)



Source: ECB.

International reserves held by the NBP increased from EUR 95 billion in early 2018 to around EUR 115 billion by end-2019. The reserve-to-GDP ratio was at around 22% at end-2019.

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



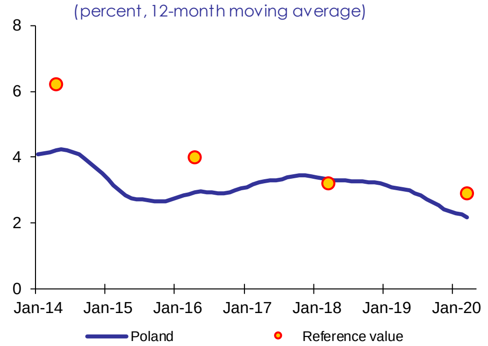
Source: Eurostat and Thomson Reuters.

Short-term interest rate differentials vis-à-vis the euro area were stable at around 200 basis points between spring 2018 and summer 2019, when they increased to around 210 basis points. The Polish three-month rate remained stable until March 2020, in line with the unchanged policy rate of the NBP, as the euro money market priced in the September 2019 rate cut of the ECB. In March 2020, the Polish 3-month rate fell, as the NBP started its easing measures, and the spread vis-à-vis the euro area reached around 190 basis points.

6.5. LONG-TERM INTEREST RATES

Long-term interest rates in Poland used for the convergence assessment reflect secondary market yields on a single benchmark government bond with a residual maturity of around 9 years.

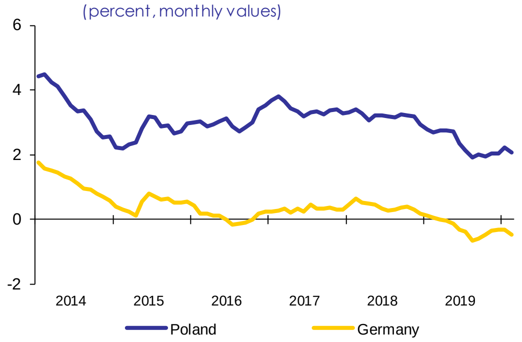
Graph 6.6: **Poland - Long-term interest rate criterion**
(percent, 12-month moving average)



Source: Commission services.

The Polish 12-month 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 2018. It gradually decreased from 3.3% at that time to about 2.3% by end-2019. In March 2020, the latest month for which data are available, the reference value, given by the average of long-term interest rates in Portugal, Cyprus and Italy plus 2 percentage points, stood at 2.9%. In that month, the 12-month moving average of the yield on the Polish benchmark bond stood at 2.2%, i.e. 0.7 percentage points below the reference value.

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



Source: Eurostat.

The long-term interest rate of Poland was around 3.2% between May and November 2018, before it decreased to 2.7% by early 2019. It decreased further to around 2% in summer 2019, as the prospect of monetary easing by major central banks generally suppressed long-term yields. Poland's long-term interest rate fell to around 1.8% in March 2020, as the NBP launched its government securities purchases.

The long-term interest rate spread vis-à-vis the German benchmark bond generally hovered around 280 basis points between May 2018 and May 2019, before it got gradually more compressed, due mainly to the decrease of the Polish rates. It stood around 230 basis points in March 2020.

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

In December 2019, the Commission published its ninth Alert Mechanism Report (AMR 2020) under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.6), which highlighted issues related to the net international investment position. However, since overall risks remained limited, no In-Depth Review (IDR) was warranted. External vulnerabilities remain contained, given that foreign direct investment accounts for a major part of foreign liabilities. The growth of house prices was strong, but risks of overheating are limited.

6.6.1. Developments of the balance of payments

Poland's external balance (i.e. the combined current and capital account) stayed positive in 2018-2019, mostly backed by an improvement in the services trade balance. The current account was close to balance and the capital account registered a surplus due to the inflow of EU funds. The current account position was supported by the increasingly strong performance of export of services. Although the trade in goods balance turned negative in 2018, it shifted into a surplus in 2019, partially reflecting an increase in exports of manufacturing goods. After stabilising in 2018, the primary income balance somewhat deteriorated in 2019. The secondary income balance remained

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

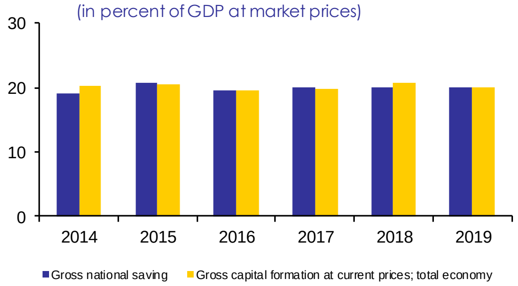
	2014	2015	2016	2017	2018	2019
Current account	-2.1	-0.6	-0.5	0.1	-1.0	0.5
of which: Balance of trade in goods	-0.8	0.5	0.7	0.3	-1.0	0.5
Balance of trade in services	2.2	2.5	3.3	3.8	4.4	4.8
Primary income balance	-3.4	-3.4	-4.2	-4.1	-4.1	-4.4
Secondary income balance	-0.1	-0.2	-0.3	0.0	-0.3	-0.3
Capital account	2.4	2.4	1.0	1.3	2.1	2.0
External balance 1)	0.4	1.8	0.5	1.3	1.1	2.5
Financial account	-1.1	0.1	0.3	-0.5	0.3	1.7
of which: Direct investment	-2.4	-2.1	-0.9	-1.4	-2.5	-1.9
Portfolio investment	0.4	0.7	-0.8	-0.9	0.7	2.1
Other investment 2)	0.7	1.4	-2.8	3.4	0.8	-0.3
Change in reserves	0.1	0.2	4.8	-1.5	1.3	1.7
Financial account without reserves	-1.2	-0.1	-4.5	1.0	-0.9	-0.1
Errors and omissions	-1.5	-1.7	-0.2	-1.8	-0.7	-0.8
Gross capital formation	20.4	20.5	19.6	19.8	20.7	19.6
Gross saving	19.0	20.7	19.6	19.9	19.8	20.0
Gross external debt	71.2	70.4	75.6	68.3	63.2	59.0
International investment position	-67.6	-60.9	-60.9	-62.3	-55.1	-50.3

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

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

negative and slightly deteriorated in 2018 and 2019.

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

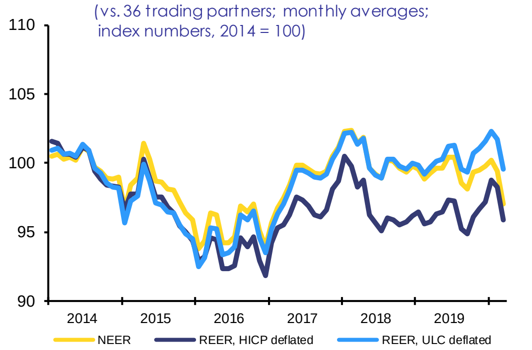


Source: Eurostat, Commission services.

Gross national saving in terms of percentage of GDP remained broadly stable in 2018 and improved slightly in 2019. In the observed period, the increase in gross savings of the corporate sector and households has offset the fall in government savings. At the same time, gross fixed capital formation (as a percent of GDP) has gradually recovered and was mainly driven by public investment spending with support of the EU funds. The private sector investment remained weak, and in relation to GDP is still below the levels observed among Poland's regional peers.

Poland's external competitiveness has remained robust. Poland's export performance (as measured by the growth of its exports relative to its foreign markets) improved in 2018 and 2019 with, however, a slowing pace. Following an appreciation in 2017, both the nominal and real effective exchange rates broadly stabilised in 2018 and 2019.

Graph 6.9: **Poland - Effective exchange rates**
(vs. 36 trading partners; monthly averages; index numbers, 2014 = 100)



Source: Commission services.

In the financial account of the balance of payments, direct investment recorded a net inflow of around 2.5% of GDP in 2018 and 2% of GDP in 2019, mainly due to reinvested earnings. Net portfolio investment outflows increased in 2018

Table 6.5:
Poland - Market integration

	2014	2015	2016	2017	2018	2019
Trade openness 1) (%)	48.5	49.5	51.7	53.7	55.0	54.3
Trade with EA in goods & services 2)+3) (%)	27.0	27.9	29.4	30.6	31.2	30.4
Export performance (% change) 4)	3.3	3.9	5.1	3.7	3.3	2.3
World Bank's Ease of Doing Business Index rankings 5)	28	25	24	27	33	40
WEF's Global Competitiveness Index rankings 6)	43	41	36	39	37	37
Internal Market Transposition Deficit 7) (%)	1.0	0.7	1.4	1.5	1.4	1.0
Real house price index 8)	97.4	100.0	102.3	104.1	109.3	116.5
Residential investment 9) (%)	3.0	2.5	2.4	2.2	1.9	1.9

1) (Imports + Exports of goods and services / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics, Balance of Payments).
2) (Imports + Exports of goods with EA-19 / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).
3) Trade in services with EA-19 (average credit and debit in % of GDP at current prices) (Balance of Payments).
4) Index for exports of goods and services divided by an index for growth of markets (percentage change on preceding year).
5) New methodology as of 2014 (World Bank).
6) (World Economic Forum)
7) Percentage of internal market directives not yet communicated as having been transposed, relative to the total.
(November data, as of 2016 date refers to the year of publication).
8) Deflated house price index (2015=100) (Eurostat).
9) Gross capital formation in residential buildings (in % of GDP) (Eurostat).

Sources: Eurostat, World Bank, World Economic Forum, Commission services.

and 2019, primarily owing to non-residents decreasing the value of their portfolio of debt securities and residents expanding their holdings of foreign bonds. Net outflows of other investment, following a noticeable increase in 2017, stabilised at around 0.8% of GDP in 2018 and ceased in 2019.

The total gross external debt has kept decreasing rapidly form around 68% of GDP in 2017 to 59% in 2019. The net international investment position (NIIP) also significantly improved from minus 62.3% of GDP in 2018 to minus 50.3% in 2019. Although this remains well beyond the indicative threshold set in the MIP scoreboard (-35% of GDP), the external vulnerabilities remain contained, as major part of the NIIP consists of the accumulated stock of foreign direct investments.

According to the Commission services' Spring 2020 Forecast, which is based on national accounts data, the external balance is expected to remain in a positive territory, with around 1.3% of GDP in 2020 and 1.7% in 2021.

6.6.2. Market integration

Poland's economy is well integrated with the euro area through both trade and investment linkages. Trade openness increased from 48.5% in 2014 to some 55% of GDP in 2019. The share of trade with euro-area partners expressed in percentage of GDP was broadly stable in recent years, reaching around 31%. Poland's main goods trading partners in 2019 were Germany, Czechia, the Netherlands and China.

FDI inflows to Poland have mainly originated from the Netherlands, Germany, Luxembourg and France, which together provided nearly two-thirds of the FDI stock at the end of 2018. The significant size and growth of the domestic market as well as good access to large regional markets have supported the attractiveness of the country for FDI.

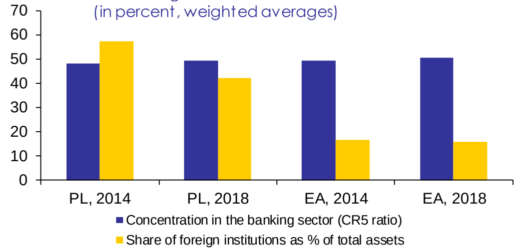
On the basis of selected indicators relating to the business environment, Poland performs around the average of euro-area Member States. In the World Bank's Ease of Doing Business index, Poland scores comparatively poorly with regard to starting a business, followed by the sub-index related to registering property. In the World Bank's Worldwide Governance Indicators, Poland performs relatively weakly in terms of "political stability and no violence" and the "rule of law". According to the latest data, Poland lags behind in the transposition of EU directives as the deficit was at 1.0%, which is above the target (0.5%) proposed by the European Commission in the Single Market Act (2011).

The 4th Anti-Money Laundering Directive imposed transposition by 26 June 2017 and from 2018 to 2020 Poland has communicated to the Commission the adoption of several transposition measures, which ensure a complete transposition of the Directive. The Commission is completing its analysis of whether the notified measures are in conformity with the Directive. As regards the 5th Anti-Money Laundering Directive, whose transposition deadline elapsed on 10 January 2020, Poland has officially notified its national transposition measures and declared a partial transposition.

Overall, the labour market appears flexible and employment protection legislation does not appear to be very strict (as also measured by the 2013 OECD employment protection indicator). However, structural challenges include a low participation of certain groups, especially women, the low-skilled, older people and persons with disabilities and their carers. A lack of labour market flexibility in some areas, such as a limited use of part-time employment arrangements, is another important challenge. Disincentives to work stemming from the benefit system and limited access to long-term care and childcare are important barriers to labour market participation. Domestic labour mobility is hampered by sector-specific arrangements, such as the special social security system for farmers, as well as underdeveloped rental housing market and the transport infrastructure, in particular in rural areas. Non-EU workers, in particular from Ukraine, play an important role in the Polish labour market.

Poland's financial sector is well integrated within the overall EU financial system. Foreign ownership in total assets of the Polish banking sector decreased from around 58% in 2014 to around 42% by 2018, in line with the government's strategy to boost domestic ownership. Concentration in the Polish banking sector has remained close to the euro-area average. The share of total assets owned by the five largest lenders amounted to 50% at end-2018.

Graph 6.10: **Poland - Foreign ownership and concentration in the banking sector**
(in percent, weighted averages)

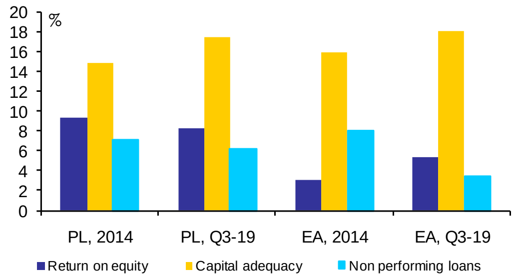


Source: ECB, Structural financial indicators.

The capital adequacy ratio of the banking sector increased to around 18% by end-September 2019, which is close to the average of the euro area. The share of non-performing loans was 6.2%, above the euro-area average NPL level. Profitability, as measured by return on equity (ROE), reached around 8% by the third quarter of 2019, which is above the average of the euro area. In the future, the profitability of the banking sector could be negatively affected by the remaining stock of foreign-currency denominated mortgage loans, following the European Court of Justice's ruling in October 2019 ([39]). The COVID-19 pandemic could also have a significant impact on the indicators analysed in this paragraph over the coming months.

Real house prices increased dynamically in 2018 and 2019 in Poland. Investment in dwellings has not reacted to rising demand and has remained modest at around 2% of GDP. Net bank lending for house purchase gathered momentum over the past two years (with growth of around 7% in December 2019), driven up by variable rate zloty mortgages.

Graph 6.11: **Poland - Selected banking sector soundness indicators**

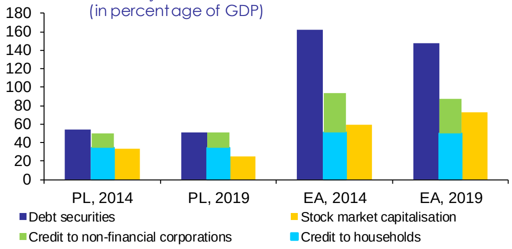


Note: Q3-19 Return on equity is calculated over the last four quarters.
Source: ECB, EC calculations.

The financial system in Poland is smaller relative to GDP than that of the euro area countries. Credit to the private economy (households and non-financial corporations) has increased to 51% of GDP in 2019 from around 50% in 2014. The share of foreign-currency denominated loans (mainly in Swiss franc and to lesser extent in euro) continued to decline, but it still amounted to about 23% of outstanding total housing loans.

([39]) Judgement in Case C-260/18, which confirmed the possibility to annul a mortgage contract in specific cases.

Graph 6.12: **Poland - Recent development of the financial system relative to the euro area**
(in percentage of GDP)



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

The total capitalisation of the Warsaw Stock Exchange reached 25% of GDP in 2019, which is rather small in comparison to the euro-area average (of around 72%). However, it is maturing and has been upgraded to the "developed market status" by index provider FTSE Russell. The debt securities market is one of most liquid in the region but remains small in comparison with the euro area (51% against 148% of GDP) and is dominated by government bonds. Consolidated private sector debt decreased from around 78% in 2014 to 76% of GDP in 2018, significantly below the euro-area average.

7. ROMANIA

7.1. FLEGAL COMPATIBILITY

7.1.1. Introduction

The Banca Naţională a României (BNR – Romanian national bank, hereafter 'BNR') is governed by Law No. 312 on the Statute of the Bank of Romania of 28 June 2004 (hereinafter 'the BNR Law') which entered into force on 30 July 2004.

The BNR law has not been amended since the Commission's 2018 Convergence Report. Therefore, the comments provided in the Commission's 2018 Convergence Report are largely repeated in this year's assessment.

7.1.2. Central Bank independence

As regards central bank independence, a number of incompatibilities and imperfections have been identified with respect to the TFEU and the ESCB/ECB Statute.

According to Article 33(10) of the BNR Law, the Minister of Public Finances and one of the State Secretaries in the Ministry of Public Finance may participate, without voting rights, in the meetings of the BNR Board. Although a dialogue between a central bank and third parties is not prohibited as such, this dialogue should be constructed in such a way that the Government should not be in a position to influence the central bank's decision-making in areas for which its independence is protected by the Treaty. The active participation of the Minister and one of the State Secretaries, even without voting right, in discussions of the BNR Board where BNR policy is set could structurally offer to the Government the possibility to influence the central bank when taking its key decisions. Against this background, Article 33(10) of the BNR Law is incompatible with Article 130 of the TFEU.

Article 3(1) of the BNR Law needs to be amended with a view to ensuring full compatibility with Article 130 of the TFEU and Article 7 of the ESCB/ECB Statute. Pursuant to Article 3(1) of the BNR Law, the members of the BNR's decision-making bodies shall not seek or take instructions from public authorities or from any other institution or authority. First, for legal certainty reasons, it should be clarified that the BNR's institutional independence is also protected vis-à-vis national, foreign and EU institutions, bodies, offices or agencies. Moreover, Article 3 should expressly oblige the government not to seek to influence the members of the BNR's decision-making bodies in the performance of their tasks.

The BNR Law should be supplemented by rules and procedures ensuring a smooth and continuous functioning of the BNR in case of the Governor's termination of office (e.g. due to expiration of the term of office, resignation or dismissal). So far, Article 33(5) of the BNR Law provides that in case the Board of BNR becomes incomplete, the vacancies shall be filled following the procedure for the appointment of the members of the Board of BNR. Article 35(5) of the BNR Law stipulates that in case the Governor is absent or incapacitated to act, the Senior Deputy Governor shall replace the Governor.

Pursuant to Article 33(9) of the BNR Law, the decision to recall a member of the BNR Board (including the Governor) from office may be appealed to the Romanian High Court of Cassation and Justice. However, Article 33(9) of the BNR Law remains silent on the right of judicial review by the Court of Justice of the European Union in the event of the Governor's dismissal provided in Article 14.2 of the ESCB/ECB Statute. This imperfection should be corrected.

Article 33(7) of the BNR Law provides that no member of the Board of BNR may be recalled from office for other reasons or following a procedure other than those provided in Article 33(6) of this Law. Law 161/2003 on certain measures for transparency in the exercise of public dignities, public functions and business relationships and for the prevention and sanctioning of corruption and the Law 176/2010 on the integrity in the exercise of public functions and dignities define the conflicts of interest incompatibilities applicable to the Governor and other members of the Board of the BNR and require them to report on their interests and wealth. For the sake of legal certainty, it is recommended to remove this imperfection and provide a clarification that the sanctions for the breach of obligations under those Laws do not constitute extra grounds for dismissal of the Governor of the

Board of BNR, in addition to those contained in Article 33 of the BNR Law.

According to Articles 21 and 23 of the Law concerning the organisation and functioning of the Court of Auditors (No 94/1992), the Court of Auditors is empowered to control the establishment, management and use of the public sector's financial resources, including BNR's financial resources, and to audit the performance in the management of the funds of the BNR. Those provisions constitute an imperfection as regards Article 27.1 of the ESCB/ECB Statutes and thus, for legal certainty reasons, it is recommended to define clearly in the Law that the scope of audit by the Court of Auditors, is without prejudice to the activities of the BNR's independent external auditors.

Article 43 of the BNR Law provides that the BNR must transfer to the State budget an 80% share of the net revenues left after deducting expenses relating to the financial year, including provisions for credit risk, and any losses relating to previous financial years that remain uncovered. Such a procedure could, in certain circumstances, be seen as an intra-year credit (see section 7.1.3.), which negatively impacts on the financial independence of the BNR. A Member State may not put its central bank in a position where it has insufficient financial resources to carry out its ESCB tasks, and also its own national tasks, such as financing its administration and own operations. Article 43(3) of the BNR Law also provides that the BNR sets up provisions for credit risk in accordance with its rules, after having consulted the Ministry of Public Finance. The central bank must be free to independently create financial provisions to safeguard the real value of its capital and assets. Article 43 of the BNR Law is incompatible with Article 130 of the TFEU and Article 7 of the ECB/ESCB Statute and should, therefore, be adapted, to ensure that the above arrangements do not undermine the ability of the BNR to carry out its tasks in an independent manner.

7.1.3. Prohibition of monetary financing and privileged access

According to Article 26 of the BNR Law, the BNR under exceptional circumstances and only on a case-by-case basis may grant loans to credit institutions which are unsecured or secured with assets other than assets eligible to collateralise the monetary or foreign exchange policy operations of the BNR. It cannot be excluded that such lending results in the provision of solvency support to a credit institution that is facing financial difficulties and thereby would breach the prohibition of monetary financing and be incompatible with Article 123 of the TFEU. Article 26 of the BNR Law should be amended to avoid such a lending operation.

Articles 6(1) and 29(1) of the BNR Law prohibit the direct purchases by the BNR in the primary market of debt instruments issued by the State, national and local public authorities, autonomous public enterprises, national corporations, national companies and other majority state-owned companies. Article 6(2) of the BNR Law extends this prohibition to the debt instruments issued by other bodies governed by public law and public undertakings of other EU Member States. Article 7(2) of the BNR Law prohibits the BNR from granting overdraft facilities or any other type of credit facility to the State, central and local public authorities, autonomous public service undertakings, national societies, national companies and other majority state owned companies. Article 7(4) of the BNR Law extends this prohibition to other bodies governed by public law and public undertakings of Member States. These provisions do not fully mirror the entities listed in Article 123 of the TFEU (amongst others, a reference to Union institutions is missing) and, therefore, have to be amended.

Pursuant to Article 7(3) of the BNR Law, majority state-owned credit institutions are exempted from the prohibition on granting overdraft facilities and any other type of credit facility under Article 7(2) of the BNR Law and benefit from loans granted by the BNR in the same way as any other credit institution eligible under the BNR's regulations. The wording of Article 7(3) of the BNR Law is incompatible with the wording of Article 123(2) of the TFEU, which only exempts publicly owned credit institutions "in the context of the supply of reserves by central banks", and should be aligned.

As noted above in point 7.1.2., Article 43 of the BNR Law provides that the BNR shall transfer to the State on a monthly basis 80% of its net revenues left after deduction of the expenses related to the financial year and the uncovered loss of the previous financial years. This provision does not rule out the possibility of an intra-year anticipated profit distribution under circumstances where the BNR would accumulate profit during the first half of a year, but suffer losses during the second half. The adjustment would be made by the State only after the closure of the financial year and would thus imply an intra-year credit to the State, which would breach the prohibition on monetary financing. This provision is, therefore, also incompatible with the Article 123 of the TFEU and has to be amended.

7.1.4. Integration in the ESCB

Objectives

Pursuant to Article 2(3) of the BNR Law, the secondary objective of the BNR is to support the State's general economic policy. Article 2(3) of the BNR Law contains an imperfection 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.

Tasks

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

- absence of a general reference to the BNR as an integral part of the ESCB (Article 1 of the BNR Law);
- 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, 21 (1) and (2), 22(3) and 33(1)(a) and (e) of the BNR Law);
- conduct of foreign exchange operations and the definition of foreign exchange policy (Articles 2(2)(a) and (d), 9 and 33(1)(a) of the BNR Law);
- holding and management of foreign reserves (Articles 2(2)(e), 9(2)(c), 30 and 31 of the BNR Law);
- right to authorise the issue of banknotes and the volume of coins (Articles 2(2)(c), 12 to 18 of the BNR Law);
- non-recognition of the role of the ECB and of the Council in regulating, monitoring and controlling foreign currency transactions (Articles 10 and 11 of the BNR Law);
- lack of reference to the role of the ECB in payment systems (Articles 2(2)(b), 22 and 33(1)(b) of the BNR Law).

There are also imperfections regarding the:

- non-recognition of the role of the ECB and the EU in the collection of statistics (Article 49 of the BNR Law);
- non-recognition of the role of the ECB and of the Council in the appointment of an external auditor (Article 36(1) of the BNR Law);
- absence of an obligation to comply with the ESCB/ECB regime for the financial reporting of NCB operations (Articles 37(3) and 40 of the BNR Law);
- non-recognition of the ECB's right to impose sanctions (Article 57 of the BNR Law).

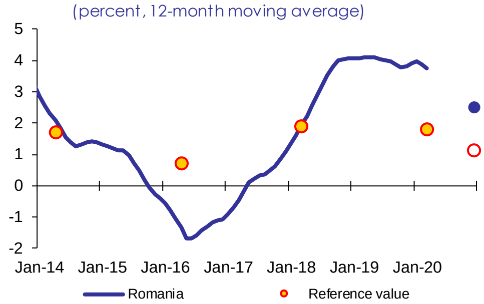
7.1.5. Assessment of compatibility

As regards the independence of the BNR, the prohibition on monetary financing and the BNR's integration into the ESCB at the time of euro adoption, the legislation in Romania, in particular the BNR Law, is not fully compatible with the compliance duty under Article 131 of the TFEU. The Romanian authorities are invited to remedy the above mentioned incompatibilities.

7.2. PRICE STABILITY

7.2.1. Respect of the reference value

Graph 7.1: **Romania - Inflation criterion**
(percent, 12-month moving average)



Note: The dots in December 2020 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2020 Forecast.

The 12-month average inflation rate, which is used for the convergence assessment, was above the reference value at the time of the last convergence assessment of Romania in 2018. It increased steadily since then to 4.1% in December 2018 and remained close to 4% throughout 2019. In March 2020, the reference value was 1.8%, calculated as the average of the 12-month average inflation rates in Portugal, Cyprus and Italy plus 1.5 percentage

Table 7.1:
Romania - Components of inflation

	2014	2015	2016	2017	2018	2019	Mar-20	weights in total 2020
	(percentage change)[1]							
HICP	1.4	-0.4	-1.1	1.1	4.1	3.9	3.7	1000
Non-energy industrial goods	1.6	1.0	-0.7	0.9	1.7	2.4	2.4	288
Energy	2.3	-2.7	-4.4	0.4	12.2	2.7	1.3	109
Unprocessed food	-0.7	-3.4	-2.5	3.9	5.3	6.2	5.8	117
Processed food	0.2	-1.6	-0.9	2.2	3.7	5.5	5.4	246
Services	3.1	2.2	0.7	-0.5	2.7	3.6	3.8	241
HICP excl. energy and unproc. food	1.7	0.7	-0.2	0.9	2.7	3.8	3.8	775
HICP at constant tax rates	1.1	1.2	2.1	2.0	3.8	3.7	3.7	1000
Administered prices HICP	2.0	1.6	-2.5	0.5	4.2	2.6	2.2	114

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

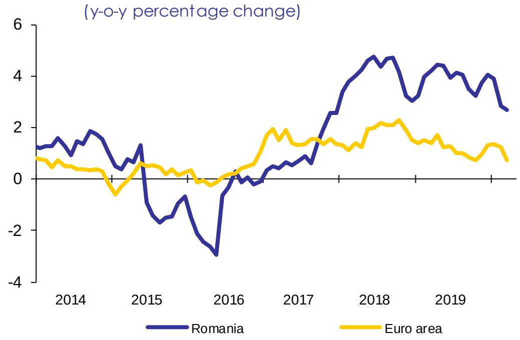
Sources: Eurostat, Commission services.

points. The corresponding inflation rate in Romania was 3.7%, which was 1.9 percentage points above the reference value. The 12-month average inflation rate is projected to remain well above the reference value in the months ahead.

7.2.2. Recent inflation developments

After peaking in June 2018, annual HICP inflation in Romania slowed down in 2019. The annual average rate of inflation increased strongly to 4.1% in 2018 as the effect of past VAT cuts faded away, global oil prices picked up and the January 2017 cut in excise duties was reversed. In 2019, headline inflation decelerated somewhat mainly due to declining energy prices. Overall, annual HICP inflation was 3.9% in 2019. Over the past two years, annual HICP inflation in Romania was higher than in the euro area by around 2.5 percentage points on average. Inflation declined in early 2020, reaching 2.7% in March. Core inflation (measured as HICP inflation excluding energy and unprocessed food) accelerated from 1.9% in January to 2.9% in December 2018. Its average of 2.7% in 2018 was lower than headline inflation (4.1%) as energy prices increased significantly that year (12.2 %). In 2019, core inflation accelerated further, averaging 3.8% for the year as a whole. Although declining, robust wage growth in 2019 put upward pressure on core inflation, while the evolution of pork meat prices further enhanced this trend.

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



Source: Eurostat.

Both processed and unprocessed food price inflation continued to increase in 2018, despite a four-percentage point VAT rate cut for food products adopted in mid-2018. In 2019, processed food price inflation also increased due to the effects of the African swine flu epidemic, which lowered pork meat supply. Similarly, non-energy industrial goods price inflation increased from 1.7% in 2018 to 2.4% in 2019. Services price inflation increased from 2.7% in 2018 to 3.6% in 2019. The introduction of a 3% turnover tax for telecom companies at the end of 2018 resulted in higher prices for telephony and television services in 2019.

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

	2014	2015	2016	2017	2018	2019	2020 1)	2021 1)
HICP inflation								
Romania	1.4	-0.4	-1.1	1.1	4.1	3.9	2.5	3.1
Euro area	0.4	0.2	0.2	1.5	1.8	1.2	0.2	1.1
Private consumption deflator								
Romania	1.1	1.0	0.7	2.7	4.2	5.2	2.0	2.0
Euro area	0.5	0.3	0.4	1.3	1.4	1.2	0.3	1.2
Nominal compensation per employee								
Romania	6.9	1.9	15.0	14.8	13.4	8.9	2.6	4.8
Euro area	1.4	1.3	1.2	1.7	2.2	2.1	1.1	0.4
Labour productivity								
Romania	2.6	5.2	6.0	4.6	4.2	4.1	-3.6	3.5
Euro area	0.8	1.0	0.5	1.0	0.4	0.1	-3.2	2.4
Nominal unit labour costs								
Romania	4.2	-3.1	8.5	9.8	8.8	4.5	6.4	1.3
Euro area	0.6	0.5	0.7	0.7	1.8	2.1	4.3	-1.9
Imports of goods deflator								
Romania	-1.9	-1.3	-7.3	5.3	4.5	2.1	-1.5	1.0
Euro area	-2.4	-3.3	-3.3	3.4	2.7	-0.6	-3.6	1.1

1) Commission services' Spring 2020 Forecast.

Source: Eurostat, Commission services.

7.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and cyclical stance

Economic growth was strong over the past two years. Romania's economy expanded by 4.4% in 2018 and 4.1% in 2019, with private consumption, supported by significant increases in public and private wages, as the main growth driver. Investment was rather volatile in recent years. It fell in 2018 and rebounded strongly in 2019 driven mainly by construction and by increased spending on local public investment projects. The private consumption boom also fuelled import growth. As a consequence, despite relatively strong export performance, net exports worked as a drag on real GDP growth. The growing trade deficit worsened the current account deficit. According to the Commission services' Spring 2020 Forecast, real GDP growth is expected to drop by 6% this year, due to the impact of the COVID-19 crisis, and to partially recover next year (+4.2%). With the exception of government expenditure, which is set to continue increasing this year reflecting the fiscal effort requested to fight the pandemic, all GDP components are projected to decline substantially. Private consumption is expected to decline in 2020 but pick up again in 2021, as consumer spending reflects the gradual exit from lockdown measures. Investment, on the other hand, is projected to record a double-digit dip in 2020 and recover only to a limited extent next year, due to confidence effects. As imports are set to contract more sharply than exports, the trade balance deficit as well as the current account deficits are expected to improve in 2020. However, this positive evolution is projected to start reversing next year as the revival of consumption is expected to give a new impetus to imports. The output gap was positive but declined further in 2018 and 2019. It is projected to turn negative in 2020 and remain negative over the forecast horizon, albeit less so in 2021.

Following the sharply expansionary fiscal stance, as measured by the change in the structural balance, in 2017, the stance remained broadly stable in 2018 and was loosened further in 2019 due to high expenditure growth. According to the Commission services' Spring 2020 Forecast, which is based on a no-policy change assumption, the structural deficit is projected to increase further in 2020 and 2021, implying an expansionary fiscal policy stance.

The BNR, operating within an inflation targeting framework ([40]), increased the key policy rate in

([40]) As from 2013, the BNR follows a flat multi-annual inflation target of 2.5% (± 1 percentage point).

January, February and May 2018 by a total of 75 basis points to 2.5%, these being the first policy rate hikes in almost a decade. As part of the measures announced in March 2020 in response to the COVID-19 crisis, the BNR reduced the key policy rate by 50 basis points to 2.0%. It also announced purchases of government bonds in the secondary market to consolidate the structural liquidity in the banking system, thereby supporting favourable financing conditions for the Romanian economy. The reserve requirement ratio for foreign currency denominated liabilities, which had remained unchanged at 8% since May 2017, was reduced to 6% in February 2020. The reserve requirement ratio for leu denominated liabilities has been kept unchanged at 8% since May 2015. Credit to the economy continued to expand in 2018 (6.5%) and 2019 (7.4%), supported primarily by double-digit growth in mortgage lending. Lending to non-financial corporations accelerated in 2019 (7%) and in the first 3 months of 2020 (5.4%)]. Consumer credit growth hovered around 5% in both 2018 and 2019 and declined to 4.4% in the first quarter of 2020.

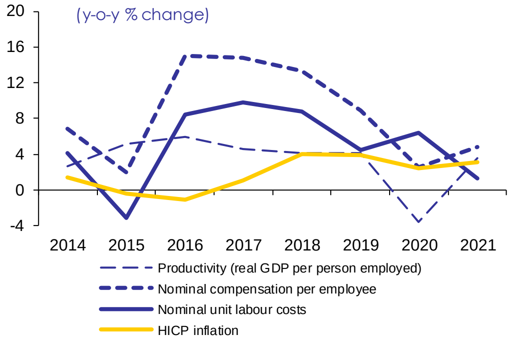
Wages and labour costs

Labour market conditions continued to improve throughout 2018 and 2019 in line with the robust economic growth. Activity and employment rates increased, while the unemployment rate continued to decrease from 4.2% in 2018 to 3.9% in 2019, the lowest level in more than 20 years. However, unemployment rate is projected to increase significantly in 2020 to 6.5%, in the context of the COVID-19 pandemic, also supported by the return of workers from abroad. Undeclared work remains a challenge and its negative impact is expected to be exacerbated in the current context, underlining the need to support the transition into declared work.

The very tight labour market, coupled with a declining labour force due to a shrinking working age population, and persistent skills shortages have led to an acceleration of wage growth in recent years. Nominal compensation per employee increased by 13.4% in 2018 and approximately 9% in 2019. This dynamic was also driven by significant public-sector wage increases while the minimum wage was repeatedly increased in January 2018 (31%), January 2019 (9.5%) and January 2020 (7.2%). The growth of compensation per employee is expected to slow down significantly in 2020, in the aftermath of the crisis, and recover somewhat in 2021.

Labour productivity per person grew by 4.2% in 2018 and 3.8% in 2019. In 2020 labour productivity is forecast to decline, reflecting the severe economic downturn and the efforts to support labour hording, and resume growth the following year by around 3%. The growth of labour compensation outpaced that of productivity in 2018 and 2019, resulting in significant increases in nominal unit labour costs by 8.9% in 2018 and 4.9% in 2019. According to the Commission services' Spring 2020 Forecast, ULC growth is expected to accelerate in 2020 and moderate in 2021, while remaining among the highest in the EU.

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



Source: Eurostat, Commission services' Spring 2020 Forecast.

External factors

Due to the openness of the Romanian economy and its deep integration into the global and the EU economy, developments in import prices play a significant role in domestic price formation. In particular, energy and food prices have been a significant determinant of price inflation in Romania, given the large weight of these categories in the Romanian HICP and the fact that Romania is a net importer of both energy and food. Import price inflation (measured by the imports of goods deflator) significantly exceeded consumer price inflation in 2018, partly due to the increasing price of fuel commodities. In 2019 import price inflation was below consumer price inflation reflecting the moderation of fuel commodities prices.

The leu's nominal effective exchange rate (measured against a group of 36 trading partners) remained broadly stable in 2018 and depreciated on average by 2% in 2019. Despite the changes in the nominal effective exchange rate suggesting inflationary pressures, the fluctuations of the leu appears to have weighed moderately on import price dynamics in recent years. Looking ahead,

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

Outturn and forecast [1]	2014	2015	2016	2017	2018	2019	2020	2021
General government balance	-1.2	-0.6	-2.6	-2.6	-2.9	-4.3	-9.2	-11.4
- Total revenues	34.1	35.5	31.9	30.8	31.9	31.7	32.3	32.2
- Total expenditure	35.3	36.1	34.5	33.5	34.8	36.0	41.5	43.5
of which:								
- Interest expenditure	1.7	1.6	1.5	1.3	1.1	1.2	1.5	1.7
p.m.: Tax burden	27.5	28.0	26.5	25.8	26.9	26.8	26.5	26.7
Primary balance	0.5	1.0	-1.1	-1.4	-1.8	-3.1	-7.8	-9.6
Cyclically-adjusted balance [2]	-0.8	-0.1	-2.3	-3.0	-3.3	-4.4	-6.7	-9.2
One-off and temporary measures [3]	0.0	0.3	-0.4	0.0	-0.3	-0.1	0.0	0.0
Structural balance [2)4)]	-0.8	-0.4	-1.9	-3.0	-2.9	-4.3	-6.7	-9.2
Government gross debt	39.2	37.8	37.3	35.1	34.7	35.2	46.2	54.7
p.m: Real GDP growth (%)	3.4	3.9	4.8	7.1	4.4	4.1	-6.0	4.2
p.m: Output gap [2]	-1.4	-1.5	-1.1	1.3	1.0	0.5	-8.0	-6.6

1) Commission services' Spring 2020 Forecast.
2) Due to the COVID-19 pandemic, these estimates are surrounded by an unusually high level of uncertainty.
3) COVID-19-related measures were not classified as one-offs in the Commission services' Spring 2020 Forecast, due to the activation of the general escape clause of the SGP.
4) Cyclically-adjusted balance excluding one-off and other temporary measures.
Source: Commission services.

imported inflation is expected to remain subdued in line with muted global commodity and industrial prices.

Administered prices and taxes

Administered prices the Romanian HICP basket (11.4%) is somewhat below the euro area average. The average annual change in administered prices was 4.2% in 2018, very close to the headline inflation rate. However, in 2019 administered prices increased by 2.7%, which was 1.2 percentage points below headline inflation, mainly reflecting the capping of the domestically produced natural gas sold to households to RON 68/Mwh and the introduction of regulated prices for electricity at the end of 2018. Following legislative changes adopted at the beginning of 2020, the liberalisation of gas and electricity prices for households should be resumed as of 1 July 2020 and 1 January 2021, respectively. However, uncertainties persist about the form in which the related government emergency ordinance 1/2020, which is currently under debate in Parliament, and will eventually be transformed into law. Following a significant increase in both gas and electricity prices in 2018, in 2019 electricity prices remained stable while gas prices increased somewhat, but less than most other administrated prices.

Tax changes had a less pronounced influence on inflation in Romania in the last two years compared with previous years. HICP inflation measured at constant taxes was 3.8% in 2018, which was 0.3 percentage points lower than the headline HICP inflation rate. In 2019, HICP inflation measured at constant taxes was 3.7%, only 0.2 percentage points below the headline inflation rate.

Medium-term prospects

According to the Commission services' Spring 2020 Forecast, annual HICP inflation is projected to decline to 2.5% in 2020 and 3.1% in 2021. The significant decline expected in 2020 is mainly due to the drop in the international oil prices. Services inflation is projected to decline, reflecting the reduce demand pressure during the COVID-19 crisis. Processed and unprocessed food price inflation is also expected to ease over the forecast horizon.

Risks to the inflation outlook are broadly balanced and stem mainly from the evolution of global food and energy prices Other aspects, such as a persistent high unemployment rate, a prolonged decline in demand for certain services, the evolution of fiscal policy in the aftermath of the pandemic (i.e. the introduction of new taxes or the increase of existing taxes) also contribute to the uncertainty of the inflation forecast.

In 2018, the level of consumer prices in Romania was about 51% of the euro area average and the GDP per capita was more than 60% of the euro area average in PPS terms. In line with the catching-up of the Romanian economy, further price level convergence is expected.

7.3. PUBLIC FINANCES

7.3.1. Recent fiscal developments

The general government deficit increased from 2.9% in 2018 to 4.3% in 2019. The 2019 general government deficit was significantly higher than the 2.8% of GDP target set by the government in the 2019 Convergence Programme. The deficit increase was driven by current expenditures (on public wages, goods and services and social benefits) and by a rebound of public investment from the historically low levels of the previous years. The structural deficit increased from around 3% of potential GDP in 2018 to around 4.3% in 2019. The public-debt-to-GDP ratio amounted to 34.7% in 2018 and 35.2% in 2019.

7.3.2. Medium-term prospects

Since 2016, Romania has been increasingly diverging from its Medium-Term budgetary Objective required by the Council in Regulation 1466/97, despite high economic growth. As a consequence, since spring 2017 the Council has issued bi-annual recommendations under the Significant Deviation Procedure, to which Romania has not responded with effective action. Moreover, as a consequence of the breach in 2019 of the 3% of GDP reference value of the Treaty, on 4 April 2020 the Council opened an Excessive Deficit Procedure for Romania.

The 2020 budget, amended on 17 April 2020, targets a general government deficit of 6.7% of GDP in 2020. The government increased the 2020 deficit target from the originally planned 3.6% of GDP to account for the fiscal and macroeconomic effects of the COVID-19 crisis. The amended budget includes around 1.3 pps of GDP of additional COVID-19 related spending, out of which 0.4 pps of GDP financed by EU transfers. This additional spending mainly concerns allocations for a technical unemployment benefit to employees and similar benefits to other categories of workers, medical equipment and other expenditures to help fight COVID-19 and bonuses for employees in the health sector working with patients infected with COVID-19. The budget amendment maintained a significant increase of spending on old-age pensions driven by the full year effect of the 15% pensions' increase of September 2019 and a further 40% pensions' increase scheduled for September 2020.

The Commission services' Spring 2020 Forecast which is based on a no-policy change assumption, projects a general government deficit of around 9.2% of GDP in 2020. The difference from the government's target stems, in particular, from a difference in the underlying macroeconomic projections and a moderation of some current spending items in the 2020 budget, which is not fully supported by enacted measures. The Commission projects the general government deficit to further increase to around 11.4% of GDP in 2021, despite the phasing out of pandemic-relief related expenditures. This is due to the full-year effect of the 40% increase in pensions in September 2020, an additional upward pension recalculation scheduled for September 2021, and the doubling of child allowance payments.

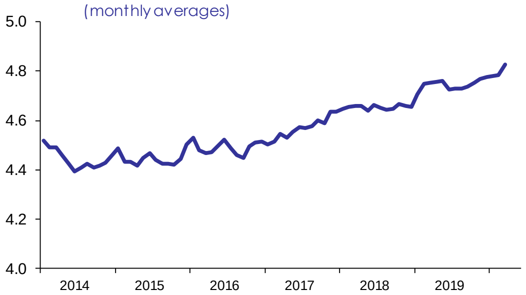
The structural fiscal deficit is projected by the Commission to significantly increase in 2020 and 2021, respectively. The public-debt-to-GDP ratio is forecast by the Commission to increase to 46.2% in 2020 and 54.7%in 2021.

The implementation track record of the Romanian fiscal framework has been generally weak and has not improved since the last report, despite having the appropriate legislative setting (it should be recalled that Romania is bound by the Fiscal Compact provisions of the TSCG and has transposed those requirements in the national legal order). The annual budget laws and their intra-annual revisions have repeatedly been in contradiction with various domestic fiscal rules (structural balance rule, ceilings for the nominal and primary balances, personnel expenditure and total government expenditure excluding EU funds), as also flagged in the opinions of the Romanian Fiscal Council. Moreover, because of significant delays in its publication, the medium-term budgetary strategy has not guided the annual budgetary process.

7.4. 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 ([41]). De facto, the exchange rate regime moved gradually from a strongly managed float – including through the use of administrative measures until 1997 – to a more flexible one. In 2005, Romania shifted to a direct inflation targeting framework combined with a floating exchange rate regime. The BNR has, nonetheless, stressed that currency intervention remains available as a policy instrument.

Graph 7.4: **Romania - RON/EUR exchange rate**
(monthly averages)

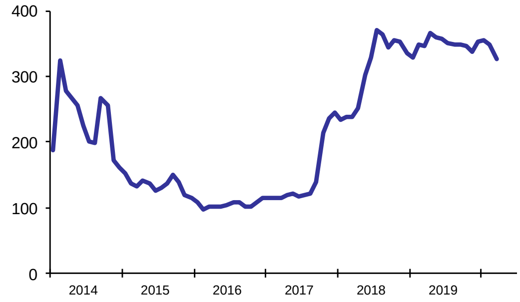


Source: ECB.

The leu continued to depreciate steadily against the euro over the past two years. After remaining broadly stable at around 4.5 RON/EUR between 2014 and 2016, the leu experienced a gradual depreciation against the euro since 2017. Between early 2018 and late 2019, the leu weakened against the euro by around 3%. Over this period, the volatility of leu's inter-day exchange rate was moderate compared to that of other floating currencies in Member States with a derogation. In March 2020, the leu's exchange rate against the euro averaged around 4.8.

The gross international reserves held by the BNR declined throughout most of 2018, to a low of around EUR 35bn in the third quarter of 2018. The reserves increased to close to EUR 37.5bn at the end of 2019, equivalent to 18% of GDP, and stood at EUR 39bn in the first quarter of 2020. Over this period, movements in the level of international reserves were influenced by sovereign debt management decisions, such as euro-denominated government bond issuances amounting to EUR 2bn in both February 2018 and in July 2019 and EUR 3bn in January 2020. Over the same period, Romania also repaid its last instalments of the 2009 financial assistance loans provided by the EU and the IMF, notably in April 2018 (EUR 1bn), October 2018 (EUR 0.15bn) and May 2019 (EUR 1bn).

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



Source: National Bank of Romania.

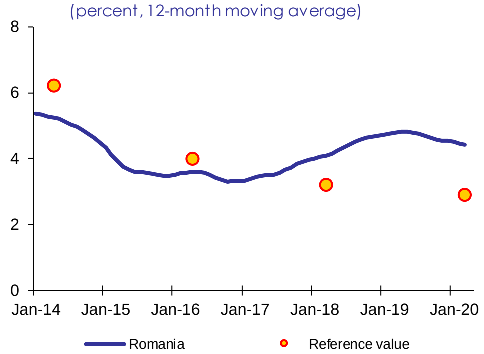
Short-term interest rate spreads vis-à-vis the euro increased by around 130 basis points between January and July 2018, in part reflecting three policy rate hikes by around 10 basis points each in January, February and May 2018. Following these increases, the BNR kept its key policy rate unchanged at 2.5%. The three-month interest rate spread relative to the euro stood at around 325 basis points in March 2020 compared to its peak of 370 basis points in July 2018.

7.5. LONG-TERM INTEREST RATES

The long-term interest rates in Romania used for the purpose of the convergence examination reflect secondary market yields on a single government benchmark bond with a residual maturity of around 9 years.

([41]) 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.

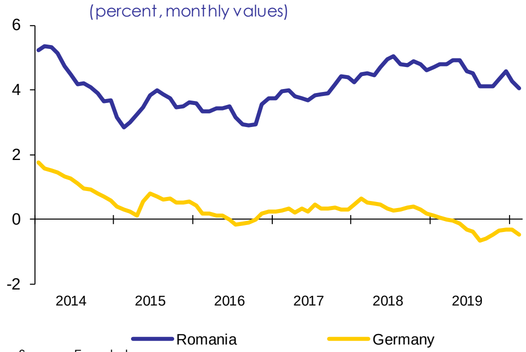
Graph 7.6: **Romania - Long-term interest rate criterion**
(percent, 12-month moving average)



Source: Commission services.

The Romanian 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 of Romania in 2018. Since then, it increased further to around 4.8% in May 2019 and decreased throughout the rest of 2019. In March 2020, the reference value, given by the average of long-term interest rates in Portugal, Cyprus and Italy plus 2 percentage points, stood at 2.9%. In that month, the 12-month moving average of the yield on the Romanian benchmark bond was at 4.4%, i.e. 1.5 percentage points above the reference value.

Graph 7.7: **Romania - Long-term interest ratescent**
(percent, monthly values)



Source: Eurostat.

Long-term interest rates increased gradually from around 4.5% in April 2018 to 5.1% in July 2018. After remaining stable at around 4.8% on average between August 2018 and May 2019, long-term interest rates started to decline and reached 4.3% in November 2019. The latter reflected the monetary policy loosening measures by major central banks, which suppressed long-term yields. Long-term interest rates increased to 4.6% in March 2020 and the long-term spread versus the German benchmark bond peaked at around 510 basis points in that month ([42]).

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

In December 2019, the Commission published its ninth Alert Mechanism Report (AMR 2020) under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.6), which concluded that an In-Depth Review (IDR) was warranted for Romania. In February 2020, the Commission published its annual country report on Romania, including an In-Depth Review (IDR). This report confirmed the macroeconomic imbalances identified in the previous year. Romania continues to experience strong growth of unit labour costs and a deteriorating external position, while frequent and unpredictable legislative changes affect the business environment.

The current account balance continued to deteriorate in 2019 due to a strong fiscal-led private consumption boom, which fuelled import growth. The strong GDP growth allowed for an improvement of the negative net international investment position despite the unfavourable evolution of the current account. Reflecting catching-up dynamics, most of the net international investment position related to net foreign direct investment liabilities, which mitigated external risks. The IDR analysis also cautioned against a reversal of the favourable evolution of the net international investment position due to persistent current account deficits and projected lower GDP growth. Cost competitiveness had deteriorated on the back of strong wage growth, in particular successive minimum wage and public sector wage increases, in excess of productivity.

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

7.6.1. Developments of the balance of payments

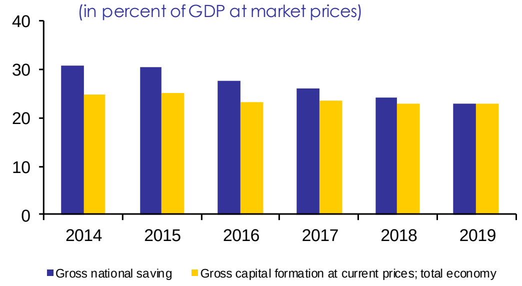
Romania's external balance (i.e. the combined current and capital account) deteriorated further from -1.6% of GDP in 2017 to -3.2% of GDP in 2018 and -3.3% of GDP in 2019. While the capital account remained in surplus, the deterioration of the external position was driven by the worsening of the current account deficit, which increased from -4.4% of GDP in 2018 to -4.6% of GDP in 2019.

Despite continued growth in export market shares in 2018 and 2019, the growth of imports spurred by booming private consumption has persistently outpaced that of exports. As a result, the balance of trade in goods deteriorated markedly, particularly in 2018 and 2019 when it exceeded -7% of GDP. The balance of trade in services, driven mainly by exports of transportation and IT services, remained positive but declined below 4% of GDP in 2019 and could not offset the negative and widening deficit in the trade in goods.

The balance of primary income remained negative, albeit slightly less so in 2019, reflecting mainly the outflow of investment income linked to the country's negative net international investment position. The balance of secondary income, which consists mainly of remittances, continues to be positive, and slightly more so in 2019, but was outweighed by the negative balance of primary income. The capital account surplus stood at 1.2% of GDP in 2018 (unchanged compared to 2017), reflecting the slow uptake of projects financed by EU funds under the 2014-2020 programming period. However, in 2019 the capital account surplus increased slightly to 1.3% of GDP.

Graph 7.8: **Romania - Saving and investment**

(in percent of GDP at market prices)



Source: Eurostat, Commission services.

Current account developments in Romania also reflect the evolution of the savings-investment balance. Romania's saving-investment balance continued to deteriorate in 2018-19. Gross national saving as a share of GDP fell below 25% in both years, mainly due to a decline in gross public savings. Investment as a share of GDP stabilized around 23% in 2018-2019.

Net FDI inflows declined slightly in 2018 and 2019 to 2.4% of GDP. Net portfolio inflows declined gradually from 1.4% of GDP in 2018 to 1.1% of GDP in 2019. Other investment continued to record net outflows in 2018 and 2019. Despite a widening of the current account deficit, Romania's net international investment position as a share of GDP continued to improve on the back of high nominal GDP growth rates. It slightly increased from -43.7% of GDP in 2018 to -43.4% in 2019. Gross external debt continued to decline and remained below 50% of GDP in 2018 and 2019.

According to the Commission services' Spring 2020 Forecast, the external balance is expected to improve in 2020, mainly due to a narrowing of the trade deficit as a result of imports contracting sharper than exports as private consumption and investment drop during the lockdown period. The current account deficit is expected to decline to 3.3% in 2020 but start increasing again in 2021 when it is projected to reach 3.4%. The capital account surplus, is expected to improve, reflecting a higher absorption of EU funds.

Between 2009 and 2011, Romania benefitted from EU balance-of-payments assistance programme and an IMF stand-by arrangement. The EU-IMF programme was followed by two successor programmes (2011-2013 and 2013-2015), which were treated as precautionary and no drawings were made. Post-programme surveillance ended in April 2018, when 70% of the financial assistance from the European Union was repaid. In October 2018 and May 2019, Romania paid the outstanding amount (EUR 1.15 bn) of the EUR 5 bn loan under the first assistance programme.

Romania’s external cost competitiveness, as measured by ULC-deflated real effective exchange rate (REER), continued to deteriorate in 2018-2019, driven by robust wage growth. On the other hand, the HICP-based REER indicates broadly stable external price competitiveness, as the depreciation of the NEER largely compensated for Romania’s higher inflation relative to its trading partners.

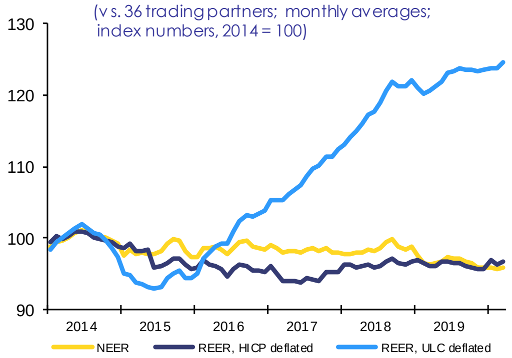
Table 7.4:
Romania - Balance of payments **(percentage of GDP)**

	2014	2015	2016	2017	2018	2019
Current account	-0.2	-0.6	-1.4	-2.8	-4.4	-4.6
of which: Balance of trade in goods	-4.3	-4.9	-5.5	-6.5	-7.2	-7.8
Balance of trade in services	4.0	4.3	4.6	4.4	4.1	3.9
Primary income balance	-0.5	-1.1	-1.3	-1.4	-1.8	-1.4
Secondary income balance	0.6	1.1	0.8	0.8	0.6	0.7
Capital account	2.6	2.4	2.5	1.2	1.2	1.3
External balance [1]	2.5	1.8	1.1	-1.6	-3.2	-3.3
Financial account	2.0	1.4	1.6	-1.7	-2.5	-2.4
of which: Direct investment	-1.8	-1.8	-2.6	-2.6	-2.4	-2.4
Portfolio investment	-1.9	0.0	-0.6	-1.6	-1.4	-1.1
Other investment [2]	6.6	3.6	3.4	2.3	1.7	1.2
Of which International financial assistance	3.0	1.8	0.1	0.6	0.1	0.4
Change in reserves	-0.9	-0.4	1.3	0.2	-0.4	-0.1
Financial account without reserves	7.7	5.4	3.0	1.3	0.4	0.5
Errors and omissions	-0.5	-0.5	0.4	-0.1	0.6	0.9
Gross capital formation	24.7	25.1	23.3	23.4	22.8	22.9
Gross saving	24.2	24.0	21.3	20.1	17.7	18.4
Gross external debt	64.6	59.1	55.4	52.0	48.8	47.4
International investment position	-56.5	-53.7	-48.6	-46.6	-43.6	-42.8

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

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

Graph 7.9: **Romania - Effective exchange rates**
(vs. 36 trading partners; monthly averages; index numbers, 2014 = 100)



Source: Commission services.

Although less dynamic than in 2016, export performance has remained robust in 2018-19 despite growing unit labour costs. Export market shares increased by 4% in 2018. This could be explained by the fact that the largest wage increases took place in sectors not exposed to international competition (such as public administration), while wages in the tradable sectors had a less dynamic evolution. Another potential explanation is the fact that the large exporters are usually multinational companies, able to accommodate certain wage increases without a significant pass-through to prices.

7.6.2. Market integration

Romania's economy is well integrated with the euro area through both trade, including through participation in supply chains, and investment. The trade openness of Romania has increased in the aftermath of the crisis, but is still relatively low. Trade openness in 2018 stood at 46.5% of GDP and declined in 2019 to around 45% of GDP. In 2019, Romania's main trading partners within the euro area were Germany, Italy and France, while outside the euro area it mainly traded with Hungary, the United Kingdom, and Bulgaria. After increasing steadily for several years and reaching 26.3% of GDP in 2018, trade with the euro area declined slightly to 25% of GDP in 2019.

Romania attracted substantial amounts of FDI in the past decade. However, FDI inflows have been volatile in recent years. Net FDI inflows increased by about 18.6% in 2018 and declined slightly by 0.8% in 2019. The inward FDI stock reached 39.2% of GDP in 2018 and 40% in 2019. FDI inflows originated mainly from euro-area Member States, with the Netherlands, Germany and Austria accounting for about half of the FDI stock at the end of 2018.

The persistent regulatory unpredictability has been one of the main factors negatively affecting the

Table 7.5:
Romania - Market integration

	2014	2015	2016	2017	2018	2019
Trade openness [1] (%)	45.3	45.2	45.3	46.4	46.5	44.9
Trade with EA in goods & services [2)+3)] (%)	24.7	25.3	25.6	26.2	26.3	25.0
Export performance (% change) [4]	3.9	0.4	12.3	1.7	2.7	2.4
World Bank's Ease of Doing Business Index rankings [5]	37	35	36	45	52	55
WEF's Global Competitiveness Index rankings [6]	59	53	62	68	52	51
Internal Market Transposition Deficit [7] (%)	1.1	1.0	1.1	2.0	1.5	1.1
Real house price index [8]	98.2	100.0	105.2	108.6	110.0	108.1
Residential investment [9] (%)	2.4	2.4	2.6	2.7	2.0	n.a.

1) (Imports + Exports of goods and services / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics, Balance of Payments).
2) (Imports + Exports of goods with EA-19 / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).
3) Trade in services with EA-19 (average credit and debit in % of GDP at current prices) (Balance of Payments).
4) Index for exports of goods and services divided by an index for growth of markets (percentage change on preceding year).
5) New methodology as of 2014 (World Bank).
6) (World Economic Forum)
7) Percentage of internal market directives not yet communicated as having been transposed, relative to the total.
(November data, as of 2016 date refers to the year of publication).
8) Deflated house price index (2015=100) (Eurostat).
9) Gross capital formation in residential buildings (in % of GDP) (Eurostat).

Sources: Eurostat, World Bank, World Economic Forum, Commission services.

business environment in recent years. Frequent changes in legislation, often adopted without stakeholder consultation or adequate impact assessment hurt investment and production decisions. One example in this respect is the government emergency ordinance (GEO) 114 adopted in December 2018, which introduced a set of far-reaching measures affecting the functioning of the banking sector, the second pension pillar, and energy and telecommunication companies. Although it was subsequently amended and the most problematic provisions were eliminated, the perception of an unpredictable regulatory environment prevails.

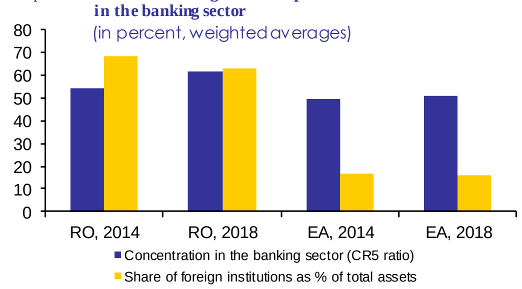
Romania’s performance in international rankings of competitiveness and ease of doing business is relatively weak compared to many euro-area Member States. In the WEF's Global Competitiveness Index, Romania's position is still low although slightly improving (from 68 in 2017 to 51 in 2019 out of 141), with weakness in areas such as institutions, the quality of infrastructure and innovative capability. According to the World Bank's Ease of Doing Business indicator, Romania’s ranking continued to deteriorate. Moreover, Romania continues to score relatively poorly also in the World Bank's Worldwide Governance Indicators in terms of public administration performance, control of corruption, ‘voice and accountability’, political stability, regulatory quality and rule of law. According to the 2019 Single Market Scoreboard, Romania's transposition deficit of EU Directives was at 1.1%. While it is still above the EU average (0.7%) and the target (0.5%) proposed by the European Commission in the Single Market Act (2011), it represents nevertheless an improvement compared to previous years (2% in 2017 and 1.5% in 2018).

The 4th Anti-Money Laundering Directive imposed transposition by 26 June 2017. After being referred before the Court of Justice for not having notified any transposition measures on July 2018 (Case C-2018/549), Romania has communicated to the Commission the adoption of transposition measures, which ensure a complete transposition of the Directive, without prejudice to its conformity assessment.

As regards the 5th Anti-Money Laundering Directive, whose transposition deadline elapsed on 10 January 2020, Romania has not yet officially notified any national transposition measures, which has led to a letter of formal notice from the Commission in February 2020. Transposition measures are expected to be adopted in May-June 2020.

The Romanian labour market suffers from significant structural challenges. Unfavourable demographic trends are expected to continue for the foreseeable future. Population aging, limited internal labour mobility and continued emigration represent a significant drag on potential economic growth. Despite improvements observed in recent years, the employment and activity rates remain below EU averages. Skills shortages and mismatches also have an adverse impact on employment. Undeclared work continues to distort the labour market. Although the most recent minimum wage increase in January 2020 was based on a number of economic indicators and followed discussions with trade unions and employers' organizations, the majority of such decisions in recent years were taken without consultation with the social partners. The functioning of social dialogue remains weak and social partners' involvement in policymaking continues to be very limited.

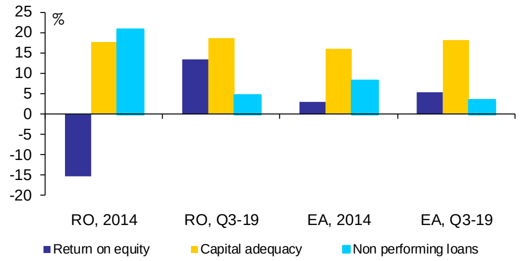
Graph 7.10: **Romania - Foreign ownership and concentration in the banking sector**
(in percent, weighted averages)



Source: ECB, Structural financial indicators.

The Romanian financial sector continues to be highly integrated into the EU financial sector, in particular through the strong presence of foreign banks, insurance companies and private pension funds in Romania. Foreign-owned banks, the majority of which are subsidiaries of parent banks based in the euro area, had a share of assets in the total held by the Romanian banking sector of 63% in 2018, well above the euro area average of nearly 16%. Concentration in the banking sector, as measured by the market share of the largest five credit institutions, increased to 62% in 2018 and remained above the euro area average.

Graph 7.11: **Romania - Selected banking sector soundness indicators**

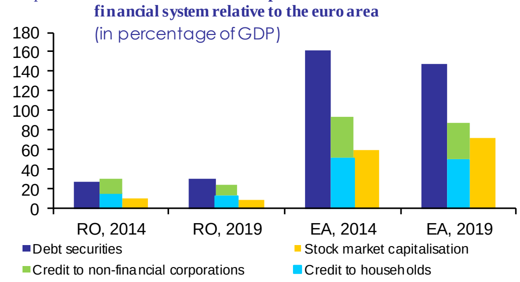


Note: Q3-19 Return on equity is calculated over the last four quarters.
Source: ECB, EC calculations, NBR.

The Romanian banking sector has remained resilient and well capitalised, with a capital adequacy ratio for the banking system of 18.7% at the end of September 2019, well above the euro area average. After posting substantial losses in 2014 mainly due to sizeable loan-loss provisions on impaired assets, the banking system returned to profitability in 2015 and remained profitable during 2016-2019. The return on equity for the banking sector was 13.4% in Q3 2019, well above the euro area average of 5.3%. The decline in the stock of non-performing loans in recent years and the low inflow of new non-performing loans coupled with the increase in loan volumes supported the banking sector's profitability. The ratio of non-performing loans (90 days overdue) stood at 4.6% in September 2019, which was slightly above the euro area average. The COVID-19 pandemic could have a significant impact on the indicators analysed in this paragraph over the coming months.

House prices continued to grow in 2018 and declined in2019. However, the growth rate of real house prices slowed down in 2018 due to tighter conditions by the public programme for first-time home buyers ('*Prima Casă*' programme) and on loans provided by credit institutions. Real house prices increased at an annual growth rate of 1.3% in 2018 and decreased by 1.7% in 2019. Supported mainly by *'Prima Casă'* programme, mortgage loans to households continued to increase in 2019, up by 7.7% in December 2019 compared to the same month in previous year.

Graph 7.12: **Romania - Recent development of the financial system relative to the euro area**
(in percentage of GDP)



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

The size of the financial sector in Romania as a percent of GDP is small compared to the euro area countries. Domestic bank credit to the private non-financial sector was around 24% of GDP at the end of 2019, well below the euro area average (almost 90% of GDP), reflecting the low level of financial intermediation in Romania. Equity and debt markets in Romania remain considerably underdeveloped. In 2019, stock market capitalisation (9.4% of GDP) remained significantly below the euro area (72.3% of GDP). The size of the debt securities' market is also very small relative to the euro area (30.3% compared to 147.9% of GDP) and continued to be dominated by issuances of government debt (T-bills and bonds denominated in both leu and foreign currency). The issuance of corporate and municipal bonds remains very limited. Consolidated private sector debt continued to decline from its peak of 75% of GDP in 2010 to 47% in 2018, which was the lowest ratio in the EU.

8. SWEDEN

8.1. LEGAL COMPATIBILITY

8.1.1. Introduction

The legal rules governing the Swedish Central Bank (Riksbank) are laid down in the Instrument of Government (as part of the Swedish Constitution), the Riksbank Act from 1988, as amended, and the Law on Exchange Rate Policy from 1998. No amendments to these legal acts were passed with regard to the incompatibilities and the imperfections mentioned in the Commission's 2018 Convergence Report.

8.1.2. Central Bank independence

Article 3 of Chapter 6 of the Riksbank Act obliges the Riksbank to inform the minister appointed by the Swedish Government about a monetary policy decision of major importance prior to its approval by the Riksbank. A dialogue between a central bank and third parties is not prohibited as such, but regular upfront information of government representatives about monetary policy decisions, especially when the Riksbank would consider them as of major importance, could structurally offer to the government an incentive and the possibility to influence the Riksbank when taking key decisions. Therefore, the obligation to inform the minister about a monetary policy decision of major importance prior to its approval by the Riksbank limits the possibility for the Riksbank to take decisions independently and offers the possibility for the Government to seek to influence them. Such procedure is incompatible with the prohibition on giving instructions to the Central Bank, pursuant to Article 130 of the TFEU and Article 7 of the ESCB/ECB Statute. Article 3 of Chapter 6 should be revised in order to ensure that monetary policy decisions of major importance are communicated to the minister, if ever, only after its approval by the Riksbank and for information purposes only.

Pursuant to Article 2 of Chapter 3 of the Riksbank Act and Article 13 of Chapter 9 of the Instrument of Government, the prohibition on the members of the Executive Board to seek or take instructions only covers monetary policy issues. The provisions do not provide for their independence in the performance of ESCB-related tasks directly entrusted by the Treaties. By means of broad interpretation through reference to the explanatory memorandum to the Law (the memorandum extends the coverage to all ESCB tasks), one could consider these tasks as tacitly encompassed by the principle of central bank independence. However, the principle of the Riksbank's institutional independence cannot be considered as fully respected as long as the legal text itself does not contain a clear reference to them. Both provisions, therefore, are considered as incompatible with Article 130 of the TFEU and Article 7 of the ESCB/ECB Statute.

Pursuant to Article 4 of Chapter 10 of the Riksbank Act, the Swedish Parliament approves the Central Bank's profit and loss account and its balance sheet and determines the allocation of the Central Bank's profit. This practice impinges on the financial independence of the Riksbank and is incompatible with Article 130 of the TFEU. The Parliament must not be involved in the relevant decision-making process. Its right should be limited to approving the Central Bank's decision on the profit allocation.([43])

Article 4 of Chapter 1 of the Riksbank Act provides for the replacement of the Governor, in case of absence or incapacity, by the Vice-Governors nominated by the General Council. It is unclear whether the notion "absence" in Article 4 also refers to cases such as the expiry of the term of office, resignation, dismissal or other cause of termination of office. To ensure the smooth and continuous functioning of the Riksbank, the Riksbank Act would benefit from some improvement and should provide for clear procedures and rules regarding the succession of the Governor in case the notion "absence" also refers to instances of termination of office as well as in case the Governor is incapacitated.

8.1.3. Prohibition of monetary financing and privileged access

Under Article 8 of Chapter 6 of the Riksbank Act, the Riksbank may, in exceptional circumstances, grant credits or provide guarantees on special terms to banking institutions and Swedish

([43]) Legislative proposals to tackle the flaw have been submitted by the Swedish legislator since 2013 but those still provided for a decisive role of the Parliament in profit distribution and budget allocation, which are incompatible with the principle of financial independence as enshrined in Article 130 of the TFEU.

companies that are under the supervision of the Financial Services Authority. In order to comply with the prohibition on monetary financing of Article 123 of the TFEU it should be clearly specified that the loan is granted against adequate collateral to ensure that the Riksbank would not suffer any loss in case of the debtor's default. When the Swedish Parliament inserted a new article 8a in Chapter 6 of the Riksbank Act obliging the Riksbank to provide information to the Government and a number of relevant public authorities on implemented liquidity support, the occasion was not seized to amend Article 8 as suggested above. Therefore, it continues to constitute an incompatibility with the prohibition on monetary financing under Article 123 of the TFEU.

Pursuant to Article 1(3) of Chapter 8 of the Riksbank Act, the Riksbank shall not extend credits or purchase debt instruments "directly from the State, another public body or institution of the European Union". The Article does not enumerate the entities covered by the prohibition of monetary financing correctly. Therefore, Article 1 is incompatible with the wording of Article 123(1) of the TFEU and 21(1) of the ESCB/ECB Statute.

According to Article 1(4) of Chapter 8 of the Riksbank Act, the Riksbank may grant credit to and purchase debt instruments from financial institutions owned by the State or another public body. This provision of Article 1 does not fully comply with Article 123(2) of the TFEU and Article 21.3 of the ESCB/ECB Statute because the exemption only covers publicly owned institutions. For the sake of legal certainty it should be added that, in the context of the supply of reserves by central banks, these publicly owned credit institutions should be given the same treatment as private credit institutions.

The provisions of Article 4 of Chapter 10 on the allocation of the Riksbank’s profit are supplemented by non-statutory guidelines on profit distribution, according to which the Riksbank should pay 80% of its profit to the Swedish State, after adjustment for exchange rate and gold valuation effects and based on a five-year average, with the remaining 20% used to increase its contingency and balancing funds. Although these guidelines are not legally binding but accepted as a practice by Parliament for calculating profit allocation and as 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. The law should ensure that the reserve capital of Riksbank is left unaffected in any case and that the actual contribution to the State budget does not exceed the amount of the net distributable profit.

8.1.4. Integration in the ESCB

Objectives

Chapter 1, Article 2 of the Riksbank Act should include a reference to the secondary objective of the ESCB, while the promotion of a safe and efficient payment system as a task 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, Articles 1 and 2 of the Act and Chapter 9, Article 13 of the Instrument of Government);
- 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 Instrument of Government);
- conduct of foreign exchange operations and the definition of foreign exchange policy (Chapter 7 of the Act; Chapter 8, Article13 and Chapter 9, Article 12 of the Instrument of Government); Articles 1 to 4 of the Law on Exchange Rate Policy of 1998;
- 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 Instrument of Government);
- ECB's right to impose sanctions (Chapter 11, Articles 2a, 3 and 5 of the Act).

There are furthermore some imperfections regarding the:

- non-recognition of the role of the ECB and of the EU in the collection of statistics (Chapter 6, Articles 4(2) and Article 9, 10 and 11 of the Act);

- non-recognition of the role of the ECB in the functioning of payment systems (Chapter 1, Article 2; Chapter 6, Article 7 of the Act);
- non-recognition of the role of the ECB and of the Council in the appointment of an external auditor;
- non-recognition of the role of the ECB in the field of international cooperation (Chapter 7, Article 6).

8.1.5. Assessment of compatibility

As regards the prohibition on monetary financing, the independence of the Riksbank as well as its integration into the ESCB at the time of euro adoption, the legislation in Sweden, in particular the Riksbank Act and the Instrument of Government as part of the Swedish Constitution, is not fully compatible with the compliance duty under Article 131 of the TFEU.

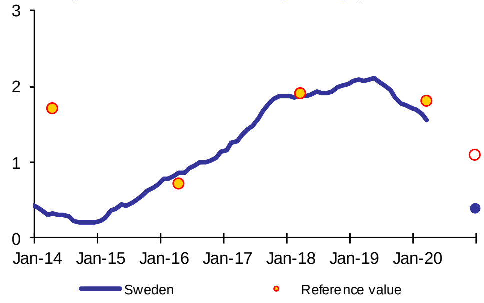
It is understood that the Committee on the Inquiry of the Riksbank set up by the Swedish Government in 2016 conducted an extensive review of the Swedish monetary system, including relevant constitutional provisions and the Riksbank Act and published a report. Swedish authorities are currently waiting for the results of a public consultation on this report before engaging in a legislative process with a view to amend relevant Swedish legislation. In this context, the Swedish authorities are invited and encouraged to remedy the abovementioned incompatibilities.

8.2. PRICE STABILITY

8.2.1. Respect of the reference value

The twelve-month average inflation rate, which is used for the convergence assessment, was at the reference value at the time of the last convergence assessment of Sweden in 2018. The twelve-month average inflation rate in Sweden then gradually increased to a peak of 2.1% in April-May 2019, and fell again thereafter. In March 2020, the reference value was 1.8%, calculated as the average of the 12-month average inflation rates in Portugal, Cyprus, and Italy plus 1.5 percentage points. The corresponding inflation rate in Sweden was 1.6%, i.e. below the reference value. The 12-month average inflation rate is projected to decline and stay below the reference value in the months ahead.

Graph 8.1: **Sweden - Inflation criterion**
(percent, 12-month moving average)



Note: The dots in December 2020 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2020 Forecast.

8.2.2. Recent inflation developments

HICP inflation in Sweden started to pick-up in 2018 to reach a peak of 2.5% in September of that year. This was mainly due to sharply increasing energy and unprocessed food prices and resulted in an average inflation rate of 2.0% in 2018. In 2019, HICP inflation reached 1.7% on average. Year-on-year inflation fell markedly from the middle of the year to a low of 1.3% in September, driven by negative base effects of energy and unprocessed food prices, before picking up somewhat subsequently. In the first part of 2020 headline HICP inflation fell back from 1.5% in January to 0.8% in March 2020.

In 2018, core inflation (measured as HICP inflation excluding energy and unprocessed food) was subdued at 1.2%, as unit labour cost gains remained muted despite the tight labour market. Core inflation increased to 1.6% in 2019, likely reflecting in part the lagged impact of the weakening of the krona as well as an increase of 2.0% in administered prices. The new methodology for measuring prices of package holidays ([44]) coupled with changes in calculating dental costs led to some volatility in inflation rates. Price increases for non-energy industrial goods remained very low in both 2018 and 2019, whereas prices for processed food and services rose somewhat more rapidly in 2019 before moderating in the early months of 2020. Both producer and

([44]) From 2017, Statistics Sweden changed its handling of seasonal prices of package holidays. For more details about the new methodology, see Statistics Sweden: http://www.scb.se/contentassets/6dc31ffdd808460eb498b66419042afb/andringar-i-kpi-fran-2017-en-editetr_feb_mt.pdf

Table 8.1:
Sweden - Components of inflation

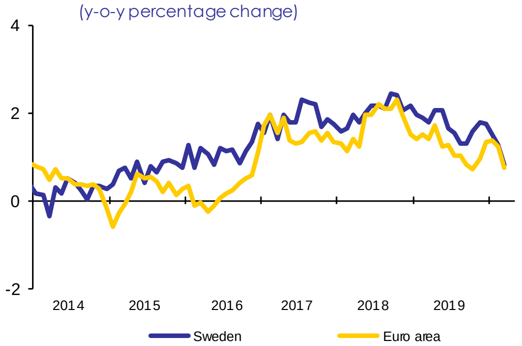
	2014	2015	2016	2017	2018	2019	Mar-20	weights in total 2020
(percentage change) 1)								
HICP	0.2	0.7	1.1	1.9	2.0	1.7	1.6	1000
Non-energy industrial goods	-0.4	0.3	1.1	0.0	0.0	0.3	0.3	293
Energy	-2.0	-4.7	1.0	5.3	9.6	2.9	-0.5	87
Unprocessed food	0.0	4.1	2.6	2.0	4.5	2.3	2.3	36
Processed food	1.0	2.1	0.5	2.0	1.8	2.8	2.8	163
Services	0.9	1.3	1.3	2.3	1.8	2.0	2.4	421
HICP excl. energy and unproc. food	0.5	1.1	1.1	1.5	1.2	1.6	1.7	877
HICP at constant tax rates	0.2	0.5	1.0	1.7	1.8	1.6	1.5	1000
Administered prices HICP	1.7	1.3	0.9	2.1	1.3	2.0	2.0	147

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

Sources: Eurostat, Commission services.

import price inflation fell back since 2019, having surged in 2018 on the back of higher energy prices.

Graph 8.2: **Sweden - HICP inflation**



Source: Eurostat.

8.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and cyclical stance

The Swedish economy is experiencing an unprecedented slowdown in the wake of the impact of COVID-19, after a long period of economic expansion. Following a relatively strong performance in 2018, with real GDP growing by 2.2%, economic growth moderated to 1.2% in 2019. The slowdown in 2019 was largely driven by weaker domestic demand, in particular a slump in housing investment, whereas net exports held up. In the wake of the abrupt fall in economic activity due to the COVID-19 induced crisis, real GDP is expected to fall sharply by 6.1% in 2020, with the output gap falling abruptly from positive in 2019 to strongly negative in 2020. GDP is expected to rebound by 4.3% in 2021. A strong recovery in particularly private consumption and exports is expected to drive such an increase in GDP growth in 2021.

The fiscal stance, as measured by the change in the structural balance, turned expansionary in 2018 and remained broadly neutral in 2019. It is expected to become strongly expansionary in 2020 due to the measures directed at countering the impact of the COVID-19-induced crisis and contractionary in 2021 as a substantial part of measures are expected to be unwound.

Monetary policy, conducted within an inflation targeting framework ([45]), has overall remained expansionary, but policy rates have left the negative territory in the period covered by the report. The Riksbank raised the policy rate by 25 basis points to -0.25% in December 2018, and further to 0% in December 2019, on the assessment that conditions were good for inflation to remain close to the target over the period ahead. Moreover, the assessment considered the necessity of more analysis of the impact of a prolonged period of negative interest rates.

([45]) Since 1995, the Riksbank has targeted increases in the domestic CPI with the aim of keeping inflation at 2%. In September 2017 the Riksbank changed its target from measuring inflation in terms of CPI to CPIF (CPI with the interest rate component kept unchanged).

Table 8.2:
Sweden - Other inflation and cost indicators **(annual percentage change)**

	2014	2015	2016	2017	2018	2019	2020 1)	2021 1)
HICP inflation								
Sweden	0.2	0.7	1.1	1.9	2.0	1.7	0.4	1.1
Euro area	0.4	0.2	0.2	1.5	1.8	1.2	0.2	1.1
Private consumption deflator								
Sweden	0.9	1.1	0.9	1.8	2.2	1.9	0.3	1.0
Euro area	0.5	0.3	0.4	1.3	1.4	1.2	0.3	1.2
Nominal compensation per employee								
Sweden	2.3	2.6	2.6	2.1	3.9	3.0	-1.3	5.6
Euro area	1.4	1.3	1.2	1.7	2.2	2.1	1.1	0.4
Labour productivity								
Sweden	1.3	2.9	0.6	0.0	0.6	0.7	-3.6	3.2
Euro area	0.8	1.0	0.5	1.0	0.4	0.1	-3.2	2.4
Nominal unit labour costs								
Sweden	1.0	-0.3	2.0	2.1	3.3	2.4	2.4	2.3
Euro area	0.6	0.5	0.7	0.7	1.8	2.1	4.3	-1.9
Imports of goods deflator								
Sweden	1.2	0.0	-2.2	4.6	6.7	2.3	-2.6	-0.4
Euro area	-2.4	-3.3	-3.3	3.4	2.7	-0.6	-3.6	1.1

1) Commission services' Spring 2020 Forecast.

Source: Eurostat, Commission services.

The Riksbank considered monetary policy to remain expansionary, also in view of the Riksbank's extensive purchases of government bonds. In December 2017, the Executive Board of the Riksbank decided to halt the asset purchase programme started in 2015, but to continuously reinvest redemptions and coupon payments in the government bond portfolio. In April 2019 the Riksbank decided to extend the purchase of government bonds for a nominal value of 45 billion Swedish krona from July 2019 to December 2020. In order to limit the impact of the COVID-19-induced crisis, the Riksbank in March 2020 took a series of measures in subsequent monetary policy meetings: i) further purchases of securities by up to SEK 315 billion in 2020, including government, municipal and mortgage bonds; ii) reduction in the lending rate for overnight loans to banks from 0.75 to 0.20 percentage points above the repo rate; iii) allowing banks to borrow unlimited amounts on a weekly basis against collateral at three months' maturity at an interest rate of 0.20 percentage points above the repo rate; iv) start purchasing commercial paper issued in Swedish kronor by Swedish non-financial corporations; and v) offering loans in dollars thanks to the swap arrangement of up to 60 billion USD that the Riksbank agreed with the US Federal Reserve. The Riksbank also increased the flexibility of the collateral framework, giving banks more scope to use mortgage bonds as collateral and subsequently temporarily enlarged the circle of monetary policy counterparties. The Riksbank's total holdings of domestic government bonds amounted to a cumulative SEK 340 billion in January 2020 about one third of the outstanding stock of central government debt instruments . At its latest meeting in April 2020, the Riksbank left its policy rate unchanged.

Wages and labour costs

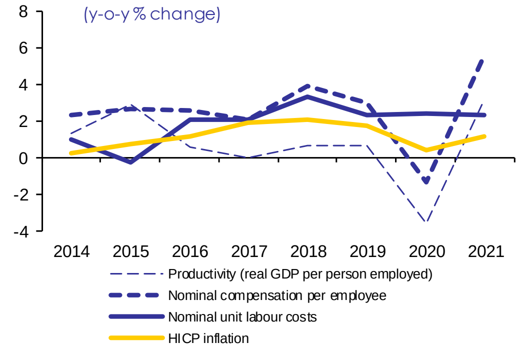
Employment recovered quickly following the financial crisis and expanded at a brisk pace, with growth at 1.6% in 2018 before slowing appreciably to 0.6% in 2019 in the wake of the economic slowdown. The rise in employment was driven primarily by services, the public sector (in particular health care, education, and local government), and construction, while the number of employed persons in manufacturing and energy sectors decreased.

In the past few years, strong employment growth led to a progressively tightening labour market with increasing skills shortages. However, the decline in the unemployment rate remained moderate, due to the relatively strong growth of the working age population. In particular, in past years many migrants joined the labour force. Having fallen to 6.3% in 2018, the unemployment rate increased to 6.8% in 2019 and is expected to rise sharply to close to 10% in 2020 in the wake of COVID-19 pandemic, and to fall slightly in the following year is.

The growth in nominal compensation per employee reached 3.9% in 2018. Despite the tight labour market, nominal gains moderated to 3.0% on average in 2019. In the first half of 2020, negotiations between social partners were due to determine benchmark wage increases for the coming years. In Sweden, social partners typically first negotiate a benchmark agreement for exporting sectors aimed at maintaining cost competitiveness vis-a-vis major trading partners; other sectors tend to follow this benchmark rather closely. However, against the backdrop of the COVID-19 induced crisis, social partners have deferred negotiations on a new multi-annual wage agreement and overall compensation growth is expected to remain muted. This should feed into moderate underlying inflation of close to 1% in both 2020 and 2021.

Sweden had sluggish labour productivity growth in recent years. Strong cyclical swings in economic activity and employment imply that forecast aggregate measures of changes in labour productivity for 2020 and 2021 are severely distorted. Given relatively modest expected wage increases, the underlying rise in nominal unit labour costs (ULC), is projected to stabilize at around 2½% over the forecast period, suggesting that the impact from labour costs on core inflation are expected to remain contained. Overall, Sweden should not experience major changes in cost competitiveness.

Graph 8.3: **Sweden - Inflation, productivity and wage trends**



Source: Eurostat, Commission services' Spring 2020 Forecast.

External factors

Given the openness of the Swedish economy, developments in import prices play an important role in domestic price formation. Import price growth (measured by the deflator of imports of goods) has fluctuated significantly over the past years. In 2018, the import deflator increased sharply by 6.7% due to higher commodity prices, amplified by the krona depreciation. Its growth eased in 2019 to just above 2% but stayed well above the rate registered in the euro area, partly due to the lagged effect of exchange rate depreciation. The impact of changes in import prices on consumer price inflation is difficult to gauge, as there is evidence that the pass-through has been weakening in recent years. Explanations provided in the literature relate, for instance, to changes in competitive conditions and the rise of global value chains.([46]) For the first part of 2020, the sharp drop in energy prices in the wake of the pandemic will have a strong negative impact on consumer prices. However, the effect over the entire forecast horizon to 2021 is difficult to gauge, given uncertainties surrounding the recovery path.

The real effective exchange rate (measured against a group of 36 trading partners) fell markedly in 2018 and 2019, largely due to the weakening in the nominal exchange rate of the krona. In 2018 and 2019, there were no major discrepancies between the growth in domestic prices and the growth in domestic prices of Sweden's main trading partners. For 2020 and 2021, major discrepancies are not expected to occur. Overall, Swedish cost developments do not pose major challenges to competitiveness.

Administered prices and taxes

The share of administered prices in the Swedish HICP basket amounts to just above 12%, a value around the euro-area average. The most important item in the administrated price basket is rents. In contrast to 2018, administrative price inflation outpaced total HICP inflation in 2019, increasing from 1.3% in 2018 to 2.0% in 2019. This is largely accounted for by a marked increase in fully administered prices.

Tax changes also contributed somewhat to higher headline inflation as the pace at which HICP at constant taxes increased over the past two years was slightly lower than for HICP.

([46]) For evidence on the pass-through see https://www.riksbank.se/globalassets/media/rapporter/rpp/engelska/2019/the-significance-of-the-krona-for-inflation-article-in-account-of-monetary-policy-2018.pdf.

Table 8.3:
Sweden - Budgetary developments and projections (as % of GDP unless indicated otherwise)

Outturn and forecast [1]	2014	2015	2016	2017	2018	2019	2020	2021
General government balance	-1.5	0.0	1.0	1.4	0.8	0.5	-5.6	-2.2
- Total revenues	49.3	49.5	50.7	50.7	50.6	49.8	49.5	49.8
- Total expenditure	50.9	49.5	49.7	49.3	49.8	49.3	55.1	52.0
of which:								
- Interest expenditure	0.7	0.6	0.5	0.5	0.5	0.4	0.3	0.3
p.m.: Tax burden	42.9	43.3	44.6	44.7	44.4	43.6	42.9	43.3
Primary balance	-0.8	0.6	1.5	1.9	1.3	0.9	-5.3	-1.8
Cyclically-adjusted balance [2]	-0.6	-0.3	0.5	0.8	0.0	0.1	-2.1	-0.2
One-off and temporary measures [3]	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Structural balance [2)4]	-0.6	-0.3	0.5	0.8	0.0	0.1	-2.1	-0.2
Government gross debt	45.1	43.9	42.2	40.8	38.8	35.1	42.6	42.5
p.m: Real GDP growth (%)	2.7	4.4	2.4	2.4	2.2	1.2	-6.1	4.3
p.m: Output gap [2]	-1.7	0.6	0.9	1.1	1.4	0.8	-6.3	-3.7

1) Commission services' Spring 2020 Forecast.
2) Due to the COVID-19 pandemic, these estimates are surrounded by an unusually high level of uncertainty.
3) COVID-19-related measures were not classified as one-offs in the Commission services' Spring 2020 Forecast, due to the activation of the general escape clause of the SGP.
4) Cyclically-adjusted balance excluding one-off and other temporary measures.
Source: Commission services.

Medium-term prospects

HICP inflation is expected to fall from 1.7% in 2019 to 0.4% in 2020, mainly due to lower contributions from energy prices, before moving somewhat higher to 1.1% in 2021, as core inflation would remain muted. These data have to be taken with a pinch of salt, as in the near term, price measurement is likely to be distorted.([47]) This is partly due to missing observations or low sample sizes as the consumption of certain categories of goods and services is affected by physical restrictions due to measures to combat COVID-19. Some items, such as food products, may experience some upward impact on prices due to bottlenecks in supply and distribution. Overall, inflation is expected to remain below the Riksbank's target, reflecting subdued prices in line with an economy operating below its potential.

Risks to the inflation outlook are difficult to gauge in the current uncertain economic environment but appear to be balanced. While it is hard to interpret surveys on inflation expectations at this juncture markets expectations appear not to attach a high likelihood to substantial changes in krona valuation.

The level of consumer prices in Sweden relative to the euro area has gradually increased since Sweden joined the EU in 1995. In 2018, the Swedish price level stood at 116% of the euro-area average. At the same time, the relative real GDP per capita level in Sweden has slightly declined since 2012, reaching about 122% of the euro-area average in PPS terms in 2018.

In the medium term, inflation could gradually rise should a marked economic recovery occur, given weak productivity trends and the reported skill shortages. However, as resource utilisation is expected to abate somewhat, there is uncertainty on how resource pressure will feed into inflation in the current low interest rate environment. In particular, should low wage expectations continue weighing on disposable income, there would be no reason to believe that consumer price inflation will receive a large push.

([47]) See a recent paper from Statistics Sweden: https://www.scb.se/contentassets/1b48f2064ebd46a78eda4d68d51c0403/8-pm---hantering_av_effekter_av_corona-pandemin_i_kpi_och_hikp.pdf

8.3. PUBLIC FINANCES

8.3.1. Recent fiscal developments

Sweden's general government surplus decreased from 0.8% of GDP in 2018 to 0.5% of GDP in 2019. This mainly reflected weaker revenue as real GDP growth slowed. By contrast, the expenditure ratio remained stable, as expenditure of local government increased while outlays on immigration and integration continued to fall.

The expenditure-to-GDP ratio decreased from 49.8% of GDP in 2018 to 49.3% in 2019. The revenues-to-GDP ratio decreased from 50.6% to 49.8% of GDP between 2018 and 2019.

The 2019 general government surplus was marginally lower than the surplus of 0.6% of GDP targeted in the 2019 Convergence Programme. At 0.1%, the structural balance remained broadly unchanged with respect to 2018.

The government debt-to-GDP ratio decreased to 35.1% in 2019, as fiscal management remained prudent in the face of slower growth. The marked decrease of the debt ratio by almost 4 percentage points in 2019 is largely attributable to a reduction in loan-financed foreign currency reserves by the Riksbank. In March 2019, the Riksbank decided to reduce the size of the foreign currency reserve, implying that the outstanding foreign currency loans maturing in 2019 did not need be refinanced. Consequently, the Debt Office did not raise further loans on behalf of the Riksbank in 2019, which translated into a lower general government debt ratio.

8.3.2. Medium-term prospect.

The 2020 budget bill foresaw a slightly expansionary stance, mainly due to several tax cuts, which are being implemented. These include the abolition of the 5% 'austerity tax' levied on the portion of individual incomes exceeding SEK 689,300 per year (removing the top layer of progressivity), and a reduction in income tax rates for income above SEK 17,000 /month for the over-65s. The aim of the measure is to address the gap between taxation of employment income and pension income. Moreover, the budget includes new spending on security and a commitment to use SEK 3.2 billion to promote the transition to a fossil-free economy.

The supplementary Spring budget contained a broad range of measures aimed at cushioning the economic impact of the COVID-19 crisis. In particular, the Swedish authorities responded to the COVID-19 crisis with a series of coordinated fiscal, monetary and financial support measures successively scaled up as the pandemic spread. Fiscal measures in the supplementary Spring budget are estimated to amount to around 2½% of GDP. These include extra outlays on health care, education and social protection, as well as support for the regions and local authorities responsible for the health care system. The government has further taken steps that, while not having a direct budgetary impact, limit crisis-related costs to the corporate sector, employees, self-employed and small businesses. These include taking over sick pay costs, funding of temporary unemployment, reductions in social security contributions, lowering requirements to receive unemployment benefits, contributing to rent reductions, extending of credit guarantees and allowing the postponement and reimbursement of tax and VAT payments to support corporate liquidity, as well as different kinds of loan guarantees.

Against this backdrop, the Commission services' Spring 2020 Forecast, which is based on a no-policy-change assumption, projects the general government balance to deteriorate sharply in 2020. The balance is set to swing from a surplus in 2019 to a deficit of around 5 ½ % of GDP in 2020, but should improve markedly in 2021 assuming that the measures adopted to fight the pandemic are limited to 2020. The structural balance is set to worsen by around 2 percentage points in 2020 before improving again in 2021 as growth rebounds, nominal government deficit falls, and the output gap is set to narrow. The revenue-to-GDP ratio is expected to stabilise at just below 50% of GDP in 2021 while expenditures are forecast to reach around 52% of GDP.

Gross government debt is well below the 60% of GDP Treaty reference value and this is expected to stay so, reaching around 42% of GDP in 2020 and 2021, despite the marked increase in the debt ratio due to the impact of the COVID-19 pandemic. The stabilization of the debt ratio mirrors the projected economic recovery in a low interest rate environment.

Building on a strong institutional set-up and a robust fiscal track-record, a revised fiscal framework came into force in Sweden in 2019.

The main changes are the introduction of a debt anchor set at 35% of GDP, with a 5 percentage point tolerance margin, and a lower net lending surplus target over the cycle to 0.33% of GDP, from the previous 1% of GDP. The revised fiscal framework kept the expenditure ceiling and a balanced budget requirement for local authorities. The fulfilment of the surplus target will be assessed based on a single indicator (i.e. the structural balance over the current and subsequent year) instead of the previous system of several indicators whose relative weights were not defined. This should ensure adequate safety margins for economic fluctuations.

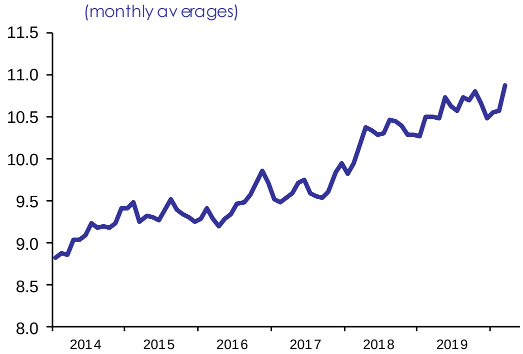
In addition, the new fiscal framework entails a strengthened mandate for the Fiscal Policy Council (*Finanspolitiska rådet*), which has functioned since 2007 to monitor fiscal rules and evaluate the official macro-forecasts. The selection process for members of the Council was changed on 1 July 2018 to one steered by a nomination committee which includes, among others, the Chair and Deputy Chair of the Riksdag's Finance Committee. The change was motivated by the desire to give the independent fiscal body more democratic legitimacy and increase its responsibilities and diversity. Some of the elements in the fiscal framework contribute to bringing the Swedish national provisions in line with provisions in the Budgetary Frameworks Directive, ([48]) e.g. introducing a new debt anchor as an explicit multi-annual debt objective or mandating the Fiscal Council with the regular assessment of government's economic forecasts.

8.4. EXCHANGE RATE STABILITY

The Swedish krona does not participate in ERM II. As indicated above, the Riksbank pursues inflation targeting under a floating exchange rate regime.

The long-term trend of the krona depreciating against the euro that started in 2013 continues, with a cumulated depreciation of more than 26% in early 2020 compared to the 2013 peak. In 2018, the krona depreciated by 6% against the euro, and by further 3% in 2019, when it reached a peak at 10.80 SEK/EUR in October 2019, before slightly appreciating to the range 10.5-10.6 between December 2019 and February 2020. Since mid-February, the krona started depreciating at a fast rate reaching a peak of 11.2 on 18 March. In the following days, the euro started losing some value and, while remaining above the threshold of the 10.9 SEK/EUR since then, brought the krona exchange rate at a value of 10.88 SEK/EUR on average in March 2020. Short-term interest rate spreads vis-à-vis the euro area have come back to positive territory since December 2018. This follows a long negative period starting in February 2015, when the Riksbank had introduced a negative policy rate, cutting its repo rate to minus 0.1% and started its asset purchase programme.

Graph 8.4: **Sweden - SEK/EUR exchange rate**
(monthly averages)



Source: ECB.

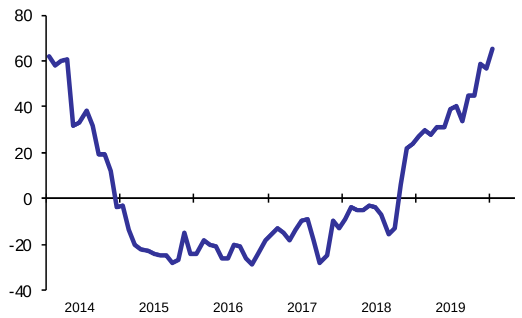
The increases in the monetary policy rate decided by the Riksbank in December 2018 and 2019 (see above) seem to have been the main driver of the increase of the 3-months STIBOR-EURIBOR spread. The spread averaged -7 basis points in 2018 and 33 in 2019, with two periods of rapid increases, January to April and August to December, when it reached 47 basis points, only temporarily interrupted in September 2019. The spread continued increasing in 2020 and inn March 2020 it stood at around 65 basis points. The depreciation of the Swedish krona in 2018 and 2019, therefore, does not seem to be accounted for by monetary policy actions, contrary to the one during 2014-2016. As indicated in the next section, the uncovered interest parity relation does- not hold on average in 2018 and 2019 also if one measures it using the spread between the curve of the yields of Swedish government bonds with respect to German government bonds.

Since December 2015, the Riksbank can intervene on foreign exchange markets in order to prevent a de-anchoring of inflation expectations due to a strengthening krona. The level of foreign currency reserves decreased by more than 10% in krona (almost 4% in US dollars) between December 2017 and December 2018 and by almost 17%

([48]) The Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States, available at: http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:32011L0085

(12% in US dollars) between December 2018 and December 2019, when it stood at around SEK 480 billion. In the beginning of 2020, international reserves stood below the level of SEK 470 billion (45 billion US dollars), or around 9% of GDP. These changes reflect Riksbank decisions to somewhat lower the level of foreign exchange reserves, which had been increased substantially after the global financial crisis, financed by loans from the Swedish National Debt Office. The change in foreign reserves therefore, does not bear a direct relation to changes in the exchange rate.

Graph 8.5: **Sweden - 3-M Stibor spread to 3-M Euribor**
(basis points, monthly values)



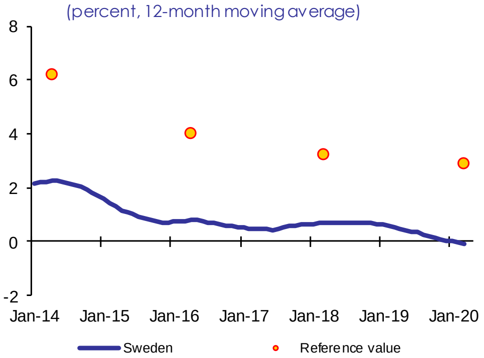
Source: Eurostat and EBF (European Banking Federation).

8.5. LONG-TERM INTEREST RATES

Long-term interest rates used to assess adherence to the convergence criterion reflect secondary market yields on a single benchmark government bond with a residual maturity of around ten years.

The Swedish 12-month average long-term interest rate, relevant for the assessment of the Treaty criterion was well below the reference value at the time of the 2020 convergence assessment of Sweden. Average long-term rates in Sweden continued to stay below 1% over the last two years, where they have been since June 2015. They were on a declining trajectory since June 2018, when they were at 0.7%, and went below 0.1% since November 2019 and in negative territory since February 2020. In March 2020, the latest month for which data are available, the reference value, given by the average of long-term interest rates in Portugal, Cyprus, and Italy plus 2 percentage points, stood at 2.9%. In that month, the 12-month moving average of the yield on the Swedish benchmark bond stood at -0.1%, i.e. 3.0 percentage points below the reference value.

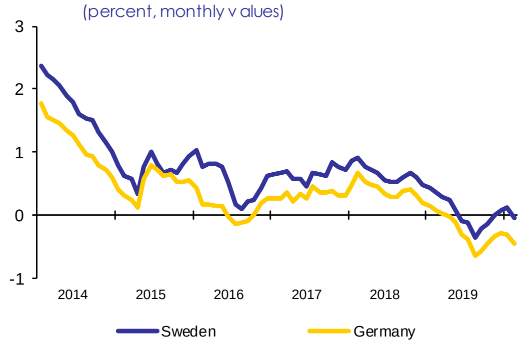
Graph 8.6: **Sweden - Long-term interest rate criterion**
(percent, 12-month moving average)



Source: Commission services.

Looking at monthly data, long-term interest rates recorded a new all-time low in August 2019, at -0.36, within the first period ever of negative rates, between June and October 2019. Long-term rates after recovering and turning positive in November 2019 turned negative again in February 2020 to reach -0.17% in March 2020.The compression of Swedish long-term interest rates reflected the continuation of the non-standard monetary policy measures, with continued acquisition and/or repurchase of governments bonds as a response to the low domestic inflation environment, and its safe-haven premium. The yields of the Swedish benchmark government bond remained relatively well connected to the German benchmark bond, in line with the safe-haven status of Swedish government bonds. Long-term interest spreads vis-à-vis the German benchmark bond remained relatively low. Spreads started increasing to touch 42 basis points in January 2020, having decreased during 2018 to reach 20 basis points in May 2019. In March 2020, they were at 37 basis points. [49]

Graph 8.7: **Sweden - Long-term interest rates**
(percent, monthly values)



Source: Eurostat.

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

8.6. ADDITIONAL FACTORS

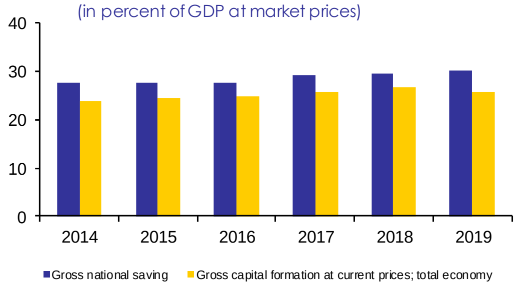
The Treaty (Article 140 TFEU) calls for an examination of other factors relevant to economic integration and convergence to be taken into account in the assessment. The assessment of the additional factors – including balance of payments developments, product, labour and financial market integration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

In December 2019, the Commission published its ninth Alert Mechanism Report (AMR 2020) under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.6), which concluded that an In-Depth Review (IDR) was warranted for Sweden. In February 2020, the Commission published its annual country report on Sweden, including an IDR. This report led to the conclusion that Sweden continues to experience macroeconomic imbalances. Overvalued house price levels coupled with a continued rise in household debt poses risks of a disorderly correction. While household debt as a share of GDP and disposable income has stabilised recently, it remains high. After a correction and stabilization of house prices over 2017-2018, prices have gradually recovered and remain close to historically high levels. Although the banking sector appears adequately capitalised, a disorderly correction would negatively affect the financial sector given its large exposure to household mortgages. In such a case, there could also be negative spill-overs to neighbouring countries given the systemic financial interlinkages. Some policy measures have been taken in recent years to address rising household debt, especially through macro-prudential policies. However, important policy gaps remain in the area of housing-related taxation, boosting housing supply and the rental market.

8.6.1. Developments of the balance of payments

According to Balance of Payments data, Sweden's current account continued its gradual decline to reach 1.7% of GDP in 2018 as the economy experienced a strong expansion fuelled by solid gains in domestic demand. A decline in the balance of trade for both goods and services contributed to the lower current account surplus, only partially compensated for by the increase in the primary income balance from 2015 onwards. In 2019, the current account balance rebounded to reach 3.9%, as the goods and services balances posted substantial gains. The solid export performance in goods was supported by terms-of-trade effects and by the composition of trade in a mature phase of the cyclical expansion, while improvements in services exports was probably owing to some special non-recurrent factors, such as transfers of intellectual property. By contrast, current transfers have delivered a negative impact on the current account balance, reflecting Sweden's foreign aid and positive net contributions to international organisations, as well as remittances transferred by foreign workers in Sweden to their home countries.

Graph 8.8: **Sweden - Saving and investment**
(in percent of GDP at market prices)



Source: Eurostat, Commission services.

According to National Accounts data, Sweden's large savings-investment surplus persisted in 2018 and 2019, reflecting a combination of high and increasing net savings by the private sector, compounded by fiscal surpluses. High private sector savings reflect a combination of factors including a pension regime with substantial mandatory contributions in presence of decreasing expected pension payments, precautionary savings, and high profitability of enterprises, which is supported by moderate increases in wage costs. Strong corporate profitability in combination with relatively subdued business investment translated in corporate savings boosting those of the private sector. Total gross capital formation peaked at around 26.8% of GDP in 2018 and this is share is expected to decline somewhat over the forecast period as the economy is cooling.

Sweden's export market share has been declining overall since the early 2000s, a phenomenon shared with several high-income countries. The export performance of the Swedish economy slightly deteriorated in 2018 but rebounded in 2019. Short-term fluctuations in export shares appear to reflect cyclical composition effects of export specialisation rather than changes in structural features. The trend decline in the export market shares is linked to changing global trade

Table 8.4:
Sweden - Balance of payments **(percentage of GDP)**

	2014	2015	2016	2017	2018	2019
Current account	4.5	4.1	3.5	3.1	1.7	3.9
of which: Balance of trade in goods	3.0	2.8	2.1	2.1	1.5	3.0
Balance of trade in services	1.3	2.2	2.1	0.8	0.1	0.3
Primary income balance	1.9	0.7	0.6	1.7	1.7	2.5
Secondary income balance	-1.8	-1.6	-1.3	-1.5	-1.7	-1.9
Capital account	-0.1	-0.2	-0.1	-0.1	0.0	0.0
External balance [1)]	4.4	3.9	3.4	3.0	1.7	3.9
Financial account	2.7	1.4	-4.9	3.9	1.3	3.4
of which: Direct investment	0.9	0.9	-2.8	2.1	2.4	0.4
Portfolio investment	4.0	-2.6	1.2	0.5	-1.8	2.1
Other investment [2)]	-2.2	2.9	-4.2	1.2	0.8	2.1
Change in reserves	0.0	0.3	0.8	0.1	-0.1	-1.2
Financial account without reserves	2.7	1.2	-5.8	3.8	1.4	4.6
Errors and omissions	-1.6	-2.5	-8.4	0.9	-0.4	-0.5
Gross capital formation	23.7	24.4	24.7	25.8	26.8	25.8
Gross saving	27.6	27.7	27.6	29.2	29.4	30.3
Gross external debt	188.5	179.7	175.1	176.0	170.7	166.5
International investment position	-2.2	-5.3	-1.9	1.3	8.0	21.2

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

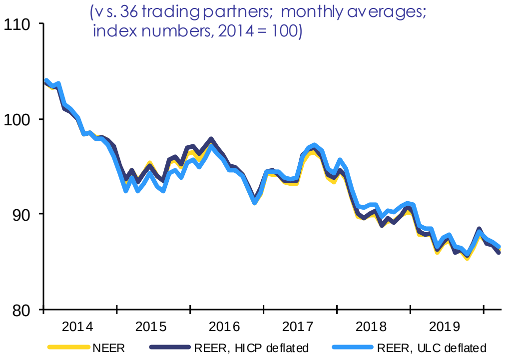
Sources: Eurostat, Statistics Sweden, Commission services.

patterns, which affect most mature, industrialised economies with a similar focus on high-value-added exports. This downward trend, therefore, does not suggest any underlying competitiveness issues per se.

This benign conclusion on competitiveness is buttressed by the developments in cost competitiveness indicators. The real effective exchange rate weakened from the second half of 2017 onwards, mainly due to a fall in the nominal effective exchange rate of the krona. Given the advanced stage of the cycle, unit labour costs (ULC) have been growing fairly moderately over the same period, broadly in line with Sweden's main trading partners.

Sweden's net international investment position improved markedly to around 8% of GDP in 2018, and deteriorated again the following year. Sweden's financial account shows relatively large fluctuations over time. However, seen over a longer period, the financial account balance mainly reflects Sweden's role as a net FDI investor abroad. By contrast, the balance of portfolio investments fluctuated appreciably year to year, mirroring the interplay of financial market conditions and perceptions, exchange rates and relative cyclical positions. External reserves remained constant in 2018 and 2019. External debt has been on a declining trend, and decreased by more than 20 percentage points between 2014 and 2019, to 166.5% of GDP. The strong fiscal position with the concurrent decline in gross government debt has been a key factor behind this decline.

Graph 8.9: **Sweden - Effective exchange rates**
(vs. 36 trading partners; monthly averages; index numbers, 2014 = 100)



Source: Commission services.

According to the Commission services' Spring 2018 Forecast, which is based on National Accounts data, net exports are expected to drag down real GDP growth in 2020 in view of sharply falling world trade and disruptions in production of exporting manufacturers. The net contribution of

Table 8.5:
Sweden - Market integration

	2014	2015	2016	2017	2018	2019
Trade openness 1) (%)	40.8	41.0	40.0	41.6	43.5	44.3
Trade with EA in goods & services 2)+3) (%)	17.4	17.4	17.4	18.3	19.0	19.1
Export performance (% change) 4)	0.5	2.7	-0.5	-0.5	-0.2	1.7
World Bank's Ease of Doing Business Index rankings 5)	9	9	9	10	12	10
WEF's Global Competitiveness Index rankings 6)	10	9	6	7	9	8
Internal Market Transposition Deficit 7) (%)	0.3	0.2	0.4	1.4	0.3	0.1
Real house price index 8)	89.4	100.0	107.3	112.4	109.0	109.6
Residential investment 9) (%)	4.2	4.7	5.3	5.7	5.4	5.0

1) (Imports + Exports of goods and services / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics, Balance of Payments).
2) (Imports + Exports of goods with EA-19 / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).
3) Trade in services with EA-19 (average credit and debit in % of GDP at current prices) (Balance of Payments).
4) Index for exports of goods and services divided by an index for growth of markets (percentage change on preceding year).
5) New methodology as of 2014 (World Bank).
6) (World Economic Forum)
7) Percentage of internal market directives not yet communicated as having been transposed, relative to the total.
(November data, as of 2016 date refers to the year of publication).
8) Deflated house price index (2015=100) (Eurostat).
9) Gross capital formation in residential buildings (in % of GDP) (Eurostat).

Sources: Eurostat, World Bank, World Economic Forum, Commission services.

growth would turn positive in 2021, on the back of the projected recovery. The current account surplus is expected to fall somewhat in 2020. It is projected to slightly rise again in 2021, to 4.0% of GDP, in National Account terms.

8.6.2. Market integration

Sweden is well integrated with the euro area through trade and investment linkages. Trade openness of the Swedish economy has been high, at 40% or more every year since 2005, with an increase by more than 3 points of GDP over the last five years to reach 44.3% in 2019. Trade with the EU has represented more than 40% of all Swedish trade since 2005 and more than 45% over the period 2018-2019. The main euro-area trading partners are Germany, the Netherlands and Finland, while among non-euro-area countries Norway and Denmark are the main trade partners.

The stock of inward FDI has remained stable relative to GDP in recent years (64% of GDP in 2018). In 2018, 76% of the total FDI stock originated from the EU, with the Netherlands, the UK, Luxembourg, Germany and Finland accounting for 62% of this total.

Regarding the business environment, Sweden regularly scores top positions in international rankings, well above most euro-area Member State and currently ranks in the top ten at global level, with respect to the World Bank's Ease of Doing Business indicator and to the WEF's Global Competitiveness Index. Sweden also tops rankings in public administration performance according to the World Bank's Worldwide Governance Indicators. Sweden's deficit in the transposition of EU directives in 2018 and 2019 was at 0.3% and 0.1%, below the EU average and the 0.5% target as proposed by the European Commission in the Single Market Act (2011).

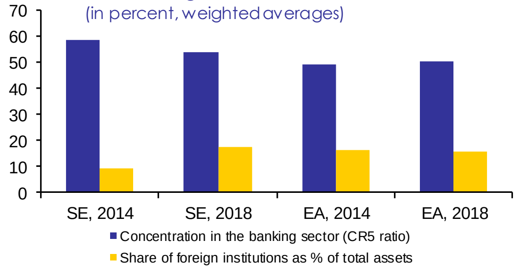
The 4th Anti-Money Laundering Directive imposed transposition by 26 June 2017 and from 2017 to 2020 Sweden has communicated to the Commission the adoption of several transposition measures, which ensure a complete transposition of the Directive. The Commission is completing its analysis of whether the notified measures conform to the Directive. As regards the 5th Anti-Money Laundering Directive, whose transposition deadline elapsed on 10 January 2020, Sweden has notified national transposition measures and declared a complete transposition. The Commission is analysing the communicated measures to assess their completeness and conformity with the directive.

Beyond the transposition of the Directive, persistent allegations of suspected money laundering have affected the reputation of Swedish banks. Effective supervision requires increased resources and appropriate procedures to apply the risk-based approach in place. Sweden has strengthened the capacity of its Financial Supervisory Authority, but the agency's capacity is still low compared to the size of the Swedish financial sector.

The Swedish labour market, largely governed by negotiations between social partners at sectorial level, is characterised by high employment rates. Low nominal wage increases in recent years have been a factor behind muted underlying inflation. Sweden has one of the lowest wage dispersions in the EU, with high entry wages and relatively little wage progression. According to the 2015 OECD employment protection indicator, the employment protection of permanent workers is rather high compared to that of temporary workers. The dispersion of regional unemployment rates is relatively low, but persistent imbalances in the housing market and high costs of housing in the larger cities pose challenges to labour mobility. The integration of low-skilled workers and those born outside the EU remain a key challenge for the Swedish labour market, though, as the employment rate of both groups is significantly below the overall employment rate. Skills shortages are pronounced in education, health care, social work, information and communication technology, industry and construction.

Sweden's financial sector is well integrated into the EU financial sector, especially through interlinkages in the Nordic-Baltic financial cluster. Subsidiaries and branches of the Swedish banking groups hold large market shares in Lithuania, Latvia and Estonia. They also have substantial market shares in Denmark and Norway. At the end of 2017, Nordea moved its headquarters to Finland. This move significantly reduced the asset-to-GDP ratio of the Swedish domestic banking sector from 269% of GDP in 2017 to 225% of GDP in 2019.

Graph 8.10: **Sweden - Foreign ownership and concentration in the banking sector**
(in percent, weighted averages)



Source: ECB, Structural financial indicators.

Moreover, in the wake of the move of Nordea's headquarters, the share of foreign ownership in the Swedish financial market almost doubled in 2018, increasing from 9.4% in 2017 to 17.8%, surpassing the euro-area average at 15.8%. Bank concentration as measured by the market share of the largest five credit institutions in total assets remained high at 54%, significantly above the euro-area average, which was 50.6% at the end of 2018.

The capital adequacy ratio of Swedish banks is just above the euro area average. It stood at 20.6% in the third quarter of 2019, compared to the euro area average of 18.1%. At the beginning of 2020, Sweden had the highest level of the Countercyclical Capital Buffer in the EU, as it had been raised from 2% to 2.5% on 19 September 2019. On 13 March 2020, the Swedish Financial Supervisory Authority (*Finansinspektionen*, FSA) reduced the Countercyclical Capital Buffer to 0% ([50]) to support credit provision and help counter the impact of the COVID-19 induced crisis. The FSA further temporarily allows banks to fall below the liquidity coverage ratio (LCR) for individual currencies and total currencies. This comes on top of the measures taken by the Riksbank described previously.

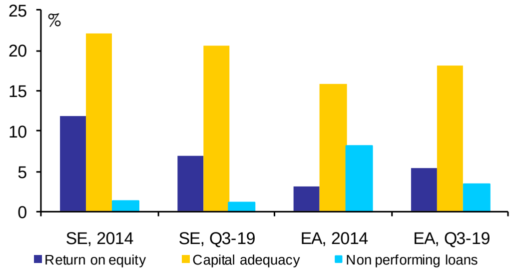
At the end of 2018, the FSA revised the calculation method for the risk-weight-floor imposed on residential mortgages exposures of banks using internal risk models, enhancing the international comparability of reported capital ratios. This measure under Article 458 of the Capital Requirements Regulation ([51]) led to a drop in reported bank capitalisation as a ratio of risk-weighted assets and moved it closer to the EU average. Improved comparability implies that the fall in the reported capital ratio for Swedish banks vis-à-vis EU peers is probably overestimated. The leverage ratio remains between 4% and 5% for most Swedish banks, which is among the lowest in the EU. The phasing in of changes in capital requirements agreed by the Basel Committee on Banking Supervision may lead to higher capital buffers for Swedish banks going towards full implementation on 1 January 2027.

The ratio of non-performing loans (0.8% in the third quarter 2019) has stayed low in recent years and among the lowest in the EU and also

([50]) See https://fi.se/en/published/coronavirus/
([51]) In line with Article 458 of the Capital Requirement Regulation, Finansinspektionen replaced the method used to apply the risk weight floor of 25% for Swedish mortgages for Interal Ratings Based with a (credit institution-specific) minimum level of 25% for the average risk weight on Swedish housing loans.

significantly lower than the euro area average, which remains just below 3%. High asset quality, cost-efficiency, market concentration and the ability to earn a positive interest margin ([52]) – which allows to cover the large external funding gap faced by Swedish banks – support the profitability of the banks. The latter is among the highest in Europe. The sector's average return on equity (ROE), which was high and increasing in 2018 (13.1% in Q4 2018), stood at almost 7% in the third quarter of 2019, above the euro area average of slightly above 5%.

Graph 8.11: **Sweden - Selected banking sector soundness indicators**



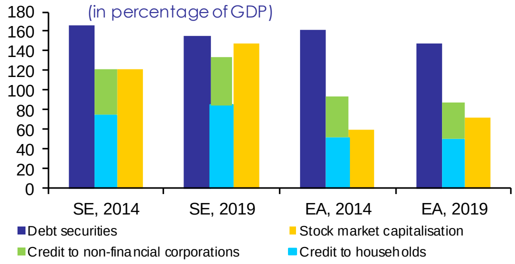
Note: Q3-19 Return on equity is calculated over the last four quarters.
Source: ECB, EC calculations.

Real house prices have more than tripled over the past two decades, significantly outpacing income growth. The increase has been paired with an increase in household debt. At the beginning of 2020, house prices had recovered to around the peak level of August 2017. First available data suggest a price decline as of mid-March however, as the economy started to contract. In 2018, the high household debt ratio was mirrored, together with high debt of non-financial corporations, in a consolidated private debt-to-GDP ratio of above 200%, well above the 135% figure of the euro area. The consolidated private debt-to-GDP ratio slightly increased in 2019, reaching 205% of GDP.

Housing construction activity has increased significantly over the past years, reaching an average growth of 5.4% between 2016 and 2019. However, since 2019 housing construction has started to fall. In the current situation of sharp economic slowdown with high uncertainty, strongly valued house prices coupled with a high household debt ratio continue to entail risks of a disorderly deleveraging process, potentially with a significant broader impact on the real economy and in an extreme scenario the banking sector. In a more structural sense, housing shortages and an sub-optimally functioning housing market have negative knock-on effects on labour mobility, income and wealth inequality as well as social equality.

Capital markets in Sweden are very well developed compared to the euro area. The capitalization index, measuring the ratio to GDP of the value of the stock of quoted shares issued by Swedish enterprises stood at about 115% at the end of 2018, just below the level of the end of 2014. This is roughly four times the euro-area capitalization index of 60.8% in 2019 (59.6% in 2018).

Graph 8.12: **Sweden - Recent development of the financial system relative to the euro area**
(in percentage of GDP)



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

The total amount of outstanding debt securities stood in 2019 at 155% of GDP, more than 10 points below the value of 2014. Outstanding bank credit to non-financial companies and households stood in 2019 at about 133% of GDP. This level is above the value of 2014 (122%), with an increase of the share given to households from 61% in 2014 to almost 70% in 2019.

([52]) The interest margin refers to the difference between interest paid by banks on their funding and interest earned by banks from their activity.