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REPORT FROM THE COMMISSION

CONVERGENCE REPORT 2010

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

{SEC(2010) 598 final}

1. PURPOSE OF THE REPORT

Article 140(1) of the Treaty on the Functioning of the European Union (henceforth TFEU) requires the Commission and the ECB to report to the Council, at least once every two years, or at the request of a Member State with a derogation, on the progress made by the Member States in fulfilling their obligations regarding the achievement of economic and monetary union. The latest Commission and ECB regular Convergence Reports were adopted in May 2008.

The 2010 Convergence Report covers the following nine Member States with a derogation: Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania and Sweden. Denmark and the United Kingdom have not expressed a wish to adopt the euro and are therefore not covered in the assessment. A more detailed assessment of the state of convergence in these countries is provided in a Technical Annex to this report (SEC(2010) 598).

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

The examination of the compatibility of national legislation, including the statutes of the national central banks, with Articles 130 and 131 of the TFEU and the ESCB/ECB Statute requires also an assessment of compliance with the prohibition of monetary financing (Article 123) and the prohibition of privileged access (Article 124); consistency with the ESCB's objectives (Article 127(1)); and integration of national central banks into the ESCB (several TFEU and ESCB/ECB Statute Articles).

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

Article 1 of the Protocol on the convergence criteria further 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*"[1]. The requirement of sustainability implies that the satisfactory inflation performance must essentially be attributable to the behaviour of input costs and other factors influencing price developments in a structural manner, rather than the influence of temporary factors. Therefore, the convergence examination includes an assessment of the factors underlying inflation and of medium-term prospects. From a forward-looking perspective, the report also assesses whether the country is likely to meet the reference value in the months ahead[2]. The sustainability of inflation performance deserves particular attention at the current juncture. The fall-out from the financial crisis has significantly impacted on inflation performance in many countries and macroeconomic volatility is high. The inflation reference value was calculated to be 1.0% in March 2010, with Portugal, Estonia and Belgium as the three best-performing Member States[3]. At the current juncture characterised by large common adverse shocks (the global economic and financial crisis and the associated strong disinflationary pressures), an unusual number of countries face episodes of negative inflation rates. In these specific circumstances, negative rates of inflation constitute an economically meaningful benchmark against which to assess countries' price stability performance. However it seems warranted to exclude from the best performers those countries whose average inflation rate is distant from the euro area average inflation (0.3% in March 2010) by a wide margin – in line with the precedent of the 2004 Convergence Report[4] – as these outliers cannot reasonably be judged as being best performers in terms of price stability and including them would severely affect the reference value and thus the fairness of the criterion. In March 2010, this leads to the exclusion of Ireland, the only country whose 12-month average inflation rate (at -2.3% in March 2010) deviated by a wide margin from that of the euro area and other Member States, mainly reflecting the severe economic downturn.

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

1 For the purpose of the criterion on price stability, inflation is measured by the Harmonised Index of Consumer Prices (HICP) defined in Council Regulation (EC) No 2494/95, amended by Regulation (EC) No 1882/2003 of the European Parliament and the Council and by Regulation (EC) No 596/2009 of the European Parliament and the Council.

2 All the forecasts for inflation and other variables in the current report are from the Commission services' Spring 2010 Forecast. The Commission services' forecasts are based on a set of common assumptions for external variables and on a no-policy change assumption while taking into consideration measures that are known in sufficient detail. The forecast of the reference value is subject to significant uncertainties given that it is calculated on the basis of the inflation forecasts for the three Member States projected to be the best performers in terms of price stability in the forecast period, thereby increasing the possible margin of error.

3 The cut-off date for the data used in this report is 23 April 2010.

4 When Lithuania's average 12-month inflation was 2.3 percentage points below the euro area average 12-month inflation and was excluded from the best performers.

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

Article 3 of the Protocol on the convergence criteria 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*"[5].

The relevant two-year period for assessing exchange rate stability in this report is 24 April 2008 to 23 April 2010. When assessing exchange rate developments, the analysis takes into account the impact of external official financing arrangements wherever relevant, including their size, the amount and profile of assistance flows and the possible policy conditionality.

The fourth indent of Article 140(1) of the TFEU requires "*the durability of convergence achieved by the Member State with a derogation and of its participation in the exchange rate mechanism being reflected* ***in the long-term interest rate levels***". Article 4 of the Protocol on the convergence criteria further 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 2 percentage points that of, at most, the three best-performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions*".

The interest rate reference value was calculated to be 6.0% in March 2010[6].

Article 140(1) of the TFEU also requires an examination of other factors relevant to economic integration and convergence. These additional factors include financial and product market integration, the development of the balance of payments on current account and the development of unit labour costs and other price indices. The latter are covered within the assessment of price stability.

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

6 Estonia, which was one of the best performing Member States in terms of price stability in March 2010, does not have a harmonized benchmark long-term government bond or a comparable security that could be used for the calculation of the reference value. Therefore, in line with Article 4 of the Protocol (referring to 'at most the three best performing Member States'), the reference value for March 2010 is calculated as the simple average of the average long-term interest rates in the two other best performing Member States in terms of price stability - Portugal (4.2%) and Belgium (3.8%) - plus 2 percentage points.

2. BULGARIA

Legislation in Bulgaria - in particular the Law on the Bulgarian National Bank (henceforth BNB) - is not fully compatible with Article 130 and 131 of the TFEU and the ESCB/ECB Statute. The law on conflicts of interests contains provisions which are incompatible with the independence of the BNB. Incompatibilities and imperfections as regards the central bank integration into the ESCB subsist in the fields of monetary policy, banknotes and coins issues, the promotion of the smooth operation of payment systems, the ECB's approval before participation in international monetary institutions, the statistical role of the ECB and the EU, the auditing by independent external auditors, the institutional and personal independence, as well as the prohibition on monetary financing. A draft law elaborated by the Bulgarian Government in cooperation with the BNB, subject to its entry into force, would remove some of the existing imperfections. However, it does not cover the issues related to the integration of the BNB into the Eurosystem.

In Bulgaria, 12-month average inflation has been above the reference value since EU accession in 2007. The average inflation rate in Bulgaria during the 12 months to March 2010 was 1.7%, above the reference value of 1.0%. It is expected to remain above but move close to the reference value in the months ahead.

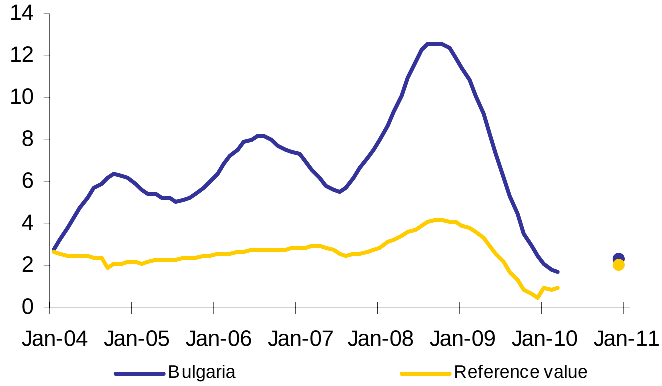
Annual HICP inflation increased strongly in the first half of 2008, peaking at 15% as a result of buoyant domestic demand and rapid increases in global food and energy prices. Since the onset of the financial crisis, inflation declined sharply to about 1.6% in late-2009 as commodity prices fell, domestic demand weakened significantly and unit labour costs increased at a more moderate pace. It picked up slightly again in early 2010 on the back of higher excise duties and rebounding fuel prices. In March 2010, annual HICP stood at 2.4%.

Inflation is expected to remain moderate at around 2.3% in 2010 according to the Commission services' Spring 2010 Forecast, reflecting the negative output gap, subdued unit labour cost increases and moderate growth of food and energy prices. Inflation is, however, likely to accelerate slightly to 2.7% in 2011 amid strengthening economic activity. The relatively low price level in Bulgaria (48% of the euro area average in 2008) suggests significant potential for further price level convergence in the long term.

Bulgaria does not fulfil the criterion on price stability.

Graph 1a: **Bulgaria - Inflation criterion since 2004**

(percent, 12-month moving average)



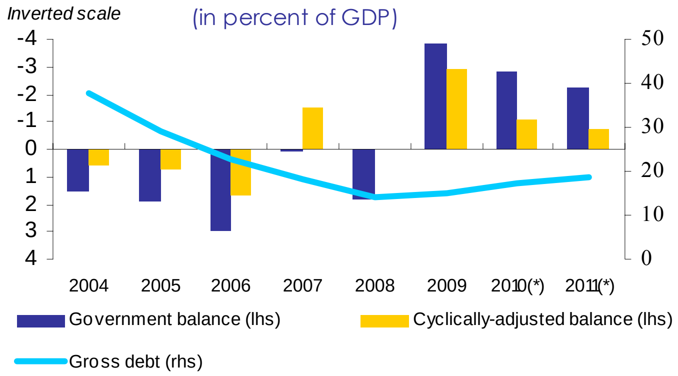
Note: The dots show the projected reference value and 12-month average inflation in the country in December 2010.
Sources: Eurostat, Commission services' Spring 2010 Forecast.

Bulgaria's general government balance was maintained in surplus over the period 2004-2008, amounting to 1.7% of GDP on average. With the onset of the crisis, the general government budget balance deteriorated significantly to a deficit of 3.9% of GDP in 2009 on the back of increased expenditures and falling revenues. According to the Commission services' Spring 2010 Forecast, the deficit-to-GDP ratio will amount to 2.8% in 2010 and 2.2% in 2011, under a no-policy-change assumption. In early 2010 the budget gap was still expanding amid weak revenue collection and higher than foreseen expenditure. However, improvements in the macroeconomic environment and the already adopted additional fiscal consolidation measures are expected to set the budget deficit on a declining path starting from the middle of the year. The gross public debt ratio remained low at around 15% of GDP in 2009, but it is projected to increase to about 17% of GDP in 2010 and 19% of GDP in 2011.

As the 3% of GDP limit for the general government deficit has been breached in 2009, the Commission has submitted a report in accordance with Article 126(3) of the Treaty, as required by the Stability and Growth Pact.

Graph 1b: **Bulgaria - Government budget balance and debt**

(in percent of GDP)



(*) Commission services' Spring 2010 Forecast.
Source: Eurostat, Commission services.

The Bulgarian lev is not participating in ERM II. The Bulgarian National Bank pursues its primary objective of price stability through an exchange rate anchor in the context of a Currency Board Arrangement (CBA). Bulgaria introduced its CBA on 1

July 1997, pegging the Bulgarian lev to the German mark and later the euro. Additional indicators, such as the developments in foreign exchange reserves and short-term interest rates, point to an increase in investors' risk perceptions in the context of the global financial crisis, which has however reversed partly since autumn 2009. A sizeable official reserves buffer continues to underpin the resilience of the CBA. During the two-year assessment period, the Bulgarian lev remained fully stable vis-à-vis the euro, in line with the operation of the CBA.

Bulgaria does not fulfil the exchange rate criterion.

The average long-term interest rate in Bulgaria in the year to March 2010 was 6.9%, above the reference value of 6.0%. Average long-term interest rates in Bulgaria stayed below the reference value from 2005 to mid-2009, but since then have exceeded the reference value. Yield spreads vis-à-vis the euro area long-term benchmark bonds[7] gradually widened from about 30 basis points in 2007 to around 110 basis points in late 2008, reflecting inflation differentials and broader concerns about the overheating of the Bulgarian economy. Long-term interest spreads increased further in 2009, reaching 350 basis points in the first half of the year as global risk appetite declined and country risk premia increased. Spreads started to narrow in the second half of 2009 on returning investors' confidence, and declined to 220 basis points in March 2010.

Bulgaria does not fulfil the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including balance of payments developments and product and financial market integration. Bulgaria’s external deficit widened significantly over the last decade, reaching some 27% of GDP in 2007, before contracting to 9% in 2009 as the trade gap started to close amid weakening domestic demand. The external deficit remains however relatively large. External financing has sharply contracted as previously large net FDI inflows declined and private credit flows slowed. The Bulgarian economy is highly integrated within the EU. In particular, trade and FDI relations with other Member States are extensive and integration of the domestic financial sector into the broader EU financial sector is also substantial, mainly thanks to a high level of foreign ownership of the banking system.

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

3. THE CZECH REPUBLIC

Legislation in the Czech Republic - in particular, the Act on the Czech National Bank (henceforth CNB) and the Act on the Financial Arbitrator - is not fully compatible with Article 130 and 131 of the TFEU and the ESCB/ECB Statute. Incompatibilities notably concern the central bank integration into the ESCB at the time of euro

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7 Countries' long-term interest spreads vis-à-vis the euro area long-term benchmark bonds are computed using the monthly series "EMU convergence criterion bond yields" published by Eurostat. The series is also published by the ECB under the name "Long-term interest rate for convergence purposes".

adoption, the central bank independence and the prohibition on monetary financing. The Act on the CNB also contains imperfections relating to the role of the ECB in the field of international cooperation, the role of the ECB and the EU for the collection of statistics and for the appointment of external auditors, the promotion of smooth operation of payment systems, the absence of an obligation to comply with the Eurosystem's regime for the financial reporting of NCB operations, the personal independence and the prohibition on monetary financing.

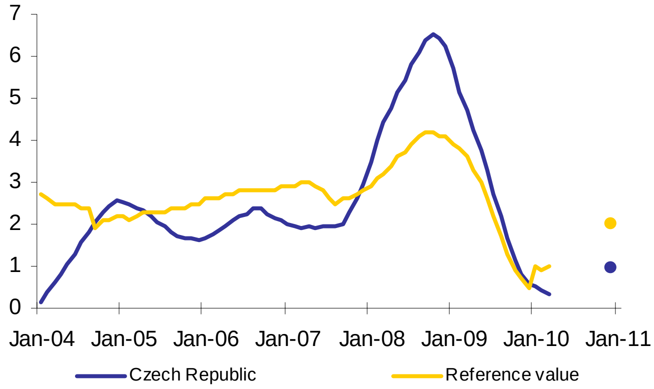
In the Czech Republic, 12-month average inflation has been below the reference value since January 2010. The average inflation rate in the Czech Republic during the 12 months to March 2010 was 0.3%, below the reference value of 1.0%, and it is likely to remain below the reference value in the months ahead.

Inflation in the Czech Republic picked up sharply in the second half of 2007 and averaged 6.3% in 2008. This was the combined result of rising energy and food prices, indirect tax changes and administered price increases. When the one-off impact of cost-push factors ebbed away and the Czech economy entered into recession, headline inflation dropped rapidly, averaging 0.6% in 2009. Headline inflation remained moderate in the first quarter of 2010, despite further increases in indirect taxes.

Inflation is expected to average around 1.0% in 2010, according to the Commission services' Spring 2010 Forecast, reflecting subdued economic activity and favourable unit labour cost developments. It is forecasted to increase moderately in 2011 to around 1.3% on average, in line with a recovery in economic activity. The price level in the Czech Republic (about 70% of the euro area average in 2008) suggests some potential for price level convergence in the long term. The favourable past track record and the anchoring of inflation expectations at a low level provide the basis for sustainable low inflation in the future.

The Czech Republic fulfils the criterion on price stability.

Graph 2a: **Czech Republic - Inflation criterion since 2004**
(percent, 12-month moving average)



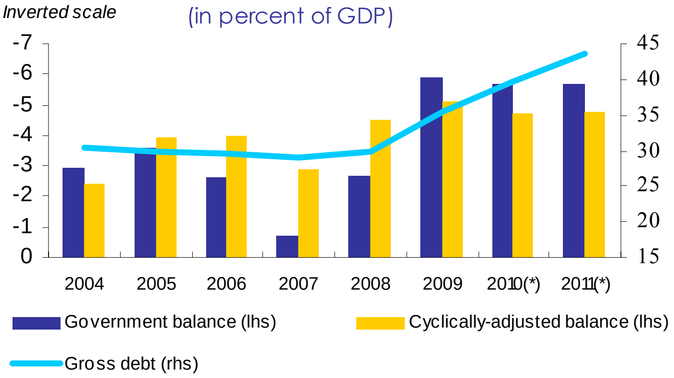
Note: The dots show the projected reference value and 12-month average inflation in the country in December 2010.
Sources: Eurostat, Commission services' Spring 2010 Forecast.

The Czech Republic is at present the subject of a Council Decision on the existence of an excessive deficit (Council Decision of 2 December 2009). The Council recommended the Czech Republic to correct the excessive deficit by 2013 and to take effective action by 2 June 2010. The general government deficit in the Czech Republic bottomed out at 0.7% of GDP in 2007, partly reflecting favourable cyclical conditions, but rebounded to 2.7% of GDP in 2008 and increased further to 5.9% of GDP in 2009. According to the Commission services' Spring 2010 Forecast, which is based on a no-policy-change assumption, the deficit-to-GDP ratio will amount to 5.7% in both 2010 and 2011, while general government debt is expected to increase from 39.8% of GDP in 2010 to 43.5% in 2011.

The Czech Republic does not fulfil the criterion on the government budgetary position.

Graph 2b: **Czech Rep - Government budget balance and debt**

(in percent of GDP)



(*) Commission services' Spring 2010 Forecast.
Source: Eurostat, Commission services.

The Czech koruna is not participating in ERM II. The Czech Republic operates a floating exchange rate regime. Following a steady appreciation since 2004, the exchange rate of the koruna strengthened to an all-time high against the euro in July 2008. The koruna depreciated strongly vis-à-vis the major currencies during the second half of 2008 amid the intensifying global financial crisis, despite the emergence of positive short-term interest rate spreads. The koruna recovered part of its losses in 2009 and early 2010, amid heightened currency volatility, reflecting a moderation in global risk aversion and the improving external balance. During the two years before this assessment, the koruna depreciated against the euro by 1.1%.

The Czech Republic does not fulfil the exchange rate criterion.

The average long-term interest rate in the Czech Republic in the year to March 2010 was 4.7%, below the reference value of 6.0%. Average long-term interest rates in the Czech Republic have been below the reference value since EU accession in May 2004. Yield spreads vis-à-vis euro area long-term benchmark bonds widened amid the intensification of the global financial crisis in the second half 2008. Nonetheless, the yields on Czech government bonds have been less affected than other non euro area Member States. Spreads vis-à-vis the euro narrowed in the second half of 2009 and in the first quarter 2010, reflecting notably cuts in the central bank's policy rates as well as the comparatively strong fundamentals of the country. Spreads were at around 40 basis points in March 2010.

The Czech Republic fulfils the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including balance of payments developments and product and financial market integration. After having reached a deficit of 2.6% of GDP in 2007, the external balance of the Czech Republic improved to a moderate surplus in 2008-2009, reflecting both a higher trade surplus and a narrowing income balance deficit. The improvement in the external balance of the Czech Republic suggests that external financing constraints pose no major problems. The Czech economy is highly integrated with the EU. In particular, trade and FDI relations with other Member States are extensive and integration of the domestic financial sector into the broader EU sector has progressed substantially, mainly through a high degree of foreign ownership of financial intermediaries.

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

4. ESTONIA

Legislation in Estonia is fully compatible with Article 130 and 131 of the TFEU and the ESCB/ECB Statute. The revised Eesti Pank Act was adopted by the Parliament on April 22, 2010, and as amended is now compatible with Article 130 and 131. The Currency Law and the Law on the Security of the Estonian kroon was repealed and replaced by the Law on Introduction of euro adopted by the Parliament also on April 22, 2010, with effect from the date of the introduction of the euro foreseen on 1 January 2011. Article 111 of Estonia's Constitution is not formally compatible with the requirements of the TFEU and the ECB/ESCB Statute, as regards the central bank integration into the ESCB at the time of euro adoption. However, the ruling of May 11, 2006 of the Constitutional Review Chamber of Estonia's Supreme Court removes the need for further amendment.

In Estonia, 12-month average inflation has been below the reference value since December 2009. The average inflation rate in Estonia during the 12 months to March 2010 was -0.7%, well below the reference value of 1.0%, and it is likely to remain below the reference value in the months ahead.

HICP annual inflation picked up in 2007 on the back of strong domestic demand and rapid wage increases, amid increasing capacity constraints in the economy. Inflation peaked at double digits in 2008, followed by a rapid decline in 2009. Domestic demand-related pressures started to ease in early 2008 as the economic cycle started to turn, although increases in excise duties and rising global commodity prices delayed the downward adjustment. The economic downturn and the ensuing decline in demand and wages led to negative annual inflation rates from the second half of 2009 onwards, while inflation turned positive again in March following an increase in administered prices in January and March 2010 and increases in global energy prices.

Inflation is expected to remain subdued in 2010 and to pick up slightly to 2.0% in 2011 according to the Commission services' Spring 2010 Forecast. In 2010 inflation is likely to be driven mainly by increased indirect taxes, as underlying inflationary pressures remain subdued, with consumption and nominal wages projected to strengthen moderately only from 2011. The price level in Estonia (75% of the euro area average in 2008) suggests some potential for further price level convergence in the long term.

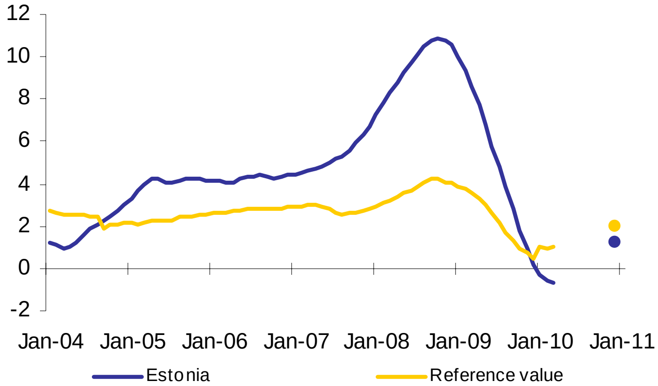
Sustainable convergence implies that respect of the reference value reflects underlying fundamentals rather than temporary factors. In the case of Estonia, the steep economic downturn has been an important temporary factor driving 12-month average inflation to its current negative level, and a moderate rebound is expected once the recovery gains hold. At the same time, the pace of disinflation and the evolution of underlying domestic drivers (notably unit labour costs) point to a broadly flexible wage and price formation process.

Medium-term inflation prospects will critically depend on the alignment of wage setting and productivity developments. Continued flexible labour markets together with competitive price formation in product markets will be key to maintain price stability in the medium term. Price developments will also depend on maintaining an ambitious fiscal policy stance, including cautious wage setting in the public sector, to keep domestic demand in line with fundamentals and help anchor inflation expectations at low levels. The combination of factors that drove buoyant credit expansion in the past (pent-up credit demand, accelerated financial deepening and integration, rapid risk spread compression) is not expected to recur.

Together with the fact that the reference value is met by a wide margin, these considerations support a positive assessment on the fulfilment of the price stability criterion. Nevertheless, continued vigilance will be important to prevent the re-emergence of domestic demand pressures as the recovery takes hold. These factors imply that the prospects for the sustainability of low inflation are overall favourable, provided that stability-oriented policies are maintained.

Estonia fulfils the criterion on price stability.

Graph 3a: **Estonia - Inflation criterion since 2004**
(percent, 12-month moving average)

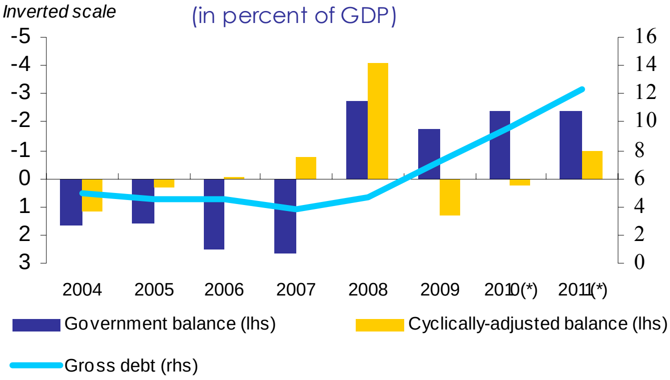


Note: The dots show the projected reference value and 12-month average inflation in the country in December 2010.
Sources: Eurostat, Commission services' Spring 2010 Forecast.

Estonia is not the subject of a Council Decision on the existence of an excessive deficit. Estonian public finances were in surplus between 2002 and 2007. In 2008, a general government deficit of 2.7% of GDP was recorded, followed by a deficit of 1.7% of GDP in 2009. According to the Commission services' Spring 2010 Forecast, the deficit-to-GDP ratio would amount to around 2½% in both 2010 and 2011 under a no-policy-change assumption. Gross public debt increased to 7.2% of GDP in 2009 and is projected to increase further to 12.4% of GDP in 2011 according to the Commission services' Spring 2010 Forecast. The government maintained a positive net asset position in 2009, owing to robust fiscal reserves accumulated over the previous years.

Estonia fulfils the criterion on the government budgetary position.

Graph 3b: **Estonia - Government budget balance and debt**
(in percent of GDP)



(*) Commission services' Spring 2010 Forecast.
Source: Eurostat, Commission services.

The Estonian kroon has participated in ERM II since 28 June 2004, i.e. for close to six years at the time of adoption of this report. Estonia has been operating a Currency Board Arrangement since the reintroduction of the kroon in 1992, with the kroon initially pegged to the Deutsche mark, and later the euro. Upon ERM II entry, Estonia unilaterally committed to maintain the currency board arrangement within the mechanism. Additional indicators, such as developments in short-term interest rates, point to a temporary increase in risk perceptions in the context of the global financial crisis, which reversed towards the end of 2009 and in early 2010 amid a resumption of investor confidence. The Currency Board Arrangement remains well supported by official reserves. A precautionary agreement with the Swedish Riksbank in the context of cross-border financial stability co-operation was in place between February and December 2009, but has not been used. During the two-year assessment period, the kroon did not deviate from the central rate, and it did not experience severe tensions.

Estonia fulfils the exchange rate criterion.

As a result of Estonia's very low level of gross public debt, no benchmark long-term government bonds or other appropriate securities are available to assess the durability of convergence as reflected in long-term interest rates. A qualitative assessment based on relevant market indicators suggests that risk perceptions vis-à-vis Estonia increased at the height of the crisis, but declined again significantly towards the end of 2009 amid a stabilising economic situation and a determined policy response to the crisis. More broadly, factors such as Estonia's fiscal policy track record, low public debt and comparatively flexible economy are conducive to the durability of convergence. Against this background, the development of financial market indicators during the reference period, as well as a broader assessment on the durability of convergence, would support a positive assessment on Estonia's fulfilment of the long-term interest rate criterion.

Additional factors have also been examined, including balance of payments developments and product and financial market integration. Estonia's external balance turned to a significant surplus of 7.4% of GDP in 2009, after several years of high deficits reaching a peak of about 18% of GDP in 2007. The surplus reflected a sharp narrowing of the trade deficit, resulting from contracting domestic demand, as well as an improvement of the income balance. According to the Commission services' 2010 Spring Forecast, Estonia's external balance is expected to remain in surplus in 2010 and 2011. External financing contracted during the crisis, but rollover risks are mitigated by the largely foreign-owned banking system and considerable external buffers. The Estonian economy is highly integrated within the EU. In particular, trade and FDI relations with other Member States are extensive, and integration of the domestic financial sector into the broader EU sector has progressed substantially, mainly through a high degree of foreign ownership of financial intermediaries.

In the light of its assessment on legal compatibility and on the fulfilment of the convergence criteria, and taking into account the additional factors, the Commission considers that Estonia fulfils the conditions for the adoption of the euro.

5. LATVIA

Legislation in Latvia - in particular the Law on the Bank of Latvia - is not fully compatible with Article 130 and 131 of the TFEU and the ESCB/ECB Statute. Incompatibilities notably concern the central bank integration into the ESCB at the time of euro adoption, the independence of the central bank and the prohibition on monetary financing. Imperfections subsist as regards the objectives of the ESCB, the promotion of the smooth operation of payment systems, the statistical role of the ECB and the EU, the appointment of external auditors and the scope of audit performed by the audit commission, the role of the ECB in the field of international cooperation, the rules for publishing balance sheets and the Eurosystem's regime for the financial reporting of NCB operations, the institutional and financial independence of the Bank, as well as the personal independence of the members of the Bank of Latvia’s decision-making bodies.

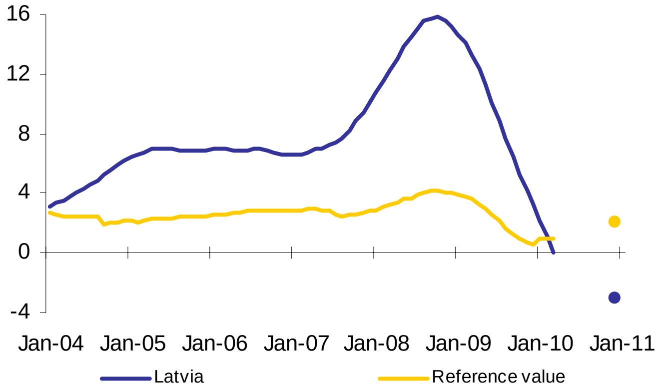
In Latvia, the 12-month average inflation rate was above the reference value between May 2004 and February 2010. The average inflation rate in Latvia during the 12 months to March 2010 was 0.1%, i.e. below the reference value of 1.0% for the first time since EU accession and it is likely to remain well below the reference value in the months ahead.

Between late 2004 and 2008, HICP inflation in Latvia was among the highest in the EU, reaching a double-digit peak in mid-2008. Subsequently, however, HICP inflation has been decreasing rapidly, driven by sharply contracting domestic demand, falling wages and declining import prices. Year-on-year inflation rates turned negative in October 2009.

HICP inflation is expected to remain in negative territory in 2010 and 2011 according to the Commission services' Spring 2010 Forecast, largely driven by domestic factors. The severe recession, which has led to a rapid increase in unemployment and a nominal reduction of gross wages, will be reflected in further declining unit labour costs, weak domestic demand and subdued headline inflation in the near to medium term. While it is still too early to conclude that the necessary realignment of wages and productivity has been fully attained, the limited scope for further price and wage reductions in a small open economy with a high share of imports in consumption like Latvia and possible outward migration suggest a return to positive inflation over the coming years. The price level in Latvia (almost 70% of the euro area average in 2008) suggests some potential for further price level convergence over the long term.

Latvia fulfils the criterion on price stability.

Graph 4a: **Latvia - Inflation criterion since 2004**
(percent, 12-month moving average)



Note: The dots show the projected reference value and 12-month average inflation in the country in December 2010.
Sources: Eurostat, Commission services' Spring 2010 Forecast.

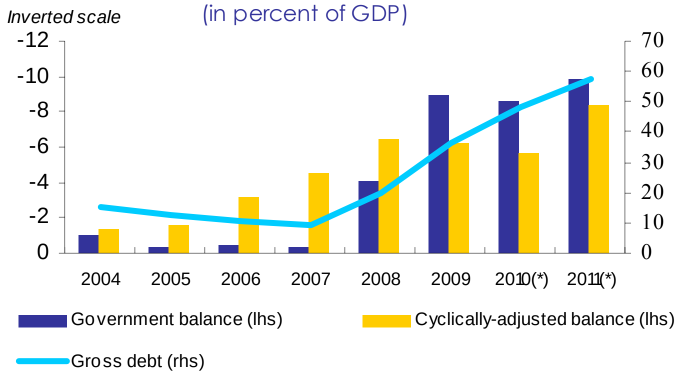
Latvia is at present the subject of a Council Decision on the existence of an excessive deficit (Council Decision of 7 July 2009)[8]. The Council recommended Latvia to correct the excessive deficit by 2012. The general government deficit in Latvia reached 4.1% of GDP in 2008 and increased further to 9.0% of GDP in 2009. The Commission services' Spring 2010 Forecast projects the deficit-to-GDP ratio to be 8.6% in 2010 and 9.9% in 2011 under a no-policy-change assumption. Gross public debt increased to above 36% of GDP in 2009 and is projected to further increase to about 57% of GDP in 2011.

Latvia does not fulfil the criterion on the government budgetary position.

[8] 2009/591/EC, OJ L 202, 4.8.2009, p.50

Graph 4b: **Latvia - Government budget balance and debt**

(in percent of GDP)



(*) Commission services' Spring 2010 Forecast.
Source: Eurostat, Commission services.

The Latvian lats has participated in ERM II since 2 May 2005, i.e. for more than five years at the time of adoption of this report. Upon ERM II entry, the authorities unilaterally committed to keep the lats within the ±1% fluctuation margin around the central rate. During the two years preceding this assessment, the lats exchange rate did not deviate from its central rate by more than ±1%. However the exchange rate was subject to episodes of severe tensions, as reflected in the evolution of additional indicators such as developments in official reserves and short-term interest rates.

The lats came under heavy pressures in autumn 2008 when, against a background of large and increasing macro-imbalances, markets grew increasingly concerned over the sustainability of the peg. The Latvian authorities' initial responses to stabilise the financial system failed to stem the capital outflows and the Bank of Latvia was forced to sell roughly one quarter of its international reserves in currency exchanges until year-end. In December 2008, an agreement to provide Latvia with a coordinated package of international financial assistance helped ease pressures on the exchange rate temporarily.

The exchange rate peg came under renewed pressure in the first half of 2009 amid political instability and a sharply deteriorating economic outlook. Tensions culminated in June when short-term interbank market rates temporarily rose to above 30%, reflecting inter alia the system-wide lats liquidity shortage and mounting uncertainty about the authorities' capacity to sustain the exchange rate regime. While the peg was successfully defended, gross foreign assets were depleted by more than one third between end-February and end-June. Financial market conditions improved visibly during summer 2009, following the loan disbursements in the context of the coordinated international financial assistance package. Since the second half of 2009, pressures on the exchange rate have been largely absent.

Latvia does not fulfil the exchange rate criterion.

The average long-term interest rate in Latvia in the year to March 2010 was 12.7%, well above the reference value of 6.0%. The average long-term interest rate in Latvia was below the reference value from May 2004 until the end of 2008. In December 2008, the 12-month moving average long-term interest rate rose above the reference value and has increased further since then. Latvia's long-term spreads to the euro area widened considerably in the second half of 2008 and in 2009, reacting to adverse changes in sentiment among investors and rating agencies towards the country amid the economic and financial crisis. Following signs of economic stabilisation and easing financial market conditions, the yield differential narrowed somewhat. It stood around 7 percentage points in March 2010.

Latvia does not fulfil the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including balance of payments developments and product and financial market integration. In the pre-crisis years, the booming economy led to a very large widening of deficits on the external balance, to above 20% of GDP in both 2006 and 2007. In the course of 2008 and 2009, the external balance adjusted rapidly to the recession that hit the country. It turned into a sizeable surplus in 2009, almost 12% of GDP, reflecting inter alia an improvement in the trade balance, mainly due to a sharp fall in imports (much more rapid than that of exports), positive figures on the income account and advanced payments by the EU structural funds.

With the escalation of the international financial turmoil in the second half of 2008, the financing of the external deficit became increasingly difficult. The global liquidity crisis prevented the private and public sectors from accessing international private capital markets and obtaining the foreign currency needed to ease the mounting liquidity strains in the banking system. In late 2008, the European Union, the IMF, the World Bank and the EBRD agreed to provide Latvia with a coordinated package of international financial assistance totalling up to EUR 7.5 billion over the period to 2011, of which up to EUR 3.1 billion under the EU Balance of Payments facility, accompanied by comprehensive policy conditionality so as to restore balance-of-payments viability. By end-March 2010, more than half of the pre-committed financial resources had been disbursed following the fulfilment of the policy conditionality associated to the successive tranches of the assistance.

The Latvian economy is increasingly integrated within the EU, and trade and FDI relations with EU Member States are growing, in particular with the neighbouring Baltic countries but also with other new Member States. Latvia's financial sector is well integrated into the broader EU economy, mainly through a high degree of foreign ownership of financial intermediaries.

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

6. LITHUANIA

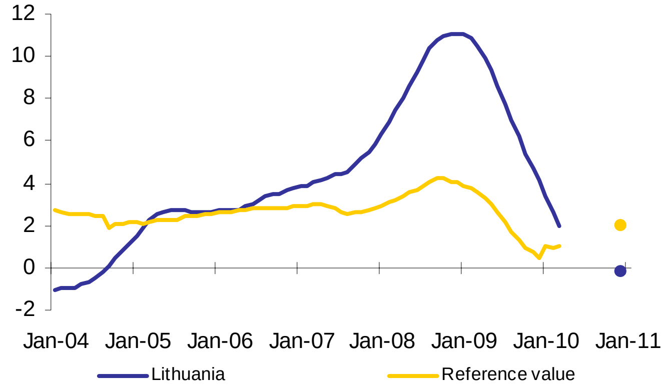
The Law on the Bank of Lithuania and other legislation concerning the Bank of Lithuania were considered fully compatible in the Convergence Report 2008. However, following their amendments, Article 23 of the Law on the Bank of Lithuania introduced a new rule on the allocation of the Bank of Lithuania profits and Article 14(4) of the Law on the State Audit Office now explicitly empowers the State Audit Office to perform the audit in the Bank of Lithuania. These are two imperfections with regard to the independence of the Central Bank. In Lithuania, 12-month average inflation remained above the reference value in 2008 and 2009, although the gap vis-à-vis the reference value narrowed gradually. The average inflation rate in Lithuania during the 12 months to March 2010 was 2.0%, above the reference value of 1.0%, and it is expected to fall below the reference value in the months ahead.

Annual HICP inflation increased sharply in the first half of 2008 amid buoyant domestic demand and strong increases in global commodity prices. Inflation peaked in mid-2008 and has been on a declining trend since then, on the back of falling oil and food prices, contracting domestic demand and declining wages. Increases in indirect taxes and administered prices only partially offset the disinflationary pressures. Annual HICP inflation receded to -0.4% in March 2010.

Inflation is expected to remain around zero in 2010 and to increase modestly to 1.4% in 2011 according to the Commission services' Spring 2010 Forecast, reflecting weak domestic demand, falling labour costs and ample spare capacity. The relatively low price level in Lithuania (around 62% of the euro area average in 2008) suggests potential for further price level convergence in the long term.

Lithuania does not fulfil the criterion on price stability.

Graph 5a: **Lithuania - Inflation criterion since 2004**
(percent, 12-month moving average)

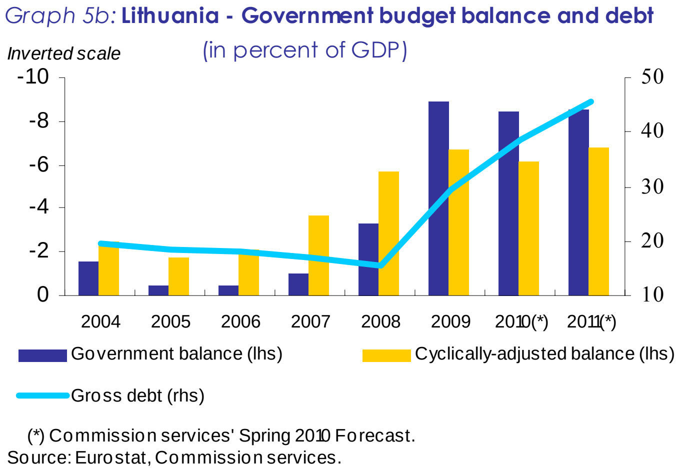


Note: The dots show the projected reference value and 12-month average inflation in the country in December 2010.
Sources: Eurostat, Commission services' Spring 2010 Forecast.

Lithuania is at present the subject of a Council Decision on the existence of an excessive deficit (Council Decision of 7 July 2009)[9]. In February 2010, the Council recommended Lithuania to correct the excessive deficit by 2012. After recording rather limited deficits over the period 2004-2007, the general government balance reached 3.2% of GDP in 2008 and an estimated 8.9% for 2009, despite the significant fiscal consolidation effort. According to the Commission services' Spring 2010 Forecast, the deficit-to-GDP ratio will amount to around 8.4% in 2010 and 8.5% in 2011 under a no-policy-change assumption. The gross public debt ratio, after declining steadily to 15.6% in 2008, increased to 29.3% in 2009 and is projected to further increase to 45.4% of GDP in 2011.

Lithuania does not fulfil the criterion on the government budgetary position.

[9] 2009/588/EC, OJ L 202, 4.8.3009, p44-45



Lithuania entered ERM II on 28 June 2004 and has been participating in the mechanism for close to six years at the time of the adoption of this report. Upon ERM II entry, the authorities unilaterally committed to maintain the prevailing Currency Board Arrangement in the mechanism. Additional indicators, such as developments in short-term interest rates, point to a temporary increase in risk perception in the context of the global financial crisis, which reversed in late 2009. The Currency Board Arrangement remains well supported by official reserves. During the two-year assessment period, the litas did not deviate from the central rate, and it did not experience severe tensions.

Lithuania fulfils the exchange rate criterion.

The average long-term interest rate in Lithuania in the year to March 2010 was 12.1%, well above the reference value of 6.0%. Average long-term interest rates in Lithuania stayed consistently below the reference value during 2004–2008. Since 2009, long-term interest rates have been above the reference value, driven by a small number of low-volume trades executed in January amid high risk perceptions towards the region, as no new trades took place for the subsequent 11 months. As new trades were executed in late 2009 and early 2010, the average long-term interest rate spread vis-à-vis the euro area narrowed markedly. Lithuania's long-term interest rate spread stood at around 150 basis points in March 2010.

Lithuania does not fulfil the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including balance of payments developments and product and financial market integration. After having reached a deficit of some 10% of GDP in 2008, Lithuania's external balance turned into a surplus of 7% of GDP in 2009, led by a sharp narrowing of the trade deficit amid falling domestic demand. According to the Commission services' 2010 Spring Forecast, Lithuania's external balance is expected to remain in surplus in 2010 and 2011. External financing has been hit by the global financial crisis, as private sector capital flows reversed sharply. The Lithuanian economy is highly open and well integrated within the EU. In particular, trade and FDI relations with other Member States are strong, and Lithuania’s financial system is well integrated into the broader EU financial system, mainly through a high degree of foreign ownership of financial intermediaries.

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

7. HUNGARY

Legislation in Hungary - in particular the Act on the Magyar Nemzeti Bank (henceforth MNB), the Statutes of the MNB, the Constitution of Hungary and the Credit Institutions Act - is not fully compatible with the TFEU and the ESCB/ECB Statute. Incompatibilities concern the central bank integration into the ESCB at the time of euro adoption, the independence as well as the prohibition on monetary financing. Imperfections subsist as regards the objectives of the ESCB, banknotes and coins issues, the promotion of the smooth operations of payment systems, the statistical role of the ECB and the EU, the role of the ECB in the field of international cooperation, the absence of an obligation to comply with Eurosystem's financial reporting regime, the financial and personal independence of the MNB as well as the prohibition on monetary financing.

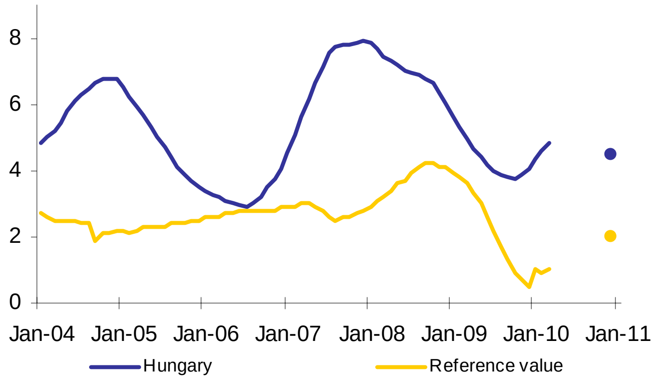
In Hungary, 12-month average inflation has been above the reference value since EU accession. The average inflation rate in Hungary during the 12 months to March 2010 was 4.8%, well above the reference value of 1.0%, and it is likely to remain above the reference value in the months ahead.

HICP annual inflation peaked in early 2007 as a result of a surge in energy and food prices and increases in indirect taxes and administered prices. Inflation then declined until January 2009, as inflation in food and energy items gradually receded and the inflationary impact of one-off measures faded out. Inflation started to rise again in the first half of 2009 driven by the pass-through of the weaker exchange rate to unprocessed food and industrial goods prices. As the downward adjustment in growth of nominal compensation per employee did not fully match the drop in labour productivity in the recession, growth of nominal unit labour costs remained positive. A VAT increase in July 2009 induced a further jump in consumer prices. HICP inflation averaged 4.0% in 2009.

Inflation is expected to drop to below 3% in the second half of 2011. The fading out of the inflationary impact of one-off measures adopted in 2009 is expected to be the main driver of the disinflationary process, while the substantial negative output gap is likely to further constrain underlying inflationary pressures and unit labour cost increases. The relatively low price level in Hungary (about 65% of the euro area average in 2008) suggests potential for further price level convergence in the long term.

Hungary does not fulfil the criterion on price stability.

Graph 6a: **Hungary - Inflation criterion since 2004**
(percent, 12-month moving average)

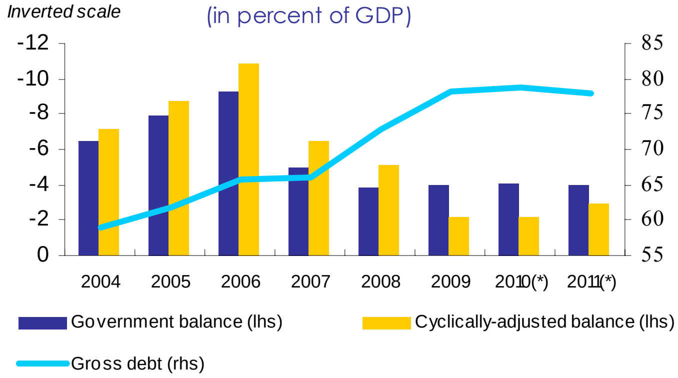


Note: The dots show the projected reference value and 12-month average inflation in the country in December 2010.
Sources: Eurostat, Commission services' Spring 2010 Forecast.

Hungary is at present the subject of a Council Decision on the existence of an excessive deficit (Council Decision of 5 July 2004)[10]. The most recent Council Recommendation under Article 104(7) TEC was adopted on 7 July 2009. The Council recommended Hungary to put an end to the existing excessive deficit by 2011 at the latest. The general government deficit reached 3.8% of GDP in 2008 and remained broadly stable at 4.0% of GDP in 2009 despite a substantial deterioration in domestic economic activity. According to the Commission services' Spring 2010 Forecast, the deficit-to-GDP ratio should remain broadly unchanged in both 2010 and 2011 under a no-policy-change assumption. Government gross debt increased to almost 80% of GDP in 2009 and is projected to remain broadly stable until 2011.

Hungary does not fulfil the criterion on the government budgetary position.

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



(*) Commission services' Spring 2010 Forecast.
Source: Eurostat, Commission services.

The Hungarian forint is not participating in ERM II. In February 2008, Hungary moved to a free-floating exchange rate regime, abandoning the unilateral peg of the forint to the euro (with a +/- 15% fluctuation band). The forint appreciated strongly in the first half of 2008 supported by three successive policy rate hikes by the central

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10 2004/918/EC, OJ L 389, 30.12.2004, p.27.

bank. However, the exchange rate depreciated substantially in the subsequent three months as the Hungarian economy appeared to be particularly vulnerable to the global financial market turmoil. The agreement to provide Hungary with a coordinated package of international financial assistance coupled with a tightening of monetary policy led to a temporary stabilization of the exchange rate, but depreciation pressures resumed in early 2009. In line with the general improvement in global financial markets, the forint started to recover in early March 2009 and followed an appreciating trend until July 2009. Thereafter, the exchange rate remained relatively stable, amid a gradual loosening of monetary policy. During the two-year assessment period, the forint depreciated by about 4.6% against the euro.

Hungary does not fulfil the exchange rate criterion.

The average long-term interest rate in Hungary in the year to March 2010 was 8.4%, above the reference value of 6.0%. Average long-term interest rates in Hungary stayed above the reference value since EU accession, reflecting high risk premia in view of perceived weak macroeconomic fundamentals. From a low of less than 200 basis points in July 2007, spreads vis-à-vis euro area long-term benchmark bonds widened to above 700 basis points in March 2009. The upward trend initially reflected lower global risk appetite vis-à-vis emerging markets but later increasingly also specific concerns about Hungarian financial stability. An improving global financial market situation and the adoption of additional fiscal consolidation measures brought about a gradual narrowing of spreads to the euro area, to about 350 basis points in March 2010.

Hungary does not fulfil the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including balance of payments developments and product and financial market integration. After having reached a deficit of some 6% of GDP in 2008, Hungary's external balance turned into a surplus of 1.6% of GDP in 2009, mainly as a result of a large improvement in the trade balance induced by a substantial fall in domestic demand. The composition of external financing changed substantially following EU accession, with net portfolio inflows turning negative in 2007 and FDI coverage of the external deficit also declining substantially in 2008. As a result, other investment, notably banks' external borrowing, became the major source of external financing since 2007. The large vulnerability to shifts in external financing conditions led to balance of payments difficulties in autumn 2008, as private foreign capital inflows contracted in the context of the global financial market turmoil. In late October 2008, the European Union, the International Monetary Fund and the World Bank agreed on a EUR 20 billion assistance package for Hungary, of which EUR 6.5 billion under the EU Balance of Payments facility. The majority of the pre-committed financial resources was disbursed in late 2008 and throughout 2009, following the fulfilment of the policy conditionality associated to the successive tranches of the assistance.

The Hungarian economy is highly integrated within the EU. In particular, trade and FDI relations with other Member States are extensive and integration of the domestic financial sector into the broader EU financial sector is also substantial, mainly through a high degree of foreign ownership of financial intermediaries.

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

8. POLAND

Legislation in Poland - in particular the Act on the National Bank of Poland (henceforth NBP) and the Constitution of Poland - is not fully compatible with Article 130 and 131 TFEU and the ESCB/ECB Statute. Incompatibilities concern the objectives of the ESCB, the central bank integration into the ESCB at the time of euro adoption, the independence of the central bank, the prohibition on monetary financing and the objectives of the monetary policy. Imperfections subsist as regards the reference to the objectives of the ESCB, the statistical role of the ECB and the EU, the role of the ECB in the field of international cooperation, the role of the ECB and the Council for appointing the external auditor, the role of the ECB for the functioning of payment systems, the absence of an obligation to comply with Eurosystem's financial reporting regime, the obligation to consult the ECB for certain acts and the personal independence of the NBP's decision-making bodies.

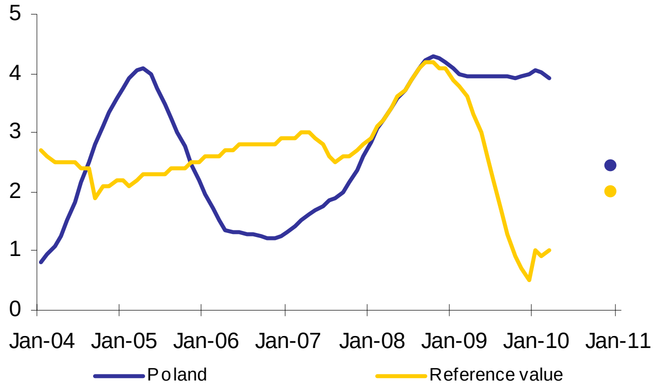
In Poland, 12-month average inflation has been above the reference value since October 2008. The average inflation rate in Poland during the 12 months to March 2010 was 3.9%, well above the reference value of 1.0%, and it is likely to remain above the reference value in the months ahead.

HICP annual inflation was elevated in 2008-2009, averaging about 4%. In 2008, this reflected the rapid increase in global food and energy prices, together with buoyant domestic demand and a rapid increase in unit labour costs. In 2009, a surge in unprocessed food prices, increases in administered prices (notably of electricity and gas), higher excises taxes as well as the effect of the strong weakening of the zloty in the second half of 2008 and early 2009 offset the dampening effect of weaker demand on inflation. Subsequently, the disinflationary effect of low domestic demand contributed to a moderate decline in HICP inflation.

Inflation is expected to be lower in 2010 and 2011, averaging about 2.5% according to the Commission services' Spring 2010 Forecast. The projected fall in inflation reflects the negative output gap following the crisis, subdued increases in unit labour cost and the expected lower growth of food and energy prices. Inflation is likely to increase somewhat in the course of 2011, on the back of a rebound in economic activity. The relatively low price level in Poland (about 66% of the euro area average in 2008) suggests potential for further price level convergence in the long term.

Poland does not fulfil the criterion on price stability.

Graph 7a: **Poland - Inflation criterion since 2004**
(percent, 12-month moving average)

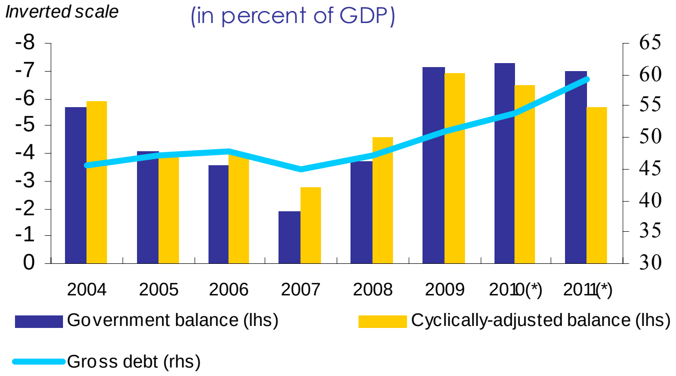


Note: The dots show the projected reference value and 12-month average inflation in the country in December 2010.
Sources: Eurostat, Commission services' Spring 2010 Forecast.

Poland is at present the subject of a Council Decision on the existence of an excessive deficit (Council Decision of 6 July 2009)[11]. The Council recommended Poland to correct the excessive deficit by 2012. The general government deficit in Poland reached 3.6% of GDP in 2008 and increased further to 7.1% of GDP in 2009. According to the Commission services' Spring 2010 Forecast, the deficit-to-GDP ratio will amount to around 7 ½% in both 2010 and 2011 under a no-policy-change assumption. Despite high average real GDP growth, gross public debt increased to 51% of GDP in 2009 and is projected to further increase to about 59% of GDP in 2011.

Poland does not fulfil the criterion on the government budgetary position.

Graph 7b: **Poland - Government budget balance and debt**
(in percent of GDP)



(*) Commission services' Spring 2010 Forecast.
Source: Eurostat, Commission services.

The Polish zloty is not participating in ERM II. Poland operates a floating exchange rate regime. Following a steady appreciation between 2004 and mid-2008, the zloty lost about 30% against the euro between July 2008 and February 2009. The impact of a generalised increase in risk aversion of investors during the financial crisis and the deterioration in sentiment vis-à-vis emerging markets were amplified by the

[11] 2009/589/EC, OJ L 202, 4.8.2009, p.46.

exercising of foreign exchange option contracts. In this period, there was also a sharp widening of 3-month interest rate spreads vis-à-vis the euro area, to above 300 basis points. Since March 2009, the zloty has been on a broadly appreciating trend, amid improved market sentiment and supported by the granting of an IMF Flexible Credit Line, which has however not been drawn on by the Polish authorities. During the two-year assessment period, the zloty depreciated by about 12% against the euro.

Poland does not fulfil the exchange rate criterion.

The average long-term interest rate in Poland in the year to March 2010 was 6.1%, above the reference value of 6.0%. Average long-term interest rates in Poland stayed below the reference value from November 2005 to December 2009, but since then have been slightly above it. From a relatively low level of below 100 basis points, yield spreads vis-à-vis the euro area gradually widened in the course of 2007 and 2008, initially reflecting expectations of further tightening of monetary policy and, from the second half of 2008, a broad sell-off of emerging markets' assets. Long-term yield spreads to the euro area remained broadly stable at around 230 basis points on average in 2009 and stood at about 200 basis points in March 2010.

Poland does not fulfil the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including balance of payments developments and product and financial market integration. After having reached a deficit of some 4% of GDP in 2008, Poland's external account was broadly in balance in 2009, led by a sharp narrowing of the trade deficit resulting from a fall in domestic demand and a price-driven shift in the composition of imports in favour of domestically produced goods. External financing has remained broadly resilient, with the external deficit financed by net FDI inflows and, to an increasing extent, by intra-group bank and corporate lending. The Polish economy is increasingly integrated within the EU. In particular, trade and FDI relations with other Member States are growing, and integration of the domestic financial sector into the broader EU sector has progressed substantially, mainly through a high degree of foreign ownership of financial intermediaries.

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

9. ROMANIA

Legislation in Romania, in particular the Law on the BNR, is not fully compatible with Article 130 and 131 of the TFEU and the ESCB/ECB Statute. Incompatibilities concern the central bank integration into the ESCB at the time of euro adoption, the independence of the Banca Națională a României (henceforth BNR) as well as the prohibition on monetary financing. Imperfections subsist as regards the reference to the objectives of the ESCB, institutional and personal independence, the ECB's right to be consulted in its fields of competence, the absence of an obligation to comply with the Eurosystem's regime for the financial reporting of NCB operations, the promotion of the smooth operation of payment systems, the statistical role of the ECB and of the EU and their role for the appointment of an external auditor.

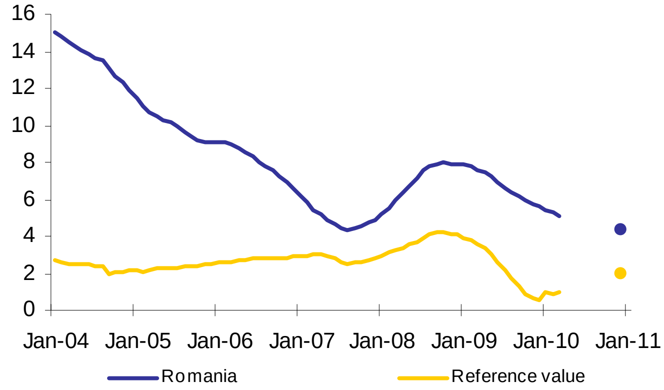
In Romania, 12-month average inflation has been above the reference value since EU accession in 2007. The average inflation rate in Romania during the 12 months to March 2010 was 5.0%, well above the reference value of 1.0%, and it is likely to remain well above the reference value in the months ahead.

Romanian inflation was elevated in recent years. Annual inflation increased sharply in the second half of 2007 on the back of rising food and fuel prices, and strong growth of unit labour costs. Inflation peaked at a three-year high of 9.1% in July 2008. In 2009, HICP inflation remained high despite the sharp economic downturn, averaging 5.6%. This reflected inter alia substantial increases in excise duties as well as persistently high inflation in services.

Inflation is expected to moderate in 2010 and 2011 on the back of muted economic activity and in line with fading price effects related to the excise duty hikes. The Commission services' Spring 2010 Forecast projects annual HICP inflation to average 4.3% in 2010 and 3.0% in 2011. The relatively low price level in Romania (around 58% of the euro area average in 2008) suggests significant potential for further price level convergence in the long term.

Romania does not fulfil the criterion on price stability.

Graph 8a: **Romania - Inflation criterion since 2004**
(percent, 12-month moving average)

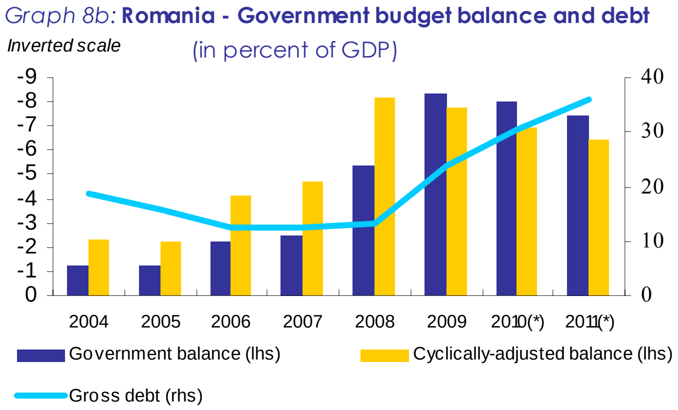


Note: The dots show the projected reference value and 12-month average inflation in the country in December 2010.
Sources: Eurostat, Commission services' Spring 2010 Forecast.

Romania is at present the subject of a Council Decision on the existence of an excessive deficit (Council Decision of 7 July 2009)[12]. In February 2010, the Council recommended Romania to correct the excessive deficit by 2012. The general government deficit in Romania exceeded the 3% threshold in 2008, reaching 5.4% of GDP, and deteriorated further to 8.3% of GDP in 2009. According to the Commission services' Spring 2010 Forecast, which is based on a no-policy-change assumption, the deficit-to-GDP ratio will amount to 8.0% in 2010 and decrease to 7.4% in 2011, while general government debt is expected to increase from 30.5% of GDP in 2010 to 35.8% in 2011.

Romania does not fulfil the criterion on the government budgetary position.

[12] 2009/589/EC, OJ L 202, 4.8.2009, p.46.



(*) Commission services' Spring 2010 Forecast.
Source: Eurostat, Commission services.

The Romanian leu is not participating in ERM II. Romania operates a floating exchange rate regime. Following an appreciation trend between end-2004 and mid-2007, the start of turbulences on world financial markets in the second half of 2007 led to a substantial depreciation of the exchange rate of the leu. Strong weakening pressures set in again during autumn 2008 amid the intensification of the global financial crisis and against a background of large domestic macroeconomic imbalances. Short-term interest rate differentials vis-à-vis the euro area started to widen in late 2008 as the ensuing lack of liquidity drove up Romanian short-term interest rates, reflecting heightened risk aversion among financial institutions. Following an agreement in early 2009 to provide Romania with a coordinated package of international financial assistance, financial market pressures eased somewhat and the Romanian leu broadly stabilised in the course of 2009 and in early 2010. Short-term interest rate spreads vis-à-vis the euro area narrowed in 2009 and early 2010, reflecting notably improved money market conditions, declines in the BNR's key policy rates as well as positive confidence effects related to the disbursements of the international financial assistance. During the two years before this assessment, the leu depreciated against the euro by 12.9%.

Romania does not fulfil the exchange rate criterion.

Average long-term interest rates in Romania have been above the reference value since EU accession. The average long-term interest rate in Romania in the year to March 2010 was 9.4%, above the reference value of 6.0%. Spreads vis-à-vis the euro area widened in the second half of 2007 and in 2008, in the wake of the global financial crisis and domestic imbalances. Long-term interest rates in Romania remained elevated in 2009 amid increased volatility, before narrowing slightly in early 2010 on the back of some signs of easing in domestic market conditions. The spread vis-à-vis the euro area was around 350 basis points in March 2010.

Romania does not fulfil the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including balance of payments developments and product and financial market integration. Romania's external deficit reached a peak in 2007-2008, averaging some 12% of GDP. This reflected mainly a worsening trade balance as imports were buoyed by rapid growth in domestic demand. Romania's external deficit fell sharply to 4.0% of GDP in 2009, led by a sharp narrowing of the trade deficit induced by an abrupt contraction in domestic demand and changes in the relative prices of domestic and foreign goods. The sizeable external shortfall raised concerns about external debt sustainability amid tightening external funding conditions in the context of the intensifying global turmoil. With the government also facing increasing difficulties to meet growing refinancing needs in the market, the EU, IMF, World Bank, EIB and EBRD agreed in early 2009 to provide Romania with a co-ordinated package of international financial assistance totalling up to EUR 20 billion over the period to 2012, of which up to EUR 5 billion under the EU Balance of Payments facility. Following the granting of international financial assistance, external financing pressures eased somewhat by late 2009 and in early 2010, in line with the rapid improvement in the external balance and with some stabilisation in domestic financial markets. By March 2010, more than half of the pre-committed financial resources were disbursed following the fulfilment of the policy conditionality associated to successive tranches of the assistance.

The Romanian economy is increasingly integrated within the EU. In particular, trade and FDI relations with other Member States are growing, and integration of the domestic financial sector into the broader EU sector has progressed substantially, mainly through a high degree of foreign ownership of financial intermediaries.

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

10. SWEDEN

Legislation in Sweden - in particular the Sveriges Riksbank Act, the Instrument of Government (part of the Swedish Constitution) and the Law on the Exchange Rate Policy - is not fully compatible with Articles 130 and 131 of the TFEU and the ESCB/ECB Statute. Incompatibilities concern the prohibition on monetary financing, the independence of the central bank as well as its integration into the ESCB at the time of euro adoption. Several imperfections subsist as regards the objectives of the Central Bank, the promotion of the smooth operation of payment systems, the prohibition on monetary financing, the role of the ECB for the functioning of the payment systems and in the field of international cooperation, the statistical role of the ECB and of the EU and the ECB and Council's role for the appointment of external auditors.

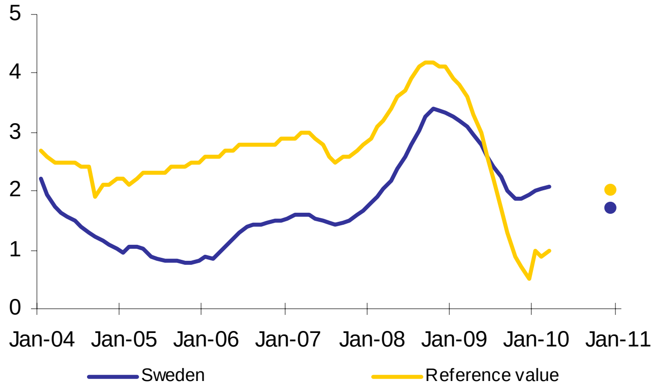
In Sweden, 12-month average inflation moved above the reference value in July 2009 for the first time since December 1996. The average inflation rate in Sweden during the 12 months to March 2010 was 2.1%, above the reference value of 1.0%, but it is likely to return below the reference value in the months ahead.

HICP annual inflation was fairly elevated in 2008, averaging about 3.3%. This reflected rapid increases in global food and energy prices as well as rising unit labour costs and the impact of a weaker krona. At the end of 2008, inflation began to fall quickly amid a steep downturn in economic activity and decelerating food and energy prices. On average, inflation amounted to 1.9% in 2009.

Inflation is expected to remain moderate in 2010 and 2011, averaging about 1.7% according to the Commission services' Spring 2010 Forecast, as ample spare capacity is expected to hold down price and unit labour cost increases.

Sweden does not fulfil the criterion on price stability.

Graph 9a: **Sweden - Inflation criterion since 2004**
(percent, 12-month moving average)

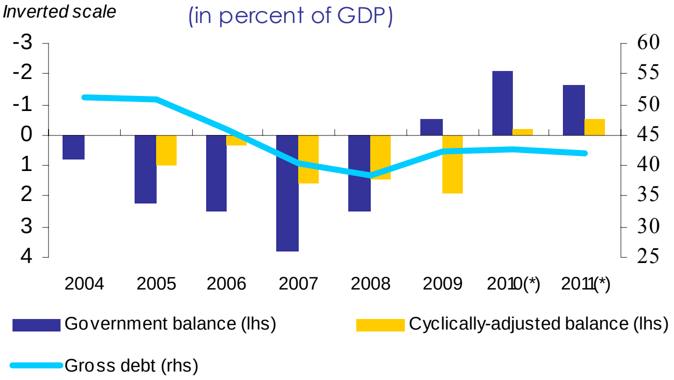


Note: The dots show the projected reference value and 12-month average inflation in the country in December 2010.
Sources: Eurostat, Commission services' Spring 2010 Forecast.

Sweden is not the subject of a Council Decision on the existence of an excessive deficit. Over the period 2002-2007, the general government balance improved, peaking at a surplus of 3.8% of GDP in 2007. With the onset of the crisis, the budgetary position deteriorated, with the surplus shrinking to 2.5% of GDP in 2008 and turning into a deficit of 0.8% of GDP in 2009. According to the Commission services' Spring 2010 Forecast, the deficit-to-GDP ratio will amount to around 2.1% in 2010 and 1.6% in 2011 under a no-policy-change assumption. The gross public debt ratio increased to 42.8% of GDP in 2009 and it is projected to increase further to about 46% of GDP in 2010 and 2011.

Sweden fulfils the criterion on the government budgetary position.

Graph 9b: **Sweden - Government budget balance and debt**
(in percent of GDP)



(*) Commission services' Spring 2010 Forecast.
Source: Eurostat, Commission services.

The Swedish krona is not participating in ERM II. Sweden has pursued a floating exchange rate regime and inflation targeting since the early 1990s. The krona depreciated sharply in connection with the aggravation of the financial crisis in September 2008 as investors became more risk averse. Between August 2008 and the beginning of March 2009, the krona lost almost 20% against the euro, partly also due to a negative short-term interest spread vis-à-vis the euro area. However, the krona has since then recovered a large part of its losses on the back of a stabilisation in financial markets and an improved global economic outlook. During the two-year assessment period, the krona depreciated by 3% against the euro.

Sweden does not fulfil the exchange rate criterion.

The average long-term interest rate in Sweden in the year to March 2010 was 3.3%, below the reference value of 6.0%. Average long-term interest rates have been below the reference value since EU accession in 1995. The yield spreads vis-à-vis euro area long-term benchmark bonds turned negative in 2008, reaching a low of minus 100 basis points around the turn of the year 2008/2009. The negative yield spread subsequently narrowed but still remains around minus 45 basis points.

Sweden fulfils the criterion on the convergence of long-term interest rates.

Additional factors have also been examined, including balance of payments developments and product and financial market integration. The Swedish external account has been in surplus since the mid-1990s, driven by high net exports in goods and recently also in services. The external account surplus has increased from around 4% of GDP in the early 2000s to a level of around 7-8% since 2003. The Swedish economy is open and well integrated within the EU, with a share of intra-EU trade in goods well above the EU average and a growing share of intra-EU FDI. Sweden's financial sector is well integrated into the broader EU financial sector, with particularly strong links to other Nordic countries and the Baltic States. Sweden's financial sector is well developed, both in size and sophistication and corresponds to its advanced stage of economic development.

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