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REPORT FROM THE COMMISSION

CONVERGENCE REPORT 2012

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

{SWD(2012) 144 final}

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1. PURPOSE OF THE REPORT

Article 140(1) of the Treaty on the Functioning of the European Union (hereafter TFEU) requires the Commission and the ECB to report to the Council, at least once every two years, or at the request of a Member State with a derogation[1], on the progress made by the Member States in fulfilling their obligations regarding the achievement of economic and monetary union. The latest Commission and ECB Convergence Reports were adopted in May 2010.

The 2012 Convergence Report covers the following eight Member States with a derogation: Bulgaria, the Czech Republic, Latvia, Lithuania, Hungary, Poland, Romania and Sweden[2]. A more detailed assessment of the state of convergence in these Member States is provided in a Technical Annex to this report (SWD(2012) 144). At the time of the last Convergence Report in 2010, Member States had shown uneven progress with convergence, as many of them were undergoing significant adjustments of previously accumulated imbalances, against the background of the economic and financial crisis. The present examination takes place in a still difficult external environment, with a fragile recovery in the region and recurrent headwinds on financial markets.

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

The economic and financial crisis has exposed gaps in the current economic governance system of EMU and showed that its existing instruments need to be used

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

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

more fully. The present examination takes place within a context of the reform of EMU governance, which was undertaken over past two years with the aim of ensuring a sustainable functioning of economic and monetary union. The assessment of convergence is thus aligned with the broader "European semester" approach which takes an integrated and upstream look at the economic policy challenges facing the EMU in ensuring fiscal sustainability, competitiveness, financial market stability and economic growth. The key innovations in the area of governance reform, reinforcing the assessment of each Member States' convergence process and its sustainability, include *inter alia* the excessive deficit procedure, as strengthened by the 2011 reform of the Stability and Growth Pact, and new instruments in the area of surveillance of macroeconomic imbalances. In particular, it takes into account the assessment of the 2012 Convergence Programmes[3] and the findings under the Alert Mechanism Report of the Macroeconomic Imbalances Procedure[4].

Convergence criteria

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

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"*[5]. The requirement of sustainability implies that the satisfactory inflation performance must essentially be attributable to the behaviour of input costs and other factors influencing price developments in a structural manner, rather than the influence of temporary factors. Therefore, the convergence examination includes an assessment of the factors that have an impact on the inflation outlook and is complemented by a

[3] Available at http://ec.europa.eu/economy_finance/economic_governance/sgp/convergence/programmes/2012_en.htm

[4] A key lesson from the economic and financial crisis has been that the economic governance framework underpinning EMU needed to be further strengthened to address the issue of unsustainable macroeconomic trends. The new procedure on prevention and correction of macroeconomic imbalances – the Macroeconomic Imbalance Procedure (MIP) – responds to this need and was one of the key elements of the legislative package (the so-called "6-pack" that entered into force in December 2011) to enhance the governance structures in EMU

[5] 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.

reference to the most recent Commission services' forecast of inflation[6]. Related to this, the report also assesses whether the country is likely to meet the reference value in the months ahead.

The inflation reference value was calculated to be 3.1% in March 2012, with Sweden, Ireland and Slovenia as the three best-performing Member States.

The convergence **criterion dealing with public finances** 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"*. As part of an overall strengthening of economic governance in EMU, the secondary legislation related to public finances was enhanced in 2011, including the new regulations amending the Stability and Growth Pact[7].

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"*[8].

The relevant two-year period for assessing exchange rate stability in this report is 1 May 2010 to 30 April 2012. In its assessment of the exchange rate stability criterion,

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6 All forecasts for inflation and other variables in the current report are from the Commission services' Spring 2012 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.

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

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

the Commission takes into account developments in auxiliary indicators such as foreign reserve developments and short-term interest rates, as well as the role of policy measures, including foreign exchange interventions, in maintaining exchange rate stability. The analysis also 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"*. At the current juncture, sovereign bond markets in some Member States are subject to severe distortions, which make their long-term interest rates not a meaningful benchmark for the assessment of convergence. Against this background, it would not be appropriate to include the long-term interest rate of Ireland, one of the three best-performing Member States in terms of price stability, in the calculation of the reference value for the long-term interest rate criterion. Hence, the reference value is based on the long-term interest rates in Sweden and Slovenia[9].

The interest rate reference value was calculated to be 5.8% in March 2012.

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. The additional factors are important indicators that the integration of a Member State into the euro area would proceed without difficulties.

2. BULGARIA

Legislation in Bulgaria – in particular the Law on the Bulgarska narodna banka (BNB) and the Conflict of Interest Prevention and Ascertainment Act – is **not fully compatible** with the compliance duty under Article 131 of the TFEU. Incompatibilities and imperfections exist in the fields of independence of the BNB, prohibition of monetary financing and central bank integration into the ESCB, as regards the ESCB tasks laid down in Article 127(2) of the TFEU and Article 3 of the ESCB/ECB Statute.

[9] The reference value for March 2012 is calculated as the simple average of the average long-term interest rates in Sweden (2.2%) and Slovenia (5.4%). In contrast, the 12-month average long-term interest rate in Ireland was 9.1% in March 2012. Ireland has been the beneficiary of an EU/IMF financial assistance programme since December 2010.

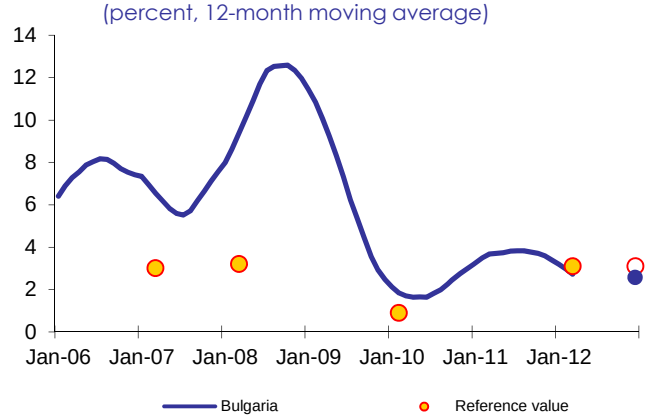
In Bulgaria, 12-month average inflation had been above the reference value at each convergence assessment since EU accession in 2007. The average inflation rate in Bulgaria during the 12 months to March 2012 was 2.7%, below the reference value of 3.1%. It is projected to remain below the reference value in the months ahead.

Annual HICP inflation declined to close to zero by late 2009 on the back of falling commodity prices and the strong recession. Strengthening commodity prices, indirect tax increases and still substantial wage growth put inflation back on an upward trend in 2010. It reached a peak of 4.6% in early 2011 before decreasing again with the fading of the impact of the former two factors to 2% by end-2011. In March 2012, annual HICP inflation stood at 1.7%.

Inflation is expected to pick up slightly during the course of 2012, as commodity price increases at the beginning of the year will feed through and high nominal wage growth is set to lift services prices, despite weak domestic demand. Accordingly, the Commission services' 2012 Spring Forecast projects annual average inflation at 2.6% in 2012 and 2.7% in 2013. The relatively low price level in Bulgaria (49% of the euro area average in 2010) suggests significant potential for further price level convergence in the long term.

Bulgaria fulfils the criterion on price stability.

Graph 2a: **Bulgaria - Inflation criterion since 2006**
(percent, 12-month moving average)



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

Bulgaria is at present the subject of a Council Decision on the existence of an excessive deficit (Council Decision of 13 July 2010)[10]. The Council recommended Bulgaria to take action to bring the deficit below 3% of GDP by 2011 in a credible and sustainable manner. The general government balance fell from a deficit of 4.3% of GDP in 2009 to 3.1% in 2010, on the back of lower expenditures-to-GDP. The deficit-to-GDP ratio was 2.1% in 2011 and according to the Commission services' Spring 2012 Forecast, it is projected to improve further to 1.9% of GDP in 2012 and 1.7% in 2013, under a no-policy-change assumption, supported by a continued freeze in public sector wage bill and pensions as well as measures to boost revenue collection. The gross public debt ratio remained low at around 16.3% of GDP in

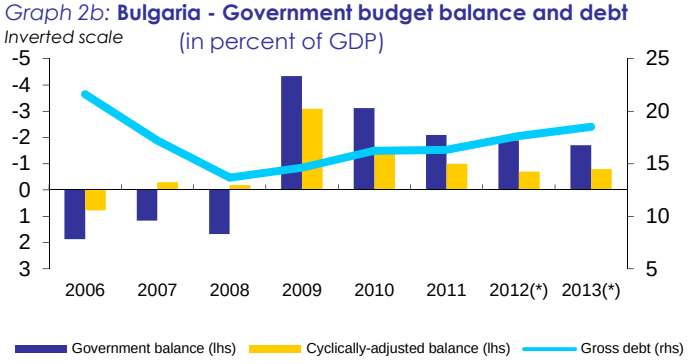
[10] 2010/422/EU (OJ L 199, 31.7.2010, p. 26).

2011 and it is projected to increase to 17.6% of GDP in 2012 and 18.5% of GDP in 2013.

In view of these developments and the Commission services' Spring 2012 Forecast, the Commission considers that the excessive deficit has been corrected with a credible and sustainable reduction of the budget deficit below 3% of GDP. The Commission is therefore recommending that the Council abrogate the decision on the existence of an excessive deficit for Bulgaria.

If the Council decides to abrogate the excessive deficit procedure for Bulgaria, **Bulgaria will fulfil the criterion on public finances.**

Graph 2b: **Bulgaria - Government budget balance and debt**



(*) Commission services' Spring 2012 Forecast.
Source: Eurostat, Commission services.

The Bulgarian lev is not participating in ERM II. The BNB pursues its primary objective of price stability through an exchange rate anchor in the context of a Currency Board Arrangement (CBA). Bulgaria introduced its CBA on 1 July 1997, pegging the Bulgarian lev to the German mark and later the euro. Additional indicators, such as developments in foreign exchange reserves and short-term interest rates, suggest that investors' risk perception towards Bulgaria has been generally improving since 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 2012 was 5.3%, below the reference value of 5.8%. It gradually declined from above 7% in early 2010 to somewhat above 5% by end-2011. Yield spreads vis-à-vis the euro area long-term benchmark bonds[11] were volatile but gradually declined between autumn 2009 and early 2012, as Bulgarian bond yields fell with the calming of global financial tensions and a reduction in the country risk premia. In mid-2010, a temporary bout of pressure affecting the Bulgarian long-term yields was linked to the euro-area sovereign debt crisis and concerns about the quality of Bulgarian public finance statistics.

[11] 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 "Harmonised long-term interest rate for convergence assessment purposes".

Bulgaria 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. Bulgaria's external balance adjusted from very large deficits until 2008 to broadly balanced position in 2010 and a surplus of around 2% of GDP in 2011. The improvement was mostly on account of the trade balance, as imports fell with lower domestic demand, while exports grew dynamically in 2010 and 2011. The reduction in net external funding of the banking sector resulted in significant outflows in the financial account, partly counterbalanced by FDI inflows, which continued albeit at a lower level than before the crisis. The Bulgarian economy is well integrated within the EU economy, particularly through strong trade and FDI linkages. On the basis of selected indicators relating to the business environment, Bulgaria performs below the average of euro area Member States. The integration of the domestic financial sector into the EU financial system is substantial, mainly thanks to a high level of foreign ownership of the banking system. In line with the conclusion of the Alert Mechanism Report from February 2012, Bulgaria was subject to an in-depth review in the context of the Macroeconomic Imbalance Procedure.

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 Česká národní banka (ČNB) – is **not fully compatible** with the compliance duty under Article 131 of the TFEU. Incompatibilities notably concern the independence of the central bank, the prohibition of monetary financing and central bank integration into the ESCB at the time of euro adoption with regard to the ESCB tasks laid down in Article 127(2) of the TFEU and Article 3 of the ESCB/ECB Statute. In addition, the Act on the ČNB also contains some imperfections relating to central bank independence, the prohibition of monetary financing and ESCB tasks.

In the Czech Republic, 12-month average inflation was below the reference value at the time of the last convergence assessment in 2010. The average inflation rate in the Czech Republic during the 12 months to March 2012 was 2.7%, below the reference value of 3.1%. It is projected to increase above the reference value in the months ahead.

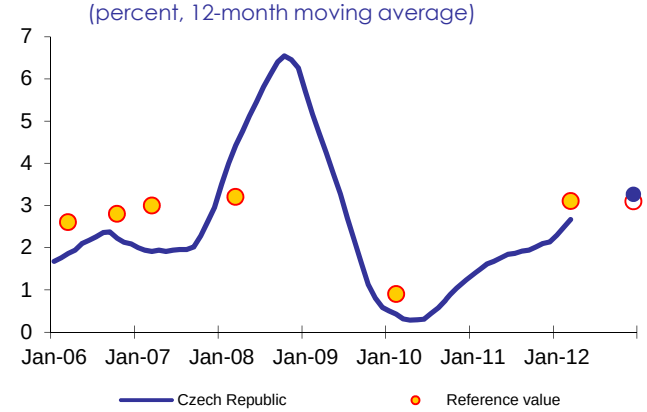
Inflation in the Czech Republic moved broadly in line with euro area levels in recent years. Annual inflation fell sharply and briefly became negative in the course of 2009, when the Czech economy entered recession. Inflation remained subdued in 2010 and 2011 amid muted domestic demand, while import price developments largely drove domestic prices. Headline inflation picked up in early 2012, largely due to an increase in the VAT preferential rate.

Inflation is expected to remain higher in 2012 compared to recent years in response to the VAT rate increase, though sluggish domestic demand and favourable unit labour cost developments are expected to moderate price increases going forward.

On this basis, the Commission services' Spring 2012 Forecast projects annual HICP inflation to average 3.3% in 2012 and 2.2% in 2013. The price level in the Czech Republic (about 72% of the euro area average in 2010) suggests potential for price level convergence in the long term.

The Czech Republic does not fulfil the criterion on price stability.

Graph 3a: **Czech Republic - Inflation criterion since 2006**
(percent, 12-month moving average)

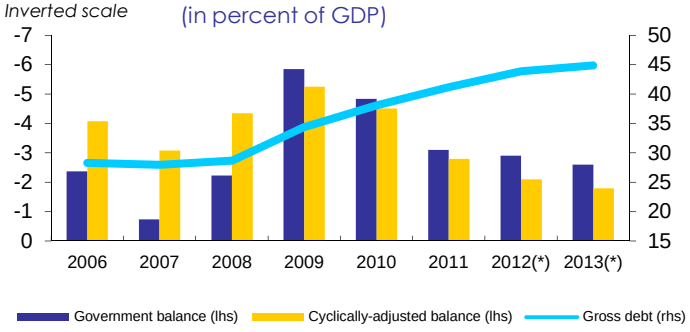


Note: The dots in December 2012 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2012 Forecast.

The Czech Republic is at present the subject of a Council Decision on the existence of an excessive deficit (Council Decision from 2 December 2009)[12]. The Council recommended the Czech Republic to correct the excessive deficit by 2013. The general government deficit in the Czech Republic peaked at 5.8% of GDP in 2009, but it declined to 4.8% and 3.1% of GDP in 2010 and 2011 respectively amid fiscal consolidation efforts. According to the Commission services' Spring 2012 Forecast, which is based on a no-policy-change assumption, the deficit-to-GDP ratio will amount to 2.9% in 2012 and 2.6% in 2013, while general government debt is expected to increase from 43.9% of GDP in 2012 to 44.9% of GDP in 2013.

The Czech Republic does not fulfil the criterion on public finances.

Graph 3b: **Czech Rep. - Government budget balance and debt**
Inverted scale (in percent of GDP)



(*) Commission services' Spring 2012 Forecast.
Source: Eurostat, Commission services.

12 2010/284/EU (OJ L 125, 21.5.2010, p. 36–37).

The Czech koruna is not participating in ERM II. The Czech Republic operates a floating exchange rate regime. Following a strong weakening impetus amid the unfolding global financial crisis in late 2008, the koruna's exchange rate against the euro followed a broad appreciation trend between 2009 and mid-2011. Short-term interest rate spreads vis-à-vis the euro narrowed significantly in 2009-2010 and turned negative in 2011 amid tensions in euro area financial markets. The koruna depreciated in the second half of 2011, but it recovered part of the losses in early 2012. During the two years before this assessment, the koruna appreciated against the euro by 2.8%.

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 2012 was 3.5%, well below the reference value of 5.8%. Average long-term interest rates in the Czech Republic stayed below the reference value at each convergence assessment since EU accession in May 2004. Yield spreads vis-à-vis euro area long-term benchmark bonds widened sharply amid global market tensions in late 2008 and in the first half of 2009, but they remained less affected compared to other Member States with a derogation. The long-term yields on Czech government bonds markedly declined between 2009 and early 2012, reflecting notably cuts in the central bank's policy rates as well as the comparatively strong fundamentals of the economy.

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. In the years 2008-2011, the external deficit averaged at moderate levels of around 2% of GDP; an increase in the merchandise trade surplus was counteracted by rising net income outflows amid solid FDI-related profits. The Czech economy is highly integrated within the EU economy through strong trade and FDI linkages. On the basis of selected indicators relating to the business environment, the Czech Republic performs below the average of euro area Member States. The integration of the domestic financial sector into the EU financial system is substantial, particularly through strong interbank linkages.

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. LATVIA

Legislation in Latvia – in particular the Law on the Latvijas Banka – is **not fully compatible** with the compliance duty under Article 131 of the TFEU. Incompatibilities notably concern the independence of the central bank, the prohibition of monetary financing and central bank integration into the ESCB at the time of euro adoption with regard to the ESCB tasks laid down in Article 127(2) of the TFEU and Article 3 of the ESCB/ECB Statute. In addition, imperfections subsist in the field of central bank independence and ESCB tasks.

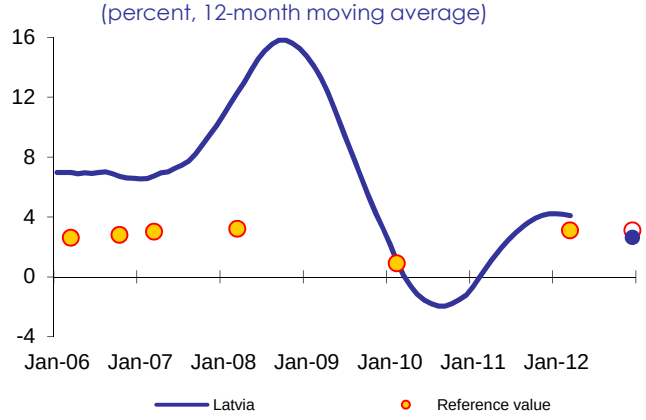
In Latvia, the 12-month average inflation rate was below the reference value at the time of the last convergence assessment in 2010. The average inflation rate in Latvia during the 12 months to March 2012 was 4.1%, i.e. above the reference value of 3.1%. It is projected to decrease below the reference value in the months ahead.

After a peak of annual HICP inflation at 15.3% in 2008, significant nominal wage adjustment and a correction in import prices led to negative headline inflation between October 2009 and November 2010. As the cycle turned and a new global commodity price shock set in, average inflation rose from -1.2% in 2010 to 4.2% in 2011, boosted also by indirect tax increases. In March 2012, annual inflation moderated to 3.2%, as the impact of the temporary factors waned.

HICP inflation is expected to fall to 2.6% on average in 2012, according to the Commission services' Spring 2012 Forecast, with the slowing economic recovery and fading effect of indirect tax changes in 2011. It is projected to fall further in 2013 to 2.1% on average, in the context of relatively weak domestic demand. The price level in Latvia (close to 70% of the euro area average in 2010) suggests potential for further price level convergence over the long term.

Latvia does not fulfil the criterion on price stability.

Graph 4a: **Latvia - Inflation criterion since 2006**
(percent, 12-month moving average)



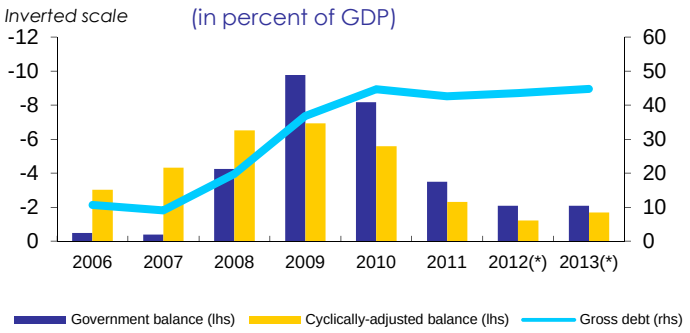
Note: The dots in December 2012 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2012 Forecast.

Latvia is at present subject of a Council Decision on the existence of an excessive deficit (Council Decision of 7 July 2009)[13]. The Council recommended Latvia to correct the excessive deficit by 2012. The general government deficit in Latvia reached 8.2% of GDP in 2010, but decreased to 3.5% of GDP in 2011 due to a considerable consolidation effort. The Commission services' Spring 2012 Forecast projects the deficit-to-GDP ratio to further moderate to 2.1% both in 2012 and 2013 under a no-policy-change assumption. The ratio of gross public debt to GDP decreased to 42.6% in 2011 but it is projected to increase to 44.7% of GDP by end-2013.

Latvia does not fulfil the criterion on public finances.

[13] 2009/591/EC (OJ L 202, 4.8.2009, p. 50).

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



(*) Commission services' Spring 2012 Forecast.
Source: Eurostat, Commission services.

The Latvian lats has participated in ERM II since 2 May 2005, i.e. for more than seven 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% and it did not experience severe tensions, though the lats traded mostly close to the lower limit of the unilateral band. At the beginning of 2011, and more lastingly from late 2011, the exchange rate moved to the strong side of the band, as the Latvian Treasury changed the conversion practice of its foreign currency funds and thereby increased market demand for lats. Additional indicators, such as developments in foreign exchange reserves and short-term interest rates do not reveal significant pressures on the exchange rate. The last disbursements by the IMF and the EU under the financial assistance programme took place in August and October 2010, respectively. In June 2011, Latvia successfully returned to the international bond market, followed by another significant issuance in February 2012, signalling good market access.

Latvia fulfils the exchange rate criterion.

The average long-term interest rate in Latvia in the year to March 2012 was 5.8%, at the reference value of 5.8%. The average long-term interest rate in Latvia has been above the reference value at the 2010 convergence assessment, but it declined strongly from almost 13% in early 2010 to below 6% by end-2011. Latvia's long-term spreads to the euro area long-term benchmark bonds largely compressed in 2010, as confidence in the currency peg was regained, fiscal consolidation yielded results and the conversion of assistance programme funds created ample lats liquidity. The Treasury returned to the 10-year domestic bond market with several smaller issues during the first half of 2011 and yields on these bonds were quite resilient to international financial market turmoil in late 2011.

Latvia 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 external balance reversed in 2008-2009 from large deficits during the boom years to a surplus of around 11% of GDP in 2009, which decreased to 4.9% of GDP in 2010 and 0.9% of GDP in 2011. The two most important drivers of the external balance were the trade deficit and the income balance. In the financial account, the FDI balance gradually

improved from 2009, but repayment of net external funding of the banking sector continued even in 2011. The EU-IMF balance of payments assistance programme granted to Latvia in late 2008 was successfully concluded in January 2012. Latvia borrowed altogether only about EUR 4.5 billion out of the total EUR 7.5 billion that was available under the programme. In confidence of its policies and of its regained market access, Latvia has not requested a follow-up programme.

Latvia's economy is well integrated within the EU economy through trade and FDI linkages. On the basis of selected indicators relating to the business environment, Latvia performs broadly in line with the average of euro area Member States. The integration of the domestic financial sector into the EU financial system is substantial, mainly thanks to a high level of foreign ownership of the banking system.

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.

5. LITHUANIA

Legislation in Lithuania **is compatible** with the TFEU and the ESCB/ECB Statute with the exception of one imperfection regarding central bank independence: Article 14(4) of the Law on the State Audit Office should be fully brought in line with Article 27.1 of the ESCB/ECB Statute.

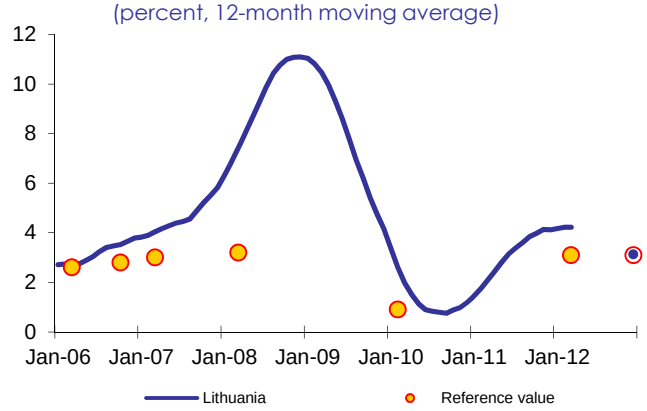
In Lithuania, 12-month average inflation was above the reference value at the time of each convergence assessment since 2006. During the 12 months to March 2012, the average inflation rate in Lithuania was 4.2%, above the reference value of 3.1%. It is projected to approach the reference value in the months ahead.

Annual HICP inflation peaked at above 12% in mid-2008 and then decreased rapidly throughout 2009 as the economy moved into recession. Following a marginal year-on-year decline in the price level in early 2010, annual inflation increased gradually to some 5% in May 2011, mainly as a result of substantial commodity price increases. Subsequently, it declined slowly to below 4% at the end of 2011, largely due to lower food price inflation. Annual inflation broadly stabilised in early 2012.

Inflation is expected to decrease to around 3% in 2012 and 2013 according to the Commission services' Spring 2012 Forecast, reflecting a slower pace of output growth and the elevated level of unemployment. The relatively low price level in Lithuania (around 62% of the euro-area average in 2010) 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 2006**
(percent, 12-month moving average)



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

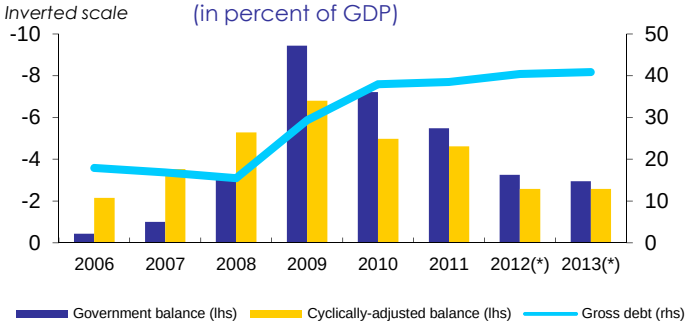
Lithuania is at present the subject of a Council Decision on the existence of an excessive deficit (Council Decision of 7 July 2009)[14]. In February 2010, the Council recommended Lithuania to correct the excessive deficit by 2012. The general government deficit decreased from 7.2% of GDP in 2010 to 5.5% of GDP in 2011 thanks to continued fiscal consolidation efforts. According to the Commission

[14] 2009/588/EC (OJ L 202, 4.8.2009, p. 44-45).

services' Spring 2012 Forecast, the deficit-to-GDP ratio should amount to 3.2% in 2012 based on the 2012 budget and 3% of GDP in 2013 under a no-policy-change assumption. Government gross debt is expected to increase from 38.5% of GDP in 2011 and to just below 41% of GDP in 2013.

Lithuania does not fulfil the criterion on public finances.

Graph 5b: **Lithuania - Government budget balance and debt**



(*) Commission services' Spring 2012 Forecast.
Source: Eurostat, Commission services.

Lithuania entered ERM II on 28 June 2004 and has been participating in the mechanism for almost eight years at the time of the adoption of this report. Upon ERM II entry, the authorities unilaterally committed to maintain the prevailing Currency Board Arrangement within the mechanism. The Currency Board Arrangement remains well supported by official reserves. Short-term interest differentials vis-à-vis the euro area have remained below 50 basis points since early 2011. 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.

Average long-term interest rates in Lithuania were above the reference value at the time of the last convergence assessment in 2010. The average long-term interest rate in the year to March 2012 was 5.2%, below the reference value of 5.8%. Long-term interest rates remained at just above 5% from March 2010 until late 2011, when they increased slightly. The long-term interest rate used for the convergence examination should, however, be interpreted with caution as it reflects the secondary market yield on a single benchmark government bond with a comparatively short residual maturity of around 6 years while the Lithuanian market is very shallow.

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

Additional factors have also been examined, including balance of payments developments as well as product and financial market integration. After turning to a substantial surplus in 2009, Lithuania's external balance deteriorated again in 2010 and 2011, reflecting a worsening of the current account balance, while the capital account surplus continued to increase thanks to higher absorption of EU funds. At the same time, Lithuania managed to attract increasing net inflows of foreign direct investment in 2010 and 2011. The Lithuanian economy is well integrated into the EU economy through trade and FDI linkages. On the basis of selected indicators relating

to the business environment, Lithuania performs broadly in line with the average of euro area Member States. Lithuania's financial sector is well integrated into the EU financial system as confirmed by the high share of foreign-owned banks.

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.

6. HUNGARY

Legislation as presently in force in Hungary - in particular the Act on the Magyar Nemzeti Bank (MNB) and the Transitional Provisions of the Fundamental Law of Hungary - is **not fully compatible** with the compliance obligations under Article 131 of the TFEU. Incompatibilities notably concern the independence of the MNB, the prohibition of monetary financing and central bank integration into the ESCB at the time of euro adoption with regard to the ESCB tasks laid down in Article 127(2) of the TFEU and Article 3 of the ESCB/ECB Statute. In addition, the Law on the MNB also contains further imperfections relating to central bank independence and MNB integration into the ESCB. The draft legislation as presented by the government on 7 March 2012 for the ECB opinions will, if adopted, remove the incompatibilities as regards the central bank independence.

In Hungary, 12-month average inflation was above the reference value at the time of each convergence assessment since EU accession. The average inflation rate in Hungary during the 12 months to March 2012 was 4.3%, above the reference value of 3.1%. It is projected to move well above the reference value in the months ahead.

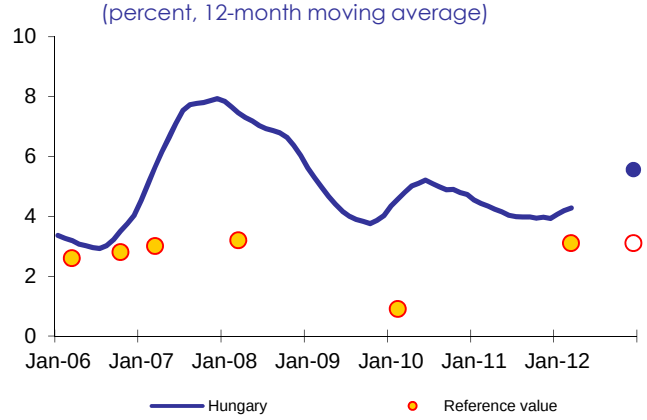
Annual HICP inflation peaked at above 6% in January 2010, pushed up by indirect tax hikes adopted in 2009 and pass-through from a weaker exchange rate. Amid substantial volatility, consumer price inflation broadly followed a downward trend, declining to around 3% in July 2011, as the inflationary impact of one-off measures faded and the exchange rate strengthened. Annual inflation increased again in the second half of 2011, driven mainly by energy price increases reflecting higher commodity prices and a weaker exchange rate. In early 2012, a new round of indirect tax hikes induced a further pick-up in consumer prices.

Inflation is expected to increase to above 5% in 2012 and then to decline to just below 4% in 2013 according to the Commission services' Spring 2012 Forecast, mainly reflecting the changing inflation contribution of indirect tax hikes. The relatively low price level in Hungary (about 62% of the euro area average in 2010) 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 2006**

(percent, 12-month moving average)



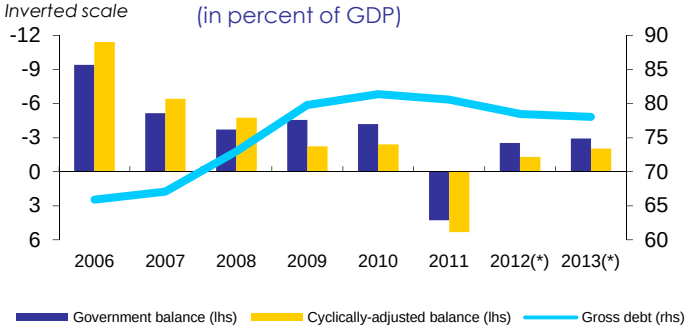
Note: The dots in December 2012 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2012 Forecast.

Hungary is at present the subject of a Council Decision on the existence of an excessive deficit (Council Decision of 5 July 2004)[15]. In 2009, the Council recommended Hungary to correct the excessive deficit by 2011. In January 2012, the Council established that Hungary had not taken effective action in response to the 2009 Council Recommendation, as compliance with the 3% of GDP reference value in 2011 was not based on a structural and sustainable correction. In March 2012, the Council issued a new (the fifth consecutive) recommendation to Hungary under Article 126(7) and, on the basis of its January non-compliance decision, it partially suspended commitments of the EU Cohesion Fund for 2013 (amounting to some EUR 0.5bn). The general government balance, after recording a deficit of 4.2% of GDP in 2010, turned to a surplus of 4.3% of GDP in 2011 due to significant one-off operations without which the deficit would have exceeded 5% of GDP; the structural balance is estimated to have remained in a deficit of above 4% of GDP in 2011. According to the Commission services' Spring 2012 Forecast, the deficit-to-GDP ratio will amount to 2.5% in 2012, as well as 2.9% in 2013 under a no-policy-change assumption. General government debt is expected to fall from 80.6% of GDP in 2011 to 78% of GDP in 2013.

Hungary does not fulfil the criterion on public finances.

Graph 6b: **Hungary - Government budget balance and debt**

Inverted scale (in percent of GDP)



(*) Commission services' Spring 2012 Forecast.
Source: Eurostat, Commission services.

15 2004/918/EC (OJ L 389, 30.12.2004, p. 27).

The Hungarian forint is not participating in ERM II. In February 2008, Hungary moved to a floating exchange rate regime, abandoning the unilateral peg of the forint to the euro (with a ±15% fluctuation band). The forint exchange rate against the euro exhibited high volatility in recent years. After having enjoyed a period of relative stability between August 2009 and April 2010 in the context of the EU-IMF balance of payments assistance programme, the forint depreciated sharply in May 2010 and remained weaker throughout the summer 2010. It followed a mild appreciating trend from September 2010 until April 2011 and then broadly stabilised for another three months. In the second half of 2011, as mounting financial market tensions in the euro area started to also negatively affect currency markets in central and eastern Europe, the forint depreciated by some 12% against the euro, also due to some controversial domestic economic policy measures such as the possibility to repay foreign currency-denominated mortgage loans at historical exchange rates. It recovered part of the losses in early 2012 amid a pick-up in global risk appetite and expectations that an agreement on precautionary balance of payments assistance by the EU and the IMF would be reached soon. During the two-year assessment period, the forint depreciated by 6.5% against the euro.

Hungary does not fulfil the exchange rate criterion.

Average long-term interest rates in Hungary were above the reference value at the time of each convergence assessment since EU accession, reflecting high risk premia in view of perceived weak macroeconomic fundamentals. The average long-term interest rate in the year to March 2012 was 8.0%, well above the reference value of 5.8%. Between September 2009 and September 2011 long-term interest rates predominantly oscillated between 6.5% and 8%. Afterwards, they followed a steep upward trend, exceeding 9% in January 2012, as a number of controversial policy measures adopted by the Hungarian authorities raised investors' concerns regarding local financial stability.

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 as well as product and financial market integration. After turning into surplus in 2009, Hungary's external balance improved further in 2010 and 2011. The continued adjustment was driven by falling domestic demand, dampening import growth, combined with a resilient export performance as well as higher absorption of EU funds. Net foreign direct investment inflows remained relatively small in 2010 before ceasing entirely in 2011, as larger direct investments by residents abroad offset increased foreign direct investments in Hungary. The balance of payments assistance granted to Hungary by the EU and the IMF in 2008 expired in 2010 with no disbursements from the pre-committed official funding taking place after mid-2009. However, Hungary asked for precautionary balance of payments assistance by the EU and the IMF in November 2011 amid a deteriorating financial market situation. No agreement on a possible assistance programme was reached by the cut-off date of the report. In line with the conclusion of the Alert Mechanism Report from February 2012, Hungary was subject to an in-depth review in the context of the Macroeconomic Imbalance Procedure.

The Hungarian economy is highly integrated into the EU economy through strong trade and FDI linkages. On the basis of selected indicators relating to the business environment, Hungary performs below the average of euro area Member States. It scores particularly poorly in terms of the legal and regulatory framework, which is complex and unstable due to frequent and sometimes ad-hoc modifications. Hungary's financial sector is well integrated into the EU financial system as confirmed by the substantial share of foreign-owned banks.

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.

7. POLAND

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

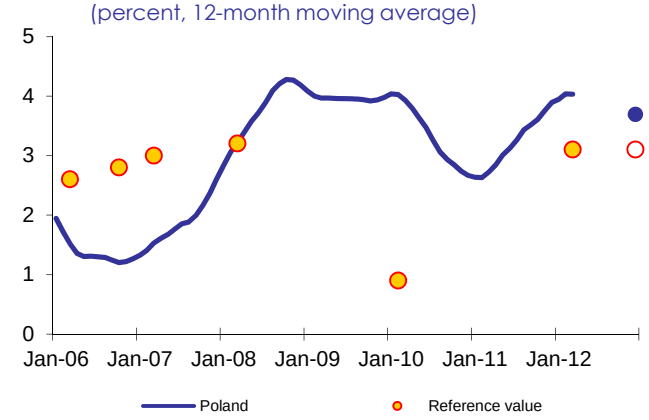
In Poland, 12-month average inflation was above the reference value at the time of the last convergence assessment in 2010. The average inflation rate in Poland during the 12 months to March 2012 was 4.0%, above the reference value of 3.1%, and it is likely to remain above the reference value in the months ahead.

Annual HICP inflation declined gradually from 4.5% to below 2% between mid-2009 and mid-2010, mainly reflecting lower food and service price increases. Afterwards, inflation started to pick up again, driven by rising commodity prices and a VAT rate increase effective from January 2011. Although it declined temporarily between May and September 2011, largely due to a favourable evolution of unprocessed food prices, the considerable weakening of the exchange rate in late 2011 pushed annual inflation back up to 4.5% in December 2011. Annual inflation declined somewhat in early 2012, mainly due to favourable base effects.

Inflation is expected to decrease to 3.7% in 2012 and 2.9% in 2013 according to the Commission services' Spring 2012 Forecast, as the inflationary impact of one-off measures effective in 2011 should largely fade out while output growth is likely to decline. The relatively low price level in Poland (close to 60% of the euro-area average in 2010) 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 2006**
(percent, 12-month moving average)

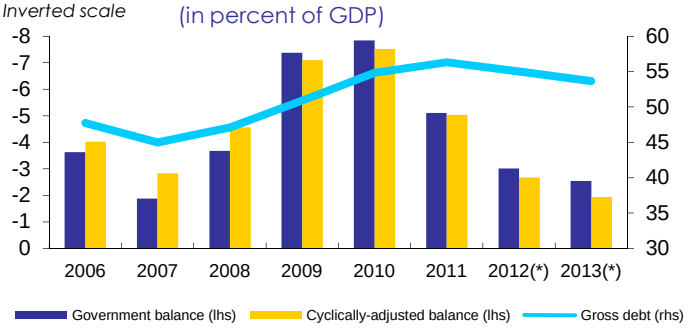


Note: The dots in December 2012 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2012 Forecast.

Poland is at present the subject of a Council Decision on the existence of an excessive deficit (Council Decision of 7 July 2009)[16]. The Council recommended Poland to correct the excessive deficit by 2012. The general government deficit in Poland decreased from 7.8% of GDP in 2010 to 5.1% of GDP in 2011. According to the Commission services' Spring 2012 Forecast, the deficit-to-GDP ratio should amount to 3.0% in 2012 and 2.5% in 2013 under a no-policy-change assumption. Despite high average real GDP growth, government gross debt increased to 56.3% of GDP in 2011 but it is projected to decline to below 54% of GDP in 2013.

Poland does not fulfil the criterion on public finances.

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



(*) Commission services' Spring 2012 Forecast.
Source: Eurostat, Commission services.

The Polish zloty is not participating in ERM II. Since April 2000, Poland has been operating a floating exchange rate regime. The zloty exchange rate against the euro has recently displayed relatively high volatility. From early-2010 until mid-2011, the zloty's exchange rate predominantly oscillated in a relatively wide range between 3.85 and 4.15 PLN/EUR. In August 2011, rising financial market tensions in the euro-area started to negatively affect currency markets in central and eastern Europe. As a result, the zloty weakened by some 11% against the euro between July and December 2011. In early 2012, the zloty exchange rate against the euro partly

16 2009/589/EC (OJ L 202, 4.8.2009, p. 46).

recovered earlier losses. During the two-year assessment period, the zloty depreciated by 6.1% against the euro.

Poland does not fulfil the exchange rate criterion.

Average long-term interest rates in Poland were above the reference value at the time of the last convergence assessment in 2010. The average long-term interest rate in the year to March 2012 was 5.8%, at the reference value of 5.8%. Long-term interest rates decreased from above 6% in early 2010 to below 5.5% in September 2010, reflecting the substantial fall in domestic inflation. They returned to above 6% by early 2011 amid a gradual monetary policy tightening. Long-term interest rates declined again to below 6% by mid-2011 and then to below 5.5% in early 2012, benefiting from improved investor sentiment towards the country.

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

Additional factors have also been examined, including balance of payments developments as well as product and financial market integration. While remaining in deficit, Poland's external balance improved considerably in 2009. Although it worsened somewhat in 2010 due to a higher current account deficit, it improved again in 2011, as the rapidly increasing surplus on the capital account, induced by higher absorption of EU funds, offset the further deterioration in the current account balance. Net inflows of foreign direct investment (FDI) decreased substantially in 2010, mostly as a result of lower direct investment in Poland, before recovering again in 2011, when they covered about 40% of the current account deficit. The Polish economy is well integrated into the EU economy through trade and FDI linkages. On the basis of selected indicators relating to the business environment, Poland performs below the average of euro area Member States. Poland's financial sector is well integrated into the EU financial system as confirmed by the high share of foreign-owned banks.

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.

8. ROMANIA

Legislation in Romania, in particular the Law on the Banca Naţională a României (BNR), is **not fully compatible** with the compliance duty under Article 131 of the TFEU. Incompatibilities concern the independence of the central bank, the prohibition of monetary financing and central bank integration into the ESCB at the time of euro adoption. In addition, the Law on the BNR also contains imperfections relating to central bank independence and BNR integration into the ESCB at the time of euro adoption.

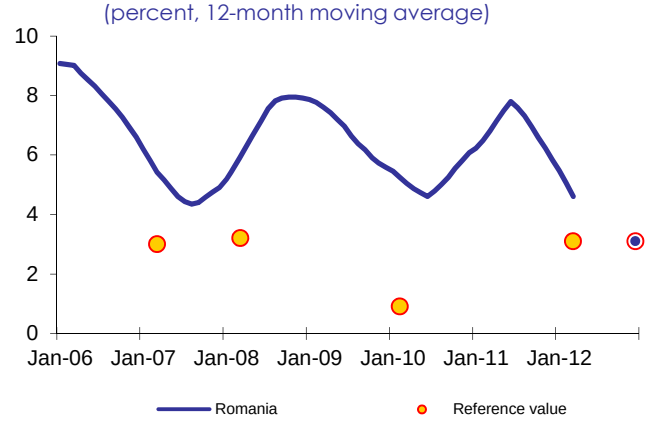
In Romania, 12-month average inflation was above the reference value at each convergence assessment since EU accession in 2007. The average inflation rate in Romania during the 12 months to March 2012 was 4.6%, well above the reference value of 3.1%. It is projected to approach the reference value in the months ahead.

Romania recorded volatile and, for protracted periods, high inflation rates in recent years. In 2009, annual inflation remained elevated despite the sharp economic downturn amid increases in excise duties and persistently high inflation in services. Inflation increased sharply in the second half of 2010 due to a 5 percentage point increase in the standard VAT rate. Inflation fell sharply in the second half of 2011, averaging 3.8%. This reflected *inter alia* a VAT-related base effect and easing food prices due to an exceptionally good agricultural harvest.

Inflation is expected to remain lower in 2012 and 2013 compared to recent years, amid sluggish domestic demand and on assumption of moderate increases in administered prices. The Commission services' Spring 2012 Forecast projects annual HICP inflation to average 3.1% in 2012 and 3.4% in 2013. The relatively low price level in Romania (around 56% of the euro area average in 2010) 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 2006**
(percent, 12-month moving average)



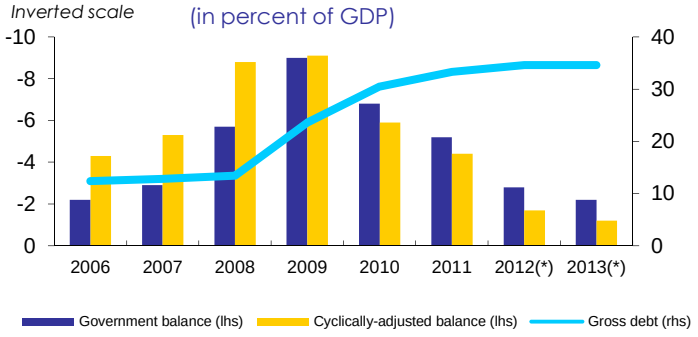
Note: The dots in December 2012 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2012 Forecast.

Romania is at present the subject of a Council Decision on the existence of an excessive deficit (Council Decision of 7 July 2009)[17]. In February 2010, the Council recommended Romania to correct the excessive deficit by 2012. The general government deficit in Romania peaked at 9.0% of GDP in 2009, but it declined to 6.8% and 5.2% of GDP in 2010 and 2011 respectively amid fiscal consolidation efforts. According to the Commission services' Spring 2012 Forecast, which is based on a no-policy-change assumption, the deficit-to-GDP ratio will amount to 2.8% in 2012 and 2.2% in 2013, while general government debt is expected to stabilise at 34.6% of GDP in 2012 and 2013 respectively.

Romania does not fulfil the criterion on public finances.

17 2009/590/EC (OJ L 202, 4.8.2009, p. 48).

Graph 8b: **Romania - Government budget balance and debt**



(*) Commission services' Spring 2012 Forecast.
Source: Eurostat, Commission services.

The Romanian leu is not participating in ERM II. Romania operates a floating exchange rate regime. The nominal exchange rate of the leu against the euro fluctuated in a wide range in the pre-crisis years. The leu faced significant weakening pressures in 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 as the ensuing lack of liquidity drove up Romanian short-term interest rates. Following an agreement in early 2009 to provide Romania with a coordinated package of international financial assistance, financial market pressures eased and the leu broadly stabilised against the euro at levels that then prevailed for most of the period from 2009 to 2011. The leu's exchange rate against the euro depreciated during temporary bouts of global risk aversion, including in the second half of 2011. In early 2012, it remained at a moderately weaker level than the 2009-2011 average. During the two years before this assessment, the leu depreciated against the euro by 6.4%.

Romania does not fulfil the exchange rate criterion.

Average long-term interest rates in Romania were above the reference value at each convergence assessment since EU accession. The average long-term interest rate in Romania in the year to March 2012 was 7.3%, above the reference value of 5.8%. Spreads vis-à-vis the euro area peaked in the midst of the global financial crisis in mid-2009. Long-term interest rates in Romania declined sharply in late 2009 and remained at just above 7% for most of the period 2010-2011, before falling further in early 2012. This decline reflected, *inter alia*, a downward adjustment in the expected path of interbank rates as well as robust demand for sovereign bonds amid fiscal consolidation efforts.

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 balance (i.e. the combined current and capital account) improved markedly during the global crisis. The external deficit declined from a peak of around 13% of GDP in 2007 to an average of around 4% of GDP in the years 2009-2011. The narrowing of the external shortfall over the past three years reflected in particular a significantly lower merchandise trade deficit, due to a sharp decline in imports amid plummeting

domestic demand. Romania has been a recipient of international financial assistance since 2009. In spring 2011, following the successful completion of the first balance-of-payments assistance programme, a precautionary EU-IMF programme (available until early 2013) totalling up to about EUR 5 billion was made available to Romania. No funding has been requested under the programme so far. External financing pressures eased markedly in 2010-2011 amid the sharp improvement in the external balance, disbursements of international financial assistance and recovery in global risk appetite.

The Romanian economy is well integrated to the EU economy through trade and FDI linkages. On the basis of selected indicators relating to the business environment, Romania performs poorly compared to euro area Member States. The integration of the domestic financial sector into the EU financial system is substantial, mainly through a high degree of foreign ownership of financial intermediaries[18].

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.

9. SWEDEN

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

In Sweden, 12-month average inflation was above the reference value at the time of the last convergence assessment in 2010. Since then, inflation has gradually declined. The average inflation rate in Sweden during the 12 months to March 2012 was 1.3%, well below the reference value of 3.1% and is likely to remain well below the reference value in the months ahead.

After averaging 3.4% in 2008, HICP inflation has been below 2% in the following years as a stronger krona together with subdued unit labour costs have held back inflationary pressures. Inflation temporarily picked up in the second half of 2010 amid higher energy prices but fell back in the course of 2011. On average, inflation amounted to 1.4% in 2011.

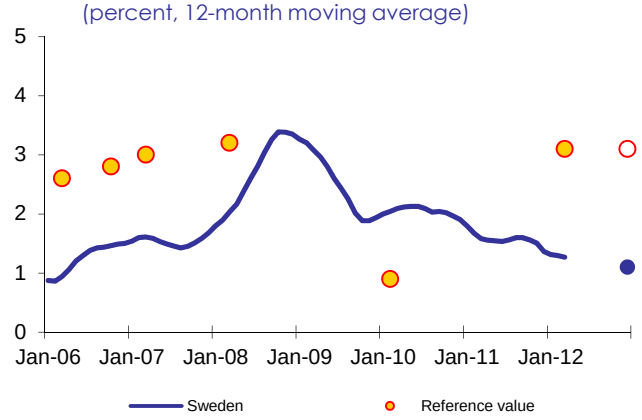
Inflation is expected to remain moderate in 2012 and 2013, averaging about 1.1% and 1.5%, respectively, according to the Commission services' Spring 2012 Forecast, as low domestic demand and ample spare capacity is expected to restrain the inflationary impact of higher unit labour costs.

Sweden fulfils the criterion on price stability.

[18] Romania, as a Member State under EU-IMF financial assistance programme and in order to avoid the duplication of surveillance procedures, is not examined under the macroeconomic imbalances procedure in 2012. It was therefore not covered in the Alert Mechanism Report and in-depth reviews.

Graph 9a: **Sweden - Inflation criterion since 2006**

(percent, 12-month moving average)



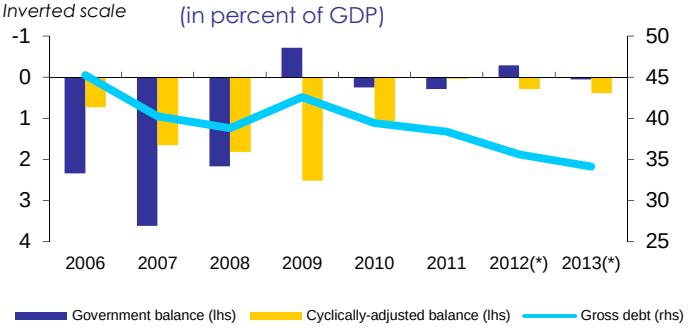
Note: The dots in December 2012 show the projected reference value and 12-month average inflation in the country.
Sources: Eurostat, Commission services' Spring 2012 Forecast.

Sweden is not the subject of a Council Decision on the existence of an excessive deficit. Swedish public finances were strong in the run-up to the global financial crisis, with general government surpluses amounting to 3.6% and 2.2% in 2007 and 2008, respectively. The balance briefly turned into a deficit of 0.7% in 2009. As the economic recovery got underway, the balance swung back into a small surplus of 0.3% in 2010, remaining at that level in 2011. According to the Commission services' Spring 2012 Forecast, the government balance will end up in deficit of 0.3% in 2012, before turning back to a surplus of 0.1% in 2013 under a no-policy-change assumption. The gross public debt ratio stood at 38.4% of GDP in 2011 and it is projected to continue its downward trend and reach to 34.2% of GDP in 2013.

Sweden fulfils the criterion on public finances.

Graph 9b: **Sweden - Government budget balance and debt**

Inverted scale (in percent of GDP)



(*) Commission services' Spring 2012 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 the midst of the financial crisis in 2008 as investors became more risk averse, but it then quickly recovered. The krona strengthened by some 20% against the euro between March 2009 and February 2011. After some weakening in the first half of 2011, the krona broadly stabilised before strengthening in the end of 2011 as Sweden's strong public finances triggered safe-haven flows into krona.

During the two-year assessment period, the krona appreciated by 7.7% against the euro.

Sweden does not fulfil the exchange rate criterion.

The average long-term interest rate in Sweden in the year to March 2012 was 2.2%, well below the reference value of 5.8%. Average long-term interest rates have been below the reference value since EU accession in 1995. Swedish long-term interest rates have very closely followed the lowest long-term yields among EU countries in recent years.

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 some 4% of GDP in the early 2000s to around 7-8% since 2004. The Swedish economy is highly integrated within the EU economy through strong trade and FDI linkages. On the basis of selected indicators relating to the business environment, Sweden performs well above the average of euro area Member States, particularly due to the high level of technological adoptions, innovations, internet access, higher education and quality of public and private institutions. The integration of the domestic financial sector into the EU financial sector is substantial, 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. Sweden however saw very strong increases in house prices over past years which have started to stabilise only recently. In line with the conclusion of the Alert Mechanism Report from February 2012, Sweden was subject to an in-depth review in the context of the Macroeconomic Imbalance Procedure.

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 Sweden does not fulfil the conditions for the adoption of the euro.