Deutscher Bundestag **Drucksache 20/2296**

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Unterrichtung

durch das Bundesministerium der Finanzen

gemäß § 9a des Gesetzes über die Zusammenarbeit von Bundesregierung und Deutschem Bundestag in Angelegenheiten der Europäischen Union

Beitritt Kroatien zum Euroraum

Schreiben des Bundesministerium der Finanzen – E B 3 – Vw 9536/13/10001 :009 – vom 15. Juni 2022

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Kroatien beabsichtigt, der dritten Stufe der Wirtschafts- und Währungsunion zum 1. Januar 2023 beizutreten. Die am 1. Juni 2022 veröffentlichten Konvergenzberichte der Europäischen Kommission und der Europäischen Zentralbank (EZB) kommen zu dem Ergebnis, dass Kroatien die Voraussetzungen für den Beitritt zum Euroraum, die sogenannten Konvergenzkriterien, erfüllt. Ebenfalls am 1. Juni 2022 hat die Europäische Kommission einen Vorschlag für einen Beschluss des Rates vorgelegt, der das kroatische Beitrittsersuchen befürwortet und die Ausnahmeregelung des Artikels 139 des Vertrages über die Arbeitsweise der Europäischen Union (AEUV) für Kroatien aufhebt sowie – darauf aufbauend – einen Vorschlag zur rechtlichen Umsetzung der Einführung des Euros in Kroatien.

Die an den Deutschen Bundestag übermittelten Ursprungsdateien ermöglichten keine Weiterverarbeitung zu einer barrierefreien Bundestagsdrucksache.

Die Berichte der Europäischen Kommission und der EZB würdigen die Anstrengungen Kroatiens, die Konvergenzkriterien für den Eurobeitritt zu erfüllen. Im Einzelnen attestieren die Berichte, dass die rechtliche Konvergenz gegeben ist, die Inflationsrate sowie der langfristige Zinssatz in der Referenzperiode unterhalb der Referenzwerte liegen, die Tragfähigkeit der öffentlichen Finanzen erreicht wird, die Wechselkursstabilität gegenüber dem Euro besteht und sich die realwirtschaftliche Konvergenz als hinreichend darstellt.

Die Bundesregierung teilt die Gesamteinschätzung der Konvergenzberichte und beabsichtigt, dem Beschlussvorschlag der Europäischen Kommission zum Beitritt Kroatiens zum Euroraum zuzustimmen.

Auf europäischer Ebene ist für das weitere Verfahren ein enger Zeitplan vorgesehen: Nach der politischen Beratung des Rates Wirtschaft und Finanzen am 16./17. Juni 2022 zum Euroraumbeitritt Kroatiens sind entsprechend Artikel 140 Absatz 2 AEUV als weitere Schritte vorgesehen – die Aussprache im Europäischen Rat am 23./24. Juni 2022, die Anhörung des Europäischen Parlaments vom 4. bis 7. Juli 2022 und die abschließende Entscheidung des Rates Wirtschaft und Finanzen am 12. Juli 2022.

Das Gesetz über die Zusammenarbeit von Bundesregierung und Deutschem Bundestag in Angelegenheiten der Europäischen Union (EUZBBG) sieht in § 9a ein besonderes parlamentarisches Beteiligungsverfahren für Fälle der Einführung des Euro in einem Mitgliedstaat vor. Vor der abschließenden Entscheidung im Rat sollen der Deutsche Bundestag und die Bundesregierung das Einvernehmen herstellen. Ich weise den Deutschen Bundestag in diesem Zusammenhang vorsorglich ausdrücklich auf sein verfassungsrechtliches Recht zur Stellungnahme hin.

Im Hinblick auf den dargestellten, engen zeitlichen Beratungsverlauf auf europäischer Ebene bitte ich den Deutschen Bundestag, von seinem Recht zur Stellungnahme so frühzeitig wie möglich Gebrauch zu machen, damit die Bundesregierung rechtzeitig – wenn möglich bereits in der Aussprache im Europäischen Rat am 23./24. Juni 2022 – diese Haltung zum Beitrittsgesuch Kroatiens berücksichtigen kann. Die klare Positionierung Deutschlands zur Erweiterung der Eurozone, wenn alle Voraussetzungen für den Beitritt erfüllt sind, ist ein wichtiges Signal sowohl gegenüber Kroatien als auch für die Eurozone insgesamt.

Mit Blick auf das Ziel, Einvernehmen mit dem Deutschen Bundestag herzustellen, stehe ich jederzeit für eine weitergehende Unterrichtung und Aussprache zur Verfügung. Zur besseren Übersicht übersende ich Ihnen mit diesem Schreiben fünf Anlagen und verweise insbesondere auf Anlage 1 mit einer Darstellung der wesentlichen Inhalte der Konvergenzberichte der Europäischen Kommission und der Europäischen Zentralbank.

Die Bundesregierung wird im Rahmen ihrer fortlaufenden Unterrichtung über den Rat Wirtschaft und Finanzen kontinuierlich über die weitere Entwicklung der Vorgänge informieren.

Anlage 1

Wesentliche Ergebnisse der Konvergenzberichte der Europäischen Union und der Europäischen Zentralbank für Kroatien (HRV)

I. Wesentliche Ergebnisse der Konvergenzberichte

Am 1. Juni 2022 veröffentlichten EZB und Europäische Kommission (KOM) ihre turnusmäßigen Konvergenzberichte, die darlegen, inwieweit die EU Mitgliedstaaten außerhalb des Euroraums die Bedingungen für den Beitritt zum Euroraum erfüllen und welche Fortschritte sie beim Konvergenzprozess erreicht haben. In den Berichten prüften die Organe, u.a. auch ob Kroatien einen hohen Grad an dauerhafter Konvergenz erreicht hat. Kroatien erfüllt nach Einschätzung der Europäischen Kommission und der EZB sämtliche Konvergenzkriterien, bestehend aus rechtlicher Konvergenz und vier wirtschaftlichen Kriterien (Preisstabilität, tragfähige öffentliche Finanzlage, Wechselkursstabilität gegenüber dem Euro und langfristiger Zinssatz).

Rechtliche Konvergenz: KOM und EZB stimmen überein, dass die kroatischen Rechtsvorschriften im monetären Bereich mit EU-Recht konform sind, dazu zählen vor allem die Unabhängigkeit der Zentralbank, das Verbot monetärer Staatsfinanzierung und die rechtliche Integration der kroatischen Nationalbank (CNB) in das Europäische System der Zentralbanken und der EZB. Die Satzung und das Gesetz über die CNB sind vollständig mit den Artikeln 130 und 131 des AEUV vereinbar.

Preisstabilität: Für den zwölfmonatigen Referenzzeitraum von Mai 2021 bis April 2022 weist HRV eine durchschnittliche Inflationsrate von 4,7 % aus. Sie liegt damit leicht unter dem Referenzwert von 4,9 %. KOM und EZB erwarten, dass die kroatische Inflationsrate 2022 mit 6,1% deutlich über den Referenzwert steigen wird. KOM prognostiziert, dass dieser Anstieg mit der Inflation im Euroraum, die sie in ihrer Frühjahrsprognose ebenfalls auf 6,1% schätzt, übereinstimmen wird. Die Inflationszyklen HRVs seien bereits in hohem Maße mit dem Inflationszyklus des Euroraums synchronisiert. Der Referenzwert wurde berechnet, indem zum ungewichteten arithmetischen Mittel der im Referenzzeitraum gemessenen Inflationsraten von Frankreich (3,2 %), Finnland (3,3 %) und Griechenland (3,6 %) 1,5 Prozentpunkte addiert wurden. Die EZB äußert jedoch Bedenken hinsichtlich der Nachhaltigkeit der Preisstabilität. Der weitere wirtschaftliche Aufholprozess dürfte zu erhöhten Inflationsraten gegenüber dem Euroraum führen, da das BIP-pro-Kopf und das Preisniveau in HRV immer noch niedriger sind als im Euroraum. Um den Aufbau eines übermäßigen Preisdrucks und makroökonomischer Ungleichgewichte zu verhindern, muss der Aufholprozess durch geeignete strukturelle Maßnahmen unterstützt werden. KOM sieht dieses Risiko nicht und verweist darauf, dass HRV im Vergleich zu allen anderen Mitgliedstaaten zum Zeitpunkt des Euro-Beitritts den höchsten Grad an Preiskonvergenz mit dem Euroraum erreicht hat.

Tragfähige öffentliche Finanzlage: 2021 lag das öffentliche Defizit bei 2,9 % des BIP, also knapp unterhalb des Maastricht-Referenzwertes von 3 %. Für 2022 erwartet die KOM ein öffentliches Defizit von 2,3 % des BIP. Vor der Pandemie hatte HRV einen ausgeglichenen Haushalt. Nachdem der öffentliche Schuldenstand in 2020 um 16 Prozentpunkte auf 87 % des BIPs gestiegen war, sank er in 2021 auf 79,8 %. Er lag über dem Grenzwert von 60 %. Laut EZB und KOM hat HRV seinen finanzpolitischen Rahmen verbessert, gleichzeitig sind noch weitere Fortschritte, inklusive der Umsetzung der Maßnahmen im Rahmen der Aufbau- und Resilienzfazilität erforderlich, um die Schuldenquote auf einen dauerhaften Abwärtspfad zu bringen. Insgesamt erfüllt HRV laut KOM und EZB das Kriterium der tragfähigen öffentlichen Finanzen.

Wechselkursstabilität gegenüber dem Euro: HRV nimmt seit dem 10. Juli 2020 und somit für den größten Teil des zweijährigen Referenzzeitraums vom 26. Mai 2020 bis zum 25. Mai 2022 am WKM II teil. Die kroatische Kuna wurde in den WKM II zu einem Leitkurs von 7,53450 Kuna pro Euro mit einer Standardschwankungsbreite von ±15 % aufgenommen. Im Referenzzeitraum wies der Wechselkurs der kroatischen Kuna gegenüber dem Euro ein geringes Maß an Schwankungsbreite auf und bewegte sich in der Nähe seines Leitkurses. Seit der Aufnahme der Kuna in den WKM II sowie während des gesamten Referenzzeitraums betrug die maximale Abweichung vom Leitkurs nach oben 1,0 %, während die maximale Abweichung nach unten 0,8 % betrug.

Langfristiger Zinssatz: Der langfristige Zinssatz lag im Verlauf des Referenzzeitraums von Mai 2021 bis April 2022 mit durchschnittlich 0,8 % unterhalb des Referenzwertes von 2,6 %. Der Referenzwert wurde berechnet, indem zum Zwölfmonatsdurchschnitt der langfristigen Zinssätze Frankreichs (0,3 %), Finnlands (0,2 %) und Griechenlands (1,4 %), die drei Länder, die auch in die Berechnung des Referenzwerts für das Preisstabilitätskriterium einbezogen wurden, 2 Prozentpunkte addiert wurden.

Zusätzliche Punkte: HRV würde von Strukturreformen profitieren, die darauf abzielen, das institutionelle und unternehmerische Umfeld zu verbessern, den Wettbewerb auf den Gütermärkten anzukurbeln, Ungleichgewichte auf dem Arbeitsmarkt und Engpässe beim Arbeitskräfteangebot abzubauen und die Effizienz der öffentlichen Verwaltung und des Justizsystems zu steigern. Unter dem Punkt weitere Faktoren führt die KOM aus, dass HRV bei den Rahmenbedingungen für Unternehmen nach gängigen Indikatoren schlechter abschneidet, als die meisten MS des Euroraums. Die Reformen und Investitionen, die im kroatischen Aufbau- und Resilienzplan enthalten sind, adressieren einige der strukturellen Schwächen der HRV Wirtschaft. Dieser dürfte dazu beitragen, dass HRV mittelfristig auf einem nachhaltigen Konvergenzpfad bleibt.

II. HRV Wirtschaftslage

	2018	**2019**	**2020**	**2021**	**2022**	**2023**
Reales BIP-Wachstum (in % ggü. Vorjahr)	2,9	3,5	-8,1	10,2	3,4	3,0
Inflation (jahresdurchschnittlich in %)	1,6	0,8	0,0	2,7	6,1	2,8
Haushaltssaldo (in % des BIP)	0,0	0,2	-7,3	-2,9	-2,3	-1,8
Staatsverschuldung (in % des BIP)	73,3	71,1	87,3	79,8	75,3	73,1
Struktureller Saldo (in % des BIP)	-1,2	-1,4	-4,4	-3,1	-2,7	-2,3
Leistungsbilanzsaldo (in % des BIP)	1,9	2,8	-0,9	3,3	1,7	0,3
Arbeitslosenquote	8,5	6,6	7,5	7,6	6,3	6,0

Quelle: KOM-Frühjahrsprognose 2022 (Mai 2022)

Vor Beginn des Kriegs in der Ukraine, zeigten die Prognosen für HRV optimistische Entwicklungspfade im Hinblick auf die zukünftige Wirtschaftsentwicklung sowie die Entwicklung von Defizit und Schuldenstand. Letztere sind während der Pandemie und auch als Folge zweier schwerer Erdbeben im Jahr 2020 deutlich angestiegen. Die wirtschaftlichen Entwicklungen im Jahr 2021 deuten auf eine vollständige V-förmige Erholung der kroatischen Wirtschaft hin, mit einer Reduktion des Defizits auf 2.9 % und des Schuldenstands auf 79,8 %.

Auswirkungen des Kriegs in der Ukraine auf die HRV Wirtschaft sind spürbar (reflektiert in einer nach unten korrigierten Wachstumsprognose), halten sich aber im Rahmen. KOM geht für 2022 von einem nach wie vor soliden Wachstum von 3,4 % aus. Während Unsicherheit und Inflation zu einem Rückgang des privaten Konsums führen, wird angenommen, dass die Umsetzung des nationalen Aufbau- und Resilienzplans sowie der beschleunigte Wiederaufbau nach den Erdbeben, die Wirtschaftsleistung durch steigende Investitionen positiv beeinflussen werden.

KOM prognostiziert für 2022 eine Inflationsrate von 6,1 %, die auf stark ansteigende Energie- und Lebensmittelpreise zurückzuführen ist. Maßnahmen der HRV Regierung (u.a. Reduzierung von Energiesteuern) zielen darauf ab, die Haushalte zu entlasten. Es wird von einem bremsenden Effekt auf die Inflation ausgegangen.

Anlage 2

European Commission

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Directorate-General for Economic and Financial Affairs

Convergence Report

2022

EUROPEAN ECONOMY

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ABBREVIATIONS

Member States

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

Currencies

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

Central Banks

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

Other abbreviations

AMR	Alert Mechanism Report
BoP	Balance of Payments
CAR	Capital adequacy ratio
CBA	Currency board arrangement
CEE	Central and Eastern Europe
CIT	Corporate Income Tax
CPI	Consumer price index
CR5	Concentration ratio (aggregated market share of five banks with the largest market share)
EC	European Community
ECB	European Central Bank
EDP	Excessive Deficit Procedure
EMU	Economic and monetary union

ERM II	Exchange rate mechanism II
ESA	European System of Accounts
ESCB	European System of Central Banks
EU	European Union
Eurostat	Statistical Office of the European Union
FDI	Foreign direct investment
FGS	Funding for Growth Scheme
FSA	Financial Supervisory Authority
GDP	Gross domestic product
HICP	Harmonised index of consumer prices
HFSA	Hungarian Financial Supervisory Authority
IDR	In-Depth Review
MFI	Monetary Financial Institution
MIP	Macroeconomic Imbalance Procedure
NCBs	National central banks
NEER	Nominal effective exchange rate
NIK	Najwyższa Izba Kontroli (Poland's Supreme Chamber of Control)
NPL	Non-performing loans
OJ	Official Journal
OJL	Official Journal Lex
PIT	Personal Income Tax
PPS	Purchasing Power Standard
REER	Real effective exchange rate
RRF	Recovery and Resilience Facility
RRP	Recovery and Resilience Plan
SGP	Stability and Growth Pact
TFEU	Treaty on the Functioning of the European Union
ULC	Unit labour costs
VAT	Value added tax

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The report was coordinated by Adriana Reut under the supervision of Eric Ruscher, Head of Unit and approved by Lucio Pench, Director, Declan Costello, Deputy Director General, and Maarten Verwey, Director General.

Questions and comments may be referred to Adriana Reut (adriana.reut@ec.europa.eu).

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Convergence Report 2022

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

EUROPEAN
COMMISSION

Brussels, 1.6.2022
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REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

CONVERGENCE REPORT 2022

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

{SWD(2022) 280 final}

1. PURPOSE OF THE REPORT

The euro is meant to be the single currency of the European Union as a whole. It is now used every day by around 343 million people in 19 Member States in the euro area. The practical benefits include stable prices, lower transaction costs for people and businesses, more transparent and competitive markets and increased intra-EU and international trade. The euro is also the second most used currency worldwide.

Article 140(1) of the Treaty on the Functioning of the European Union (TFEU) requires the Commission and the European Central Bank (ECB) to report to the Council, at least once every 2 years, or at the request of a Member State with a derogation[1], on the progress made by Member States in fulfilling their obligations on the achievement of economic and monetary union. The latest Commission and ECB Convergence Reports were adopted in June 2020.

The 2022 Convergence Report covers the following seven Member States with a derogation: Bulgaria, Czechia, Croatia, Hungary, Poland, Romania and Sweden[2]. The staff working document accompanying this report provides a more detailed assessment of the state of convergence in these Member States[3].

Article 140(1) TFEU requires the reports to include an examination of the compatibility of national legislation, including the statutes of the national central bank, with Articles 130 and 131 TFEU and the Statute of the European System of Central Banks and of the European Central Bank (‘the 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 relevant to economic integration and convergence mentioned in the final sub-paragraph of Article 140(1) TFEU. The four convergence criteria are developed further in a protocol annexed to the Treaties (Protocol No 13 on the convergence criteria).

The outbreak of the COVID-19 pandemic in March 2020 led to a severe economic downturn for the EU as a whole and in all Member States. Unprecedented action taken at EU level and by the individual Member States cushioned the impact of the crisis and led to a robust recovery in 2021. In particular, swift activation of the general escape clause of the Stability and Growth Pact, coupled with the temporary framework on State aid, enabled large-scale fiscal support in all Member States. The ECB also took a broad set of monetary policy measures to preserve favourable financing conditions for all sectors of the economy in order to support economic activity and safeguard medium-term price stability. The roll-out of the Recovery and Resilience Facility, which is the centrepiece of NextGenerationEU, is further bolstering the EU’s resilience. At the same time, the strong recovery in 2021, supply chain bottlenecks and a surge in energy prices contributed to a sharp rise in inflation throughout 2021 and into 2022.

[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 negotiated an opt-out before the adoption of the Maastricht Treaty and does not participate in the third stage of economic and monetary union.

[2] Denmark has not expressed an intention to adopt the euro and is therefore not covered in the assessment.

[3] The cut-off date for the data used in this report is 18 May 2022. The convergence assessment is based on a range of monthly convergence indicators that are calculated up to April 2022.

Russia’s invasion of Ukraine on 24 February 2022 forced a re-assessment of the outlook for the EU economy, which had been expected to expand strongly in 2022 and 2023. The crisis has mainly dealt a new supply-side shock to an economy that was already facing inflationary pressures. It has weakened recovery prospects and reinforced upward price pressures, while further underlining the need for greater private and public investment to diversify Europe’s energy supplies and improve energy security. Several of the Member States with a derogation assessed in this report are among the most heavily exposed to the crisis triggered by Russia’s invasion of Ukraine. To varying degrees, this exposure reflects the relatively high energy intensity of their economies, strong dependency by some on Russian gas and oil supplies, trade linkages with Russia and the provision of frontline assistance to people fleeing Ukraine. The Commission proposed a REPowerEU plan on 18 May 2022, for which the Recovery and Resilience Facility will be a key tool. It aims to phase out dependence on fossil fuels from Russia well before 2030 by diversifying the EU’s gas supplies and speeding up the green transition.

On 23 May 2022, the Commission presented its European Semester spring 2022 package. Member States should primarily focus on the timely implementation of the recovery and resilience plans (RRPs). Therefore, the Commission proposes to the Council to address to all Member States with an approved RRP: a recommendation on fiscal policy, including fiscal-structural reforms where relevant; a recommendation on the implementation of the RRP and the cohesion policy programmes; a recommendation on energy policy in line with the objectives of REPowerEU; where relevant, an additional recommendation on outstanding and/or newly emerging structural challenges. The scope of the recommendations is larger for Member States that do not have approved RRPs.

The outbreak of the COVID-19 pandemic, the measures taken in response to that crisis, the surge in commodity prices, the supply bottlenecks and the robust recovery in 2021 have had a significant impact on some of the economic convergence indicators used in this report. This is especially the case for the assessment of the price stability criterion. Differences in inflation performance across the EU have increased mainly due to the heterogeneous impact of the recovery on Member States’ inflation rates and the differences in energy price inflation. In addition, the various fiscal measures taken by national authorities to cushion the impact of higher energy prices play a role. While some of these measures, such as social transfers to most vulnerable households, do not have a direct impact on consumer prices, others have a more direct impact on the inflation convergence assessment. In addition, long-term interest rates were influenced, initially, by the policy measures taken to stabilise financial markets and preserve favourable financing conditions and, later, by higher inflation expectations and the differing paths of monetary tightening.

The 2020 economic recession and fiscal response to the COVID-19 pandemic led to a sharp increase in general government deficits and debt. In 2020, the deficit was above the 3% of GDP Treaty reference value in 25 Member States, with an EU aggregate deficit of 6.8% of GDP. In 2021, the strong economic recovery contributed to an improvement in government deficits and debt improved, with fifteen Member States recording deficits higher than 3% of GDP and the EU aggregate deficit declining to 4.7% of GDP. In March 2020, the European Commission, with the agreement of the EU Ministers of Finance, activated the general escape clause of the Stability and Growth Pact. On 23 May 2022, in its Communication on the 2022

European Semester spring package, the Commission considered that the Union was not yet out of a period of severe economic downturn and that the conditions to maintain the general escape clause in 2023 and to deactivate it as of 2024 were met. The Commission invited the Council to endorse this conclusion to provide clarity to Member States. In spring 2020, 2021 and 2022, the Commission considered that a decision on whether to place Member States under the excessive deficit procedure should not be taken, taking into account the extraordinary macroeconomic and fiscal impact of the COVID-19 pandemic that, together with the geopolitical situation in spring 2022, create exceptional uncertainty, including for designing a detailed path for fiscal policy[4]. These conclusions have straightforward implications for the assessment of the criterion on the government budgetary position presented in this report.

The impact of Russia’s invasion of Ukraine on the historical data used in the 2022 Convergence Report is limited. This is a consequence of the report’s cut-off date (18 May), which together with the Treaty-defined calculation methods of the price stability and long-term interest rate criteria (i.e. one year averages), mean that the corresponding data largely reflect the situation prior to Russia’s invasion. Instead, the extent to which the economic convergence indicators are affected by the crisis triggered by Russia’s invasion as well as by other ongoing economic developments is fully captured in the economic projections for 2022 and 2023, which the Commission published on 16 May 2022 (Commission’s Spring 2022 Economic Forecast) and which are used to assess the sustainability of convergence. This forecast is the first comprehensive Commission assessment of the likely economic effects in 2022 and 2023 of the crisis triggered by Russia’s invasion of Ukraine, and as such, is surrounded by higher than usual uncertainty.

Convergence criteria

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

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

Article 1 of the Protocol on the convergence criteria further provides that *‘the criterion on price stability […] shall mean that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1.5 percentage points that of, at most, the three best-performing Member States in terms*

[4] On 3 April 2020, the Council decided that an excessive deficit exists in Romania based on the planned excessive deficit in 2019.

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 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. The convergence examination therefore includes an assessment of the factors that have an impact on the inflation outlook and is complemented by a reference to the most recent Commission 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 4.9% in April 2022, with France, Finland and Greece as the three 'best-performing Member States'[7].

Malta and Portugal have been identified as outliers, as their inflation rates deviated by a wide margin from the euro area average and were driven by country-specific factors that limit their scope to act as meaningful benchmarks for other Member States[8]. This is consistent with past practice as outliers were identified in the Convergence Reports of 2004, 2010, 2013, 2014 and 2016. Outliers are identified on the basis of two criteria taken in combination: i) an inflation rate substantially below the euro area average and ii) an inflation rate driven by country-specific factors that cannot be seen as representative of the process driving inflation in the euro area. In past Convergence Reports, Member States that had an inflation rate 1.5 percentage points or more below the euro area were generally considered as outliers. In April 2022, the 12-month average inflation rates of Malta and Portugal were respectively 2.2 percentage points and 1.7 percentage points below the euro area average of 4.4%.

In addition, the inflation performances of Malta and Portugal were driven by country-specific factors. In the case of Malta, country-specific factors that are reflected in the comparatively low average inflation rate include broadly stable energy prices in a context of surging international oil and gas prices and larger changes in the weights used to calculate the HICP than in most other EU countries in 2021. The absence of energy price inflation in Malta was notably enabled by government measures, including through financial support to the energy sector. A fixed price contract for the supply of liquefied natural gas also contributed.

In the case of Portugal, country-specific factors that are reflected in the comparatively very low average inflation rate include comparatively low energy inflation and the weaker cyclical position of the country compared with most other EU Member States. A combination of factors weighed on energy inflation, including a broad range of regulatory measures that kept the growth in retail prices of electricity and natural gas well below the EU average. In addition, the COVID-19 crisis had a prolonged negative impact on Portuguese activity and inflation. The country's activity was more severely hit than in most other EU Member States in the

[5] For the purpose of the criterion on price stability, inflation is measured by the Harmonised Index of Consumer Prices (HICP) defined in Regulation (EU) 2016/792 of the European Parliament and of the Council.

[6] All forecasts for inflation and other variables in the current report are from the Commission's Spring 2022 Economic Forecast. The 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.

[7] The respective twelve-month average inflation rates were 3.2%, 3.3% and 3.6%.

[8] In April 2022, the twelve-month average inflation rates of Malta and Portugal were 2.1% and 2.6% respectively and that of the euro area 4.4%.

early stages of the pandemic and its recovery has since been comparatively slow. In the fourth quarter of 2021, Portugal's GDP was still significantly below its pre-crisis peak and the gap was the second largest in the EU. This reflects mainly Portugal's large exposure to tourism and particularly aviation-based tourism, which has been heavily and durably hit by the pandemic. The relative weakness in Portugal's recovery has had a lasting dampening effect on inflation in services, particularly in sectors related to tourism.

The convergence **criterion dealing with public finances** is defined in the second indent of Article 140(1) TFEU as *''the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 126(6)''*.

Furthermore, Article 2 of the Protocol on the convergence criteria states that this criterion means that *''at the time of the examination the Member State is not the subject of a Council decision under Article 126(6) of the said Treaty that an excessive deficit exists''*.

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

Article 3 of the Protocol on the convergence criteria provides that: *''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''*[9].

The relevant two-year period for assessing exchange rate stability in this report is 19 May 2020 to 18 May 2022. In its assessment of the exchange rate stability criterion, the Commission takes into account developments in auxiliary indicators such as foreign reserve developments and short-term interest rates. It also takes into account the role of policy measures, including foreign exchange interventions, and international financial assistance wherever relevant, in maintaining exchange rate stability. Two of the Member States with a derogation assessed in this report currently participate in the European exchange rate mechanism (ERM II) – Bulgaria and Croatia. Entry into ERM II is decided upon request of a Member State by mutual agreement of all ERM II participants[10]. This report is not related to the ERM II entry process and it does not provide an assessment of a Member State's capacity to join ERM II.

The fourth indent of Article 140(1) TFEU requires that '*the durability of convergence achieved by the Member State with a derogation and of its participation in the exchange rate mechanism' is 'reflected in the* ***long-term interest rate levels***'.

[9] 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.

[10] ERM II participants are the euro-area finance ministries, the ECB, non-euro area ERM II finance ministries and central banks.

Article 4 of the Protocol on the convergence criteria further states 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 2.6% in April 2022[11].

Article 140(1) TFEU also requires the reports to take account of **other factors** relevant to economic integration and convergence. These include the integration of markets, the development of the balance of payments on current account and of unit labour costs and other price indices[12]. The latter are covered within the assessment of price stability. The additional factors to be considered are important indicators on whether a Member State would integrate into the euro area without difficulties and they broaden the view on the sustainability of convergence.

The assessment of the degree of sustainable convergence for the Member States with a derogation presented in this report draws on the Commission's Spring 2022 Economic Forecast and the policy guidance provided under the European Semester. It is informed in particular by the fiscal surveillance carried out under the Stability and Growth Pact and the Macroeconomic Imbalance Procedure. It also reflects the Commission's assessments of fiscal sustainability risks and of the national fiscal frameworks, as well as the implementation of the recovery and resilience plans.

2. BULGARIA

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

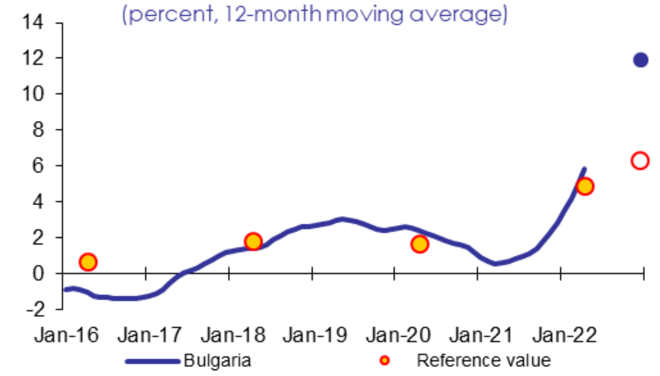
Legislation in Bulgaria — in particular the Law on the Bulgarian National Bank — **is not fully compatible** with the compliance duty under Article 131 TFEU. Incompatibilities and imperfections exist in the fields of central bank independence, the prohibition of monetary financing and central bank integration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

Bulgaria does not fulfil the criterion on price stability. The average inflation rate in Bulgaria during the 12 months to April 2022 was 5.9%, above the reference value of 4.9%. The Commission projects it to remain above the reference value in the months ahead.

[11] The reference value for April 2022 is calculated as the simple average of the 12-month average of long-term interest rates of France (0.3%), Finland (0.2%) and Greece (1.4%), plus two percentage points.

[12] It is, however, important to bear in mind that unit labour costs data may have been impacted by the labour retention schemes put in place in some Member States following the outbreak of the pandemic.

Graph 2a: **Bulgaria - Inflation criterion since 2016**
(percent, 12-month moving average)



Note: The dots at the right end of the graph show the projected reference value and 12-month average inflation rate of the country in December 2022. The reference values for 2016, 2018 and 2020 refer to the reference values calculated in the previous Convergence Reports.

Source: Eurostat, Commission's Spring 2022 Economic Forecast.

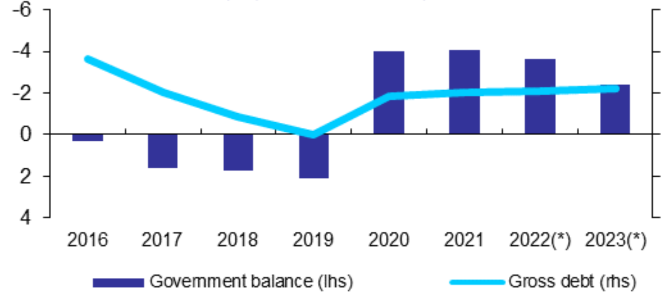
Bulgaria's annual HICP inflation rate averaged 1.2% in 2020, and accelerated to 2.8% in 2021. Annual HICP inflation decreased from 1.3% in April 2020 to -0.3% in January 2021. Headline inflation then increased during the course of 2021, before accelerating sharply in the first months of 2022, reaching 12.1% in April 2022. Deflation in unprocessed food prices and low inflation rates in processed food prices drove inflation down in April 2020 to January 2021. The subsequent acceleration of inflation in 2021 was due to strong contributions from all broad categories. In particular, fuel prices contributed 3.5 percentage points to the annual inflation rate in December 2021. In the first part of 2022, headline inflation continued to increase on the back of higher energy prices and other broad-based price increases. Annual HICP inflation rates in Bulgaria in 2020 and 2021 were on average higher than those of the euro area.

In the Commission's Spring 2022 Economic Forecast, inflation is projected to accelerate significantly from 2.8% in 2021 to 11.9% in 2022, gradually easing to 5.0% in 2023. Headline inflation is expected to increase and remain elevated because of persistently higher costs of energy and other intermediate products, expected increases in regulated gas and heating prices, as well as higher international food prices and growing import deflators. The relatively low price level in Bulgaria (about 52% of the euro area average in 2020) suggests significant potential for price level convergence in the long term.

Bulgaria fulfils the criterion on public finances. Bulgaria is not the subject of a Council Decision on the existence of an excessive deficit. The general government balance remained broadly stable with a deficit of 4.0% of GDP in 2020 and a deficit of 4.1% of GDP in 2021. After a period of budget surpluses, these deficits are the result of the pandemic-induced shock and the measures taken by the Bulgarian government in response to it. The Commission's Spring 2022 Economic Forecast expects the general government balance is projected to improve to -3.7% of GDP in 2022. Fiscal costs associated with people fleeing the war in Ukraine as well as measures in light of higher energy prices weigh on the deficit's recovery path. The deficit is expected to reach -2.4% of GDP in 2023 under a ‘no policy change’ assumption. On 23 May 2022, the Commission adopted a report prepared in accordance with Article 126(3) of the TFEU for 18 Member States, including Bulgaria. Overall, taking into account all relevant factors as appropriate, the analysis in the report suggested that Bulgaria did not fulfil the deficit criterion. In line with its Communication of 2 March 2022[13], the Commission did not propose opening new excessive deficit procedures. It noted that the COVID-19 pandemic continues to have an extraordinary macroeconomic and fiscal impact that, together with Russia's invasion of Ukraine, creates exceptional uncertainty, including for designing a detailed path for fiscal policy. On these grounds, the Commission considered that a decision on whether to place Member States under the excessive deficit procedure should not be taken in spring 2022. The public debt-to-GDP ratio increased from just below 25% in 2020 to 25.1% in 2021, and is expected to remain broadly the same in 2022, before increasing slowly towards 26% in 2023. Despite the low projected debt level by 2032 (37% of GDP), debt sustainability risks for Bulgaria appear medium in the medium term. The projection is subject to considerable uncertainty. Bulgaria has developed a strong fiscal framework in recent years, and now has a better track record in compliance. The system of rules, however, appears complex, which increases the need to streamline the process.

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

(in percent of GDP)



(*) Commission's Spring 2022 Economic Forecast.
Source: Eurostat, Commission's Spring 2022 Economic Forecast.

In line with its currency board arrangement, the exchange rate of the Bulgarian lev against the euro has been stable since the previous Convergence Report. The two-year period relevant for the assessment of exchange-rate stability extends from 19 May 2020 to 18 May 2022. The Bulgarian lev joined ERM II on 10 July 2020 and observes a central rate of 1.95583 to the euro with a standard fluctuation band of ±15%. The Bulgarian National Bank pursues its primary objective of price stability through an exchange rate anchor as part of a currency board arrangement. Bulgaria introduced its currency board arrangement in 1997, pegging the Bulgarian lev to the German mark and later to the euro. Bulgaria joined ERM II with its existing currency board arrangement in place, as a unilateral commitment, thereby placing no additional obligations on the ECB. The lev exchange rate has remained stable over the two-year assessment period without any signs of tensions or devaluation against the euro. Additional indicators, such as developments in foreign exchange reserves and short-term interest rates, suggest that investors' risk perception towards Bulgaria has remained favourable. A sizeable buffer of official reserves continues to underpincurrency board arrangement's resilience. After joining ERM II, Bulgaria committed to implement a set of policy measures – the so-called post-entry commitments – to ensure that its participation in the mechanism is sustainable and

[13] For more information, see COM(2022) 85 final: https://ec.europa.eu/info/sites/default/files/economy-finance/com_2022_85_1_en_act_en.pdf.

that the country achieves a high degree of economic convergence before adopting the euro. The measures cover four policy areas: the non-banking financial sector, the insolvency framework, the anti-money laundering framework, and governance of state-owned enterprises. Bulgaria is currently working towards completing these post-entry commitments, in cooperation with the Commission, which monitors its progress.

The lev has remained at the ERM II central rate for the 2 years covered by this assessment. There has been no devaluation of the lev’s central parity inside ERM II. By the time of a possible Council Decision in July 2022, the lev will have participated in ERM II for 24 months. Bulgaria fulfils the exchange rate criterion.

Bulgaria fulfils the criterion on the convergence of long-term interest rates. The average long-term interest rate in the year up to April 2022 was 0.5%, well below the reference value of 2.6%. Long-term interest rates in Bulgaria have been very low and fairly stable since the beginning of 2020 until the end of 2021, remaining within a band of 0.1-0.4%. There was only a brief peak in June-July 2020, when the benchmark interest rate increased to 0.7%. In the same period, the spread vis-à-vis the German benchmark bond has hovered mostly around 60 basis points, with a brief peak above 100 basis points in mid-2020. However, at the beginning of 2022, both the interest rate and the spread started to increase, and were 1.6% and 89 basis points respectively in April 2022.

The Commission has also examined **additional factors**, including balance of payments developments and the integration of markets. Bulgaria’s external balance (the combined current and capital account) has remained in surplus, at 1.5% of GDP in 2020 and 0.3% in 2021. The Bulgarian economy is well integrated with the euro area through trade and investment linkages. Selected indicators related to the business environment show that Bulgaria performs worse than many euro area Member States. Challenges also relate to the institutional framework including corruption and government efficiency. However, in the context of successful participation in the ERM II and in accordance with the recovery and resilience plan (RRP), Bulgaria is taking measures to improve the business environment and maintain financial sector stability, in the four areas covered by the post-entry ERM II commitments mentioned above. The financial sector in Bulgaria is smaller and less developed than in the euro area, with an above average share of non-performing loans that has been declining only very gradually in the past several years. Banking dominates the Bulgarian financial sector, and its banking sector is well integrated with the euro area financial sector, in particular through a high level of foreign ownership. However, market based financing is less developed, which is reflected in the very small markets for equity and private sector debt. In the context of the Macroeconomic Imbalance Procedure, the Commission concluded in its Alert Mechanism Report for 2022 that it was not necessary to carry out further in-depth analysis for Bulgaria.

The effective implementation of the reforms and investment set out in Bulgaria’s recovery and resilience plan will address key macro-economic challenges. These include social inclusion, education and skills, healthcare, decarbonisation, the digital transition, the business environment, and financing of small and medium-sized enterprises. Key investments are included in renewable energy production, electricity storage and interconnection capacities, and in the digitalisation of public administration and digital skills. Key reforms include the introduction of a framework for coal phase-out, the liberalisation of the electricity market, comprehensive educational reform, and strengthening the minimum income scheme, the anti-money laundering and the insolvency frameworks. The plan also contains measures to improve the efficiency of the public administration and justice system, to prevent, detect and correct corruption.

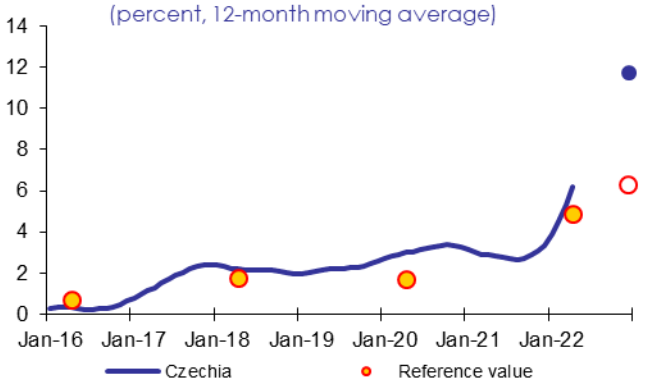
3. CZECHIA

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

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

Czechia does not fulfil the criterion on price stability. The average inflation rate in Czechia during the 12 months to April 2022 was 6.2%, well above the reference value of 4.9%. It is projected to remain well above the reference value in the months ahead.

Graph 3a: **Czechia - Inflation criterion since 2016**
(percent, 12-month moving average)



Note: The dots at the right end of the graph show the projected reference value and 12-month average inflation rate of the country in December 2022. The reference values for 2016, 2018 and 2020 refer to the reference values calculated in the previous Convergence Reports.

Source: Eurostat, Commission's Spring 2022 Economic Forecast.

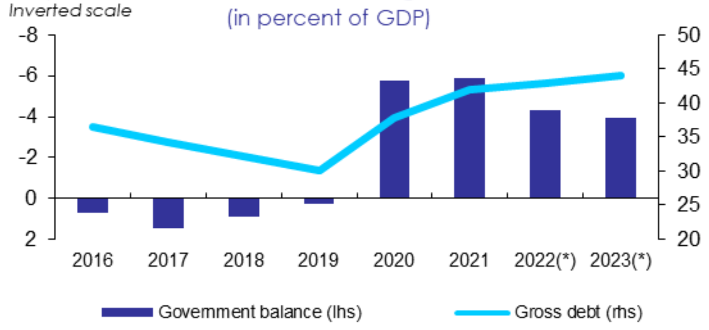
The annual HICP inflation rate eased from 3.8% at the beginning of 2020 to 2.1% in February 2021 mostly due to falling energy and food inflation. Headline inflation then picked up during the course of 2021, before accelerating sharply in the first months of 2022 to reach 13.2% in April 2022. The increase in 2021 and early 2022 was broad based, reflecting both a surge in energy prices and a strong acceleration of core inflation (driven by non-energy industrial goods and services). The annual HICP inflation rate averaged 3.3% in both 2020 and 2021. Annual HICP inflation rates in Czechia in 2020 and 2021 were on average higher than those of the euro area.

The Commission's Spring 2022 Economic Forecast expects inflation to accelerate significantly to 11.7% in 2022 and then moderate to 4.5% in 2023 . Headline inflation is expected to increase and remain elevated over both years because of persistently higher costs of energy and other intermediate products, expected increases in administered prices for energy and other utilities, and core inflation components, especially goods followed by services. The relatively low price level in Czechia (about 73% of the euro area average in 2020) suggests that there is potential for further price level convergence in the long term.

Czechia fulfils the criterion on public finances. Czechia is not the subject of a Council Decision on the existence of an excessive deficit. The general government balance worsened somewhat from a deficit of 5.8% in 2020 to a deficit of 5.9% of GDP in 2021. The Commission's Spring 2022 Economic Forecast expects the general government balance to improve to -4.3% of GDP in 2022, despite the negative impact of Russia's invasion of Ukraine. This led to the implementation of emergency and integration measures to support those fleeing Ukraine as well as measures to ease energy costs. The general government balance is forecast to reach -3.9% of GDP in 2023 under a 'no policy change' assumption. On 23 May 2022 the Commission adopted a report prepared in accordance with Article 126(3) of the TFEU for 18 Member States, including Czechia. Overall, taking into account all relevant factors as appropriate, the analysis in the report suggested that Czechia did not fulfil the deficit criterion. In line with its Communication of 2 March 2022[14], the Commission did not propose opening new excessive deficit procedures. It noted that the COVID-19 pandemic continues to have an extraordinary macroeconomic and fiscal impact that, together with Russia's invasion of Ukraine, create exceptional uncertainty, including for designing a detailed path for fiscal policy. On these grounds, the Commission considered that a decision on whether to place Member States under the excessive deficit procedure should not be taken in spring 2022. The public debt-to-GDP ratio increased from around 38% in 2020 to 41.9% in 2021, and is expected to increase to 42.8% in 2022 and to 44.0% in 2023. Debt sustainability risks for Czechia appear medium in the medium term, particularly as government debt is projected to increase to around 61% of GDP in 2032. The projection is subject to significant sensitivity to adverse macro-financial developments. The Czech national fiscal framework is well developed. After the outbreak of the COVID-19 pandemic, Parliament fast-tracked legislative amendments that allow a larger deficit over 2021–2027 and a longer adjustment path (0.5 percentage point correction per year, in structural terms).

[14] For more information, see COM(2022) 85 final: https://ec.europa.eu/info/sites/default/files/economy-finance/com_2022_85_1_en_act_en.pdf.

Graph 3b: **Czechia - Government budget balance and debt**



(*) Commission's Spring 2022 Economic Forecast.

Source: Eurostat, Commission's Spring 2022 Economic Forecast.

Czechia does not fulfil the exchange rate criterion. The Czech koruna does not participate in ERM II. Czechia operates a de jure floating exchange rate regime, allowing the central bank to make foreign exchange market interventions . Following the lock-down measures taken in the early stages of the COVID-19 pandemic, the koruna depreciated significantly by about 6% in April 2020 (year-on-year). From June 2020 it fluctuated at slightly higher levels until December 2020, when it entered an appreciation phase that ended abruptly in early 2022. The appreciation was mostly driven by a sharp monetary tightening by the ČNB. However, in the wake of Russia’s invasion of Ukraine the Czech koruna experienced strong depreciation pressures, which triggered short-lasting stabilising interventions by the ČNB in the foreign exchange market in early March 2022. In April 2022, the Czech koruna was about 12% stronger against the euro than 2 years earlier. Short-term interest rate differentials vis-à-vis the euro area increased from around 90 basis points in May 2021 to around 580 basis points by April 2022, following the strong tightening cycle that the ČNB started in August 2021.

Czechia fulfils the criterion on the convergence of long-term interest rates. The average long-term interest rate in the year to April 2022 was 2.5%, below the reference value of 2.6%. The long-term interest rate of Czechia fell in the first few months of 2020 to bottom out at around 0.9% in summer 2020. It then increased slowly to about 1.9% in spring 2021 before picking up more strongly on the back of the ČNB’s sharp monetary tightening and a rapid increase in inflation. The long-term interest rate reached 4.0% in April 2022, with the spread vis-à-vis the German benchmark bond nearing 330 basis points.

The Commission has also examined **additional factors**, including balance of payments developments and the integration of markets. Czechia’s external balance (the combined current and capital account) recorded an exceptionally high surplus of 3.6% of GDP in 2020 due to the effect of the COVID-19 crisis on the trade and primary income balances. The Czech economy is highly integrated with the euro area through trade and investment linkages. Selected indicators related to the business environment show that Czechia performs around the average of euro area Member States. Challenges relate to the institutional framework including government efficiency and the anti-corruption framework, for instance in relation to avoiding conflicts of interest. The financial sector in Czechia is smaller and less developed than in the euro area. Market based financing is less developed, which is reflected in the very small markets for equity and private sector debt. The Czech financial sector is highly integrated into the euro area financial system, in particular through a high degree of foreign ownership of financial intermediaries.

The effective implementation of the reforms and investment set out in Czechia's recovery and resilience plan (RRP) will address key macro-economic challenges. These include technological changes, such as those posed by automation and the green transition, investment in research and development, new childcare facilities, and up-skilling and reskilling actions. Key investments are included on energy efficiency of buildings, digital skills and access to finance for companies. Key reforms are aimed at addressing the quality of public administration (including digitalisation), increasing the capacity of childcare facilities, improving access to and the resilience of the healthcare sector, improving education programmes, upgrading labour market services, supporting research activities and the introduction of innovation in firms. The business environment is being improved by several e-government measures, anti-corruption reforms, including strengthening the institutional and administrative framework linked to avoiding conflict of interest and a comprehensive reform of the procedure for granting building permits, which currently represent major obstacles to investment in Czechia.

4. CROATIA

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

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

Croatia fulfils the criterion on price stability. The average inflation rate in Croatia during the 12 months to April 2022 was 4.7%, below the reference value of 4.9%. It is projected to remain below the reference value in the months ahead.

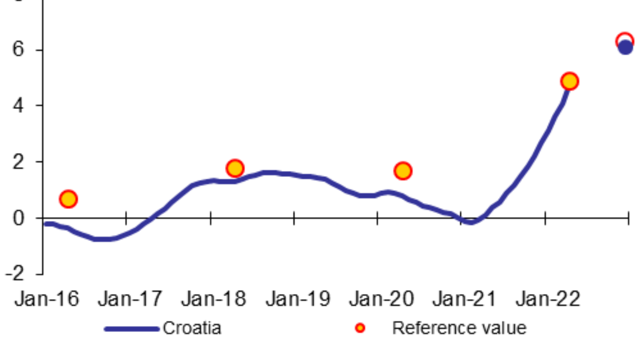
In 2021, the annual HICP inflation rate averaged 2.7%, increasing significantly compared to 2020, when it averaged 0%. Inflation was slightly negative in Croatia between April 2020 and January 2021, mostly due very low and negative energy and non-energy industrial goods inflation. It then accelerated sharply throughout 2021 and in the first months of 2022 to reach 9.6% in April. The increase in 2021 and early 2022 was broad based, reflecting higher energy prices but also an acceleration of core inflation. Annual HICP inflation rates in Croatia in 2020 and 2021 were on average very close to those of the euro area.

The Commission's Spring 2022 Economic Forecast expects annual HICP inflation to accelerate to 6.1% in 2022 before decelerating to 2.8% in 2023, mostly supported by an expected decline in international commodity prices. Headline inflation is therefore projected to remain very close to the euro area headline inflation in 2022 and 2023. Core inflation is expected to be higher than in the euro area in 2022 (i.e., 4.3% vs. 3.5%), reflecting stronger inflation in processed food and, more generally, a stronger recovery from the COVID-19 crisis in Croatia. However, this is expected to be temporary and the gap is projected to narrow in 2023 (i.e., 3.3% vs. 3.1%). Unit labour costs are projected to remain subdued in both 2022 and 2023.

The requirement of sustainability implies that respecting the reference value is the result of underlying fundamentals rather than temporary factors. The analysis of underlying fundamentals and the fact that the reference value will continue to be met in the months ahead support a positive assessment on the fulfilment of the price stability criterion. While RRP-related investments and reforms are expected to have a muted if not disinflationary effect in the long run, investments should also support aggregate demand in the short term (see the next paragraph). According to the Commission’s Spring 2022 Economic Forecast, inflation is projected to ease significantly over the forecast horizon, which suggests that any possible short-term inflationary effect of RRP-related investments should remain limited.

In the longer-term, inflation prospects will hinge in particular on wages growing in line with productivity. Inflation cycles in Croatia are already highly synchronised with the inflation cycle of the euro area and wage developments are expected to continue to underpin this synchronisation. However, although the 2013 and 2014 labour market reforms substantially increased the level of flexibility in the labour market, wage setting remains imperfectly aligned with productivity developments. This is partly linked to the public sector’s role as wage leader. The associated risks in terms of wage developments are not expected to increase with euro accession. Furthermore, RRP-related reforms (e.g., reduction of administrative burden and para-fiscal charges, deregulation of services etc.) should enhance competition on the market and reduce costs for companies, leading to downward pressure on the prices of final products in the long run. In particular, two reforms could contribute to better align productivity wages in the medium term. The first is the new wage and work model in civil and public service, which should introduce a fairer, more transparent and sustainable wage system in the state administration and public services. The second is the Amendment to the Labour Act, tackling unjustified temporary employment and incentivising workers to remain active, among others. Furthermore, although there is a potential for further price level convergence in the long term, it should be noted that at about 67% of the euro area average in 2020, the price level in Croatia has already achieved a higher level of price convergence with the euro area than other Member States when they joined the euro area.

Graph 4a: **Croatia - Inflation criterion since 2016**
(percent, 12-month moving average)

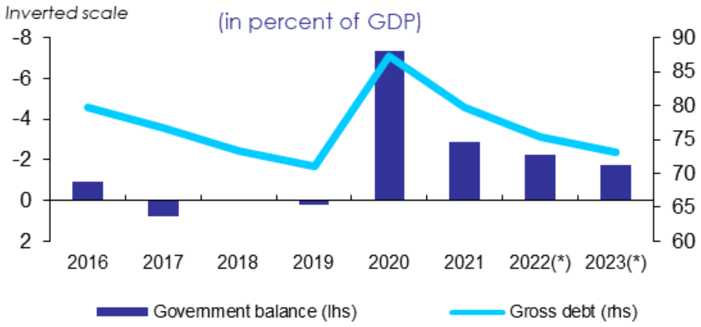


Note: The dots at the right end of the graph show the projected reference value and 12-month average inflation rate of the country in December 2022. The reference values for 2016, 2018 and 2020 refer to the reference values calculated in the previous Convergence Reports.

Source: Eurostat, Commission's Spring 2022 Economic Forecast.

Croatia fulfils the criterion on public finances. Croatia is not the subject of a Council Decision on the existence of an excessive deficit. After 3 years of broadly balanced budgets and surpluses, the general government balance turned into a deficit of 7.3% of GDP in 2020 due to the COVID-19 crisis. The general government deficit declined to 2.9% of GDP in 2021, thanks largely to the strong economic recovery and the gradual phasing out of COVID-19 support measures. The Commission's Spring 2022 Economic Forecast projects the general government balance to improve further to -2.3% of GDP in 2022, notwithstanding the measures taken by the government to reduce the economic and social impact of the increase in energy prices and the costs of assistance to those fleeing Ukraine. In 2023, the government balance should reach -1.8% of GDP on a no policy change basis. The public debt-to-GDP ratio decreased from around 87% in 2020 to 79.8% in 2021, and is expected to decline to 75.3% in 2022 and to 73.1% in 2023. Debt sustainability risks for Croatia appear medium in the medium term, with government debt projected to stay below its 2021 level until 2032. However, the projections are subject to significant sensitivity to adverse macro-financial developments. The Croatian fiscal framework has been significantly strengthened recently, largely thanks to the transposition of some of the outstanding requirements of the Council Directive on Budgetary Frameworks (2011/85/EU).

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



(*) Commission's Spring 2022 Economic Forecast.
Source: Eurostat, Commission's Spring 2022 Economic Forecast.

The exchange rate of the Croatian kuna against the euro has been broadly stable since the previous Convergence Report. The two-year period relevant for the assessment of exchange rate stability runs from 19 May 2020 to 18 May 2022. The Croatian kuna joined ERM II on 10 July 2020 and observes a central rate of 7.53450 to the euro with a standard fluctuation band of ±15%. After having depreciated against the euro by up to 2% in the first 2 months of the pandemic in March and April 2020, the kuna-euro exchange rate in the 2 months before Croatia joined ERM II was stable with only minor deviations from the post-ERM II entry central rate. The kuna has fluctuated in a narrow band of less than +/-1% against its central rate to the euro since it joined ERM II, with the Croatian central bank having operated a *de jure* managed floating exchange rate before the ERM II entry. Over the last 2 years, the kuna's exchange rate against the euro has continued to exhibit a seasonal pattern of temporary modest appreciation in the summer thanks to foreign currency inflows related to the tourism sector. On 18 May 2022, the kuna stood at 7.535 HRK/EUR, very close to its ERM II central rate to the euro and broadly stable compared to its level 2 years earlier. Additional indicators, such as developments in foreign exchange reserves and short-term interest rates, suggest that investors' risk perception towards Croatia has remained favourable. International reserves held by the Croatian National Bank stood at EUR 25 billion at the end of 2021, increasing from close to EUR 19 billion at the end of 2020. The spread of the Croatian benchmark short-term rate, i.e. the 3-month NRR rate, to the EURIBOR has been broadly stable and averaged about 60 basis points over the 2020-2021 period. Upon its ERM II entry, Croatia committed to implement a set of policy measures – the so-called post-entry commitments – to ensure that its participation in the mechanism is sustainable and that the country achieves a high degree of economic convergence before adopting the euro. The measures cover four policy areas: the anti-money laundering, the business environment, state-owned enterprises and the insolvency framework.

The kuna has remained very close to the ERM II central rate for the 2 years covered by this assessment. There has been no devaluation of the kuna's central parity inside ERM II. By the time of a possible Council Decision in July 2022, the kuna will have participated in ERM II for 24 months. Croatia fulfils the exchange rate criterion.

Croatia fulfils the criterion on the convergence of long-term interest rates. The average long-term interest rate of Croatia was 0.8% in April 2022, well below the reference value of 2.6%. Having risen in the first 2 months of the pandemic by over 60 basis points to 1.2% in April 2020, the long-term interest rate then declined very gradually, falling to as low as 0.3% by the end of 2021. The long-term interest rate picked up slightly in December 2021 and moved higher in the first few months of 2022 amid increasing geopolitical risks at global level and a deterioration in the inflation outlook against the backdrop of an already high level of inflation in most advanced economies. The spread against the German long-term benchmark bond was slightly above 100 basis points in 2020 but declined gradually in 2021, falling to around 50 basis points by the end of 2021. It widened again to above 100 basis points at the beginning of 2021, rising to 168 basis points in April 2022 after having peaked by 180 basis points in the previous month.

The Commission has also examined **additional factors**, including balance of payments developments and the integration of markets. Croatia's external balance (the combined current and capital account) decreased to 2.1% of GDP in 2020 from 4.6% of GDP in 2019 due to the economic fallout of the COVID-19 pandemic. Benefiting from a high current account surplus as a result of a strong recovery of tourism export services, it rose substantially to 5.5% of GDP in 2021. The Croatian economy is well integrated with the euro area through trade and investment linkages. Selected indicators relating to the business environment show that Croatia performs worse than many euro area Member States. Challenges *inter alia* relate to the institutional framework including regulatory quality and corruption. However, there has been renewed effort as part of post-entry ERM II commitments to improve the business environment, in particular to reduce the administrative burden and regulatory restrictions (see also below the paragraph on the RRP-related measures). Croatia’s banking sector is highly integrated with the euro area financial system, in particular through a high share of foreign ownership of financial intermediaries. In July 2020, the ECB adopted a decision to establish close cooperation with the Croatian National Bank in the field of banking supervision. The ECB is now responsible for the supervision of Croatia’s major banking institutions and Croatia has effectively joined the Banking Union. The Croatian financial sector is smaller than that of the euro area in terms of GDP. It is dominated by the banking sector which is highly integrated into the euro area banking sector, in particular through foreign ownership. At the same time, the insurance and pension funds sector is also relatively large in Croatia. However, market-based financing is less developed, which is reflected in the very small markets for equity and private sector debt. In the context of the Macroeconomic Imbalance Procedure, the Commission concluded in its Alert Mechanism Report for 2022 that Croatia warranted an In-Depth Review (IDR). In the updated scoreboard including figures until 2020, the net international investment position (NIIP), unit labour cost (ULC) growth, house price growth and general government gross debt indicators were above their indicative thresholds. However, the findings of the Commission's 2022 In-Depth Review (IDR) indicate that the unwinding of macroeconomic imbalances resumed in 2021, following a relatively contained deterioration in 2020. Based on this in-depth review, the Commission considered that Croatia is no longer experiencing macroeconomic imbalances.

The effective implementation of the reforms and investment set out in Croatia's recovery and resilience plan will address key macro-economic and institutional challenges. These include low employment and activity rates, skills gaps, a burdensome and complex business environment and the low quality of education. Key investments are included on energy efficiency and post-earthquake reconstruction of buildings, sustainable transport, the digital transition of the public administration and 5G infrastructure. Reforms are planned in areas such as early childhood education and care, the healthcare system, anti-money laundering and anti-corruption, judiciary, fiscal framework and the business environment, notably by reducing administrative barriers.

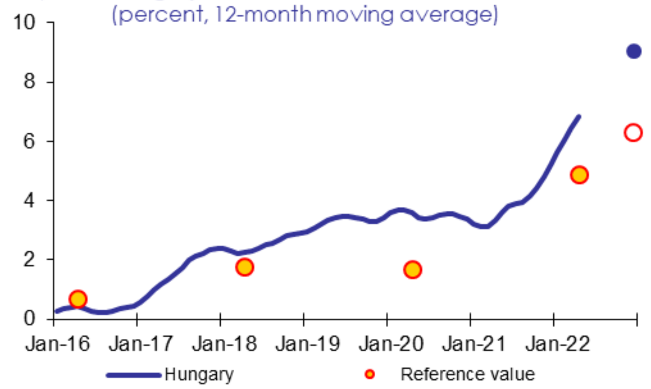
5. HUNGARY

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

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

Hungary does not fulfil the criterion on price stability. The average inflation rate in Hungary during the 12 months to April 2022 was 6.8%, well above the reference value of 4.9%. It is projected to remain well above the reference value in the months ahead.

Graph 5a: **Hungary - Inflation criterion since 2016**
(percent, 12-month moving average)



Note: The dots at the right end of the graph show the projected reference value and 12-month average inflation rate of the country in December 2022. The reference values for 2016, 2018 and 2020 refer to the reference values calculated in the previous Convergence Reports.

Source: Eurostat, Commission's Spring 2022 Economic Forecast.

Annual HICP inflation in Hungary was on an upward path in 2020 and 2021, averaging 3.4% and 5.2% respectively. Annual HICP inflation rose from 2.5% in April 2020 to 5.2% in April 2021. It then accelerated further in the first few months of 2022, reaching 8.6% in March 2022. Inflation acceleration in 2021 was mostly driven by developments in energy and commodity prices. However, core inflation (measured as HICP inflation excluding energy and unprocessed food) increased sharply, after easing slightly between August 2020 and March 2021. Inflation stood at 9.6% in April 2022. Annual HICP inflation rates in Hungary in 2020 and 2021 were on average higher than those of the euro area.

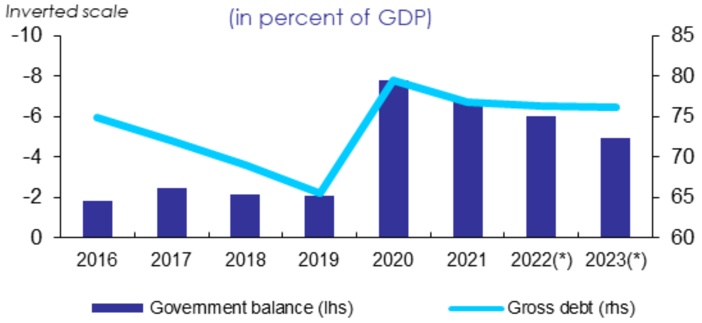
Inflation is projected to increase to 9.0% in 2022 and to slow down to 4.1% in 2023 according to the Commission's Spring 2022 Economic Forecast. Inflation is expected to be mostly driven by energy and commodity prices but also relatively sizable wage increases. The relatively low price level in Hungary (about 63% of the euro area average in 2020) suggests that there is potential for further price level convergence in the long term.

Hungary fulfils the criterion on public finances. Hungary is not the subject of a Council Decision on the existence of an excessive deficit. The general government deficit reached 7.8% of GDP in 2020, before declining to 6.8% of GDP in 2021. The Commission's Spring 2022 Economic Forecast expects that, on the back of better-than-expected output growth, the general government deficit will decrease to 6.0% of GDP in 2022, notwithstanding the measures taken by the government to reduce the economic and social impact of the increase in energy prices and the costs of assistance to those fleeing Ukraine. It is forecast to further decrease to 4.9% of GDP in 2023, under a 'no policy change' assumption. On 23 May 2022, the Commission adopted a report prepared in accordance with Article 126(3) of the TFEU for 18 Member States, including Hungary. Overall, taking into account all relevant factors as appropriate, the analysis in the report suggested that the Hungary did not fulfil the deficit and debt criteria. In line with its Communication of 2 March 2022[15], the Commission did not propose to open new excessive deficit procedures. The Commission considered, within its assessment of all relevant factors, that compliance

[15] For more information, see COM(2022) 85 final: https://ec.europa.eu/info/sites/default/files/economy-finance/com_2022_85_1_en_act_en.pdf.

with the debt reduction benchmark would imply a too demanding frontloaded fiscal effort that risks to jeopardise growth. Therefore, in the view of the Commission, compliance with the debt reduction benchmark is not warranted under the current exceptional economic conditions. The Commission noted that the COVID-19 pandemic continues to have an extraordinary macroeconomic and fiscal impact that, together with Russia's invasion of Ukraine, create exceptional uncertainty, including for designing a detailed path for fiscal policy. On these grounds, the Commission considered that a decision on whether to place Member States under the excessive deficit procedure should not be taken in spring 2022. The public debt-to-GDP ratio decreased from around 80% in 2020 to 76.8% in 2021 and is forecast to increase to 76.4% in 2022 and decrease to 76.1 % in 2023. Debt sustainability risks for Hungary appear medium in the medium term. The projection is subject to particularly large uncertainty and is sensitive to adverse macro-financial developments. The Hungarian fiscal framework has been improved through reforms that began in 2011, but there is still room for improvement. The Fiscal Council's role in fiscal policy making could be strengthened and the volatility of the medium-term framework could still be reduced.

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



(*) Commission's Spring 2022 Economic Forecast.
Source: Eurostat, Commission's Spring 2022 Economic Forecast.

Hungary does not fulfil the exchange rate criterion. The Hungarian forint does not participate in ERM II. Hungary operates a *de jure* floating exchange rate regime, allowing for foreign exchange market interventions by the central bank. Overall, the forint depreciated against the euro over the period covered by the report, resulting from oscillating depreciation and re-appreciation movements. In particular, there was a strong depreciation immediately after the Russia's invasion of Ukraine, partially reduced thanks to restrictive monetary policy. In April 2022, the forint was about 5% weaker against the euro than 2 years earlier. Short-term interest rate differentials vis-à-vis the euro area increased substantially since the beginning of the COVID-19 crisis, when the previous upward movement in Hungarian rates was accentuated. The spread first increased in winter 2020 and early spring 2020, when monetary rates were raised to support the exchange rate at the height of the crisis. After a stabilisation at around 130 basis point between January and June 2021, the spread started to increase steeply due to monetary policy tightening. The spread reached 705 basis points in April 2022.

Hungary does not fulfil the criterion on the convergence of long-term interest rates. The average long-term interest rate stood at 4.1% in April 2022, above the reference value of 2.6%. Hungary's long-term interest rate, which stood at around

2.5% in April 2020, decreased until the end of 2020, reflecting the monetary easing conducted by major central banks. Hungary's long-term interest rate started to increase again in 2021, in particular from September 2021 onwards, reflecting the tightening of monetary policy, to surpass 4% in November 2021. The increase in long-term rates continued, and accelerated further in March 2022, on the back of Russia's invasion of Ukraine. Despite the increase in rates on the German benchmark bond over the same period, the long-term spread vis-à-vis the German benchmark bond has increased over the last 2 years and reached 584 basis points in April 2022.

The Commission has also examined **additional factors** have also been examined, including balance of payments developments and the integration of markets. The external balance (the combined current and capital account) deteriorated in 2020 and 2021, mainly due to strong growth in imports that was not compensated by exports, which were affected by the COVID-19 disruptions. The external balance deteriorated from 1.0% of GDP in 2020 to -0.4% in 2021. The Hungarian economy is highly integrated with the euro area through trade and investment linkages. Selected indicators relating to the business environment, show that Hungary performs worse than many euro area Member States. Hungary *inter alia* faces challenges in areas such as controlling corruption, judicial independence and the quality of decision-making. Hungary's financial system is characterised by a large presence of foreign holdings that perform no financial intermediation in the domestic economy. Excluding these, Hungary's financial system is less developed than those of the euro area. Hungary's banking sector shows a large and relatively stable weight in the financial sector and is well integrated into the euro area financial system due to a relatively large share of foreign ownership. The equity and debt markets are small and relatively less developed.

Hungary submitted its recovery and resilience plan on 11 May 2021. The plan is currently being assessed by the Commission to make sure that all assessment criteria are being fulfilled. The plan proposes investments and reforms to strengthen primary care and hospitals, increase the capacity of suburban rail and increase renewable energy production at residential level.

6. POLAND

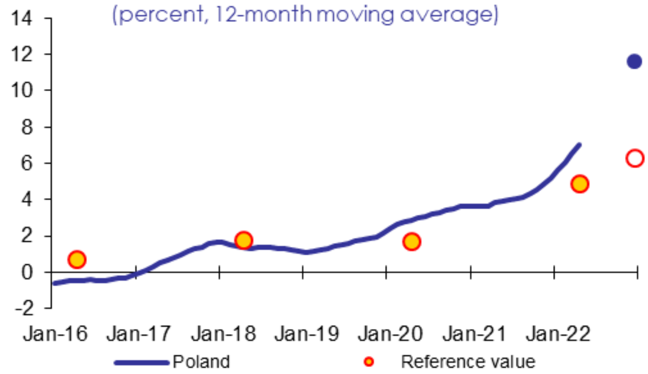
In light of its assessment on legal compatibility and on the fulfilment of the convergence criteria, and taking into account the additional relevant factors, the Commission considers that Poland does not fulfil the conditions for the adoption of the euro.

Legislation in Poland - in particular the Act on the Narodowy Bank Polski (NBP) and the Constitution of the Republic of Poland - **is not fully compatible** with the compliance duty under Article 131 TFEU. Incompatibilities relate to 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 integration of the NBP into the ESCB at the time of euro adoption.

Poland does not fulfil the criterion on price stability. The average inflation rate in Poland during the 12 months to April 2022 was 7.0%, well above the reference value of 4.9%. It is projected to remain well above the reference value in the months ahead.

Graph 6a: **Poland - Inflation criterion since 2016**

(percent, 12-month moving average)



Note: The dots at the right end of the graph show the projected reference value and 12-month average inflation rate of the country in December 2022. The reference values for 2016, 2018 and 2020 refer to the reference values calculated in the previous Convergence Reports.

Source: Eurostat, Commission's Spring 2022 Economic Forecast.

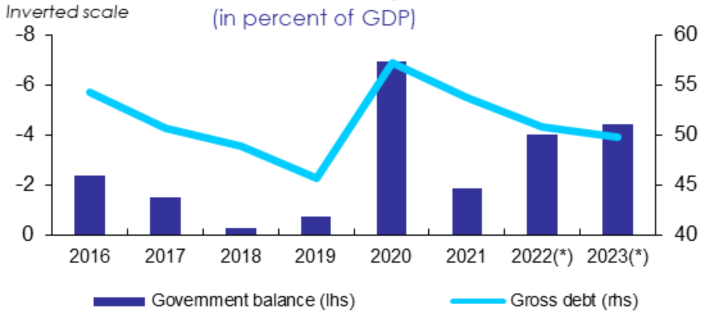
Annual HICP inflation in Poland was on a broad upward trend during most of 2020 and 2021, averaging 3.7% in 2020 and 5.2% in 2021 mostly due to service and energy inflation. Annual HICP fell to 2.9% in April 2020 following the disinflationary effect of the first wave of the pandemic in Poland. It recovered to 3.8% in June 2020 and remained broadly constant until February 2021. Annual inflation then increased sharply throughout 2021 and early 2022, driven by rising energy and food prices as well as accelerating core inflation (driven by non-energy industrial goods and services). It reached 7.0% in April 2022. Annual HICP inflation rates in Poland in 2020 and 2021 were on average higher than in the euro area.

Inflation is projected to increase to 11.6% in 2022 and to 7.3% in 2023 according to the Commission’s Spring 2022 Economic Forecast. Energy prices are expected to increase strongly amid a hike in regulated energy prices at the beginning of 2022, although the increase will be somewhat counterbalanced by a policy package put in place by the government to reduce tax rates paid in energy and food products. The relatively low price level in Poland (about 56% of the euro area average in 2020) suggests significant potential for price level convergence in the long term.

Poland fulfils the criterion on public finances. Poland is not the subject of a Council Decision on the existence of an excessive deficit. The general government deficit increased sharply to 6.9% of GDP in 2020 and fell to 1.9% in 2021. The Commission’s Spring 2022 Economic Forecast expects the deficit-to-GDP ratio to deteriorate to 4.0% in 2022, reflecting the measures taken by the government to reduce the economic and social impact of the increase in energy prices and the costs of assistance to those fleeing Ukraine. It is projected to reach 4.4% in 2023 under a ‘no policy change’ assumption. On 23 May 2022, the Commission adopted a report prepared in accordance with Article 126(3) of the TFEU for 18 Member States, including Poland. Overall, taking into account all relevant factors as appropriate, the analysis in the report suggested that Poland did not fulfil the deficit criterion. In line with its Communication of 2 March 2022[16], the Commission did not propose opening new excessive deficit procedures. It noted that the COVID-19 pandemic continues to have an extraordinary macroeconomic and fiscal impact that, together with Russia's invasion of Ukraine, create exceptional uncertainty, including for designing a detailed path for fiscal policy. On these grounds, the Commission considered that a decision on whether to place Member States under the excessive deficit procedure should not be taken in spring 2022. The public debt-to-GDP ratio decreased from around 57.1% in 2020 to 53.8% in 2021 and is forecast to further decrease to 50.8% in 2022 and 49.8% in 2023. The debt sustainability analysis for Poland indicates low risk in the medium term, particularly as government debt is projected to stay below 60% of GDP until 2032. The fiscal framework in Poland is strong overall and the numerical fiscal rules are at the centre of the framework. The framework was recently relaxed slightly to take account of the pressures emerging from the COVID-19 pandemic.

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

(in percent of GDP)



(*) Commission's Spring 2022 Economic Forecast.

Source: Eurostat, Commission's Spring 2022 Economic Forecast.

Poland does not fulfil the exchange rate criterion. The Polish zloty does not participate in ERM II. Poland operates a *de jure* floating exchange rate regime, allowing for foreign exchange market interventions by the central bank. The zloty depreciated sharply after the onset of the COVID-19 crisis in early 2020. Afterwards it went through a period of fluctuations but showed no clear trend up to February 2022. The NBP intervened actively in the foreign exchange market to stabilise the zloty during this period. The outbreak of Russia's invasion of Ukraine weakened the zloty. In April 2022, the zloty was about 2% weaker against the euro than 2 years earlier. The short-term interest rate differential vis-à-vis the euro area fluctuated strongly in 2020 and 2021, mirroring differences in the monetary policy stances in Poland and the euro area. It narrowed to historically low levels after the onset of the COVID-19 crisis on the back of an easing of the NBP's monetary policy. From October 2021, the short-term interest rate differential widened rapidly as the NBP tightened its policy and the reference rate reached 5.25% in May 2022. International reserves held by the NBP increased and by the end of 2021 constituted EUR 147 billion (around 26% of GDP).

Poland does not fulfil the criterion on the convergence of long-term interest rates. The average long-term interest rate in the year to April 2022 was 3.0%, above the reference value of 2.6%. The easing of monetary policy after the onset of the

[16] For more information, see COM(2022) 85 final: https://ec.europa.eu/info/sites/default/files/economy-finance/com_2022_85_1_en_act_en.pdf.

pandemic in 2020 contributed to a significant decrease in the long-term interest rates, which remained at 1.3% until the end of 2020. In January 2021, the long-term interest rate reached its lowest level on record (1.2%) before starting to increase moderately until the summer. The tightening of monetary policy, which started in October 2021, then contributed to a considerable increase in the long-term interest rate reaching 3.0% in April 2022. The long-term interest rate spread vis-à-vis the German benchmark bond narrowed strongly during the early months of the COVID-19 crisis and fluctuated around 180 basis points up-to April 2021. In mid-2021, it started to increase slightly and by October 2021 the spread had started to widen. By the end of 2021, the long-term interest rate spread reached around 373 basis points and continued to widen to 521 basis points in April 2022.

The Commission has also examined **additional factors**, including balance of payments developments and the integration of markets. Poland's external balance (the combined current and capital account) stayed in surplus in 2020 and 2021 but weakened in late 2021 and early 2022 due to the rising price of commodity imports. The Polish economy is well integrated with the euro area through trade and investment linkages. Selected indicators relating to the business environment show that Poland performs worse than many euro area Member States, in particular in relation to indicators on rule of law and government effectiveness. The financial sector in Poland is smaller and less developed than in the euro area. It is highly dominated by banks, which are well integrated into the euro area financial system. Market based financing is less developed, which is reflected in the very small markets for equity and private sector debt.

Poland submitted its recovery and resilience plan (RRP) on 3 May 2021. The plan proposes investments and reforms to decarbonise the Polish economy, make the transport sector more sustainable, address challenges related to the investment climate, notably with regard to the Polish judicial system as well as decision- and law-making processes, improve IT connectivity and make the healthcare system more resilient.

7. ROMANIA

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

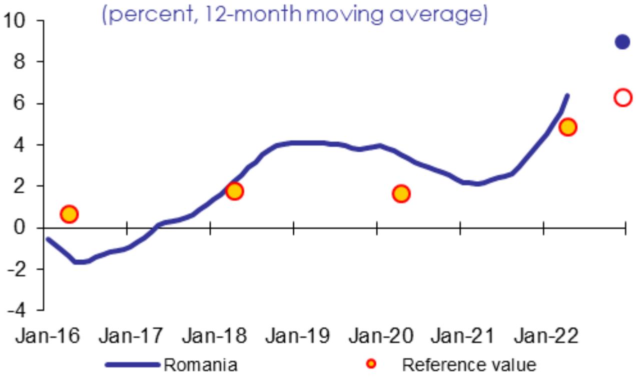
Legislation in Romania – in particular Law No. 312 on the Statute of the Bank of Romania (the BNR Law) **– is not fully compatible** with the compliance duty under Article 131 TFEU. Incompatibilities relate to the independence of the central bank, the prohibition of monetary financing and central bank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

Romania does not fulfil the criterion on price stability. The average inflation rate in Romania during the 12 months to April 2022 was 6.4%, above the reference value of 4.9%. It is projected to remain above the reference value in the months ahead.

Annual HICP inflation in Romania accelerated throughout 2021, from an average of 2.3% in 2020 to 4.1% in 2021. The annual inflation rate fell from 3.9% in January 2020 to 1.8% in May 2020, reflecting the reduced demand for goods and services at the outset of the COVID-19 pandemic, as well as the sharp drop in the international price of crude oil in the first 4 months of 2020. After a temporary rise to 2.5% in August 2020, reflecting strong food price inflation, it declined again and bottomed out at 1.7% in November 2020. Subsequently, inflation rose steadily, reaching 3.5% in June 2021 and 6.7% in December 2021. The increase was driven by higher energy prices throughout 2021 and, in the second half of 2021, was also sustained by higher core inflation. It continued to accelerate in the first 4 months of 2022, reaching 11.7% in April 2022. Annual HICP inflation rates in Romania in 2020 and 2021 were on average higher than those of the euro area.

The Commission’s Spring 2022 Economic Forecast expects the annual average rate of inflation to increase to 8.9% in 2022, before falling to 5.1% in 2023. The significant increase in 2022 is mainly due to the hike in energy prices, while higher food prices also contribute. The relatively low price level in Romania (about 52% of the euro area average in 2020) suggests significant potential for price level convergence in the long term.

Graph 7a: **Romania - Inflation criterion since 2016**
(percent, 12-month moving average)

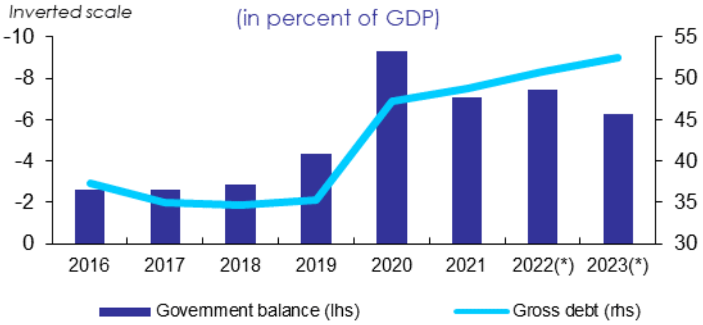


Note: The dots at the right end of the graph show the projected reference value and 12-month average inflation rate of the country in December 2022. The reference values for 2016, 2018 and 2020 refer to the reference values calculated in the previous Convergence Reports.

Source: Eurostat, Commission's Spring 2022 Economic Forecast.

Romania does not fulfil the criterion on public finances. Romania has been subject to an excessive deficit procedure since April 2020, based on the pre-pandemic developments. On 18 June 2021, taking into account the continued application of the general escape clause of the Stability and Growth Pact, the Council adopted a revised recommendation under Article 126(7) of the Treaty (TFEU), with a view to bringing an end to the excessive government deficit in Romania by 2024 at the latest. On 23 May 2022, the Commission concluded that, taking into account the deficit outturn of 7.1% of GDP in 2021 and the fiscal effort in 2021, Romania was in line with the Council recommendation of 18 June 2021 and the excessive deficit procedure should be kept in abeyance. The improvement in the general government deficit in 2021, down from 9.3% of GDP in 2020, was mainly due to higher revenues as a result of the economic recovery, while the government also implemented some consolidation measures, including a freeze in public sector wages. The Commission’s Spring 2022 Economic Forecast projects that the general government deficit will decrease further to 7.5% of GDP in 2022, notwithstanding the measures taken by the government to reduce the economic and social impact of the increase in energy prices and the costs of assistance to those fleeing Ukraine. It is forecast to decrease to 6.3% of GDP in 2023 under the ‘no policy change’ assumption. However, for both 2022 and 2023, Romania is at risk of non-compliance with the fiscal targets established in the Council Recommendation of 18 June 2021. The public debt-to-GDP ratio increased from 47.2% in 2020 to 48.8% in 2021 and is expected to increase further to 50.9% in 2022 and 52.6% in 2023. Debt sustainability risks for Romania appear medium in the medium term, particularly as government debt is projected to increase to around 73% of GDP in 2032 and due to significant sensitivity of the projections to adverse macro-financial developments. Despite having the appropriate legislative setting, the implementation track record of the Romanian fiscal framework has been generally weak and has not improved since the last report. In particular, the annual budget laws have repeatedly contradicted national fiscal rules and have not been guided by medium-term budgetary strategies.

Graph 7b: **Romania - Government budget balance and debt**



(*) Commission's Spring 2022 Economic Forecast.
Source: Eurostat, Commission's Spring 2022 Economic Forecast.

Romania does not fulfil the exchange rate criterion. The Romanian leu does not participate in ERM II. Romania operates a *de jure* floating exchange rate regime, allowing for foreign exchange market interventions by the central bank. The leu depreciated steadily against the euro in 2020 and 2021. In April 2022, the leu was about 2% weaker against the euro compared to 2 years earlier. The short-term interest rate spread vis-à-vis the euro area decreased by around 120 basis points between March 2020 and February 2021 from 330 basis points, mirroring the key policy rate cuts by the BNR over this period. Subsequently, it increased from its trough of slightly over 200 basis points in June 2021 to around 520basis points in April 2022, as monetary policy tightened between September 2021 and April 2022.

Romania does not fulfil the criterion on the convergence of long-term interest rates. The average long-term interest rate in the year to April 2022 was 4.7%, above the reference value of 2.6%. At the outset of the COVID-19 crisis, the long-term interest rate in Romania increased sharply from 4.0% in February 2020 to 4.8% in April 2020. Subsequently, it decreased steadily, reaching a low of 2.7% in February 2021, with the decline reflecting widespread monetary policy loosening measures by central banks. Interest rates started to increase again in March 2021 and were on an upward path throughout the rest of the year, rising to 5.4% in December 2021, reflecting higher inflationary pressures and, as from October 2021, monetary policy tightening in Romania. In the first 4 months of 2022, Romania's long-term interest rate increased further to 6.6% in April 2022, in the context of continued inflationary pressures, further monetary policy tightening and greater risk aversion following Russia's invasion of Ukraine. The long-term spread versus the German benchmark bond reached 586 basis points in that month, up from 310 basis points in February 2021.

The Commission has also examined **additional factors**, including balance of payments developments and the integration of markets. Romania's external balance (the combined current and capital account) deteriorated from -3.1% of GDP in 2020 to -4.8% in 2021, mainly due to a widening in the goods trade deficit. The Romanian economy is well integrated with the euro area through trade and investment linkages. Selected indicators relating to the business environment show that Romania performs worse than many euro area Member States. In particular, companies face constraints to doing business such as corruption, overly regulated markets for business services, frequent legislative changes coupled with inadequate impact assessments. The financial sector in Romania is smaller and less developed than in the euro area. Romania's banking sector is well integrated with the euro area financial system, in particular through a high level of foreign ownership in its banking system. However, market-based financing is less developed, which is reflected in the very small markets for equity and private sector debt. In the context of the Macroeconomic Imbalance Procedure, the Commission concluded in its Alert Mechanism Report for 2022 that Romania warranted an In-Depth Review (IDR). The latter concluded that Romania is experiencing macroeconomic imbalances. Vulnerabilities relate to external accounts and are linked to large fiscal deficits and to competitiveness issues that are re-emerging.

The effective implementation of the reforms and investment set out in Romania's recovery and resilience plan will address key macro-economic challenges. These include the sustainability of public finances, education, increasing greenhouse gas emissions and the lack of digital connectivity. Key investments are included for railway modernisation, the energy efficiency of buildings, the digitalisation of public administration and making the health system more resilient. Key reforms aim at addressing fiscal sustainability, improving access to financing, strengthening the public administration and modernising the social benefits system. The plan also aims at addressing the main issues related to respect of rule of law in Romania by strengthening the independence and increasing the efficiency of the judiciary, improving access to justice, and stepping up the fight against corruption.

8. SWEDEN

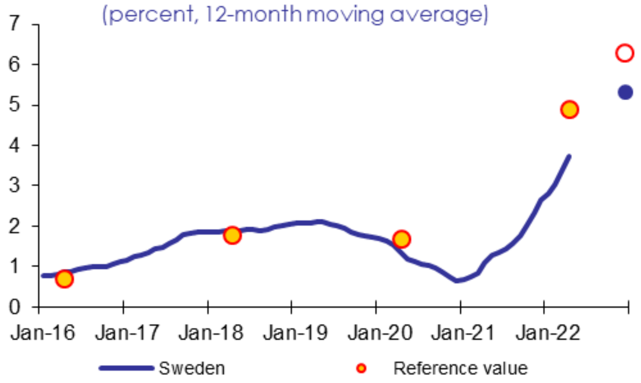
In the light of its assessment on legal compatibility and on the fulfilment of the convergence criteria, and taking into account the additional relevant factors, the Commission considers that Sweden does not fulfil the conditions for the adoption of the euro.

Legislation in Sweden – in particular the Sveriges Riksbank Act, the Instrument of Government and the Law on the Exchange Rate Policy – **is not fully compatible**

with the compliance duty under Article 131 TFEU. Incompatibilities and imperfections exist in the fields of the independence of the central bank, the prohibition of monetary financing and central bank integration into the ESCB at the time of euro adoption.

Sweden fulfils the criterion on price stability. The average inflation rate in Sweden during the 12 months to April 2022 was 3.7%, below the reference value of 4.9%. The Commission projects this to remain below the reference value in the months ahead.

Graph 8a: **Sweden - Inflation criterion since 2016**
(percent, 12-month moving average)



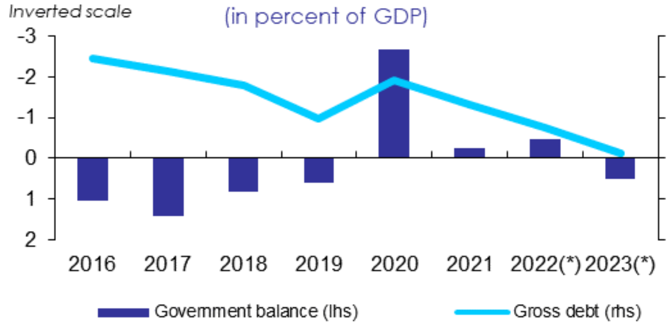
Note: The dots at the right end of the graph show the projected reference value and 12-month average inflation rate of the country in December 2022. The reference values for 2016, 2018 and 2020 refer to the reference values calculated in the previous Convergence Reports.
Source: Eurostat, Commission's Spring 2022 Economic Forecast.

Sweden's annual HICP inflation rate averaged 2.7% in 2021, up from 0.7% in 2020. During 2021, annual HICP inflation was on a strong upward trend, and accelerated sharply in the first months of 2022, reaching 6.6% in April 2022. The trend was briefly interrupted in the middle of 2021, when inflation decreased due to a temporary easing in the rate of increase for prices of services and industrial goods, as they adjusted after the first wave of the pandemic. The overall pick-up in year-on-year inflation mainly reflected markedly higher energy prices — foremost electricity prices —, and later in the year, broader price increases across various categories of the consumer price index. During 2021, inflation in Sweden was broadly in line with that of the euro area. In April 2022, annual HICP inflation stood at 6.6%.

In the Commission’s Spring 2022 Economic Forecast, the Commission projects that inflation will increase to 5.3% in 2022, on the back of higher energy and commodity prices interacting with more persistent broader price increases, and supply chain disruptions, before falling back to 3.0% in 2023. The price level in Sweden is relatively high (about 116% of the euro area average in 2020), and given the level of economic development, convergence towards the prevailing euro area price level is unlikely.

Sweden fulfils the criterion on public finances. Sweden is not the subject of a Council Decision on the existence of an excessive deficit. The general government balance improved from a deficit of 2.7% of GDP in 2020 to a deficit of 0.2% of GDP in 2021, reflecting the phasing out of several COVID-19 measures, dominating continued expenditure support in some areas, and a denominator effect as growth rebounded in 2021. The Commission’s Spring 2022 Economic Forecast expects the general government balance to reach -0.5% of GDP in 2022 and 0.5% in 2023, partly reflecting the withdrawal of fiscal support as the recovery takes hold. The public debt-to-GDP ratio decreased from 39.6% in 2020 to 36.7% in 2021 and is expected to decrease further to 33.8% in 2022 and to 30.5% in 2023. Debt sustainability risks for Sweden appear low in the medium term, particularly as government debt is projected to decline to a particularly low level by 2032 (around 11% of GDP). The sensitivity of the projections to adverse macro-financial developments is limited. Sweden has a strong fiscal framework that was reformed in 2019, preserving the key pillars of the previous set-up and strengthening these with new elements (such as a debt anchor at 35% of GDP).

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



(*) Commission's Spring 2022 Economic Forecast.
Source: Eurostat, Commission's Spring 2022 Economic Forecast.

Sweden does not fulfil the exchange rate criterion. The Swedish krona does not participate in ERM II. Sweden operates a *de jure* floating exchange rate regime, allowing for foreign exchange market interventions by the central bank. After a long period of slow depreciation against the euro between 2013 and early 2020, the krona started to appreciate on the back of the economy's resilience to the COVID-19 crisis. Between April 2020 and November 2021, the krona appreciated by almost 8% against the euro. The appreciation took place despite stable monetary conditions (compared with the euro area), where the three-month STIBOR-EURIBOR spread during 2020 and 2021 averaged 50 and 51 basis points, respectively. At the beginning of 2022, the krona depreciated, as Russia's invasion of Ukraine spurred safe-haven flows, reflecting changes in risk appetite and temporary flows associated with dividend payments of multi-national firms. Subsequently, the krona regained somewhat. In April 2022, the spread stood at around 55 basis points and the exchange rate was 5% stronger against the euro than it had been 2 years earlier.

Sweden fulfils the criterion on the convergence of long-term interest rates. The average long-term interest rate in the year to April 2022 was 0.4%, well below the reference value of 2.6%. Since the beginning of 2021, Swedish long-term interest rates have been fluctuating around a level of 0.3% on a monthly basis. This is slightly higher than the year before. The spread vis-à-vis the German benchmark bond remained low in 2020 and 2021, and even decreased slightly after a brief COVID-induced peak of 76 basis points in March 2021 to 46 basis points in February 2022. After a recent increase, the spread was 72 basis points in April 2022.

The Commission has also examined **additional factors**, including balance of payments developments and the integration of markets. Sweden's external balance (the combined current and capital account) has remained in surplus, at 6.1% of GDP in 2020 and 5.5% in 2021. Sweden's economy is well-integrated with the euro area through trade and investment linkages. Selected indicators relating to the business environment show that Sweden performs better than most euro area Member States. The financial sector in Sweden is highly developed and well-integrated into the EU financial sector. Banking dominates the financial sector, but the insurance and pension funds are integral parts of significant size. Moreover, Sweden has one of the most developed credit and equity markets among EU Member States, and market financing is among the highest in the EU. In the context of the Macroeconomic Imbalance Procedure, the Commission concluded in its Alert Mechanism Report for 2022 that an In-Depth Review was warranted for Sweden. Based on the assessment in the In-Depth Review, the Commission considers that Sweden is experiencing imbalances with vulnerabilities that relate to high and rising house prices and high household indebtedness, which exposes Sweden to the risk of adverse shocks and a disorderly correction of housing prices, with potential harmful implications for the real economy and the banking sector.

The effective implementation of the reforms and investment set out in Sweden’s recovery and resilience plan (RRP) will address key macro-economic challenges. These include the green and digital transitions, demographic change, and strengthening the education and healthcare systems. Key investments include subsidy schemes to speed up the decarbonisation of industry and transport, the roll-out of high-speed broadband in sparsely populated areas and investment in learning and digital skills. Key reforms involve requiring fuel suppliers to blend sustainable biofuels in petrol, diesel and jet fuel, improving the sustainability of the pension and social security systems, combating money laundering, increasing the accessibility and capacity of the health care system, and promoting housing supply by reducing bottlenecks in the permit procedure.

Convergence Report 2022

Technical annex

1. INTRODUCTION

1.1. ROLE OF THE REPORT

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

Member States for which the Council has not yet decided that they fulfil the necessary conditions for the adoption of the euro are referred to as 'Member States with a derogation'. Article 140 of the Treaty lays down provisions and procedures for examining the convergence situation of Member States with a derogation (Box 1.1). At least once every two years, or at the request of a Member State with a derogation, the Commission and the European Central Bank (ECB) prepare Convergence Reports for such Member States. Denmark negotiated an opt-out arrangement before the adoption of the Maastricht Treaty ([17]) and does not participate in the third stage of EMU. Until Denmark indicates that it wishes to participate in the third stage and adopt the euro, it is not the subject of an assessment as to whether it fulfils the necessary conditions for such a participation.

In 2020, the Commission and the ECB adopted their latest regular Convergence Reports ([18]). None of the Member States assessed in those reports was deemed to meet the necessary conditions for adopting the euro.

In 2022, two years have elapsed since the last regular reports were prepared. Denmark has not expressed a wish to enter the third stage of EMU ([19]). Therefore, this convergence assessment covers Bulgaria, Czechia, Croatia, Hungary, Poland, Romania and Sweden. This Commission Staff Working Document is a Technical Annex to the Convergence Report 2022 and includes a detailed assessment of the progress with convergence, as required by Article 140(1) of the Treaty.

The outbreak of the COVID-19 pandemic in March 2020 led to a severe economic downturn for the EU as a whole and in all the Member States. Unprecedented action taken at the level of the EU and the individual Member States cushioned the impact of the crisis and led to a robust recovery in 2021. In particular, the swift activation of the general escape clause of the Stability and Growth Pact, coupled with the temporary framework on State aid, enabled large-scale fiscal support in all Member States. In parallel, the EU mobilised its budget, in particular with the EU temporary instrument to Support to mitigate Unemployment Risks in an Emergency (SURE), to mitigate the impact of the crisis on workers and companies. The ECB also took a broad set of monetary policy measures to preserve favourable financing conditions for all sectors of the economy in order to support economic activity and safeguard medium-term price stability.

The roll-out of the Recovery and Resilience Facility (RRF), which is the centrepiece of NextGenerationEU, is further bolstering the EU's resilience through large-scale financial support to Member States of up to EUR 723.8 billion (in current prices) in grants (EUR 338 billion) and loans (EUR 385.8 billion) to finance reforms and investments, especially those for the green and digital transitions. At the same time, the stronger-than-expected recovery in 2021, supply chain bottlenecks and a surge in energy prices contributed to a sharp rise in inflation throughout the year and in 2022.

Russia's invasion of Ukraine on 24 February 2022 forced a re-assessment of the outlook for the EU economy, which was hitherto expected to expand vigorously in 2022 and 2023. The crisis mainly has dealt a new supply-side shock to an economy that was already facing inflationary pressures. It has weakened recovery prospects and reinforced upward price pressures, while further underlining the need for higher private and public investment to diversify Europe's energy supplies and improve energy security. Several of the Member States with a derogation assessed in this report are among the most heavily exposed to the crisis triggered by Russia's invasion of Ukraine. To varying degrees, this exposure reflects the relatively high-energy

[17] Protocol (No 16) on certain provisions relating to Denmark.

[18] European Commission, Convergence Report 2020, COM(2020) 237 final, 10 June 2020; European Central Bank, Convergence Report 2020, June 2020.

[19] The United Kingdom has withdrew from the EU since the May 2018 Convergence Report.

intensity of their economies, strong dependency by some on Russian gas and oil supplies, trade linkages with Russia and the provision of frontline assistance to people fleeing Ukraine. On 18 May 2022, the Commission proposed a REPowerEU plan, for which the RRF will be a key tool. The plan aims to phase out dependence on fossil fuels from Russia well before 2030 by diversifying the EU's gas supplies and speeding up the green transition.

On 23 May 2022, the Commission also presented its European Semester spring 2022 package. Member States should primarily focus on the timely implementation of the RRPs. Therefore, the Commission proposes to the Council to address to all Member States with an approved RRP: i) a recommendation on fiscal policy, including fiscal-structural reforms where relevant; ii) a recommendation on the implementation of the RRP and the cohesion policy programmes; iii) a recommendation on energy policy in line with the objectives of REPowerEU; iv) where relevant, an additional recommendation on outstanding and/or newly emerging structural challenges. The scope of the recommendations is larger for Member States that do not have approved RRPs.

The successive economic shocks triggered by the COVID-19 pandemic and Russia's invasion of Ukraine have important implications for the convergence assessment presented in this report.

In particular, the outbreak of the COVID-19 pandemic, the measures taken in response to that crisis, the surge in commodity prices, the supply bottlenecks and the robust recovery in 2021 have had a significant impact on some of the economic convergence indicators used in this report. This is especially the case for the assessment of the price stability criterion. Differences in inflation performance across the EU have increased mainly due to the heterogeneous impact of the recovery on Member States' inflation rates and the differences in energy price inflation. In addition, national authorities have taken a range of fiscal and regulatory measures to cushion the impact of higher energy prices. While some of these measures, such as social transfers to most vulnerable households, do not have a direct impact on consumer prices, others have a more direct impact on the inflation convergence assessment. These include price caps in wholesale or retail energy markets, changes in indirect taxes on energy products, and subsidies on energy production and consumption. In addition, long-term interest rates were influenced, initially, by the policy measures taken to stabilise financial markets and preserve favourable financing conditions and, later, by higher inflation expectations and the differentiated paths of monetary tightening across Member States.

The 2020 economic recession and the fiscal response to the COVID-19 pandemic led to a sharp increase in government deficits and debt. Government deficits in most Member States rose to above the 3% of GDP reference value of the Treaty. In 2021, government deficits and debt improved and fifteen Member States had deficits higher than 3% of GDP. In March 2020, the European Commission, with the agreement of the EU Ministers of Finance of the Member States, activated the general escape clause of the Stability and Growth Pact. On 23 May 2022, in its Communication on the 2022 European Semester spring package, the Commission considered that the Union was not yet out of a period of severe economic downturn and that the conditions to maintain the general escape clause in 2023 and to deactivate it as of 2024 were met. The Commission invited the Council to endorse this conclusion to provide clarity to Member States. In spring 2020, 2021 and 2022, the Commission considered that a decision on whether to place Member States under the Excessive Deficit Procedure should not be taken, taking into account the extraordinary macroeconomic and fiscal impact of the COVID-19 pandemic that, together with the geopolitical situation in spring 2022, create exceptional uncertainty, including for designing a detailed path for fiscal policy ([20]). These conclusions have straightforward implications for the assessment of the criterion on the government budgetary position presented in this report.

The impact of Russia's invasion of Ukraine on the historical data used in the 2022 Convergence Report is limited. This is a consequence of the cut-off date of the report (18 May 2022), which together with the Treaty-defined calculation methods of the price stability and long-term interest rate criteria (i.e. one year averages), mean that the corresponding data largely reflect the situation prior to Russia's invasion. Instead, the extent to which the economic convergence

([20]) On 3 April 2020, the Council decided that an excessive deficit existed in Romania based on the planned excessive deficit in 2019.

Box 1.1: **Article 140 of the Treaty**

"1. At least once every two years, or at the request of a Member State with a derogation, the Commission and the European Central Bank shall report to the Council on the progress made by the Member States with a derogation in fulfilling their obligations regarding the achievement of economic and monetary union. These reports shall include an examination of the compatibility between the national legislation of each of these Member States, including the statutes of its national central bank, and Articles 130 and 131 and the Statute of the ESCB and of the ECB. The reports shall also examine the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of the following criteria:

— the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability,

— the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 126(6),

— the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the euro,

— the durability of convergence achieved by the Member State with a derogation and of its participation in the exchange-rate mechanism being reflected in the long-term interest-rate levels.

The four criteria mentioned in this paragraph and the relevant periods over which they are to be respected are developed further in a Protocol annexed to the Treaties. The reports of the Commission and the European Central Bank shall also take account of the results of the integration of markets, the situation and development of the balances of payments on current account and an examination of the development of unit labour costs and other price indices.

2. After consulting the European Parliament and after discussion in the European Council, the Council shall, on a proposal from the Commission, decide which Member States with a derogation fulfil the necessary conditions on the basis of the criteria set out in paragraph 1, and abrogate the derogations of the Member States concerned.

The Council shall act having received a recommendation of a qualified majority of those among its members representing Member States whose currency is the euro. These members shall act within six months of the Council receiving the Commission's proposal.

The qualified majority of the said members, as referred to in the second subparagraph, shall be defined in accordance with Article 238(3)(a).

3. If it is decided, in accordance with the procedure set out in paragraph 2, to abrogate a derogation, the Council shall, acting with the unanimity of the Member States whose currency is the euro and the Member State concerned, on a proposal from the Commission and after consulting the European Central Bank, irrevocably fix the rate at which the euro shall be substituted for the currency of the Member State concerned, and take the other measures necessary for the introduction of the euro as the single currency in the Member State concerned."

indicators are affected by the crisis triggered by Russia's invasion as well as other ongoing economic developments is fully captured in the economic projections for 2022 and 2023, namely the Commission's Spring 2022 Economic Forecast, which are used to assess the sustainability of convergence.

The forward-looking elements of this report are based on inputs from the Commission's Spring 2022 Economic Forecast, which was published on 16 May 2022. This forecast is the first comprehensive assessment from the Commission of the likely economic effects in 2022 and 2023 of the crisis triggered by Russia's invasion of Ukraine, and as such, it is surrounded by higher than usual uncertainty ([21]).

([21]) Beyond the forecast horizon, the crisis could also have a significant effect on the economic structures of the Member States with a derogation, for instance the flow of refugees could affect their demography and labour force in the medium term, although at this stage this is subject to

The remainder of the first chapter presents the methodology used for the application of the assessment criteria. Chapters 2 to 8 examine, on a country-by-country basis, the fulfilment of the convergence criteria and other requirements in the order in which they appear in Article 140(1) (see Box 1.1). The cut-off date for the statistical data included in this Convergence Report was 18 May 2022.

1.2. APPLICATION OF THE CRITERIA

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

1.2.1. Compatibility of legislation

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

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

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

- Third, in accordance with Article 131, the integration of the national central bank into the ESCB has to be examined, in order to ensure that at the latest by the moment of euro adoption, the objectives of the national central bank are compatible with the objectives of the ESCB as formulated in Article 127 of the Treaty. The national provisions on the tasks of the national central bank are assessed against the relevant rules of the Treaty and the ESCB/ECB Statute.

1.2.2. Price stability

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

Article 1 of the Protocol on the convergence criteria further stipulates that 'the criterion on price stability […] shall mean that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1.5 percentage points that of, at most, the three best performing Member States in terms of price stability. Inflation shall be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions'.

Since national consumer price indices (CPIs) diverge substantially in terms of concepts, methods and practices, they do not constitute the appropriate means to meet the Treaty requirement

considerable uncertainty. Assessing this impact is beyond the scope of this report.

Box 1.2: Assessment of price stability and the reference value

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

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

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

As Article 140(1) of the Treaty refers to 'Member States' and does not make a distinction between euro-area and other Member States, the Convergence Reports select the three best performers from all Member States – EU-15 for the Convergence Reports before 2004, EU-25 for the reports between 2004 and 2006, EU-27 for reports between 2007 and 2013, EU-28 for reports between 2014 and 2018 and EU-27 for the reports between 2020 and 2022.

The notion of '**best performer in terms of price stability**' is not defined explicitly in the Treaty. It is appropriate to interpret this notion in a non-mechanical manner, taking into account the state of the economic environment and country-specific factors at the time of the assessment. In particular, an outlier analysis should be performed to identify those countries whose inflation rates cannot be seen as meaningful benchmarks. These outliers are identified on the basis of two criteria taken in combination: i) an inflation rate substantially below the euro area average; and ii) an inflation rate driven by country-specific factors that cannot be seen as representative of the process driving inflation in the euro area.

Outliers were identified in the Convergence Reports of 2004, 2010, 2013, 2014 and 2016. In the 2004 report, Lithuania was not taken into account in the calculation of the reference value because its negative rate of inflation, which was due to country-specific economic circumstances, was significantly diverging from that of the other Member States, making Lithuania a de facto outlier that could not be considered as 'best performer' in terms of price stability. Its 12-month average inflation rate was 2.3 percentage points below that of the euro area (2.1%). In 2010, in an environment characterised by exceptionally large common shocks (the global economic and financial crisis and the associated sharp fall in commodity prices), a significant number of countries faced episodes of negative inflation rates (the euro-area average inflation rate in March 2010 was only slightly positive, at 0.3%). In this context, Ireland was excluded from the best performers on the ground that its average inflation rate (-2.3% in March 2010) deviated by a very wide margin from that of the euro area, mainly due to the severe economic downturn in that country. In 2013, Greece was excluded from the best performers, as its inflation rate was 1.8 percentage points lower than the euro area average of 2.2%, mainly reflecting the severe adjustment needs and the exceptional situation of the Greek economy. In 2014, Greece, Bulgaria and Cyprus were identified as outliers. In April 2014, the 12-month average inflation rate of Greece, Bulgaria and Cyprus were respectively -1.2%, -0.8% and -0.4%, significantly deviating from the euro area average of 1.0%. In case of Greece and Cyprus, negative inflation mainly reflected the severe adjustment needs and exceptional situation of the economy. In case of Bulgaria, it was due to an unusually strong

(Continued on the next page)

Box (continued)

Table 1:
Inflation reference value in previous and current Convergence Reports

Convergence Report adoption date	Cut-off month	Three best performers [1) 2)]	Reference value [3)]	Euro area average inflation rate [4)]
1998	January 1998	Austria, France, Ireland	2.7	1.5
2000	March 2000	Sweden, France, Austria	2.4	1.4
2002	April 2002	United Kingdom, France, Luxembourg [5)]	3.3	2.4
2004	August 2004	Finland, Denmark, Sweden	2.4	2.1
2006 May	March 2006	Sweden, Finland, Poland	2.6	2.3
2006 December	October 2006	Poland, Finland, Sweden	2.8	2.2
2007	March 2007	Finland, Poland, Sweden	3.0	2.1
2008	March 2008	Malta, Netherlands, Denmark	3.2	2.5
2010	March 2010	Portugal, Estonia, Belgium	1.0	0.3
2012	March 2012	Sweden, Ireland, Slovenia	3.1	2.8
2013	April 2013	Sweden, Latvia, Ireland	2.7	2.2
2014	April 2014	Latvia, Portugal, Ireland	1.7	1.0
2016	April 2016	Bulgaria, Slovenia, Spain	0.7	0.1
2018	March 2018	Cyprus, Ireland, Finland	1.9	1.4
2020	March 2020	Portugal, Cyprus, Italy	1.8	1.1
2022	April 2022	France, Finland, Greece	4.9	4.4

1) EU15 until April 2004; EU25 between May 2004 and December 2006; EU27 between January 2007 and June 2013; EU28 between July 2013 and January 2020; EU27 (without UK) from February 2020 onwards.

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

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

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

5) Based on revised data, Germany would replace Luxembourg as one of the three Member States with the lowest 12-month average inflation in April 2002. This change would not affect the price and long-term interest rate reference values in April 2002.

Sources: Eurostat and European Commission calculations.

combination of disinflationary factors, inter alia, a good harvest, administrative energy price reductions and declining import prices. In 2016, it was warranted to identify Cyprus and Romania as outliers, as their inflation rates deviated by a wide margin from the euro area average. In April 2016, the 12-month average (negative) inflation rates of Cyprus and Romania were respectively 1.9 percentage points and 1.4 percentage points below the euro area inflation rate of 0.1%. In case of Cyprus, deeply negative inflation mainly reflected the adjustment needs and exceptional situation of the economy. In case of Romania, it was mainly due to large VAT rate reductions. Table 1 lists the reference value in the Convergence Reports issued since 1998.

In April 2022, the three Member States with the lowest 12-month average inflation rates are: Malta (2.1%), Portugal (2.6%) and France (3.2%). The next Member States with the lowest average inflation are Finland (3.3%), Greece (3.6%) and Denmark (3.6%). The Commission’s assessment suggests that it is warranted to identify Malta and Portugal as outliers, as their inflation rates a.) deviated by a wide margin from the euro-area average and b.) were driven by country-specific factors that limit their scope to act as meaningful benchmarks for other Member States. In past Convergence Reports those Member States that had an inflation rate of 1.5 percentage points or more below the euro area were generally considered as outliers.

In addition, the inflation performances of Malta and Portugal were driven by country-specific factors. In the case of Malta, the country-specific factors that are reflected in the comparatively low average inflation rate include broadly stable energy prices in a context surging international oil and gas prices and larger changes in the weights used to calculate the HICP than in most other EU Member States in 2021. The absence of energy price inflation in Malta was enabled by government measures, including through financial support to the energy sector. A fixed price contract for the supply of liquefied natural gas also contributed.

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Box (continued)

In the case of Portugal, country-specific factors that are reflected in the comparatively very low average inflation rate include comparatively low energy inflation and the weaker cyclical position of the country compared with most of other EU Member States. A combination of factors weighed on energy inflation, including a broad range of regulatory measures that kept the growth in retail prices of electricity and natural gas well below the EU average. In addition, the COVID-19 crisis had a prolonged negative impact on Portuguese activity and inflation. The country's activity was more severely hit than in most other EU Member States in the early stages of the pandemic and its recovery has since been comparatively slow. In the fourth quarter of 2021, Portugal's GDP was still significantly below its pre-crisis peak and the gap was the second largest in the EU. This reflects mainly Portugal's large exposure to tourism. Portugal's vulnerability was magnified by the aviation-based nature of its tourism industry. Aviation-based tourism was hit by the COVID-19 crisis more severely and more durably than the road-based tourism prevalent in most other Member States. The relative weakness in Portugal's recovery has had a lasting dampening effect on inflation in services, particularly in sectors related to tourism with Portugal posting, for instance, the lowest rate of inflation in the EU in the hotel and accommodation sector.

that inflation must be measured on a comparable basis. To this end, the Council adopted on 23 October 1995 a framework regulation ([22]) setting the legal basis for the establishment of a harmonised methodology for compiling consumer price indices in the Member States. This process resulted in the production of the Harmonised Indices of Consumer Prices (HICPs), which are used for assessing the fulfilment of the price stability criterion.

As has been the case in past convergence reports, a Member State's average rate of inflation is measured by the percentage change in the arithmetic average of the last 12 monthly indices relative to the arithmetic average of the 12 monthly indices of the previous period. The reference value is calculated as the arithmetic average of the average rate of inflation of the three 'best-performing EU Member States in terms of price stability' plus 1.5 percentage points (see Box 1.2).

Accordingly, the reference value is currently 4.9%, based on the data of France (3.2%), Finland (3.3%) and Greece (3.6%) over the 12-month period covering May 2021-April 2022. Malta and Portugal were identified as outliers, as their inflation rates deviated by a wide margin from the euro area average reflecting country-specific economic circumstances (see Box 1.2).

The Protocol on the convergence criteria not only requires Member States to have achieved a high degree of price stability but also calls for a price performance that is sustainable. The requirement of sustainability aims at ensuring that the degree of price stability and inflation convergence achieved in previous years will be maintained after adoption of the euro. This deserves particular attention as sustained divergences in price developments in one or more euro area Member States can lead to the emergence of competitiveness losses that must be corrected via painful adjustment processes and can trigger negative spillover effects on other Member States.

Inflation sustainability implies that the satisfactory inflation performance must essentially be due to the adequate behaviour of input costs and other factors influencing price developments in a structural manner, rather than reflecting the influence of cyclical or temporary factors. Therefore, this Technical Annex also takes account of the role of the macroeconomic situation and cyclical position in the inflation performance, of developments in unit labour costs as a result of trends in labour productivity and nominal compensation per head, and of developments in import prices to assess how external price developments have impacted on domestic inflation. Similarly, the impact of administered prices and indirect taxes on headline inflation is also considered.

From a forward-looking perspective, the report includes an assessment of medium-term prospects for price developments. The analysis of factors that have an impact on the inflation outlook – cyclical

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

conditions, labour market developments and credit growth – is complemented by a reference to the most recent Commission's forecast of inflation. That forecast can subsequently be used to assess whether the Member State is likely to meet the reference value also in the months ahead [23]. Medium-term inflation prospects are also assessed by reference to the economies' key structural characteristics, including the functioning of the labour and product markets.

1.2.3. Public finances

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

The convergence assessment in the budgetary area is thus directly linked to the excessive deficit procedure which is specified in Article 126 of the Treaty and further clarified in the Stability and Growth Pact (see Box 1.3 for further information on the excessive deficit procedure as strengthened by the 2011 reform of the Stability and Growth Pact). The details of the excessive deficit procedure are defined in Regulation 1467/97 as amended in 2005 and 2011 which sets out the way in which government deficit and debt levels are assessed to determine whether an excessive deficit exists, under Article 126 of TFEU. The convergence assessment in the budgetary area is therefore judged by whether the Member State is subject to a Council decision under 126(6) on the existence of an excessive deficit [24].

On 23 May 2022, the Commission adopted a report under Article 126(3) of the TFEU for 18 Member States, including for Bulgaria, Czechia, Hungary and Poland [25]. Overall, taking into account all relevant factors as appropriate, the analysis in the report suggests that the deficit criterion as defined in the Treaty and in Regulation (EC) No 1467/1997 is not fulfilled by Bulgaria, Czechia, Hungary and Poland. Taking into account all relevant factors, the analysis also suggests that the debt criterion as defined in the Treaty and in Regulation (EC) No 1467/1997 is not fulfilled by Hungary. The Commission considered, within its assessment of all relevant factors, that compliance with the debt reduction benchmark could imply a too demanding frontloaded fiscal effort that risks to jeopardise growth. Therefore, in the view of the Commission, compliance with the debt reduction benchmark is not warranted under the current exceptional economic conditions. In its conclusions, the Commission noted that the COVID-19 pandemic continues to have an extraordinary macroeconomic and fiscal impact that, together with the invasion of Ukraine by Russia, creates exceptional uncertainty, including for designing a detailed path for fiscal policy. On these grounds, the Commission considered that a decision on whether to place Member States under the EDP should not be taken in spring 2022.

While Romania had become subject to an Excessive Deficit Procedure (EDP) due to the planned non-compliance with the deficit criterion in 2019, the Commission has not proposed to open other Excessive Deficit Procedures since the outbreak of the COVID-19 pandemic. In the context of the European Semester, the fiscal recommendations for 2022 and 2023 were consistent with the principles of cross-country differentiation, while also taking into account the quality of public finances (see Box 1.4).

[23] Based on the Commission services' Spring 2022 Forecast, the inflation reference value is forecast to stand at 6.3% in December 2022.

[24] The definitions of the government deficit and debt used in this report are in accordance with the excessive deficit procedure, as was the case in previous convergence reports. These definitions are laid out in the amended Council Regulation (EC) No 479/2009. In particular, government debt is general government consolidated gross debt at nominal value. Information regarding the excessive deficit procedure and its application to different Member States since 2002 can be found at: http://ec.europa.eu/economy_finance/economic_governance/sgp/deficit/index_en.htm.

[25] Croatia was not discussed in this report. While its government debt at end 2021 was also above 60% of GDP, the general government deficit in 2021 and 2022 was (and is projected to remain) below 3% of GDP and it respected the debt reduction benchmark in 2021.

Box 1.3: **Excessive deficit procedure**

The excessive deficit procedure (EDP) is specified in Article 126 of the Treaty, the associated Protocol on the excessive deficit procedure and Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure ([1]). Together, these determine the steps to be followed to reach a Council decision on the existence and correction of an excessive deficit, which forms the basis for the assessment of compliance with the convergence criterion on the government budgetary position. The debt criterion in Article 126(2) of the Treaty was operationalised in the 2011 amendment of Council Regulation (EC) No 1467/97.

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

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

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

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

The Council and the Commission make a balanced overall assessment of the relevant factors. Those factors shall be taken into account in the steps leading to the decision on the existence of an excessive deficit when assessing compliance on the basis of the debt criterion. When assessing compliance on the basis of the deficit criterion in a country with a debt ratio exceeding the reference value, those factors shall be taken into account in the steps leading to the decision on the existence of an excessive deficit subject to the double

[1] OJ L 209, 2.8.1997, p. 6. Regulation as amended by Regulation (EC) No 1056/2005 (OJ L 174, 7.7.2005, p. 5).

[2] Council Regulation (EC) No 479/2009 on the application of the Protocol on the excessive deficit procedure (OJ L 145, 10.06.2009, p1), as amended.

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

[4] In particular, potential growth, including the various contributions, cyclical developments, and the private sector net savings position.

[5] In particular, the record of adjustment towards the medium-term budgetary objective, the level of the primary balance and developments in primary expenditure, the implementation of policies in the context of the prevention and correction of excessive macroeconomic imbalances and in the context of the common growth strategy of the Union, as well as the overall quality of public finances, in particular the effectiveness of national budgetary frameworks.

[6] In particular, debt dynamics and sustainability, including risk factors, the maturity structure and currency denomination of the debt, stock-flow adjustment and its composition, accumulated reserves and other financial assets, guarantees (in particular those linked to the financial sector), and implicit liabilities related to ageing and private debt, to the extent that it may represent a contingent implicit liability for the government.

(Continued on the next page)

Box (continued)

condition that the deficit is close to the reference value and its excess over it is temporary. Due consideration is foreseen for pension reforms introducing a multi-pillar system including a mandatory, fully-funded pillar and the net cost of the publicly managed pillar.

In the next step of the procedure, the Economic and Financial Committee (EFC) formulates an opinion on the Commission report within two weeks of its publication (Article 126(4), Article 3.1 of Regulation 1467/97). If the Commission considers that an excessive deficit exists or may occur, the Commission addresses an opinion to the Council (Article 126(5)). Then, on the basis of the Commission’s proposal and the overall assessment the Council decides whether an excessive deficit exists (Article 126(6)).

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

If effective action has been taken in compliance with a recommendation under Article 126(7) and, compared with the economic forecasts underlying the recommendation, unexpected adverse economic events with major unfavourable consequences for government finances occur subsequent to its adoption, the Council may decide, on a recommendation from the Commission, to adopt a revised recommendation under the same article. The revised recommendation may extend the deadline for the correction of the excessive deficit. In the case of severe economic downturn for the euro area or the EU as a whole, the Council may also decide, on recommendation by the Commission, to adopt a revised recommendation under Article 126(7), provided that this does not endanger fiscal sustainability in the medium term.

If the Council establishes lack of effective action in response to its recommendations, the Council adopts a decision under Article 126(8) on the basis of a Commission recommendation immediately after the expiration of the deadline for taking action (or at any time thereafter when monitoring of the action taken by the Member State indicates that action is not being implemented or is proving to be inadequate). The provisions of Article 126(9 and 11) on enhanced Council surveillance and sanctions in case of non-compliance, as well as the enforcement mechanisms introduced in 2011, are not applicable to Member States with a derogation (that is, those that have not yet adopted the euro), which is the case of the Member State considered in this report. Following a Council decision establishing, under Article 126(8), that the Member State did not take effective action in response to a Council recommendation under Article 126(7), the Council, on recommendation by the Commission, addresses to Member States with a derogation a new recommendation under Article 126(7).

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

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

Box 1.4: Fiscal policy in the EU since COVID-19 crisis

On 20 March 2020, the Commission issued a Communication where it considered that the conditions for activating the general escape clause of the Stability and Growth Pact (SGP) were fulfilled. The EU Finance Ministers endorsed the Commission’s view on 23 March 2020.

The general escape clause can be activated in case of a severe economic downturn in the euro area or the EU as a whole. Specifically, in the preventive arm of the SGP, Regulation (EC) 1466/97, Articles 5(1) and 9(1), states that “*in periods of severe economic downturn for the euro area or the Union as a whole, Member States may be allowed temporarily to depart from the adjustment path towards the medium-term budgetary objective, provided that this does not endanger fiscal sustainability in the medium term*”. For the corrective arm, Regulation (EC) 1467/97, Articles 3(5) and 5(2), stipulates that in the case of a severe economic downturn, the Council may decide, on a recommendation from the Commission, to adopt a revised fiscal trajectory for Member States under an excessive deficit procedure.

The general escape clause is a provision introduced with the SGP reform of 2011 (six-pack reform), in the wake of the global financial crisis, and was untested before the COVID-19 crisis. It allows for a collective departure from the normal requirements of the Pact. This has facilitated the deployment of large fiscal support to the healthcare sector, households and firms to cope with the pandemic and the related restrictions to economic activities.

No new Excessive Deficit Procedure (EDP) has been opened since the activation of general escape clause. The situation created by the COVID-19 crisis first and by the Russia's invasion of Ukraine in February 2022 create exceptional uncertainty, including for designing a detailed path for fiscal policy.

A bold, coordinated fiscal policy response to the pandemic, unprecedented support from new EU instruments and the accommodative monetary policy have helped the EU economy weather the COVID-19 crisis and are underpinning the recovery. However, public deficits and debts increased significantly. In 2020, the EU aggregate deficit rose to 6.8% of GDP from 0.6% in 2019. It then fell to 4.7% of GDP in 2021 and, based on the Commission’s Spring 2022 Economic Forecast, it is expected to fall further in 2022 (to 3.6%) thanks to the improved cyclical conditions and the phasing out of the emergency temporary measures related to COVID-19, while measures to mitigate to impact of the energy crisis and to provide assistance to people fleeing Ukraine have a deficit-increasing impact in 2022. The aggregate EU government debt rose by 12.5 percentage points in 2020, to 90% of GDP([1]), and is expected to fall to around 87% by the end of 2022.

For 2022, the Council provided qualitative recommendations on the 2021 Stability and Convergence Programmes in June 2021. The fiscal recommendations were differentiated on the basis of debt levels:

- Member States with high debt were recommended to use the Recovery and Resilience Facility (RRF) to finance additional investment in support of the recovery, while pursuing a prudent fiscal policy and preserving nationally financed investment. Italy and Portugal were also recommended to limit the growth of nationally-financed current expenditure (net of discretionary revenue measures).

- Member States with low/medium debt were recommended to pursue/maintain a supportive fiscal stance and preserve nationally financed investment. Lithuania, Latvia, Bulgaria and Croatia were also recommended to keep the growth of nationally financed current expenditure under control.

For the purpose of these recommendations, all the Member States with a derogation were classified in the low/medium debt group.

In 2022, based on the Commission’s Spring 2022 Economic Forecast and including the information incorporated in their 2022 Convergence Programme, the fiscal stance in 2022 is projected to be supportive in Bulgaria, Croatia, Poland and Sweden, as recommended by the Council. On the other hand, the fiscal stance in 2022 is projected to be broadly neutral in Czechia and Hungary, while the Council recommended a supportive stance. All the Member States with a derogation, except Czechia, plan to preserve their nationally-financed investment, as recommended by the Council. In the case of Czechia, nationally-financed investment

([1]) Non-consolidated for intergovernmental loans.

(Continued on the next page)

Box (continued)

is projected to provide a contractionary contribution to the fiscal stance of 0.6 percentage point in 2022. In Croatia and Bulgaria, the growth in nationally-financed primary current expenditure (net of new revenue measures) in 2022 is projected to provide a significant expansionary contribution to the overall fiscal stance (of 1.0 and 1.4 percentage points, respectively). These significant expansionary contributions are only partially due to the measures to address the economic and social impact of the increase in energy prices and the costs to offer temporary protection to displaced persons from Ukraine. Therefore, on the basis of current Commission estimates, Croatia and Bulgaria do not sufficiently keep under control the growth of nationally-financed current expenditure in 2022.

In its Communication on the 2022 European Semester spring package of 23 May 2022, the Commission considered that the Union was not yet out of a period of severe economic downturn and the conditions to maintain the general escape clause in 2023 and to deactivate it as of 2024 were met. This consideration was made in the context of war in Europe, unprecedented energy price hikes and continued supply chain disturbances, with heightened uncertainty and strong downside risks to the economic outlook. The Commission invited the Council to endorse this conclusion to provide clarity to Member States.

The Commission called for fiscal policy to be prudent in 2023, while standing ready to react to the evolving economic situation. Fiscal policy should combine higher investment with controlling the growth in nationally-financed primary current expenditure, while allowing automatic stabilisers to operate and providing temporary and targeted measures to mitigate the impact of the energy crisis and to provide assistance to people fleeing from Russia's invasion of Ukraine. Full and timely implementation of the RRPs is key to achieving higher levels of investment. Moreover, Member States' fiscal plans for 2023 should be anchored by prudent medium-term adjustment paths reflecting fiscal sustainability challenges associated with high debt-to GDP levels that have increased further due to the pandemic.

The Commission recommended that fiscal policies in 2023 should continue to be appropriately differentiated across Member States:

- High-debt Member States should ensure prudent fiscal policy, in particular by limiting the growth of nationally-financed current expenditure below medium-term potential output growth, taking into account continued temporary and targeted support to households and firms (subject to State Aid rules) most vulnerable to energy price hikes and to people fleeing Ukraine.

- Low/medium-debt Member States should specifically ensure that the growth of nationally-financed current expenditure is in line with an overall neutral policy stance, taking into account continued temporary and targeted support to households and firms (subject to State Aid rules) most vulnerable to energy price hikes and to people fleeing Ukraine.

All Member States should stand ready to adjust current spending to the evolving situation and expand public investment for the green and digital transitions and for energy security, including by making use of the RRF, REPowerEU and other EU funds.

1.2.4. Exchange rate stability

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

Article 3 of the Protocol on the convergence criteria stipulates: 'The criterion on participation in the exchange rate mechanism of the European Monetary System […] shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against the euro on its own initiative for the same period' ([26]). Based on the Council Resolution

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

Box 1.5: A reinforced approach to ERM II participation by means of upfront policy commitments by the applicant Member States

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

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

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

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

In terms of process, the ECB and the Commission monitor the fulfilment of the prior-commitments undertaken by the applicant Member States in the respective areas of competence of the ECB and the Union and in close cooperation with the Member State concerned. The two institutions regularly inform ERM II parties on the progress made with the prior-commitments. A comprehensive assessment of the applicants' banking sector is carried out by the ECB as part of the process of establishing close cooperation with the ECB. This includes an asset quality review and a stress test that aims at assessing whether banks are fundamentally sound. The results of the comprehensive assessment are made public on the ECB's website ([4]).

([1]) https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A31997Y0802%2803%29

([2]) See: https://www.consilium.europa.eu/en/press/press-releases/2018/07/12/statement-on-bulgaria-s-path-towards-erm-ii-participation/

([3]) See: https://www.consilium.europa.eu/en/press/press-releases/2019/07/08/statement-on-croatia-s-path-towards-erm-ii-participation/

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

(Continued on the next page)

Box (continued)

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

At the time of writing this report, Bulgaria, Croatia and Denmark were the only non-euro-area Member States participating in ERM II. Bulgaria and Croatia joined the ERM II on 10 July 2020 after having completed their respective prior policy commitments ([5]). Both countries established close cooperation with the ECB. In addition, the prior policy commitments of the Bulgarian authorities covered measures related to the macroprudential framework, the supervision of the non-banking financial sector, the insolvency framework, the anti-money laundering framework and the governance of state-owned enterprises ([6]). The additional prior policy commitments of the Croatian authorities covered measures related to the macroprudential framework, the anti-money laundering framework, the collection, production and dissemination of statistic, public sector governance and firms' administrative and financial burden ([7]).

At the time of ERM II entry, the Bulgarian and Croatian authorities also committed to pursue sound economic policies with the aim of preserving economic and financial stability and achieving a high degree of sustainable economic convergence. In particular, the Bulgarian authorities committed to implement specific policy measures (the so-called post-ERM II entry commitments) on the non-banking financial sector, state-owned enterprises, the insolvency framework and the anti-money laundering framework ([8]). The Croatian authorities committed to implement specific policy measures on the anti-money laundering framework, the business environment, state-owned enterprises and the insolvency framework ([9]).

([5]) For the details on the decision of the ERM II parties on Croatia and Bulgaria see: https://ec.europa.eu/commission/presscorner/detail/en/IP_20_1321

([6]) For more details on the prior-commitments taken by Bulgarian authorities see: https://www.consilium.europa.eu/media/36125/st11119-en18.pdf

([7]) For the details on the decision of the ERM II parties on Croatia and Bulgaria see: https://ec.europa.eu/commission/presscorner/detail/en/IP_20_1321

([8]) See: https://www.ecb.europa.eu/pub/pdf/annex/ecb.pr200710_annex~29156bba37.en.pdf

([9]) See: https://www.ecb.europa.eu/pub/pdf/annex/ecb.pr200710_1_annex.en.pdf

on the establishment of the ERM II ([27]), the European Monetary System has been replaced by the Exchange Rate Mechanism II upon the introduction of the euro, and the euro has become the centre of the mechanism.

In its assessment of the exchange rate stability criterion, the Commission takes into account developments in auxiliary indicators such as foreign reserve developments and short-term interest rates, as well as the role of policy measures, including foreign exchange interventions, and international financial assistance wherever relevant, in maintaining exchange rate stability.

The assessment of this criterion verifies the participation in ERM II and examines exchange rate behaviour within the mechanism. Currently two of the Member States assessed in this Convergence Report, namely Bulgaria and Croatia, participate in ERM II (see Box 1.5 for further information on ERM II participation). The relevant period for assessing exchange rate stability in this Technical Annex is 19 May 2020 to 18 May 2022.

1.2.5. Long-term interest rates

The fourth indent of Article 140(1) of the Treaty requires that 'the durability of convergence achieved by the Member State with a derogation and of its participation in the exchange rate mechanism' is 'reflected in the long-term interest rate levels'. Article 4 of the Protocol on the convergence criteria further stipulates that 'the criterion on the convergence of interest rates […] shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than two percentage points that of, at most, the three best performing Member

([27]) 97/C 236/03 of 16 June 1997, OJ C 236, 2.8.1997, p.5.

Box 1.6: **Data for the interest rate convergence**

The fourth indent of Article 140(l) of the Treaty requires that the durability of nominal convergence and exchange rate stability in Member States should be assessed by reference to long-term interest rates. Article 4 of the Protocol on the convergence criteria adds that these “Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions”.

Article 5 of the Protocol requires that the Commission should provide the statistical data used for the application of the convergence criteria. However, in the context of the interest rate criterion, the ECB has developed the criteria for harmonising the series of 10-year benchmark bond yields on behalf of Eurostat and collects the data from the central banks. The selection of bonds for inclusion in this series is based on the following criteria:

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

For sixteen Member States, the residual maturity of the benchmark bond is at least 9.5 years. For eleven Member States, the residual maturity of the benchmark bond is below 9.5 years, in particular for Lithuania and Luxembourg with residual maturity below 3 and 5 years respectively. All yields are calculated on the basis of secondary market rates, where available. For Czechia, Germany and Spain a basket of bonds is used, while a single benchmark bond is used in twenty-four Member States.

Data used in this Report can be found on Eurostat ("Maastricht criterion bond yields (mcby): EMU convergence criterion bond yields", code: tec00097). The same series is also published by the ECB's Statistical Data Warehouse (code IRS.M.*Country Code*.L.L40.CI.0000.*Currency Code*.N.Z) and in a dedicated page in the ECB website with additional information: http://www.ecb.europa.eu/stats/financial_markets_and_interest_rates/long_term_interest_rates/html/index.en.html.

States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions’ (see Box 1.6).

For the assessment of the criterion on the convergence of interest rates, yields on benchmark long-term bonds have been taken, using an average rate over the latest 12 months. The reference value for April 2022 is calculated as the simple average of the average long-term interest rates in France (0.3%), Finland (0.2%) and Greece (1.4%) plus 2 percentage points, yielding a reference value of 2.6%.

1.2.6. Additional factors

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

The assessment of additional factors gives an important indication of a Member State's ability to integrate into the euro area without difficulties. As regards the balance of payments, the focus is on the situation and development of the external balance ([28]). Market integration is assessed through

[28] The external balance is defined as the combined current and capital account (net lending/borrowing vis-à-vis the rest of the world). This concept permits in particular to take full account of external transfers (including EU transfers), which are partly recorded in the capital account. It is the concept closest to the current account as defined when the Maastricht Treaty was drafted.

Box 1.7: The Macroeconomic Imbalance Procedure (MIP)

Key elements of the MIP

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

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

In a first step for the identification of imbalances under the MIP, the Alert Mechanism Report (AMR) identifies the Member States that require more in-depth investigation on whether they may be affected by macroeconomic imbalances. The AMR builds on the economic reading of a scoreboard of economic and financial indicators with indicative thresholds. The scoreboard covers different challenges Member States may be faced with and comprises fourteen indicators of external imbalances and competitiveness developments, internal imbalances, and the employment situation ([1]). In particular, it encompasses variables that the economic literature associates with crisis episodes. Beyond the scoreboard, the analysis in the AMR takes into account additional information and assessment tools, as well as previous in-depth assessments at country level.

In a second step, the analysis carried out in the in-depth reviews (IDRs) for selected Member States provides the basis for the identification of imbalances, and their severity, by the Commission. IDR analysis makes use of updated and country-specific information and analytical tools developed by the Commission services.

Both ‘imbalances’ and ‘excessive imbalances’ imply possible recommendations by the Council upon Commission proposal, which have so far been integrated in the single package of Country-Specific Recommendations (CSRs) under the European Semester. The identification of ‘excessive imbalances’ implies a stronger surveillance process, possibly leading to an Excessive Imbalance Procedure. The latter provides a framework underpinned by a corrective action plan designed by the concerned Member State, endorsed by the Commission and the Council and monitored by the Commission, and including the possibility of sanctions for euro area Member States in case of repeated non-compliance. Whilst the Excessive Imbalance Procedure has never been launched, Member States experiencing excessive imbalances have tended to receive more policy recommendations than other Member States. Over the last two years, the approach to CSRs, including MIP-relevant ones, was subject to some streamlining as economic policy coordination refocused first on the response to the COVID-19 pandemic crisis and subsequently on the preparation and implementation of the recovery and resilience plans to address the green and digital transition challenges for our economies and societies. The review of the EU economic governance framework, encompassing the MIP, is ongoing ([2]).

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

([2]) Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee, the Committee of the Regions, “The EU economy after COVID-19: implications for economic governance”, (COM(2021) 662 final).

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Box (continued)

The 2022 Alert Mechanism Report (AMR) and In-Depth Reviews (IDR)

In its latest AMR from November 2021, the Commission concluded that IDRs were warranted for 12 Member States, which coincided with the ones that had been identified with imbalances or excessive imbalances in the previous annual MIP cycle. Three of those Member States are covered in this Convergence Report (Croatia, Romania, and Sweden). On the basis of the most recent IDRs, in May 2022, the Commission concluded that Croatia is no longer experiencing imbalances while Romania and Sweden continue experiencing imbalances ([3]).

[3] Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee, the Committee of the Regions and the European Investment Bank “2022 European Semester – Spring Package”, (COM(2022) 600 final).

trade, foreign direct investment and a smooth functioning of the internal market. Moreover, progress in financial integration is examined, together with the main characteristics, structures and trends of the financial sector. Given that Member States which adopt the euro also participate in the banking union, developments in national banking sectors are specifically looked at as well.

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

The section on additional factors makes reference to the surveillance of macroeconomic imbalances under the Macroeconomic Imbalance Procedure, which was adopted in December 2011 as one of the key elements of the legislative package (the ‘Six-Pack’) to enhance the governance structures in EMU, and integrates its results into the assessment (see Box 1.7).

2. BULGARIA

2.1. LEGAL COMPATIBILITY

2.1.1. Introduction

The legal basis for the Bulgarska Narodna Banka (BNB – central bank of Bulgaria), the Law on the Bulgarian National Bank (the BNB Law) of 1997, has been amended since the 2020 Convergence Report. Bulgarian authorities have amended the BNB Law to remedy certain incompatibilities and imperfections highlighted in the Commission's 2020 Convergence Report ([29]). In particular, it concerns issues flagged in previous convergence reports in the section on central bank independence and prohibition of monetary financing and privileged access. Other issues remain unresolved. Therefore, certain comments provided in the 2020 report are repeated also in this year's assessment.

2.1.2. Central Bank independence

The Conflict of Interest Prevention and Ascertainment Act of 2008, which regarding the possibility to dismiss the Governor of the BNB had to be brought in line with Article 14.2 of the ESCB/ECB Statute, was fully repealed and replaced by the Act on Corruption Counteraction and Eviction of Illegally Acquired Property of 2018 ([30]). Article 80(1) of the Act on Corruption Counteraction and Eviction of Illegally Acquired Property was supplemented and now explicitly provides that the ascertainment of a conflict of interest by an enforceable instrument shall be a ground for release from office, unless otherwise provided for in the Constitution or the Statute of the European System of Central Banks and of the European Central Bank. This provision is compatible with Article 14.2 of the ESCB/ECB Statute.

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

Article 13(2) of the BNB Law foresees that the Governor of the BNB shall swear an oath before the Parliament. The content of the oath laid down in paragraph one of the same provision refers inter alia to abiding by law and to contribute to the performance of the functions of the BNB. Article 13(1) was amended to provide explicitly that upon taking office, the Governor, the Deputy Governors and the other three members of the Governing Council shall be sworn in to contribute to the independent performance of the functions entrusted to the Bank. However, the imperfection in this provision has only been partially solved. Since the Governor, the Deputy Governors and the other three members of the Governing Council are involved in the performance of ESCB-related tasks, any oath should make a clear reference to the central bank independence under Article 130 of the TFEU. The Governor of the BNB acts in dual capacity as a member of BNB’s decision-making bodies and of the relevant decision-making bodies of the ECB. Article 13 of the BNB Law needs to be adapted to reflect the status and the obligations and duties of the Governor of the BNB as member of the relevant decision-making bodies of the ECB. The oath as it stands is an imperfection and should be remedied.

Article 44(1) second sentence of the BNB Law refers to the public institutions and bodies not having the right to influence the BNB, the Governor and the members of the Governing Council. The wording should be further improved by referring to the wording of Article 130 of the TFEU, which states that public authorities may not seek to influence the members of national central banks’ decision-making bodies.

Article 3 of the BNB Law providing that ’in the formulation of the general outlines of the monetary

[29] SG No. 12/2021 12.02.2021
[30] SG No. 7/19.01.2018.

policy, the BNB and the Council of Ministers shall inform each other' has been repealed. Thus, the incompatibility in the area of independence, with Article 130 of the TFEU and Article 7 of the ESCB/ECB has been solved.

2.1.3. Prohibition of monetary financing and privileged access

Article 45(1) of the BNB Law provides that the BNB shall not extend credits and guarantees, including through purchase of debt instruments, to the Council of Ministers, municipalities, other government and municipal institutions, organisations and undertakings in the public sector, European Union institutions, bodies, offices or agencies, the central government, regional, local or other public authorities, other bodies governed by public law or public sector entities of EU Member States. The list of national entities referred to in Article 45(1) is an imperfection and should be amended with a view to including the national public entities mentioned in Article 123(1) of the TFEU and Article 21.1 of the ESCB/ECB Statute.

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

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

2.1.4. Integration in the ESCB

Objectives

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

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

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

- absence of a general reference to the BNB as an integral part of the ESCB (Article 1(1) of the BNB Law) and to its subordination to the ECB's legal acts (Articles 16 (1) and (2) and 60 of the BNB Law);

- definition of monetary policy and monetary functions, operations and instruments of the ESCB (Articles 2(1) and (3), 16(4) and (5), 28, 29, 30, 31, 32, 33, 35, 38, 41 and 61 of the BNB Law);

- conduct of foreign exchange operations and the definition of foreign exchange rate policy (Articles 20(1), 28, 29, 30, 31, 32 of the BNB Law);

- right to authorise the issue of banknotes and the volume of coins (Articles 2(5), 16(9), 24 to 27 of the BNB Law);

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

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

There are also numerous imperfections regarding:

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

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

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

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

Tasks

2.1.5. Assessment of compatibility

The Commission welcomes the efforts of Bulgarian authorities to remedy the incompatibilities and imperfections in comparison to its previous 2020 Convergence Report. However, the BNB Law is not yet fully compatible with Article 131 of the TFEU as regards central bank independence, the prohibition of monetary financing and the integration in the ESCB at the time of euro adoption.

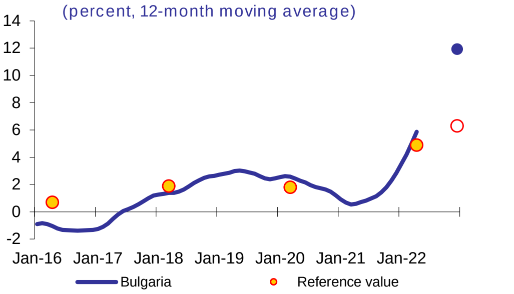
2.2. PRICE STABILITY

2.2.1. Respect of the reference value

The 12-month average inflation rate, which is used for the convergence assessment, was above the reference value at the time of the last convergence assessment of Bulgaria in 2020. It then decreased to a low of 0.5% in March 2021, after which it increased rapidly throughout the rest of 2021. In April 2022, the reference value was 4.9%, calculated as the average of the 12-month average inflation rates in France, Finland and Greece plus 1.5 percentage points. The corresponding inflation rate in Bulgaria was 5.9%, i.e. 1 percentage point above the reference value. The 12-month average inflation rate is projected to remain above the reference value in the months ahead.

Graph 2.1: **Bulgaria - Inflation criterion**

(percent, 12-month moving average)



Note: The dots at the right end of the chart show the projected reference value and 12-month average inflation rate of the country in December 2022. The reference values for 2016, 2018 and 2020 refer to the reference values calculated in the previous Convergence Reports.

Source: Eurostat, Commission's Spring 2022 Economic Forecast.

2.2.2. Recent inflation developments

The annual HICP inflation rate decreased from 1.3% in April 2020 to -0.3% in January 2021, then increased throughout 2021 and accelerated further to 12.1% in April 2022. The decline in the period April 2020 to January 2021 was mostly driven by deflation in unprocessed food prices and low inflation rates in processed food prices. Prices of meat and meat products fell after the price hike in 2019 that was caused by the African swine fever, contributing to lower food inflation. The acceleration of inflation in 2021 was due to contributions from all broad categories. Fuel prices had a contribution of 3.5 percentage points to the annual inflation in December 2021. Inflation rates in Bulgaria have exceeded those of the euro area over the past two years.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) was on a

Table 2.1:
Bulgaria - Components of inflation

	(percentage change)[1]							weights in total
	2016	2017	2018	2019	2020	2021	Apr-22	2022
HICP	-1.3	1.2	2.6	2.5	1.2	2.8	5.9	1000
Non-energy industrial goods	-1.6	-1.1	-0.5	0.2	-0.1	0.7	2.3	308
Energy	-7.0	5.8	6.4	1.4	-6.1	10.6	20.4	134
Unprocessed food	-1.1	5.9	1.3	5.3	5.5	-0.3	7.4	52
Processed food	-0.6	0.0	4.3	3.2	2.3	2.0	2.8	233
Services	-0.6	0.0	4.3	3.2	2.3	2.0	2.8	273
HICP excl. energy and unproc. food	-0.4	0.3	2.1	2.5	2.0	1.9	3.6	814
HICP at constant tax rates	-1.5	1.0	2.4	2.4	1.5	3.2	6.0	1000
Administered prices HICP	0.1	1.6	2.2	2.6	1.7	2.4	3.6	175

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

Source: Eurostat, European Commission calculations.

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

	2016	2017	2018	2019	2020	2021	2022[1)]	2023[1)]
HICP inflation								
Bulgaria	-1.3	1.2	2.6	2.5	1.2	2.8	11.9	5.0
Euro area	0.2	1.5	1.8	1.2	0.3	2.6	6.1	2.7
Private consumption deflator								
Bulgaria	1.7	4.6	2.4	2.0	-0.6	3.6	11.9	4.7
Euro area	0.4	1.3	1.5	1.1	0.5	2.3	5.8	2.7
Nominal compensation per employee								
Bulgaria	5.8	10.5	9.7	6.9	7.2	9.5	9.7	7.7
Euro area	1.2	1.7	2.1	2.1	-0.7	4.1	3.6	3.5
Labour productivity								
Bulgaria	2.5	1.0	2.8	3.7	-2.1	4.0	1.9	2.7
Euro area	0.4	1.0	0.2	0.3	-4.9	4.2	1.4	1.5
Nominal unit labour costs								
Bulgaria	3.2	9.5	6.7	3.1	9.5	5.4	7.7	4.8
Euro area	0.8	0.7	2.0	1.9	4.4	0.0	2.2	2.0
Imports of goods deflator								
Bulgaria	-6.0	7.5	2.2	-0.1	-6.0	15.0	11.9	4.3
Euro area	-3.3	3.3	2.6	-0.5	-3.8	9.6	13.2	0.8

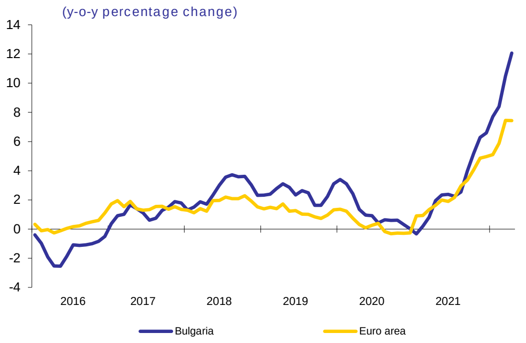
1) Commission Spring 2022 Economic Forecast.

Source: Eurostat, Commission's Spring 2022 Economic Forecast.

declining path since April 2020, arriving at 0.6% in August 2021. It then accelerated sharply as of September 2021 and reached 3.9% in December 2021. Core inflation remained above headline inflation for one year from April 2020 onwards and was then surpassed by overall HICP inflation due to energy price increases. Annual inflation in processed food was the most important determinant of core inflation dynamics. It decelerated from 4.9% in April 2020 to 1.3% in March 2021, and then gathered pace as of September 2021. The increase in processed food prices in Q4-2021 was driven by cost-push factors, such as higher prices of energy and agricultural production in this period.

Annual average inflation in services decelerated in 2020 and 2021. Weaker seasonal demand for travel, food and accommodation services in the summer exercised a sizable downward pressure on services prices in 2020 and 2021. Price weakness in the sector of hotels and restaurants was also magnified by a downward adjustment in wages during the months of lockdown. Price dynamics in non-energy industrial goods had a negligible influence on overall inflation in 2020 and most of 2021. Towards the end of 2021, prices in this category also started to rise with contributions from higher energy and from intermediate input costs and import prices.

Graph 2.2: **Bulgaria - HICP inflation**



Source: Eurostat.

2.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and growth developments

Due to the adverse impact of the pandemic, real GDP contracted by 4.4% in 2020, and then recovered by 4.2% in 2021. Across demand components, economic activity in 2020 contracted mostly due to lower external demand and reduced private investment and consumption. Exports of goods rebounded quickly already in Q3-2020, while exports of services remained subdued also in 2021. Aggregate investment remained largely unchanged in 2020, despite the impulse from public investment, and then registered a sizable decline of 11% in 2021. The contraction in capital formation in 2021 was driven by high uncertainty, combined with reduced business activity in the sectors most affected by the pandemic. In Q2-2020, private consumption contracted sharply by 3.2% quarter-on-quarter with the introduction of social distancing measures in March 2020, and then swiftly regained ground in Q3-2020. The social distancing measures subsequently introduced in late 2020 and in 2021 were less strict and more selective. Combined with the businesses adjusting to operate in the new environment (e.g. introducing home delivery), this largely avoided repeated demand slumps. In 2021, private consumption expanded strongly by 8%, underpinned by positive wage dynamics, limited job losses, due to the swift introduction of job retention schemes, supported by the SURE instrument and REACT-EU, and relatively optimistic expectations about economic activity.

According to the Commission’s Spring 2022 Economic Forecast, economic growth is forecast to slow down to 2.1% in 2022, due to both slower expansion in domestic and external demand. GDP is then forecast to grow by 3.1% in 2023. In response to increased energy and other input costs and general high uncertainty, firms are set to postpone investments and new hires. The slump in private investment is forecast to be fully compensated by public investments, supported by the Recovery and Resilience Plan. The decreased hiring intensity is expected to lead to a stabilisation of the unemployment rate slightly below 5%. Private consumption growth is expected to decelerate markedly to 2.8% in 2022 and then increase marginally to 3% in 2023. The relative slow-down in consumer spending is linked to the expected strong price increases in 2022, which are set to erode real disposable income. The output gap is projected to narrow, but remain negative in 2022 and then turn slightly positive in 2023.

In 2021, the fiscal stance ([31]) remained supportive at the same level as in 2020 (-0.6% of GDP), based on the Commission’s Spring 2022 Economic Forecast. The fiscal stance is expected to become even more supportive in 2022 (-3.4% of GDP) due to the expenditures financed through the Recovery and Resilience Fund and other EU grants and temporary support to mitigate the impact of high energy prices on vulnerable households and firms (around 0.3% of GDP ([32])). The budgetary costs related to people fleeing the war in Ukraine is assumed at 0.11% of GDP. The no policy-change forecast for 2023 shows a further supportive stance (-1.3% of GDP) thanks to the increasing expenditure financed by Recovery and Resilience Fund and other EU grants, despite the assumed phasing out of energy crisis measures.

The BNB pursues its primary objective of price stability through an exchange rate anchor in the context of a currency board arrangement (CBA) with the lev pegged to the euro. The CBA serves as a key macroeconomic policy anchor. During the COVID-19 crisis, the sound public finances and a stable banking sector combined with the exchange rate stability, ensured by the currency board, allowed Bulgaria to finance itself at favourable interest rates. In March 2020, the Bulgarian National Bank introduced a package of measures in response to the COVID-19 crisis, amounting to BGN 9.3 billion to preserve the stability and improve the flexibility of the banking system. These measures included reducing the commercial banks’ foreign exposure by BGN 7 billion and full capitalisation of profits for BGN 1.6 billion, and both were discontinued at the beginning of 2022. In April 2020, the BNB approved a non-legislative moratorium on loan repayments, in line with the Guidelines of the European Banking Authority (EBA/GL/2020/02) until end-2020. This measure expired at the end of 2021, with a total of BGN 8.1 billion of loans deferred under the arrangement. The central bank also agreed with the ECB in April 2020 to set up a precautionary currency agreement (swap line) to provide euro liquidity up to EUR 2 billion until end-2020. Given the uncertain economic outlook, the risks to the debt-service capacity of borrowers, and the quality of banks’ assets, the BNB decided in March 2022 to respond to the continued strong lending activity in the house-loan segment by increasing the countercyclical capital buffer rate applicable to domestic credit risk exposures from 0.5% to 1.0% from October 2022 and to 1.5% in effect from the beginning of 2023.

([31]) The fiscal stance is measured as the change in primary expenditure (net of discretionary revenue measures), excluding Covid-19 crisis-related temporary emergency measures but including expenditure financed by non-repayable support (grants) from the Recovery and Resilience Facility and other EU funds, relative to medium-term potential growth. A negative (positive) sign of the indicator corresponds to an excess (shortfall) of primary expenditure growth compared with medium-term economic growth, indicating an expansionary (contractionary) fiscal policy.

([32]) In incremental terms. The level amount is around 0.9% of GDP in 2022.

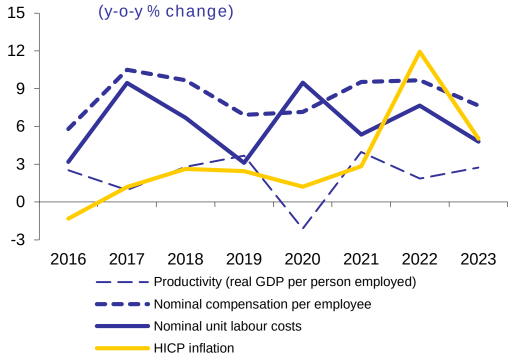
Wages and labour costs

At the onset of the COVID-19 pandemic employment quickly adjusted downwards in the sectors most affected by the domestic and external demand slump — manufacturing, trade, transport, hotels and restaurants and other services. Nevertheless, the number of persons employed fell by less compared to the economic activity in these sectors. On aggregate, gross value added declined by 6.6% quarter-on-quarter in Q2-2020, while the number of persons employed fell by 2.2% in the same period. Further job losses in the subsequent periods were prevented by the quick rebound in manufacturing production, the relaxation of containment measures and swift introduction of subsidised short-time work schemes. The recovery in employment levels continued in 2021 across all sectors. On average for 2020, the number of employed dropped by 2.3% and then grew by 0.2% in 2021. Nominal compensation per employee in the most affected sectors contracted sizably in Q2-2020, reflecting to a large extent the reduction in hours worked [33]. In the following periods aggregate wage growth resumed its upward trend, in line with the stabilisation and partial recovery of the labour market situation. On aggregate, compensation per employee grew by 7.2% in 2020 and 9.5% in 2021, broadly in line with the pre-crisis trend.

Labour productivity dropped by 4.5% in Q2-2020 as a result of labour hoarding in the sectors most affected by the COVID-19 crisis. It then recovered to pre-pandemic levels at the beginning of 2021. Overall, aggregate labour productivity declined by 2.1% in 2020 and then rebounded by 4% in 2021. The aggregate numbers, however, obscure diverging trends. Productivity in manufacturing exhibited a strong rebound already in 2020, while in the retail and wholesale trade, catering and accommodation services productivity is still on a declining path. The dynamics in nominal unit labour cost (ULC) have been strongly influenced by fluctuations in labour productivity. Wages resumed their steady growth after the contraction at the onset of the COVID-19 crisis in Q2-2020, which was driven by wage cuts in the private sector. In particular, nominal ULC went up by 5.8% quarter-on-quarter in Q2-2020 and then returned to trend growth rates, typical for the pre-crisis period. On average, ULC increased by 9.5% in 2020 and then by 5.4% in 2021. According to the Commission’s Spring 2022 Economic Forecast, ULC is expected to increase by 7.7% in 2022 and 4.8% in 2023.

Graph 2.3: **Bulgaria - Inflation, productivity and wage trends**

(y-o-y % change)



Source: Eurostat, Commission's Spring 2022 Economic Forecast.

External factors

Given the high import component of aggregate demand, imported inflation plays an important role in domestic price formation. Import prices of mineral fuels, food and other manufactured goods and materials are particularly relevant for inflation in Bulgaria. Since mid-2021, the prices for electricity on the unregulated domestic market have increased four-fold, following the regional and global price increase. In 2021, the domestic ‘Day ahead’ market became more tightly linked to the EU electricity market, as its trading platform was integrated with the ones in Greece and Romania.

The lev’s nominal effective exchange rate, which is determined by the price of the lev vis-à-vis the currencies of 36 major trade partners, appreciated by 2.8% in 2020 and 2.7% in 2021. The appreciation at the end of 2021 was strongly influenced by the depreciation of the Turkish lira against the euro. Turkey is the most important trading partner for Bulgaria outside the EU, accounting for 6.1% of total exports and 7.8% of total imports in 2021.

Administered prices and taxes

The share of administered prices in the HICP basket is relatively high at around 17%, compared to 13% in the euro area. Regulated prices of electricity, heat and water follow a seasonal pattern, as they are usually updated at the

[33] While the job retention schemes were introduced fairly swiftly at the onset of the spring 2020 lockdown, they were arguably less generous than in other EU countries. With time the scope and coverage has widened. This evolution can largely explain the less distorted figures for Bulgaria at the beginning of the crisis.

beginning of the year or in the summer months. Administered price inflation accelerated from 1.7% in 2020 to 2.4% in 2021 on the back of increasing energy prices. The National Assembly imposed a moratorium on future increases in the price for electricity, central heating and water supply in December 2021. The moratorium expired at the end of March 2022. Meanwhile, the government introduced support programmes for firms, public utilities and household gas consumers. Without the moratorium, the energy regulator had envisaged a 12% increase in the electricity price. Administered price inflation surpassed overall HICP in 2020 and then went below headline consumer price inflation in 2021.

Changes in indirect taxes had a negative effect on inflation in 2020 and 2021. As a response to the pandemic and the containment measures, VAT on hotels, restaurants and other tourist services, as well as the sale of books and other items was temporarily reduced as of mid-2020. Annual constant-tax HICP was thus 0.3 of a percentage point and 0.4 of a percentage point above headline inflation in 2020 and 2021, respectively. The measures were still in place in 2021, which explains the persistence in the inflation differential in 2021 through the carry-over effect from 2020. In the euro area, annual constant-tax HICP also exceeded the headline inflation by 0.3 of a percentage point in 2020, but then fell below overall inflation by -0.2 of a percentage point in 2021.

Medium-term prospects

Looking forward, annual HICP inflation is expected to accelerate significantly in 2022 on the back of persistently high costs of energy and other intermediate products, expected increases in regulated gas and heating prices, as well as higher international food prices and growing import deflators. In 2023, inflation is forecast to abate relative to the previous year, but to remain somewhat elevated at 5.0%, due to the lagged indirect effect of high energy cost on final goods and services prices. In the context of the weaker expected labour market pressures, the second-round effects via a wage-price spiral are projected to be limited.

In parallel to the introduction of the moratorium on prices of utilities between 15 December 2021 and 31 March 2022, the government introduced support programmes for firms, public utilities suppliers and household gas consumers that have so far mitigated the impact of sharp increases in energy prices. The discontinuation of natural gas supplies by Gazprom in late April is expected to be compensated through alternative sources, leading to a one-off increase in gas prices.

The level of consumer prices in Bulgaria stood at about 55% of the euro area average in 2020. This suggests that there is a significant potential for price level convergence in the long term, as GDP per capita in PPS (about 55% of the euro-area average in 2021) increases towards the euro-area average.

Medium-term inflation prospects will depend on wage and productivity developments as well as on the functioning of product and services markets. These developments may be substantially affected by the cyclical position of the economy. The sizable inflows of EU funds, including the RRF funding, could bring the economic output above potential. In that context, an important aspect to minimise the overheating pressures and maximise long-term productivity gains is ensuring that public investments effectively expand the production capacity of the economy in the medium term. This could be done via investments in physical and human capital and reforms to improve the functioning of product and labour markets, so that demand increase is matched by positive supply side reactions.

2.3. PUBLIC FINANCES

2.3.1. Recent fiscal developments

After a period of budget surpluses, the general government balances recorded deficits of 4.0% and 4.1% of GDP in 2020 and 2021, respectively, as the Bulgarian government took measures to respond to the pandemic-induced shock. Measures like those raising or preserving remuneration in the public and private sector sustained income taxes and revenues from social contributions. However, the reduced economic activity led to a decline in receipts from taxes on production and imports, while sales starkly declined too. As a result, total revenue decreased by around 1.3% and by 0.3 percentage points as a percentage of GDP. By contrast, the expenditure-to-GDP ratio increased by 5.7 percentage points during the same period as the government introduced emergency measures like higher wage bonuses for medical staff,

Table 2.3:

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

Outturn and forecast [1]	2016	2017	2018	2019	2020	2021	2022[1]	2023[1]
General government balance	0.3	1.6	1.7	2.1	-4.0	-4.1	-3.7	-2.4
- Total revenue	35.1	37.1	38.7	38.4	38.1	39.0	40.2	40.7
- Total expenditure	34.8	35.4	37.0	36.3	42.0	43.1	43.9	43.1
of which:								
- Interest expenditure	0.9	0.8	0.7	0.6	0.5	0.5	0.5	0.5
p.m.: Tax burden	29.2	29.8	29.7	30.3	30.6	32.4	32.6	33.1
Primary balance	1.2	2.4	2.4	2.7	-3.5	-3.6	-3.1	-1.9
Fiscal stance [2]					-0.6	-0.6	-3.4	-1.3
Government gross debt	29.1	25.1	22.1	20.0	24.7	25.1	25.3	25.6
p.m: Real GDP growth (%)	3.0	2.8	2.7	4.0	-4.4	4.2	2.1	3.1

1) Commission’s Spring 2022 Economic Forecast.

2) A negative (positive) sign of the indicator corresponds to an excess (shortfall) of primary expenditure growth compared with medium-term economic growth, indicating an expansionary (contractionary) fiscal policy.

Source: European Commission.

subsidies to corporations, pension top-ups and the purchase of medical equipment. In 2021, revenues largely recovered, thanks to higher receipts from higher taxes on production and imports, income and wealth taxes, and the upswing in sales. Overall, total public revenue as a percentage of GDP increased by 0.9 of a percentage point from 2020 to 2021, slightly lowered by the recovery of GDP. Emergency measures remained largely in place, leading to a further 1.1 percentage point in the expenditure-to-GDP ratio.

Bulgaria entered the crisis with a strong fiscal position, as reflected by budget surpluses in previous years and a low debt-to-GDP ratio of 20% in 2019. The primary deficits in 2020 and 2021 translated into a rising debt-to-GDP ratio, reaching 25.1% in 2021, which had already increased to 24.7% in 2020. A positive snowball effect of 0.6% of GDP on gross public debt contributed to the rise in 2020. However, given Bulgaria’s strong commitment towards sound fiscal policy, a negatively turning interest rate-growth differential and the expected gradual phase-out of emergency measures, the government debt-to-GDP ratio is set to stay below 26% in the medium-term.

2.3.2. Medium-term prospects

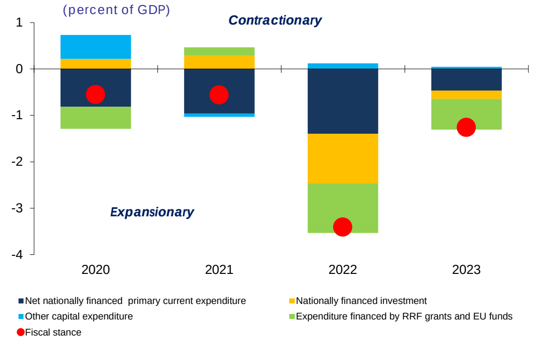
The elections held at the end of 2021, and the subsequent protracted government formation, delayed the usual adoption of the 2022 budget, which the National Assembly adopted on 25 February 2022. The budget includes, among others, the gradual increase in the excise duty on tobacco and toll taxes, increases in the minimum wage, and changes in pension policy parameters. While initially Bulgaria’s budget balance was expected to largely improve due to the gradual phasing-out of pandemic-related measures from 4.3% in 2021 to 1.8% of GDP in 2022, the worsened economic outlook due to Russia’s invasion of Ukraine and rising energy costs impede the deficit recovery. Key emergency support measures that remain in place to fight the pandemic include the provision of vaccines and medical products, pension top-ups, and business support schemes. As a consequence of Russia’s invasion of Ukraine, the Bulgarian government has introduced new measures like the evacuations of Bulgarian nationals residing in Ukraine and the provision of humanitarian aid (e.g. providing accommodation and daily allowances for up to three months upon arrival) to Ukrainian refugees arriving in Bulgaria. According to Commission estimations, the related total costs of the flow of refugees, due to the Russian military aggression in Ukraine, amount to 0.11% and 0.16% of GDP in 2022 and 2023.

On 29 April 2022, Bulgaria submitted its 2022 Convergence Programme. According to the Programme, the headline deficit is projected to increase to 5.3% of GDP in 2022 and 2.9% in 2023.

The Commission's Spring 2022 Economic Forecast, which is based on a no-policy change assumption, forecasts a general government deficit of around 3.7% of GDP in 2022. The projected government deficit is lower than the planned deficit in the Convergence Programme due to different underlying macroeconomic assumptions, including the inflow of people fleeing the war in Ukraine and the associated costs, higher growth in revenues from taxes on production and imports as well as a smaller increase in intermediate consumption. The Commission projects the general government deficit to further decrease to around 2.4% of GDP in 2023, as the costs of both COVID-19 and energy price measures are set to phase out.

In 2022, the fiscal stance is projected in the Commission's Spring 2022 Economic Forecast to continue to be supportive, at -3.4% of GDP ([34]). The positive contribution to economic activity of expenditure financed by the Recovery and Resilience Facility grants and other EU funds is projected to increase by1.1 percentage points of GDP in 2022, compared to 2021. Nationally financed investment is projected to provide as well an expansionary contribution to the fiscal stance in 2022 by 1.1 percentage points of GDP. At the same time, the growth in nationally financed primary current expenditure (net of discretionary revenue measures) in 2022 is projected to provide an expansionary contribution of -1.4 percentage points to the overall fiscal stance, as current expenditure is set to grow at a faster pace than medium-term potential growth. However, some of this expansion is due to measures related to the energy crisis (-0.2 of a percentage point) and the assistance to those fleeing Ukraine (-0.1 of a percentage point). In 2023, the fiscal stance is projected at -1.3% of GDP. The additional positive contribution to economic activity of expenditure financed by Recovery and Resilience Facility grants and other EU funds is projected to increase by 0.7 of a percentage point of GDP, compared to 2022. Nationally financed investment is projected to be expansionary too by 0.2 percentage points of GDP ([35]). The growth in nationally financed primary current expenditure is projected to provide an expansionary contribution of -0.5 of a percentage point to the overall fiscal stance in 2023. This includes the impact from the phasing out of the measures addressing the increased energy prices (0.82% of GDP).

Graph 2.4: **Bulgaria - Fiscal stance and its components**



Source: Commission's Spring 2022 Economic Forecast.

The deficit is set to fall below the Treaty threshold of 3% in 2023. While the global economic outlook remains uncertain, the positive impact of investments financed through the Recovery and Resilience Fund, as well as the continued phasing out of COVID-19 and energy price measures, improve the deficit to 2.4% of GDP. The government debt-to-GDP ratio is forecast to increase slightly to 25.6% due to the persistent primary deficits, but cushioned by economic growth.

Debt sustainability risks appear medium over the medium term. Government debt is projected to increase, reaching around 37% of GDP in 2032. This projection assumes that the structural primary balance remains constant (except for the impact of ageing) at the forecast level for 2023 of -2.2% of GDP, hence below the 2019 level.

The sensitivity to possible macro-fiscal shocks contributes to this assessment. While Bulgaria's debt is projected to stay at a low level by 2032 under all deterministic scenarios, the stochastic projections point to a particularly large degree of uncertainty.

Several factors mitigate risks, including the lengthening of debt maturity in recent years historically low borrowing costs and the expected positive impact on long-term growth of reforms under the Recovery and Resilience Plan. Risk-increasing factors include Bulgaria's negative net international investment position, the substantial share of public debt in foreign currency and contingent liability risks stemming from the poor

([34]) For a definition of the fiscal stance used in this report, see footnote in Section 2.2.3 on underlying factors and sustainability of inflation.

([35]) Other nationally financed capital expenditure is projected to provide a neutral contribution.

financial performance of some state-owned enterprises ([36]).

Bulgaria has developed a strong institutional setting. According to the Commission’s Fiscal Governance Database, with nine national fiscal rules in place at the general and subnational level, Bulgaria has the highest number of fiscal constraints in the EU, while also showing an improving track-record of compliance. The rules system, however, appears complex, not least because of using different accounting standards (both Maastricht-based and cash-based), which raises the need to streamline the process. In 2020, Bulgaria added additional flexibility in the form of escape clauses to four rules targeting the general government to enable the necessary fiscal adjustments in the face of the COVID shock (according to the Commission’s Fiscal Governance Database). Based on its broad remit, the Fiscal Council has gradually established a system for releasing its mandatory monitoring reports on the annual and medium-term fiscal plans and compliance with all the numerical rules laid down in the Public Finance Act. However, issues remain with respect to the management and planning of the government finances. The Ministry of Finance does not always seem to have enough information for the purposes of budgetary planning on the detailed content of major public expenditures. This together with the failure to produce fiscal projections in terms of the European System of National and Regional Accounts (ESA), and a systematic underestimation of budget projections raise the need to strengthen the capacity of the administration to plan, forecast and report on the general government budget in both accrual (ESA) and cash terms.

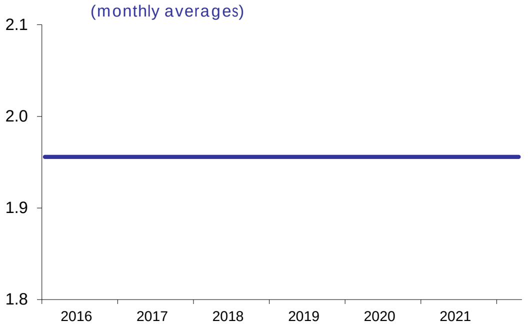
2.4. EXCHANGE RATE STABILITY

The Bulgarian lev joined the ERM II on 10 July 2020 and in parallel, the Bulgarian National Bank entered into a close cooperation with the ECB. After joining, Bulgaria committed to pursue a set of policy measures, the so-called post-entry commitments, to ensure that their participation in the mechanism is sustainable and achieves a high degree of economic convergence ahead of the euro adoption. The measures cover four policy areas: the non-banking financial sector, the insolvency framework, the anti-money laundering framework, and governance of state-owned enterprises. Bulgaria is currently working towards the completion of these post-commitments, in close liaison with the Commission, who monitors their progress.

Bulgaria introduced its CBA on 1 July 1997, pegging the Bulgarian lev to the German mark and subsequently to the euro (at an exchange rate of 1.95583 BGN/EUR). Under the CBA, the BNB has to cover its monetary liabilities with foreign reserves fully. The BNB is obliged to exchange monetary liabilities and euro at the official exchange rate without any limit.

Graph 2.5: **Bulgaria - BGN/EUR exchange rate**

(monthly averages)



Source: ECB.

Bulgaria's international reserves increased to around EUR 35 billion by the end of 2021, after having increased from EUR 25 billion at the beginning of 2020 to around EUR 31 billion at the end of the same year. International reserves increased in the course of 2021 mainly because of positive net currency inflows. The transfers of EU funds and the BNB’s net purchases of reserve currency from commercial banks account for most of the inflows. With the further increase in international reserves in 2021, their share as a percentage of GDP also increased to 51% from around 50% at the end of 2020.

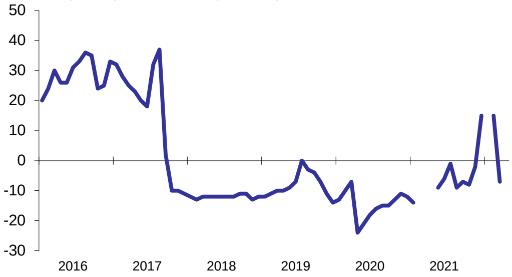
The BNB does not set monetary policy interest rates. The monetary policy of the euro area affects the domestic interest rate environment directly through the operation of Bulgaria's CBA. The BNB discontinued the production of short-term reference rates (e.g. SOFIBOR) as of 1 July 2018. Instead, the central bank publishes a base interest rate (BIR) based on the index LEONIA Plus (LEv OverNight Interest Average Plus), which is a reference rate of concluded and effected overnight deposit transactions in Bulgarian levs on the interbank market in Bulgaria. In June 2020, the BIR stood at -0.7%. Since then it has been very

[36] For further details see the 2021 Fiscal Sustainability Report.

stable until the end of 2021, when the BIR exhibited more volatility. After an increase to -0.45% in December, it fell back to -0.6% in February 2022. As a result, beside the short increase at the beginning of the year, the interest rate differential of the BIR to the 1-month Euribor rate has remained relatively stable at around -7 basis points in March 2022.

Graph 2.6: **Bulgaria - Annual effective interest rate spread to 1-M Euribor**

(basis points, monthly values)



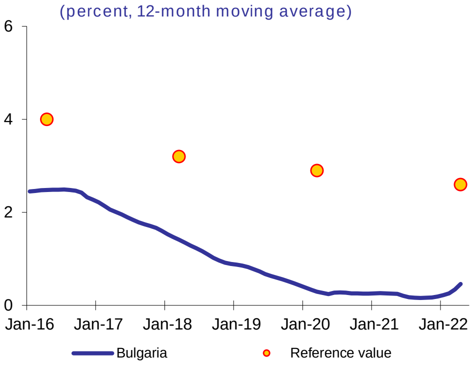
Source: Eurostat and National Bank of Bulgaria.

2.5. LONG-TERM INTEREST RATES

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

Graph 2.7: **Bulgaria - Long-term interest rate criterion**

(percent, 12-month moving average)



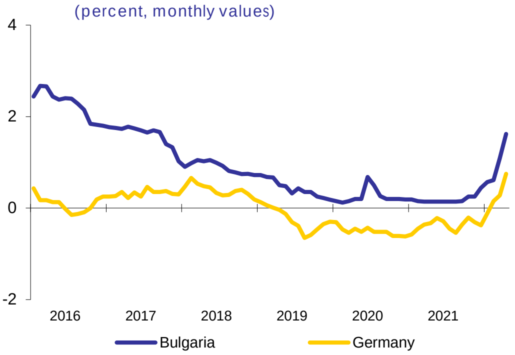
Source: European Commission.

The Bulgarian 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion was below the reference value in the 2020 convergence assessment of Bulgaria. Since then the interest rates has been very low and very stable. It stood at 0.3% at the end of 2020 and edged down to 0.2% by the end of 2021. In April 2022, the reference value, given by the average of long-term interest rates in France, Finland and Greece plus 2 percentage points, stood at 2.6%. At the same time, the 12-month moving average of the yield on the Bulgarian benchmark bond stood at 0.5%, i.e. 2.1 percentage points below the reference value.

The Bulgarian long-term interest rate has been very low and rather stable since the beginning of 2020, remaining within a band of 0.1-0.4%. There was only a brief peak in June-July, 2020, when the interest rate increased to 0.7%. The low long-term interest rates reflect the loose monetary policy in the euro area. The spread to German long-term benchmark rates has also remained broadly stable within a band of 0.4-0.8 of a basis point, with a brief episode above 100 basis points in mid-2020. At the beginning of 2022, Bulgarian long-term interest rate started to increase and reached 1.6% in April. The German long-term interest rate also increased, but by a slightly smaller amount, resulting in the spread breaking through the above-mentioned bounds to 0.9 of a basis point.

Graph 2.8: **Bulgaria - Long-term interest rates**

(percent, monthly values)



Source: Eurostat.

2.6. ADDITIONAL FACTORS

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

In November 2021, the Commission published its last Alert Mechanism Report (AMR 2022) under the Macroeconomic Imbalance Procedure (MIP – see also Box 1.7), which concluded that it was not necessary to carry out further in-depth analysis in the context of the MIP. In the past, vulnerabilities in the financial sector were coupled with high indebtedness and non-performing loans in the corporate sector. Consistent policy action and a favourable macroeconomic environment have reduced risks and vulnerabilities before the onset of the COVID-19 crisis. Taking into account the assessment in its 2020 In-Depth Review, the Commission concluded that Bulgaria was experiencing no imbalances. Notwithstanding the progress made, non-performing loans are still relatively high albeit declining in the segment of corporate loans granted by domestically owned banks.

Increased vulnerabilities in the housing market stem from the higher, although still contained, risk for overvaluation. House prices accelerated to a growth rate of 8.7% in 2021. In parallel, mortgage growth increased rapidly to 16.5% in 2021, while as a percentage of GDP, mortgages remain low compared to the euro area. The European Systemic Risk Board has issued a warning to Bulgaria in February 2022 to address these risks, as it considers macroprudential polices only partially appropriate and sufficient. Based on similar concerns, the Bulgarian National Bank increased the countercyclical capital buffer in March 2022, from 0.5% to 1% as of 1 October 2022, and 1.5% in effect from the beginning of 2023.

Bulgaria submitted its recovery and resilience plan on 15 October 2021. The Commission's positive assessment on 7 April 2022 and the Council's approval on 4 May, paved the way for the implementation of the Recovery and Resilience Plan and the disbursement of EUR 6.3 billion in grants ([37]) over the period 2022-2026, which is equivalent to 10.2% in 2019 GDP.

Bulgaria's plan includes an extensive set of mutually reinforcing reforms and investments (56 investments and 47 reforms) that contribute to effectively addressing all or a significant subset of the economic and social challenges outlined in the country-specific recommendations addressed to Bulgaria by the Council in the European Semester in 2019 and 2020.

The plan will address key macro-economic challenges such as social inclusion, education and skills, healthcare, decarbonisation and digital transition and business environment. Key investments are included in renewable energy production, electricity storage and interconnection capacities, energy efficiency of buildings and in the digitalisation of public administration and digital skills. Key reforms include the introduction of a framework for coal phase-out, the liberalisation of the electricity market, a comprehensive educational reform, and a strengthening of the minimum income scheme. A significant number of reforms and investments are expected to reinforce the institutional framework. These include reforms to improve the functioning of the judiciary system and the anti-corruption bodies, to strengthen anti-money laundering and insolvency frameworks, public procurement, whistle-blower protection, regulation of lobbying, e-government and integrity of public servants.

The plan devotes 58.9% of its total allocation to measures supporting climate objectives and 25.8% to the digital transition, all while respecting the do no significant harm principle.

The implementation of the investments in the Bulgarian plan, along with other investments under NextGenerationEU, is estimated to raise Bulgaria's GDP by 1.9% to 2.9% by 2026, of which 0.6% due to the positive spillover effects of the coordinated implementation of NextGenerationEU across Member States (Pfeiffer et al. 2021) ([38]). This does not take into account the positive impact of structural reforms on growth.

2.6.1. Developments of the balance of payments

Bulgaria's external balance (i.e. the combined current and capital accounts) shrank, but remained positive at 1.5% and 0.3% of GDP in 2020 and 2021, respectively. The reduction was driven by the current account, which turned slightly negative in 2020 and 2021, from a surplus of 1.9% in 2019. Secondary income, which largely consists of remittances from abroad, fell roughly by 50% in 2020 and 2021 possibly due to the worsened economic situation of nationals residing abroad. In addition to the deterioration of the secondary income balance, the deterioration of the external position in 2020 was also caused by an abrupt

[37] The maximum financial contribution for Bulgaria in ANNEX IV of Regulation (EU) 2021/241 is determined at EUR 6.3 billion, but 30% of the total amount available shall be recalculated with actual data by 30 June 2022..

[38] See Pfeiffer P., Varga J. and in 't Veld J. (2021), "Quantifying Spillovers of NGEU investment", European Economy Discussion Papers, No. 144 and Afman et al. (2021), "An overview of the economics of the Recovery and Resilience Facility", Quarterly Report on the Euro Area (QREA), Vol. 20, No. 3 pp. 7-16.

Table 2.4:

Bulgaria - Balance of payments **(percentage of GDP)**

	2016	2017	2018	2019	2020	2021
Current account	3.1	3.3	0.9	1.9	-0.1	-0.4
of which: Balance of trade in goods	-2.0	-1.5	-4.8	-4.7	-3.2	-4.9
Balance of trade in services	7.0	5.8	7.3	8.0	5.0	6.6
Primary income balance	-5.0	-4.3	-4.8	-4.2	-3.5	-3.3
Secondary income balance	3.1	3.3	3.2	2.9	1.5	1.1
Capital account	2.2	1.0	1.1	1.4	1.5	0.7
External balance [1)]	5.3	4.3	2.0	3.3	1.5	0.3
Financial account	9.0	3.9	5.6	3.9	4.1	4.9
of which: Direct investment	-1.2	-2.5	-1.3	-2.0	-4.5	-1.7
Portfolio investment	-1.4	5.4	2.8	2.6	1.2	3.4
Other investment [2)]	4.5	1.2	1.7	4.2	-2.1	-2.1
Change in reserves	7.1	-0.2	2.4	-0.9	9.4	5.3
Financial account without reserves	1.9	4.1	3.1	4.8	-5.4	-0.4
Errors and omissions	3.8	-0.4	3.5	0.6	2.6	4.6
Gross capital formation	19.0	19.8	21.2	21.0	20.3	19.6
Gross saving	23.5	24.9	22.2	22.9	19.9	18.5
Net international investment position	-47.5	-43.0	-37.0	-30.2	-27.1	-19.8

1) The combined current and capital account.

2) Including financial derivatives.

Sources: Eurostat, European Commission calculations, Bulgarian National Bank.

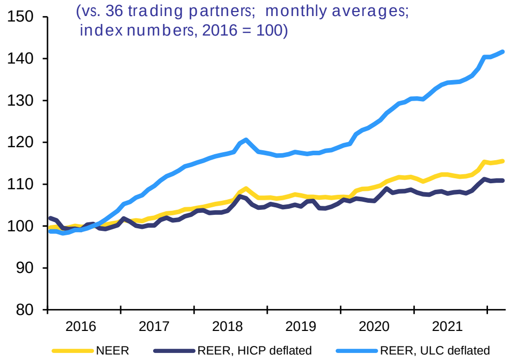
contraction in exports of services, reflecting the imposed travel restrictions and the weaker external demand for tourist services. The trade balance became less negative than in the preceding years, as nominal imports contracted more than nominal exports on account of positive terms of trade effects. The higher share of mineral fuels in imports than in exports, combined with the 31% oil price drop in 2020, partially explains these terms of trade gains. In 2021, the external balance of services improved, but remained below 2019 levels as a share of GDP, as the recovery in tourism revenues was incomplete. The balance of goods deteriorated in 2021 as imports of goods increased faster than exports of goods. The recovery in economic activity and private consumption spurred growth in imports of intermediate, investment and consumer goods. Exports of goods also grew strongly in 2021 and benefitted from further gains in terms of trade. The capital account remained in surplus.

The financial account, net of official reserves, deteriorated in 2020 and then improved in 2021. In March 2020, as part of a package of measures to preserve the stability of the banking system at the onset of the COVID-19 pandemic, the Bulgarian National Bank imposed a limit on commercial banks' foreign exposures. These measures to increase the liquidity in the banking system resulted in a simultaneous net outflow of other investments and an increase in official reserves at the central bank. In 2021, the banking sector maintained high liquidity and capital adequacy ratios and improved profitability. This positive development led to renewed investment in other assets abroad by the foreign-owned banks, while official reserves kept growing, albeit less strongly. The net inflow of Foreign Direct Investment (FDI) remained positive with positive contributions from debt instruments in 2020 and from reinvested earnings in 2020 and 2021.

The negative net international investment position continued to shrink rapidly in 2020-2021. Net external liabilities consist mostly of FDI equity, which have been relatively stable as a share of GDP after the crisis of 2009.

In 2020-2021, measures of competitiveness exhibited different dynamics depending on the deflator used. The rate of appreciation of the real effective exchange rate (REER) deflated by ULC, accelerated, as labour hoarding pushed up labour costs. [39] The appreciation in REER deflated by HICP has been more moderate, reflecting moderate price inflation until mid-2021. The swift acceleration of inflation at the end of 2021 has not caused real appreciation vis-à-vis the rest of the world, since inflation picked up globally, including in major trade partners.

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



Source: European Commission.

The swift rebound of exports following their decline in Q2-2020, caused by the global demand slump, indicates that exporting firms managed to maintain their export market share. The global hikes in prices of energy and other materials pose challenges to domestic producers to remain competitive, in addition to the problems caused by supply bottlenecks. So far, terms of trade developments have been favourable for exporters. The high energy intensity of the economy, however, bear some risks for the economic outlook. Firms are expected to respond to the cost-push shock by restricting nominal wage growth and postponing new hiring and investment decisions. This cost-saving strategy to maintain competitive position is set to be more prominent in manufacturing, while the services sector is expected to pass through higher costs to final consumers. Apart from the direct and indirect impact of the war on goods exports, Bulgarian firms are forecast to maintain market shares abroad.

According to the Commission's Spring 2022 Economic Forecast, the current account balance is expected to deteriorate further to -1.8% in 2022 and remain at that level in 2023.

2.6.2. Market integration

The economy is well integrated with the euro area through trade and investment linkages. After a period of decline between 2017 and 2020, the ratio of trade openness rebounded to close to 64% in 2021, which is close to the peak of above 68% in 2017. Bulgaria thus remains a relatively open economy. Trade with the euro area was close to 29% of total trade in 2021. Outside the EU, Bulgaria's main trading partners are Turkey and Russia (especially for energy imports).

Net FDI inflows increased, but remained relatively low at 4.5% of GDP in 2020 and 1.7% of GDP in 2021. The stock of FDI amounted to 75% of GDP in 2020 and 71% in 2021. The decline in 2021 is explained by the high nominal GDP growth. 26% of all FDI stock is directed to industry (excluding construction), 22% are invested in real estate, while the trade sector attracted 15% of total FDI stock.

The business environment is generally not supportive of investment, and institutional quality remains a challenge. According to the World Bank's Worldwide Governance Indicators (2020), Bulgaria ranks low in voice and accountability, government effectiveness, rule of law and control of corruption compared with the average of the five euro area Member States with the lowest scores. [40] Bulgaria also ranks relatively low in the World Bank's Ease of Doing Business indicator, where it maintained its rank of 61 between 2019 and 2020, but in a longer perspective the trend has been negative [41]. In addition, institutions remain among the least performing areas in the Global Competitiveness Index. In the Council Implementing Decision, approving the Recovery and Resilience Plan, the authorities have committed to a number of measures that address challenges identified in the Cooperation and Verification Mechanism (CVM), the Rule of Law Report, and also the recitals to the country-specific recommendations. This includes problems with the functioning of the judiciary, corruption and issues with the accountability and

[39] The REER based on unit labour costs should be interpreted with prudence as unit labour costs were distorted by labour retention schemes in some countries, including Bulgaria.

[40] A Member State is considered to have a 'low' ('high') ranking compared with the average five euro area Member States with the lowest scores for each indicator if its score is at least 0.3 percentage points lower (higher) than that of the average of this euro area group.

[41] The World Bank Doing Business (DB) program was paused in 2021. The programme will continue with a new governance and improved accountability and transparency under the name Business Enabling Environment (BEE). The first edition of the BEE is expected in 2023.

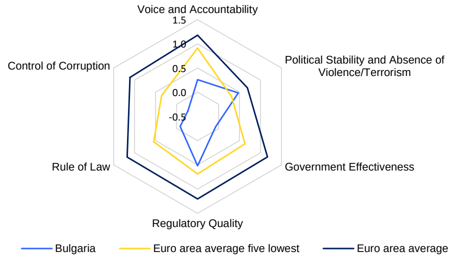
Table 2.5:
Bulgaria - Market integration

	2016	2017	2018	2019	2020	2021
Trade openness [1] (%)	64.4	68.0	66.5	64.2	57.1	64.2
Trade with EA in goods & services [2)+3)] (%)	29.4	30.2	30.2	28.5	25.4	28.6
World Bank's Ease of Doing Business Index rankings [4]	39	50	59	61	61	-
IMD World Competitiveness Ranking [5]	50	49	48	48	48	53
Internal Market Transposition Deficit [6] (%)	1.7	1.3	0.7	0.6	1.6	-
Real house price index [7]	105.3	109.3	113.8	118.3	124.4	130.5

1) (Imports + Exports of goods and services / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics, Balance of Payments).
2) (Imports + Exports of goods with EA-19 / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).
3) Trade in services with EA-19 (average credit and debit in % of GDP at current prices) (Balance of Payments).
4) Data not available for 2021. The Ease of Doing Business report by the World Bank was discontinued in September 2021.
5) International Institute for Management Development (IMD).
6) Percentage of internal market directives not yet communicated as having been transposed, relative to the total.
(November data, as of 2016 date refers to the year of publication).
7) Deflated house price index (2015=100) (Eurostat).
Sources: Eurostat, World Bank, International Institute for Management Development, European Commission calculations.

criminal liability of the Prosecutor General. For the latter, important elements are the introduction of necessary safeguards and guarantees for an independent investigation of the Prosecutor General and his deputies; possibility for a judicial review of a prosecutor's decision not to open an investigation, and annual reporting by the Prosecutor General on investigations and convictions in corruption cases. Anti-corruption measures include the set-up of a new anti-corruption body with criminal investigation powers, introduction of legislative measures to protect whistle-blowers and to regulate lobbying activities, and the establishment of an integrity verification mechanism for civil servants occupying positions that have a high corruption risk.

Graph 2.10: **Bulgaria - 2020 World Bank's Worldwide Governance Indicators**



Note: Estimate of governance ranges from -2.5 (weak) to 2.5 (strong).
Source: World Bank.

Labour and skills shortages as well as skills mismatches relative to labour market needs represent a significant barrier to business investment and limit productivity gains. The uptake of digital technologies is slow in both public and private sectors and Bulgaria ranks last among EU Member States in digital skills. There are measures in the Recovery and Resilience Plan focusing on improving the labour market relevance of the education and lifelong-learning systems, including targeting the development of digital skills, and more broadly on advancing digitalisation. This should also help to alleviate some of the labour market bottlenecks and to modernise the economy.

The 4th Anti-money Laundering Directive imposed transposition by 26 June 2017. Bulgaria communicated to the Commission several adopted measures to transpose the Directive between April 2018 and November 2019. The Commission's analysis of the communicated measures concluded that the Directive had been fully transposed. An assessment of the concrete implementation and effective application of the 4th Anti-money Laundering Directive in Bulgaria is at present ongoing.

As regards the 5th Anti-money Laundering Directive, whose transposition deadline elapsed on 10 January 2020, Bulgaria has notified national transposition measures and declared the transposition to be complete. The Commission is at present completing its analysis of whether there are any potential completeness or conformity issues in the transposition or implementation of the Directive.

The COVID-19 crisis has entailed employment losses and increased inactivity rates. More severe adverse outcomes have largely been avoided through the swift transition to short-time work schemes that were supported by the state. Unemployment increased in Q2-2020 and then broadly stabilised until the end of 2021. The COVID-19 crisis highlighted the existing social vulnerabilities, such as a high share of population at risk of poverty and social exclusion, high levels of inactivity in some population groups (e.g. NEETs, Roma), combined with regional disparities and skills mismatches. The high social inequalities weigh on the prospects for fair and inclusive growth.

Demographic developments strongly affect the labour market, and may constrain future economic growth. The population has shrunk by around 10% for the past decade on account of both mortality due to ageing and emigration. Furthermore, the share of population in working age (15-64 year) is also on a declining path, coming down from 68.5% in 2010 to 63.9% in 2020.

The financial sector in Bulgaria is smaller and less developed than in the euro area. Relative to GDP, assets managed by the financial sector are a quarter of that of the euro area. The financial sector has grown since 2016, but not at the same pace as in the euro area. Banking dominates the Bulgarian financial sector and makes up more than 53% of the financial sector's assets. The central bank is the second largest holder of financial assets with a share of 26%, more than all non-banking financial intermediaries together. Although these shares are larger than in the euro area, they compare well with the five euro-area Member States with the smallest financial sectors.

Table 2.6:
Bulgaria - Allocation of assets by financial sub-sector

						Ratio to GDP (%)
	BG		EA		EA 5 smallest	
	2016	2020	2016	2020	2016	2020
Financial corporations (total)	184	191	722	796	177	215
Central bank	49	50	45	78	37	61
Monetary financial institutions	99	102	286	311	97	98
Other financial intermediaries	17	17	202	179	20	28
Non-MMF investment funds[1)]	1	2	100	127	4	5
Insurance co. and Pension Funds	18	21	90	102	18	23
						Share of total (%)
	BG		EA		EA 5 smallest	
	2016	2020	2016	2020	2016	2020
Central bank	27	26	6	10	21	29
Monetary financial institutions	54	53	40	39	55	46
Other financial intermediaries	9	9	28	22	11	12
Non-MMF investment funds	1	1	14	16	2	2
Insurance co. and Pension Funds	10	11	12	13	10	11

1) MMF stands for money market funds.
Source: Eurostat.

The insurance and the pension-fund sector in Bulgaria is much smaller than in the euro area, relative to GDP. However, the sector's share of the total financial sector is comparable to that of the euro area. Since end-2016, the Bulgarian sector has increased its holdings of financial assets by 3.5 % of GDP, in the euro area it increased by 12.3 percentage points. Nevertheless, the financial position of the National Bureau of Bulgarian Motor Insurers has come into question due to delays in the claims handling process in one undertaking. This has led to monitoring by the international Council of Bureaux, which is still ongoing. Moreover, the introduction of the bonus-malus system has not progressed in the last two years. The investment-funds sector plays a very small role in the Bulgarian financial system, but its size is comparable to those of the five euro-area Member States with the smallest financial sectors.

Table 2.7:
Bulgaria - Financing of the economy1)

						Ratio to GDP (%)
	BG		EA		EA 5 smallest	
	2016	2020	2016	2020	2016	2020
Liabilities (total)	393	376	743	770	324	335
Loans	127	116	238	236	115	112
Non-financial co. debt securities	4	3	12	15	3	4
Financial co. debt securities	1	1	74	68	11	12
Government debt securities	25	22	83	95	51	57
Listed shares	12	10	65	73	17	18
Unlisted shares	68	73	186	193	55	56
Other equity	93	88	51	56	42	48
Trade credits and advances	64	64	33	35	29	29
						Share of total (%)
	BG		EA		EA 5 smallest	
	2016	2020	2016	2020	2016	2020
Loans	32	31	32	31	35	33
Non-financial co. debt securities	1	1	2	2	1	1
Financial co. debt securities	0	0	10	9	3	3
Government debt securities	6	6	11	12	16	17
Listed shares	3	3	9	9	5	5
Unlisted shares	17	20	25	25	18	18
Other equity	24	23	7	7	13	14
Trade credits and advances	16	17	4	5	9	9

1) The table focuses on the financing needs of a country and how these are met by the financial system. The table is constructed from the liabilities of all economic sectors, but only considers loans, debt securities, equity and trade credits. The sum of liabilities in the table only reflects the total for the liabilities considered.
Source: Eurostat.

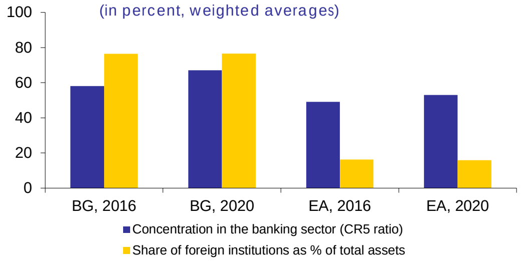
As to the financing of the economy, Bulgaria has less developed credit and equity markets relative to GDP than countries in the euro area, and market financing (debt securities and listed shares) is relatively under developed. However, Bulgaria is still fully comparable to the five euro-area Member States with the smallest national capital markets. Loans are the dominant source of funding and make up 116% of GDP in 2020, compared to 240% of GDP in the euro area. Still, corporate debt surpasses the fundamental threshold, although the gap has been narrowing and the prudential benchmark is satisfied. ([42]) Equity and private-sector-debt markets are very small compared to those of the euro area and represent only 14% of GDP altogether. This compares to 83% for private-sector debt and 73% for listed stocks in the euro area. Government debt is significantly lower than in the euro area. In terms of share in the sum of liabilities, loans in Bulgaria are comparable to that of the euro area. For securities, the differences

([42]) Methodology to compute the fundamentals-based and the prudential benchmarks based on Bricongne et al. (2017).

reflect the smaller share of market funding available in Bulgaria.

Bulgaria's banking sector is well integrated into the euro-area financial sector, in particular through a high level of foreign ownership in the banking system. The share of foreign-owned institutions in total bank assets stood at 77% in 2020. Bank concentration, as measured by the market share of the five largest credit institutions in total assets, has increased significantly since 2016, and reached almost 67% in 2020. This is 14 percentage points above the euro area average in 2020. In parallel with the inclusion of the Bulgarian lev in the ERM II, the Bulgarian National Bank entered into a close cooperation with the ECB, effectively joining the Banking Union. As of 1 October 2020, Bulgaria joined the Single Resolution Mechanism, and the ECB became responsible for the direct supervision of the significant institutions in Bulgaria, as well as the oversight of less significant institutions.

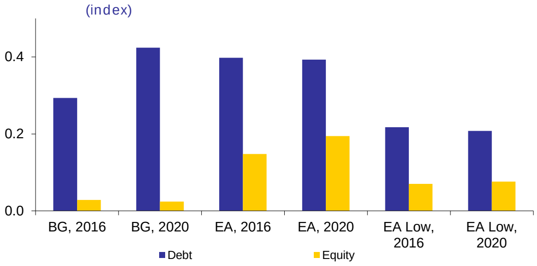
Graph 2.11: **Bulgaria - Foreign ownership and concentration in the banking sector**
(in percent, weighted averages)



Source: ECB, Structural financial indicators.

Although intra-EU integration in equity and debt markets, as measured by the home bias in portfolio investments, are in general relatively low across EU Member States, Bulgaria is commensurate to levels of integration of the average euro-area Member State in debt markets. [43] Moreover, integration in this market segment has improved markedly between 2016 and 2020. Concerning portfolio investments in equity, however, the home bias is very strong in Bulgaria relative to euro-area Member States. Almost all investments in equity markets take place domestically.

Graph 2.12: **Bulgaria - Intra-EU integration in equity and debt portfolio investment**
(index)



Note: The chart shows the extent of home bias in debt and equity markets. A value index of 1 implies 'full integration' with the financial markets of other Member States, while 0 denotes 'no integration'.

Source: FinFlows database: European Commission, Joint Research Centre (JRC).

[43] Home bias in portfolio investments measures the average propensity of investors in a Member State to invest domestically as compared with investing in other EU countries. The indicator ranges between 0 and 1, with a value of 0 indicating that investors prefer domestic over foreign assets. The inverse of the home bias can be interpreted as one measure of financial integration among EU countries.

3. CZECHIA

3.1. LEGAL COMPATIBILITY

3.1.1. Introduction

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

Following the Commission's 2020 Convergence Report, the ČNB Law was amended ([44]). However, since there have been no amendments as regards the incompatibilities highlighted in the Commission's 2020 Convergence Report, the comments made in the latter report are repeated also in this year's assessment.

3.1.2. Central Bank independence

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

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

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

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

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

[44] The amendments stem from the Act. No. 219/2021 Coll., Act No. 238/2020 Coll., Act No. 353/2021 Coll. and Act No. 417/2021 Coll.

3.1.3. Prohibition of monetary financing and privileged access

Pursuant to Article 33a of the ČNB Law, where the Financial Market Guarantee System has insufficient funds to carry out its duties arising from the legislation on deposit insurance and this situation might jeopardise the stability in the financial market, the ČNB may, upon request, exceptionally provide it with short-term credit, for a period of up to three months, guaranteed by government bonds or other securities underwritten by the Government and owned by the Financial Market Guarantee System. The Financial Market Guarantee System qualifies as a "body governed by public law" within the meaning of Article 123(1) of the TFEU, being closely dependent on the public sector entities referred to in Article 123(1) of the TFEU. The governing body of the Financial Market Guarantee System is composed of two employees of the Czech National Bank, two employees of the Ministry of Finance, and one representative appointed on a proposal from the Czech Banking Association. Although only a minority of the members of the Financial Market Guarantee System's governing body are representatives of the Ministry of Finance, the Ministry of Finance has the right to appoint and dismiss all the members of the Financial Market Guarantee System's governing body. Therefore, the provisions laid down in Article 33a of the ČNB Law regarding the possibility of ČNB granting short-term credit to the Financial Market Guarantee System are not compatible with the monetary financing prohibition and the relevant legal framework should be amended accordingly.

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

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

3.1.4. Integration in the ESCB

Objectives

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

Tasks

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

- definition of monetary policy and monetary functions, operations and instruments of the ECB/ESCB (Articles 2(2)(a), 5(1) and 23 to 26, 28, 29, 32, 33 of the ČNB Law);
- conduct of exchange rate operations and the definition of exchange rate policy (Articles 35 and 36 of the ČNB Law);
- holding and management of foreign reserves (Articles 35(c), 36 and 47a of the ČNB Law);
- non-recognition of the competences of the ECB and of the Council on the banknotes and coins (Article 2(2)(b), Articles 12 to 22 of the ČNB Law);
- ECB's right to impose sanctions (Article 46a of the ČNB Law);
- the possibility for Parliament to demand amendments to the report of the ČNB on monetary policy developments and to determine the content/scope of the extraordinary report in view of the absence of a specification regarding the non-forward-looking nature of the reports (Article 3 of the ČNB Law).
- There are also some imperfections regarding:

- the partial absence of reference to the role of the ECB and of the EU in the collection of statistics (Article 41);
- non-recognition of the role of the ECB in the functioning of the payment systems (Articles 2.2 c), 38 and 38a of the ČNB Law);
- non-recognition of the role of the ECB and of the Council in the appointment of the external audit of the ČNB (Article 48(2) of the ČNB Law);
- absence of an obligation to comply with the Eurosystem's regime for the financial reporting of NCB operations (Article 48 of the ČNB Law);
- non-recognition of the role of the ECB in the field of international cooperation (Article 2(3) of the ČNB Law).

3.1.5. Assessment of compatibility

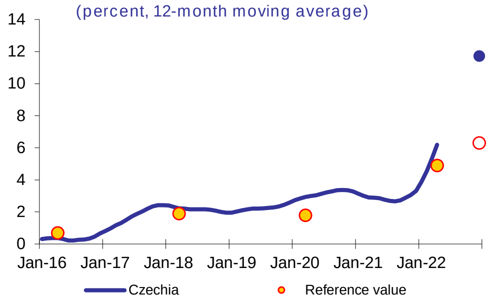
As regards the independence of the central bank, the prohibition of monetary financing and the integration of the central bank in the ESCB at the time of euro adoption, the ČNB Law is not fully compatible with the compliance duty under Article 131 of the TFEU. The Czech authorities are invited to remedy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

3.2. PRICE STABILITY

3.2.1. Respect of the reference value

The 12-month average inflation rate, which is used for the convergence assessment, was above the reference value at the time of the last convergence assessment of Czechia in 2020. After a gradual increase up to 3.4% in October 2020, it steadily decreased to 2.7% in summer 2021, before increasing steeply to 6.2% in April 2022. In April 2022, the reference value was 4.9%, calculated as the average of the 12-month average inflation rates in France, Finland, and Greece plus 1.5 percentage points. The corresponding inflation rate in Czechia was 6.2%, i.e. 1.3 percentage points above the reference value. According to the Commission's Spring 2022 Economic Forecast, the 12-month average inflation rate is projected to remain well above the reference value in the months ahead.

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



Note: The dots at the right end of the chart show the projected reference value and 12-month average inflation rate of the country in December 2022. The reference values for 2016, 2018 and 2020 refer to the reference values calculated in the previous Convergence Reports.

Source: Eurostat, Commission's Spring 2022 Economic Forecast.

3.2.2. Recent inflation developments

The annual HICP inflation rate experienced considerable volatility in the past two years. After peaking at 3.8% in January 2020, it followed a broad downward path in 2020 to reach a low of 2.1% in February 2021. The deceleration was mainly due to declining energy prices. HICP inflation then increased steadily from 2.2% to 5.4% at the end of 2021, exceeding the central bank's upper tolerance band of 3.0% continuously from August onwards ([45]). It surged further to 13.2% in April 2022. The acceleration of inflation since the beginning of 2021 is explained by a combination of strong domestic demand and external factors related to supply chain bottlenecks and surging energy prices. Since end 2018, annual HICP inflation has been higher in Czechia than in the euro area.

Core inflation (measured as HICP inflation excluding energy and unprocessed food prices) was above headline inflation in 2020 and 2021. This was mainly due to on average rather low energy inflation and slowdown of the food prices. The annual core inflation oscillated between 3.3% and 4.2% in 2020. It then decelerated moderately up to summer 2021 due services inflation before accelerating steadily to reach a rate of 6.4% in December and 10.4% in April 2022. Prices of services slowed down between summer 2020 and September 2021, but started gathering pace afterwards. The surge in core inflation since summer 2021 has been broad-based, with services, non-energy industrial goods and processed food prices all increasing strongly.

([45]) It is important to note that the ČNB's tolerance band is based on CPI inflation, which was even higher during the same period due to a different basket composition.

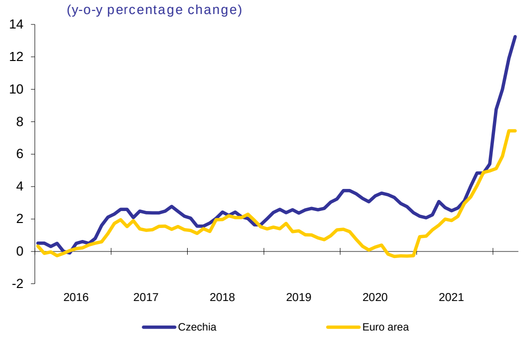
Table 3.1:
Czechia - Components of inflation

	(percentage change)[1]							weights in total
	2016	**2017**	**2018**	**2019**	**2020**	**2021**	**Apr-22**	**2022**
HICP	0.6	2.4	2.0	2.6	3.3	3.3	6.2	1000
Non-energy industrial goods	0.8	0.6	0.6	0.5	2.6	4.3	6.7	269
Energy	-2.5	1.2	3.2	4.8	-1.5	1.7	12.1	117
Unprocessed food	0.5	2.2	2.3	1.4	8.4	-1.3	0.3	52
Processed food	1.2	4.4	1.7	2.7	5.0	4.3	5.5	249
Services	1.5	2.9	2.6	3.4	3.6	3.1	5.1	314
HICP excl. energy and unproc. food	1.2	2.6	1.8	2.3	3.7	3.8	5.7	831
HICP at constant tax rates	0.4	2.6	1.9	2.6	3.2	3.4	6.0	1000
Administered prices HICP	1.4	1.1	1.5	3.7	3.6	0.8	4.5	145

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

Source: Eurostat, European Commission calculations.

Graph 3.2: **Czechia - HICP inflation**



Source: Eurostat.

3.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and growth developments

Due to the negative impact of the global pandemic, the Czech economy decelerated in 2020, when real GDP declined by 5.8%. The Czech economy rebounded by 3.3% in 2021, as activity benefited from the easing of pandemic-related restrictions. Private consumption was the main driver of GDP growth in 2021, supported by low unemployment and a pick-up in real disposable income growth, partially due to income tax changes. Private consumption is expected to remain the main driver of the economic recovery, reflecting high employment levels, pent-up demand and a declining saving rate of households. A sharp increase in the cost of living, in particular due to high energy prices is, however, likely to weigh on domestic spending. Gross fixed capital formation declined strongly in 2020 (by 7.5%), largely influenced by low investment activity in the automotive industry. Facing further problems related to supply chains, investment activity remained low during much of 2021 and started rebounding only towards the end of 2021.

According to the Commission’s Spring 2022 Economic Forecast, real GDP is expected to increase by about 1.9% in 2022 and 2.7% in 2023. Consequently, the Czech economy is projected to reach the pre-pandemic output level only during the second quarter of 2023.

In order to help combat the negative effects of the COVID pandemic on the economy, the fiscal stance was strongly expansionary in 2020 and in 2021 ([46]), through employment retention schemes as well as support targeted at the most affected sectors. The fiscal stance is expected to turn neutral in 2022 (+0.1% of GDP) as the expenditure financed through the RRF and other EU grants contributes positively by around 1.0% of GDP. Still, the phase-out of the pandemic-related measures is to help offset some of the inflationary pressures. Additional measures to cope with the inflow of people fleeing Ukraine as well as the support to households affected by the high inflation are also to provide an expansionary contribution. Government consumption contributed positively to GDP growth with a real growth of 3.4% in 2020 and 1.6% in 2021 but its real growth pace is expected to slow down to 0.6% in 2022, before picking up to 1.3% in 2023. On the other hand, public investments growth rate is likely

([46]) The fiscal stance is measured as the change in primary expenditure (net of discretionary revenue measures), excluding COVID-19 crisis-related temporary emergency measures but including expenditure financed by non-repayable support (grants) from the Recovery and Resilience Facility and other EU funds, relative to medium-term potential growth. A negative (positive) sign of the indicator corresponds to an excess (shortfall) of primary expenditure growth compared with medium-term economic growth, indicating an expansionary (contractionary) fiscal policy

Table 3.2:

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

	2016	2017	2018	2019	2020	2021	2022[1)]	2023[1)]
HICP inflation								
Czechia	0.6	2.4	2.0	2.6	3.3	3.3	11.7	4.5
Euro area	0.2	1.5	1.8	1.2	0.3	2.6	6.1	2.7
Private consumption deflator								
Czechia	0.4	2.3	2.5	2.8	2.8	3.1	11.7	5.4
Euro area	0.4	1.3	1.5	1.1	0.5	2.3	5.8	2.7
Nominal compensation per employee								
Czechia	4.0	7.2	8.1	7.2	3.2	5.7	2.4	5.3
Euro area	1.2	1.7	2.1	2.1	-0.7	4.1	3.6	3.5
Labour productivity								
Czechia	0.9	3.6	1.8	2.8	-4.2	3.2	-0.3	2.4
Euro area	0.4	1.0	0.2	0.3	-4.9	4.2	1.4	1.5
Nominal unit labour costs								
Czechia	3.0	3.5	6.1	4.3	7.7	2.4	2.8	2.8
Euro area	0.8	0.7	2.0	1.9	4.4	0.0	2.2	2.0
Imports of goods deflator								
Czechia	-3.8	0.6	-0.6	0.6	-1.0	4.9	8.2	2.9
Euro area	-3.3	3.3	2.6	-0.5	-3.8	9.6	13.2	0.8

1) Commission Spring 2022 Economic Forecast.

Source: Eurostat, Commission's Spring 2022 Economic Forecast.

to accelerate in 2022 and 2023 with the help of EU funds, with investments-to-GDP ratio expected to increase towards a past decade high of 5%.

The ČNB conducts monetary policy within an inflation targeting framework. The use of the exchange rate as an additional monetary policy instrument was discontinued in April 2017. The decision was supported by macroeconomic data and forecasting scenarios indicating a sustainable fulfilment of the 2% inflation target over the forecast horizon. After a hike in February 2020, the ČNB eased significantly its main policy rate (the 2-week repo rate) cutting it by 200 basis points in three steps in March and May to 0.25%, to counter the impact of the pandemic on the Czech economy. The key policy rate was kept at this low level until June 2021. Due to strongly increasing domestic inflation pressures, the ČNB Board raised its policy rates as from summer 2021. Overall, the main policy rate increased by 550 basis points to reach 5.75% after the ČNB Board's decision at the meeting in early May 2022. From early March 2022, the ČNB has been repeatedly active in the exchange rate market (stabilising intervention) in the aftermath of the Russia's invasion of Ukraine ([47]), although shortly, on the back of self-stabilising mechanisms in the exchange rate market.

Wages and labour costs

The labour market continued to perform well in 2020 and 2021. Despite its tightness, Czechia's labour market was in a good position to absorb the impact of the crisis. Cushioned by temporary job retention schemes supporting self-employed and companies, the unemployment rate increased only slightly to 2.6% in 2020 (annual average) and to 2.8% in 2021. As a result, nominal wage growth continued to be buoyant in 2020 and 2021 (supported by increases for public sector employees). Although wage growth moderated significantly in 2020 due to the impact of the pandemic and supply chain disruptions, the still high growth rate compared to the historical average is mainly attributable to persisting labour shortages, due to e.g. demographic factors, and to an increase in the minimum wage ([48]). Wages in both the public and private sector showed similar growth dynamics in 2020 and 2021.

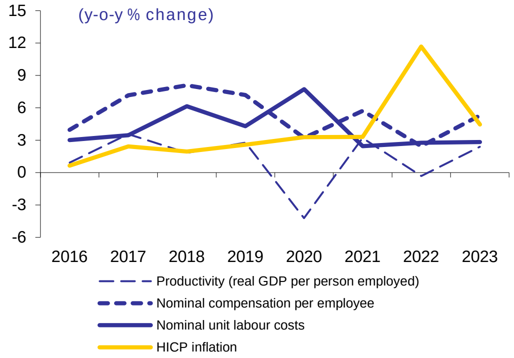
On the sectoral level, differences in wage growth are observed. Notably, the sectors that have been most adversely affected by supply chain disruptions and that have faced relatively less labour shortages experienced lower wage

([47]) The details are provided in Section 3.4 on exchange rate stability.

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

increases. The RRP will support Czechia in overcoming such sectoral imbalances by promoting policies that are inclusive and targeted at boosting skills, fostering the green and digital transition, stimulating entrepreneurship and diminishing current macroeconomic risks stemming for instance from import dependencies in energy.

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



Source: Eurostat, Commission's Spring 2022 Economic Forecast.

Labour productivity declined in 2020 and recovered only partially in 2021. As compensation per employee kept growing at a faster pace than productivity, nominal unit labour costs grew by 7.7% in 2020, and 2.4% in 2021. According to the Commission’s Spring 2022 Economic Forecast wage growth is expected to have picked up in 2021, grow slightly less in 2022 and increase more again in 2023, while productivity remains subdued in 2022 with an expected pick-up in 2023. Unit labour cost growth will also notably depend on the way labour shortages are addressed and the scope companies have to increase wages, during this time of elevated inflation. In the medium- to long term, inflation is expected to lead to increases in nominal wages. In the short-term, wage growth is, however, expected to be somewhat limited given inflation, supply chain disruptions and overall macroeconomic uncertainty reducing profit margins and therefore limiting the possibilities of companies to increase wages. Overall, the risks of significant second-round effects of wage increases – a wage-price spiral – appear to be constrained.

External factors

Given the size and openness of the Czech economy, import prices have a sizeable effect on domestic price formation. The imports of goods deflator fell by 1% in 2020, mainly due to declining oil prices. The fall was more moderate than in the euro area (-3.8%). In 2021, goods’ import prices increased by about 4.9%, driven by prices for machinery and transport equipment as well as increasing energy prices.

The nominal effective exchange rate (measured against the main 36 trading partners) depreciated in spring 2020 but recovered afterwards, contributing to bringing import prices down during that period. Import prices are set to remain broadly stable in 2022, as the effect of the expected appreciation of the koruna in 2022 should be offset by inflationary pressures stemming from the supply chain bottlenecks and by elevated oil prices.

Administered prices and taxes

The share of administered prices in the HICP basket stabilised at 15.6% in 2021, slightly above the euro area average of 13.3%. Changes in administered prices were a significant driver of inflation in 2020, as they increased by 3.6%, i.e. faster than headline HICP. This was not the case in 2021, where growth in administered prices was just 0.8%, compared to 3.3% for the overall HICP. Increases in heat energy were the main contributor to the increase in administered prices in 2020 and their decline in 2021. HICP at constant tax rates was around the same level as headline inflation both in 2020 (3.2%) and 2021 (3.4%). Administered prices picked up sharply in January 2022, due to a surge in energy prices and the reintroduction of VAT on electricity and gas (the non-prolongation of the government support measures in late 2021).

Medium-term prospects

Annual HICP inflation increased in early 2022, driven by increasing energy prices, accompanied by increasing food prices and prices of services, as well as further rises in administered prices, changes to indirect taxes and non-energy industrial goods inflation. Inflation is expected to remain elevated in the second half of 2022, before moderating in 2023, as global supply side distortions take time to resolve, and the on-going tightening of domestic monetary conditions comes into effect. According to the Commission’s Spring 2022 Economic Forecast, annual HICP inflation is projected to average at 11.7% in 2022 and 4.5% in 2023. In order to combat the effects of the high inflation, the government lowered temporarily the excise duties on petrol and diesel (from June until September 2022) and reduced the road tax on cars

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

Outturn and forecast [1]	2016	2017	2018	2019	2020	2021	2022[1]	2023[1]
General government balance	0.7	1.5	0.9	0.3	-5.8	-5.9	-4.3	-3.9
- Total revenue	40.5	40.5	41.5	41.4	41.6	40.5	40.2	39.8
- Total expenditure	39.8	39.0	40.6	41.1	47.3	46.4	44.5	43.7
of which:								
- Interest expenditure	0.9	0.7	0.7	0.7	0.8	0.7	0.9	0.9
p.m.: Tax burden	35.1	35.4	36.0	36.0	36.1	35.1	34.0	33.6
Primary balance	1.6	2.2	1.6	1.0	-5.0	-5.1	-3.4	-3.0
Fiscal stance [2]					0.0	-1.3	0.1	0.1
Government gross debt	36.6	34.2	32.1	30.1	37.7	41.9	42.8	44.0
p.m: Real GDP growth (%)	2.5	5.2	3.2	3.0	-5.8	3.3	1.9	2.7

1) Commission's Spring 2022 Economic Forecast.
2) A negative (positive) sign of the indicator corresponds to an excess (shortfall) of primary expenditure growth compared with medium-term economic growth, indicating an expansionary (contractionary) fiscal policy.
Source: European Commission.

and trucks. However, it is expected that these measures will have only a limited effect on inflation. Support measures targeted at the low-income households have also been introduced and the household allowance have been increased.

The risks to the inflation outlook are unusually high overall. The main upside risks are weaker anchoring of inflation expectations and slower appreciation of the koruna because of tightening of monetary policy abroad. At the same time, higher than expected wage growth and repercussions of Russian's invasion of Ukraine could push prices up. By contrast, consolidation of public finances is a slight downside risk to inflation.

The level of consumer prices in Czechia was about 73% of the euro-area average in 2020, suggesting that there is still potential for further price level convergence in the long term. Since 2012, Czechia has steadily converged to the euro area average in GDP per capital in PPS, to about 88% in 2021 (the COVID-19 pandemic brought about a small tick down from 89% reached in 2020).

3.3. PUBLIC FINANCES

3.3.1. Recent fiscal developments

On the back of an ample fiscal expansion launched to combat the effects of the COVID crisis, Czechia reported a deficit of the general government budget of 5.8% in 2020 and 5.9% in 2021. While government revenues proved more resilient with the revenue-to-GDP ratio dropping only 1 pp from 41.4% in 2019 to 40.5% in 2021, the expenditure-to-GDP ratio expanded from 41.0% in 2019 to 46.4% in 2021. Temporary COVID-related measures taken by the government accounted for extra expenses of about 2.7% of yearly GDP on average in 2020 and 2021. Among the largest temporary measures are the short-time work schemes, i.e. “Antivirus” programme and the Compensatory bonus for self-employed or the companies support programs “COVID-Uncovered costs” and “COVID-2021”. These temporary schemes were instrumental in maintaining employment for businesses affected by the crisis. ([49]) They were supplemented by permanent measures like the decrease in the personal income tax (about 1.8% of GDP per year) as well as cuts in VAT for certain services or the elimination of the residential transaction tax.

The 2021 general government deficit of 5.9% of GDP (almost unchanged vs 5.8% in 2020) was significantly better than the estimate of 8.8% in the 2021 Convergence Programme. This is explained by a higher nominal GDP growth of 7.6% compared to 4.9% in the program but also lower take-up for some of the pandemic-related support measures.

([49]) However, a recently published review of government accounts by the independent Supreme Audit Office found most of the 2021 increase of government expenditures as not related to the COVID-19 pandemic.

While public debt is still low compared to other EU Member States, the pace of its growth in 2020-2021 was high, with public debt-to-GDP ratio increasing from 30.1% in 2019 to 41.9% in 2021, driven by the negative headline balance only partly offset by nominal GDP growth. Liquidity support for households and companies in the form of guarantees did not have a direct budgetary impact, but the guarantees provided in response to the COVID-19 pandemic represent contingent liabilities, estimated by the Commission services at around 1.5% of 2022 GDP as of March 2022.

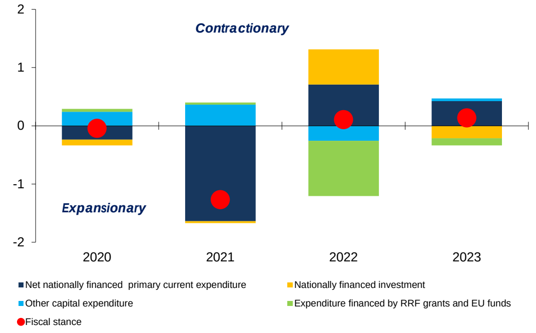
3.3.2. Medium-term prospects

The 2022 budget approved by the Czech parliament in March 2022 envisages a central government deficit of 4.2% of GDP and aims to start a correction of the high deficit registered in the previous years. The budget maintains the tax cuts implemented in 2020 (e.g. the cut in the personal income tax) and focuses instead on limiting public expenses growth. A planned phasing-out of the temporary COVID-19 support measures will help contain related expenses. Public wages growth for 2022 has been limited to 6% for health personnel, while other public employees' categories had either small indexation or their salaries frozen. On the other hand, due to high inflation, pensions are set to be boosted by two automatic indexations (in January and in June 2022), thus continuing to add pressure on expenditure. Investments are to expand further on the back of a higher contribution of EU funds including the Recovery and Resilience Facility (RRF). In light of the increase in energy prices, the Government adopted measures to help households and companies to cope with the economic and social impact of rising prices. The measures consist of a temporary decrease in excises duties on fuel prices (0.1% of GDP) but also increase in housing allowances targeted at lower income households (0.1% of GDP). The budgetary costs related to assisting people fleeing Ukraine is assumed, according to Commission's Spring 2022 Economic Forecast at close to 0.4% of GDP.

The 2022 Convergence Programme has been approved by the government on 11 May 2022. The Program aims to provide a consolidation path of the public finances over the medium term. The Program expects the general headline balance at 4.5% in 2022 and at 3.2% in 2023. The consolidation path is mostly based on containment of expenses that are forecast to grow slower than the nominal GDP growth, thus creating savings of 1.4% of GDP in 2022 and another 1.8% of GDP in 2023, compared with the levels from 2021. The government deficit in 2022 is impacted by the additional measures taken by the government to counter the social and economic impact of the increase in energy prices, as well as the provision of humanitarian assistance to people fleeing Ukraine.

According to the Commission's Spring 2022 Economic Forecast and based on a no-policy change scenario, the government balance is expected to decrease to 4.3% of GDP in 2022 and further to 3.9% in 2023, as revenues are expected to grow strongly on the back of high nominal GDP growth, while COVID-19 temporary emergency measures are expected to be phased out.

Graph 3.4: **Czechia - Fiscal stance and its components**
(percent of GDP)



Source: Commission's Spring 2022 Economic Forecast.

In 2022, the fiscal stance is projected in the Commission's Spring 2022 Economic Forecast to be broadly neutral, at +0.1% of GDP ([50]). The positive contribution to economic activity of expenditure financed by Recovery and Resilience Facility grants and other EU funds is projected at 2.0 percentage points of GDP in 2022, higher by 1.0 percentage points of GDP compared to 2021. Nationally financed investment is projected to provide a contractionary contribution to the fiscal stance of 0.6 percentage points in 2022. At the same time, the growth in nationally financed primary current expenditure (net of new revenue measures) in 2022 is projected to provide a contractionary contribution of 0.7 percentage points of GDP to the overall fiscal stance, as current expenditure is set to grow at a slower pace than medium-term potential growth.

([50]) For a definition of the fiscal stance used in this Report, see footnote in Section 3.2.3 on underlying factors and sustainability of inflation.

In 2023, the fiscal stance is projected at +0.1% of GDP. The positive contribution to economic activity of expenditure financed by Recovery and Resilience Facility grants and other EU funds is projected to increase by 0.1 percentage points of GDP in 2023. Nationally financed investment is projected to provide an expansionary contribution to the fiscal stance of 0.2 percentage points of GDP ([51]), whereas the growth in nationally financed primary current expenditure is projected to provide a contractionary contribution of 0.4 percentage points to the overall fiscal stance in 2023.

The government-debt-to-GDP ratio is forecast by the Commission to increase to 42.8% in 2022 and 44.0% in 2023, which is about 6 percentage points higher than in 2020, driven by the negative headline balance, being only partly offset by the robust nominal GDP growth.

Debt sustainability risks appear medium over the medium term, as government debt is projected to increase to around 61% of GDP in 2032. This projection assumes that the structural primary balance (except for the impact of ageing) remains constant at the forecast level for 2023 of -2.5% of GDP, hence below the 2019 level.

The sensitivity to possible macro-fiscal shocks also contributes to this assessment. In particular, if only half of the projected improvement in the structural primary balance in 2022–2023 were to occur, the projected debt ratio in 2032 would be almost 10 percentage points of GDP higher than in the baseline.

Some factors mitigate risks, including and the expected positive impact on long-term growth of reforms under the Recovery and Resilience Plan. In addition, Czechia’s negative net international investment position is contained, and this position is even positive when excluding non-defaultable instruments. Risk-increasing factors include the possible materialisation of state guarantees granted to firms and self-employed during the COVID-19 crisis though this risk appears limited given the relatively low level and low take-up ([52]).

The capacity of the Czech fiscal framework to ensure sustainable public finances is under test. The act establishing the Czech fiscal rules was amended twice in 2020: the April amendment allowed for a larger structural deficit and a longer adjustment path, while the December 2020 amendment corresponded to a “tax package”, which widened further the structural deficit. As the debt outlook has deteriorated, there is a higher risk that the threshold for triggering the debt brake (at 55% of GDP) would be reached over the medium term. Moreover, the increase of the general government deficit over the forecast horizon is mostly due to permanent measures. Against this background and in line with its mandate, the Czech Fiscal Council found the 2020 budget compliant with the national fiscal rules and that the starting position for debt projections had significantly worsened the fiscal sustainability prospects over the long-term. The Committee on Budgetary Forecasts, tasked with assessing the macroeconomic and budgetary forecasts, confirmed the realism of the forecasts in all its 2021 assessments. The local governments continued to have a positive albeit decreasing contribution to the general government balance in 2020. Only six municipalities with debt above 60% of their average revenues over the previous four years had to take remedial action with respect to the debt reduction rule ([53]). Finally, a draft law amending Act No 166/1993 is currently under consideration to broaden the mandate of the Supreme Audit Office.

3.4. EXCHANGE RATE STABILITY

The Czech koruna does not participate in ERM II. Since the late 1990s, the ČNB has been operating an explicit inflation targeting framework combined with a *de jure* floating exchange rate regime, allowing for foreign exchange market interventions by the central bank ([54]). The ČNB is legally allowed to conduct foreign exchange interventions to influence the koruna exchange rate and moderate excessive exchange rate volatility in exceptional situations (e.g. in 2022).

Following the expiry of the ČNB's exchange rate commitment in April 2017, the koruna followed a

[51] Other nationally financed capital expenditure is projected to provide a neutral contribution.

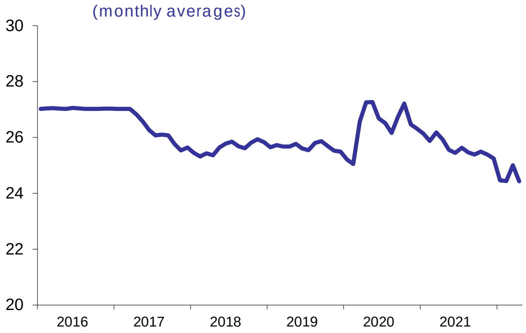
[52] For further details see the 2021 Fiscal Sustainability Report.

[53] Should the debt of a local authority exceed 60% of its average annual revenues over the last four budget years, the *debt reduction rule* implies that the local authority shall reduce its debt in the following year by at least 5% of the difference between the amount of its debt and 60% of its average revenues over the last four budget years.

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

gradual appreciation trend against the euro, strengthening from above 27 CZK/EUR in early April 2017 to 25.5 CZK/EUR in May 2018, around which level it oscillated until end of 2019. Following the lock-down measures taken in the early stages of the COVID-19 pandemic, the koruna depreciated significantly above 27 CZK/EUR in March. It then oscillated between 26 CZK/EUR and slightly above 27 CZK/EUR before entering an appreciation phase from late 2020 to reach 24.5 CZK/EUR early 2022. The appreciation was mostly driven by a sharp monetary tightening by the ČNB. However, in the wake of the Russia's invasion of Ukraine the Czech koruna experienced strong depreciation pressures, which triggered short-lived stabilising interventions of the ČNB in the foreign exchange market in early March. In April 2022, the koruna was trading again around 24.4 CZK/EUR. The ČNB has entered the foreign market around mid-May again to support the Czech koruna with the aim to limit its depreciation following the appointment of the new governor.

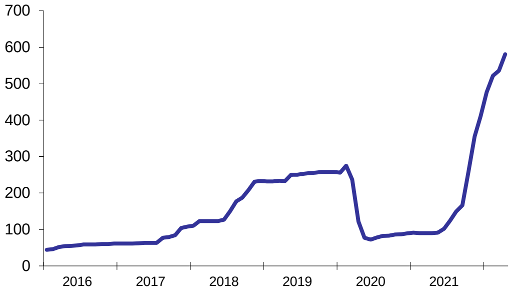
Graph 3.5: **Czechia - CZK/EUR exchange rate**
(monthly averages)



Source: ECB.

The 3-month interest rate differential vis-à-vis the euro area decreased sharply by about 200 basis points in the months following the beginning of the COVID-19 pandemic to approach 70 basis points in spring 2020. The narrowing of the spread was the result of the substantial monetary policy easing in Czechia in response to the pandemic. Afterwards, the ČNB kept its policy rates unchanged and the three-month interest rate spread relative to the euro fluctuated between 80 and 90 until June 2021. The subsequent strong tightening cycle by the ČNB from August 2021 led to a steady and large rise in the Czech 3-month PRIBOR and, accordingly, of the spread vis-à-vis the euro area which climbed up strongly and surpassed the mark of 580 basis points in April 2022.

Graph 3.6: **Czechia - 3-M Pribor spread to 3-M Euribor**
(basis points, monthly values)



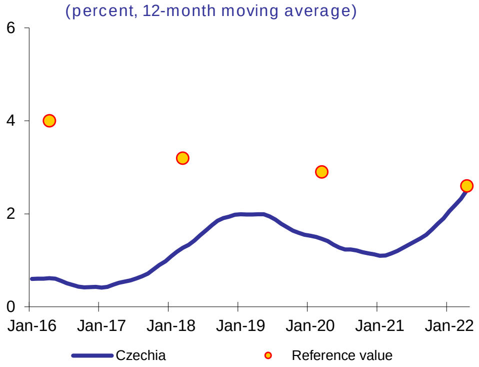
Source: Czech national Bank, Eurostat and Thomson Reuters.

International reserves held by the ČNB increased from EUR 133 billion at the end of 2019 (59% of GDP) to about EUR 157 billion (62% of GDP) at the beginning of 2022. The level of reserve assets was mainly influenced by a rise in returns on the ČNB's securities and inflows of EU funds.

3.5. LONG-TERM INTEREST RATES

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

Graph 3.7: **Czechia - Long-term interest rate criterion**
(percent, 12-month moving average)

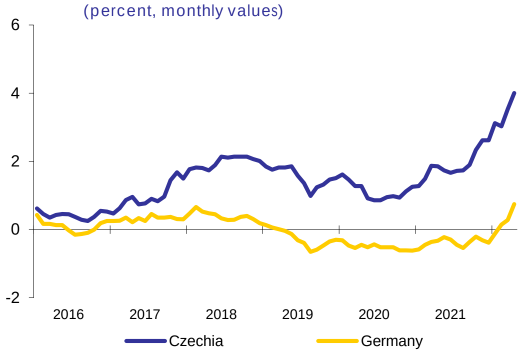


Source: European Commission.

The Czech 12-month average long-term interest rate relevant for the assessment of the Treaty criterion was well below the reference value at the time of the last convergence assessment in 2020. Since then it has followed a gradual downward trend up to February 2021, followed by a rise to about 2.2% in early 2022. In April 2022, the reference value, given by the average of long-term interest rates in France, Finland, and Greece plus 2 percentage points, stood at 2.6%. In that month, the 12-month moving average of the yield on the

Czech benchmark bond stood at 2.5%, i.e. 0.1 percentage points below the reference value.

Graph 3.8: **Czechia- Long-term interest rates**
(percent, monthly values)



Source: Eurostat.

The long-term interest rate of Czechia fell in the first months of 2020 as the ČNB's eased its monetary policy in response to the COVID-19 pandemic. It reached a local through of 0.9% in summer 2020 before increasing slowly to about 1.9% in Spring 2021. After a few months of oscillations around that level, it then rose rapidly to 2.6% in November 2021 and over 3% in early 2022 to reach 4.0% in April 2022, in line with the ČNB's sharp tightening of the monetary policy stance and a rapid increase in inflation. Consequently, the spread vis-à-vis the German long-term benchmark bond widened first by about 90 basis points between summer 2020 and spring 2021 and again by about 70 basis points between summer 2021 and early 2022 when it crossed 300 basis points. In April, it came close to 330 basis points.

3.6. ADDITIONAL FACTORS

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

In December 2021, the Commission published its tenth Alert Mechanism Report (AMR 2022) under the Macroeconomic Imbalance Procedure (MIP – see also Box 1.7), which highlighted issues relating to competitiveness and pressures in the housing market in Czechia. However, since overall risks remained limited, no In-Depth Review (IDR) was warranted for that country. While considerable improvements in current accounts have been recorded in Czechia, nominal unit labour costs have increased significantly, on the back of strong wage rises and acute labour market shortages, although some deceleration is expected. At the same time, Czechia is exposed to risks relating to the trade policy environment (such as import of commodities, strong dependence on the German economy) and related disruption of global value chains (especially in car manufacturing). Real house price growth has remained elevated both in 2020 and even accelerated in 2021. House prices appear to be overvalued in several regions in Czechia. The real house price index has continued the upward trend started in 2013, driven by supply constraints and strong demand. In 2021, it exceeded its 2015 level by about 61% ([55]).

Czechia submitted its recovery and resilience plan on 1 June 2021. The Commission's positive assessment on 19 July 2021 and Council's approval on 8 September 2021 paved the way for the implementation of the RRP and the disbursement of EUR 7 billion in grants over the period 2021–2026, which is equivalent to 3.1% of 2019 GDP.

Czechia's plan includes a set of mutually reinforcing reforms and investments (91 investments and 33 reforms) that contribute to effectively addressing all or a significant subset of the economic and social challenges outlined in the country-specific recommendations (CSRs) addressed to Czechia by the Council in the European Semester in 2019 and 2020.

The plan will address key macro-economic challenges such as technological changes, such as those posed by automation and the green transition, investment in research and development, new childcare facilities, and up-skilling and reskilling actions. Key investments are included on energy efficiency of buildings, digital skills and access to finance for companies. Key reforms are aimed at addressing the quality of public administration (including digitalisation), increasing the capacity of childcare facilities, improving access to and the resilience of the

([55]) The very fast growth of house prices in real terms (almost 11% p.a. since 2019) has been mostly driven by constraints of structural nature. The macroprudential regulation has been broadly appropriate; see ESRB, "Vulnerabilities in the real estate sectors of the EEA countries", ESRB, Frankfurt, February 2022.

Table 3.4:

Czechia - Balance of payments (percentage of GDP)

	2016	2017	2018	2019	2020	2021
Current account	1.8	1.5	0.4	0.3	2.0	-0.8
of which: Balance of trade in goods	5.4	5.1	3.7	4.1	4.9	1.2
Balance of trade in services	2.2	2.4	2.2	1.8	1.8	1.8
Primary income balance	-5.3	-5.0	-4.8	-5.0	-4.3	-3.3
Secondary income balance	-0.6	-1.0	-0.7	-0.6	-0.5	-0.5
Capital account	1.1	0.9	0.2	0.4	1.2	1.6
External balance [1)]	2.9	2.4	0.7	0.8	3.2	0.7
Financial account	2.5	2.3	1.1	0.1	2.9	0.2
of which: Direct investment	-3.9	-0.9	-0.9	-2.4	-2.6	-0.1
Portfolio investment	-3.5	-5.2	0.6	-1.8	-2.4	1.2
Other investment [2)]	-1.8	-16.0	0.6	2.4	7.0	-5.8
Change in reserves	11.7	24.4	0.9	1.9	0.8	4.8
Financial account without reserves	-9.2	-22.1	0.2	-1.8	2.0	-4.7
Errors and omissions	-0.3	-0.2	0.4	-0.6	-0.3	-0.5
Gross capital formation	26.0	26.4	27.2	27.6	25.9	30.1
Gross saving	25.8	27.2	26.6	26.7	28.4	27.8
Net international investment position	-27.2	-24.9	-24.4	-19.8	-16.3	-15.6

1) The combined current and capital account.

2) Including financial derivatives.

Sources: Eurostat, European Commission calculations, Czech National Bank.

healthcare sector, improving education programmes, upgrading labour market services, supporting research activities and the introduction of innovation in firms. The business environment is being improved by several e-government measures, anti-corruption reforms, including strengthening the institutional and administrative framework linked to avoiding conflict of interest and a comprehensive reform of the procedure for granting building permits, which currently represent major obstacles to investment in Czechia. The plan devotes 42% of its total allocation to measures supporting climate objectives, 22% to the digital transition and 35% to social expenditure; all while respecting the do no significant harm principle.

The implementation of the investments planned in Czechia's plan, along with other investments under NextGenerationEU (NGEU), is estimated to raise Czechia's GDP by 0.8% to 1.2% by 2026, of which 0.3% due to the positive spillover effects of the coordinated implementation of NGEU across Member States (Pfeiffer et al. 2021) ([56]). This does not take into account the positive impact of structural reforms on growth.

3.6.1. Developments of the balance of payments

According to balance of payments data, Czechia's external balance (i.e. the combined current and capital account) rose strongly in 2020, reaching 3.2% of GDP before decreasing to 0.7% of GDP in 2021. These developments in the external balance mostly mirror those of the current account surplus with the capital account remaining broadly stable at about 1.4% of GDP ([57]), following the below–one-per-cent balance in previous few years. The trade surplus was strongly affected by the uneven impact of the COVID-19 pandemic on exports and imports: it increased strongly in 2020 before falling back in 2021. In contrast to previous years,

([56]) See Pfeiffer P., Varga J. and in't Veld J. (2021), "Quantifying Spillovers of NGEU investment", European Economy Discussion Papers, No. 144 and Afman et al. (2021), "An overview of the economics of the Recovery and Resilience Facility", Quarterly Report on the Euro Area (QREA), Vol. 20, No. 3 pp. 7–16.

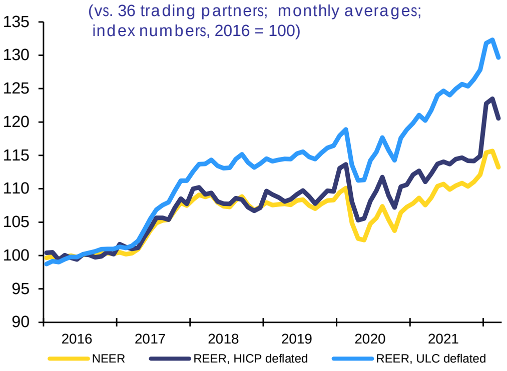
([57]) In 2020, the current account recorded the highest surplus in the history of Czechia, both in absolute terms and relative to GDP. The main reason was a reduction of the deficit on primary income as a result of a massive drop in the outflow of income on direct investment of non-residents in Czechia.

net exports contributed negatively to economic growth in 2021. While net trade in services was broadly balanced (as a sudden drop associated with travel services was compensated with an increase in other services, such as ICT), net exports of goods were negative, in particular through supply shortages, longer delivery times and increased transportation cost, as well as through the deteriorated macroeconomic situation in the main trading partners. With record credits and debits, the capital account recorded the highest surplus since 2015. It was driven by a high growth in the utilisation of funds from the EU budget and a sharp drop in net payments for emission allowances (ETS).

The crisis also temporarily affected the primary income balances (as a result of lower payments of factors of production to abroad) but left the secondary income balance broadly unchanged; the income balance as a whole stayed less negative compared to the pre-pandemic years. The capital account balance remained in surplus and increased to a level of about 1.2% of GDP in 2020 and 1.6% in 2021. A considerable net outflow of capital connected with the surplus on the current and capital accounts was evident on the financial account in 2020 (-0.2% of GDP), recovering in 2021 (1.4% of GDP). The net international investment position slightly worsened in 2021, due to a faster accumulation of liabilities relative to assets, however, remained close to -16% as in 2020.

Graph 3.9: **Czechia - Effective exchange rates**

(vs. 36 trading partners; monthly averages; index numbers, 2016 = 100)



Source: European Commission.

Measured by the export market share, the trade performance declined in 2020. In 2020–2021, measures of competitiveness exhibited different dynamics depending on the deflator used. The rate of appreciation of the real effective exchange rate (REER) deflated by ULC, accelerated, as labour hoarding pushed up labour costs. The appreciation in REER deflated by HICP has been more moderate, reflecting moderate price inflation until mid-2021. The swift acceleration of inflation at the end of 2021 has not caused a real appreciation vis-à-vis the rest of the world, since inflation has picked up globally, including major trade partners ([58]).

According to the Commission's Spring 2022 Economic Forecast based on national accounts data, the external balance is expected to contribute slightly negatively to GDP growth in 2022. However, as the external environment is expected to improve, the trade balance is set to increase in 2023.

3.6.2. Market integration

The Czech economy is highly integrated with the euro area through trade and investment linkages, although the related indicators decreased during the reporting period. The trade openness of Czechia declined slightly in 2020 but remained very high at around 87% of GDP in 2021. The share of trade with euro area countries stood at around 53% of GDP in 2021 (51% in 2020). Neighbouring euro-area countries, such as Germany, Poland and Slovakia are among its most important trade partners.

FDI inflows did not recover from a large drop recorded in 2020 (over 3% of GDP), followed by another decline of about 3% of GDP in 2021. Nevertheless, the stock of FDI inflows as percentage of GDP reached about 82% in 2021, despite labour market shortages and increasing wages. Austria, Belgium, France, the Netherlands and Switzerland are the biggest investor partners providing more than half of the FDI inflows as of end of 2021. Financial services, manufacturing, trade, hotels and restaurants are the main target sectors for FDI inflows. The geographical proximity to EU core markets, a relatively good infrastructure and a highly educated labour force have supported the attractiveness of the country for foreign investors.

Czechia's performance in international rankings of competitiveness and ease of doing business has been worsening over recent years and it is thus relatively weaker than in many euro-area Member States. In the IMD's World Competitiveness

[58] The REER based on unit labour costs should be interpreted with prudence as unit labour costs were distorted by labour retention schemes in some countries, including Czechia.

Table 3.5:
Czechia - Market integration

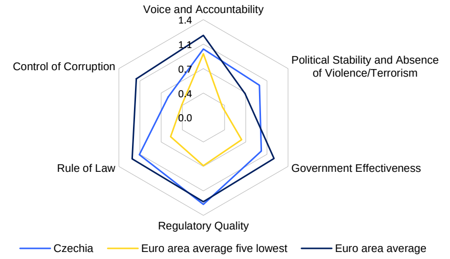
	2016	2017	2018	2019	2020	2021
Trade openness [1] (%)	88.8	90.1	89.0	86.0	83.2	86.8
Trade with EA in goods & services [2]+[3] (%)	54.9	55.6	54.4	52.5	50.5	53.1
World Bank's Ease of Doing Business Index rankings [4]	27	30	35	41	41	-
IMD World Competitiveness Ranking [5]	27	28	29	33	33	34
Internal Market Transposition Deficit [6] (%)	1.5	1.2	0.7	0.8	1.5	-
Real house price index [7]	106.8	116.5	123.4	131.0	138.3	160.6

1) (Imports + Exports of goods and services / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics, Balance of Payments).
2) (Imports + Exports of goods with EA-19 / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).
3) Trade in services with EA-19 (average credit and debit in % of GDP at current prices) (Balance of Payments).
4) Data not available for 2021. The Ease of Doing Business report by the World Bank was discontinued in September 2021.
5) International Institute for Management Development (IMD).
6) Percentage of internal market directives not yet communicated as having been transposed, relative to the total.
(November data, as of 2016 date refers to the year of publication).
7) Deflated house price index (2015=100) (Eurostat).
Sources: Eurostat, World Bank, International Institute for Management Development, European Commission calculations.

Index, Czechia's position is around the middle of the ladder and has worsened somewhat lately (from 33 in 2020 to 34 in 2021, from a total of 64 surveyed economies), with attractiveness issues related to the effectiveness of the legal environment, the competency of the government and the quality of corporate governance.

According to the World Bank's Ease of Doing Business indicator, Czechia maintained the same ranking in 2020, as in 2019, i.e. 41, but a relative worsening can be noticed with respect to 2018 or 2017, when it ranked 35th and 30th respectively ([59]).

Graph 3.10: **Czechia - 2020 World Bank's Worldwide Governance Indicators**



Note: Estimate of governance ranges from -2.5 (weak) to 2.5 (strong).
Source: World Bank.

Corruption remains an issue of concern in Czechia. Legal and institutional frameworks to address corruption are broadly in place, while the Government has prioritised some anti-corruption measures. A number of planned reform initiatives in the fight against corruption were not adopted before the end of the parliamentary term in 2021, including reforms on lobbying, whistleblowing, the Supreme Audit Office mandate, and a code of conduct for members of Parliament (some measures are included in the Recovery and Resilience Plan). Concerns remain over cases of high-level corruption.

According to the World Bank's Worldwide Governance Indicators (2020), Czechia ranks higher than the average of the five euro area Member States with the lowest scores for regulatory quality, political stability and absence of violence, rule of law and government effectiveness ([60]).

According to the 2020 Single Market Scoreboard, Czechia's transposition deficit of EU Directives was at 1.1%, a stable result for the 3rd consecutive year, very close to the EU average (1%) and the target (0.5%) proposed by the European Commission in the Single Market Act (2011).

The Czech Republic has taken steps to improve its Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT) framework. The Register on Beneficial Owners and the Central Register of Bank Accounts were established to improve transparency of beneficial owners and to provide quicker access to bank account information. The Czech authorities have achieved a substantial level of effectiveness in international

([59]) The World Bank Doing Business (DB) program was paused in 2021. The programme will continue with a new governance and improved accountability and transparency under the name Business Enabling Environment (BEE). The first edition of the BEE is expected in 2023.

([60]) A Member State is considered to have a 'low' ('high') ranking compared with the average five euro area Member States with the lowest scores for each indicator if its score is at least 0.3 percentage points lower (higher) than that of the average of this euro area group.

cooperation; confiscation of proceeds and instrumentalities of crime; and FT investigations and prosecutions. On the other hand, the Czech Republic has achieved moderate results in the other areas covered by the FATF standards and its transposition of the 5th AMLD is still under assessment by the European Commission.

The Czech labour market performed strongly in 2020 and 2021. Despite a slight increase to 2.6% in 2020 and 2.7% in 2021, Czechia remained the best performer in terms of unemployment in the EU for the fourth year in a row. The employment rate of those aged between 20 and 64 reached 79.7% in 2020, which was eight percentage points above the EU average. However, labour shortages are pervasive and hamper Czechia´s growth potential. The protection of permanent employees against collective and individual dismissals is relatively strict (as measured by the 2013 OECD employment protection indicator) whereas the duration of unemployment benefits is below the EU average. Cross-border migration flows have remained relatively subdued, although the tight labour market has started to attract workers from both EU and non-EU countries.

Table 3.6:
Czechia - Allocation of assets by financial sub-sector

						Ratio to GDP (%)
	CZ		EA		EA 5 smallest	
	2016	2020	2016	2020	2016	2020
Financial corporations (total)	215	259	722	796	177	215
Central bank	46	62	45	78	37	61
Monetary financial institutions	120	136	286	311	97	98
Other financial intermediaries	23	33	202	179	20	28
Non-MMF investment funds[1)]	7	10	100	127	4	5
Insurance co. and Pension Funds	19	19	90	102	18	23
						Share of total (%)
	CZ		EA		EA 5 smallest	
	2016	2020	2016	2020	2016	2020
Central bank	21	24	6	10	21	29
Monetary financial institutions	56	52	40	39	55	46
Other financial intermediaries	11	13	28	22	11	12
Non-MMF investment funds	3	4	14	16	2	2
Insurance co. and Pension Funds	9	7	12	13	10	11

1) MMF stands for money market funds.
Source: Eurostat.

The financial sector in Czechia continues to be smaller and somewhat less developed than in the euro area. Relative to GDP, assets managed by the financial sector are slightly above one third of that of the euro area, however, surpassing the five euro-area Member States with the smallest financial sectors. The size of the financial sector has increased by about 45 percentage points since 2016, reaching almost 260% of GDP in 2020. Banks dominate the Czech financial sector and make up around 52% of the financial sector's assets in 2020. The central bank is the second largest holder of financial assets with a share of 24% (more than double compared to the euro area average) and has exactly the same share as all non-banking financial intermediaries together. Although these shares are larger and more dominating than in the euro area, they compare well with the five euro-area Member States with the smallest financial sectors.

The insurance and the pension-fund sectors in Czechia continues to be smaller (five-times) than in the euro area, relative to GDP. However, the sector's share of the total financial sector is relatively comparable to that of the euro area. Since end-2016, the Czech sector has not changed its holdings of financial assets relative to GDP (slightly reducing its share in the Czech financial sector), compared to an increase by about 12 percentage points in the euro area. The investment-funds sector plays a very small role in the Czech financial system, but its size is comparable to that of the five euro-area Member States with the smallest financial sectors.

Table 3.7:
Czechia - Financing of the economy1)

						Ratio to GDP (%)
	CZ		EA		EA 5 smallest	
	2016	2020	2016	2020	2016	2020
Liabilities (total)	341	341	743	770	324	335
Loans	94	96	238	236	115	112
Non-financial co. debt securities	7	6	12	15	3	4
Financial co. debt securities	15	20	74	68	11	12
Government debt securities	39	38	83	95	51	57
Listed shares	13	10	65	73	17	18
Unlisted shares	66	70	186	193	55	56
Other equity	61	63	51	56	42	48
Trade credits and advances	47	36	33	35	29	29
						Share of total (%)
	CZ		EA		EA 5 smallest	
	2016	2020	2016	2020	2016	2020
Loans	28	28	32	31	35	33
Non-financial co. debt securities	2	2	2	2	1	1
Financial co. debt securities	4	6	10	9	3	3
Government debt securities	11	11	11	12	16	17
Listed shares	4	3	9	9	5	5
Unlisted shares	19	21	25	25	18	18
Other equity	18	19	7	7	13	14
Trade credits and advances	14	11	4	5	9	9

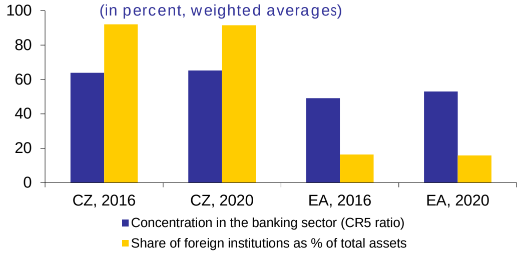
1) The table focuses on the financing needs of a country and how these are met by the financial system. The table is constructed from the liabilities of all economic sectors, but only considers loans, debt securities, equity and trade credits. The sum of liabilities in the table only reflects the total for the liabilities considered.
Source: Eurostat.

As to the financing of the economy, Czechia has less developed credit and equity markets relative to GDP than countries in the euro area, and market financing (especially debt securities and listed shares) is relatively under-developed. However, Czechia is still comparable to the five euro-area Member States with the smallest national capital markets. Loans are the dominant source of funding and make up 96% of GDP in 2020, compared to 240% of GDP in the euro area. Unlisted shares and other equity are another important source of funding and stand at 70% and 63% of GDP in 2020 (related to FDI), compared to 192% and 55% in the euro area respectively. The decrease of the share of trade credits and advances, the fourth source of private funding (36% of GDP), brings it at par with its euro area average counterpart. Financing through private debt markets remains low vis-à-vis their euro area counterparts, and also equity markets are very small compared to those of the euro area and represent 10% of GDP. This compares to 83% for private-sector debt and 73% for listed stocks in the euro area. Government debt is also lower than in the euro area. In terms of share of the sum of liabilities, loans in Czechia are comparable to that of the euro area, while trade credits and advances are higher than in the euro area. For security and equity financing, the large differences reflect the smaller share of market funding available in Czechia compared to the euro area.

The Czech financial sector is highly integrated into the EU financial sector. This integration is noticeable in ownership linkages of the banking system. Foreign institutions held more than 90% of banking sector's assets via their local branches and subsidiaries in 2020. Concentration in the banking sector, as measured by the market share of the largest five credit institutions in total assets, edged up from almost 64% in 2018 to over 65% in 2020 and thus continued to exceed the euro-area average of 53% by about 12 percentage points.

Graph 3.11: **Czechia - Foreign ownership and concentration in the banking sector**

(in percent, weighted averages)

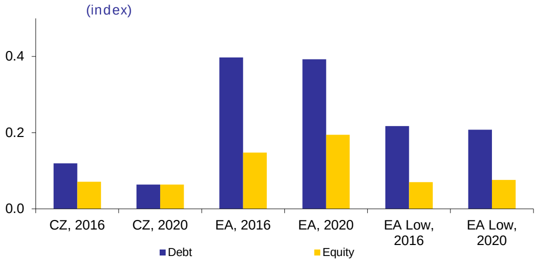


Source: ECB, Structural financial indicators.

Although intra-EU integration in equity and debt markets, as measured by the home bias in portfolio investments, are in general relatively low across EU Member States, Czechia is roughly comparable in terms of levels of integration of the low euro-area Member State in equity markets ([61]). Integration in this market segment, has slightly worsened between 2016 and 2020. The very large home bias indicates that an overwhelming majority of investments in equity markets does still take place domestically. Similarly, in case of debt markets, the home bias remains very strong in Czechia relative to euro-area Member States. The very large home bias indicates that most of the transactions in the debt market take place domestically.

Graph 3.12: **Czechia - Intra-EU integration in equity and debt portfolio investment**

(index)



Note: The chart shows the extent of home bias in debt and equity markets. A value index of 1 implies 'full integration' with the financial markets of other Member States, while 0 denotes 'no integration'.

Source: FinFlows database: European Commission, Joint Research Centre (JRC).

[61] Home bias in portfolio investments measures the average propensity of investors in a Member State to invest domestically as compared with investing in other EU countries. The indicator ranges between 0 and 1, with a value of 0 indicating that investors prefer domestic over foreign assets. The inverse of the home bias can be interpreted as one measure of financial integration among EU countries.

4. CROATIA

4.1. LEGAL COMPATIBILITY

4.1.1. Introduction

The main legal rules governing the Croatian National Bank (Hrvatska narodna banka – HNB) are laid down in Article 53 of the Constitution of the Republic of Croatia ([62]) and the Act on the Croatian National Bank (the HNB Act) ([63]). The HNB Act was amended in 2013 with a view to Croatia entering the European Union on 1 July 2013. The Act provides for specific rules applying to the HNB as of EU accession of Croatia and a specific chapter for rules applying to the HNB as of the moment the euro becomes the official currency of the Republic. The Act also contains provisions regarding the close cooperation of Croatia with the ECB for banking supervision purposes ([64]). Article 53 of the Constitution of the Republic of Croatia and the HNB Act have not been amended since the Commission's 2020 Convergence Report.

4.1.2. Central Bank independence

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

No incompatibilities and imperfections exist in this area.

4.1.3. Prohibition of monetary financing and privileged access

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

4.1.4. Integration in the ESCB

Objectives

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

Tasks

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

4.1.5. Assessment of compatibility

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

4.2. PRICE STABILITY

4.2.1. Respect of the reference value

The 12-month average inflation rate, which is used for the convergence assessment, was below the reference value at the time of the 2020 convergence assessment of Croatia. From then, it decreased to reach to -0.2 % in February 2021 before shifting again to an upward trend. In April 2022, the reference value was 4.9%, calculated as the average of the 12-month average inflation rates in France, Finland and Greece, plus 1.5 percentage

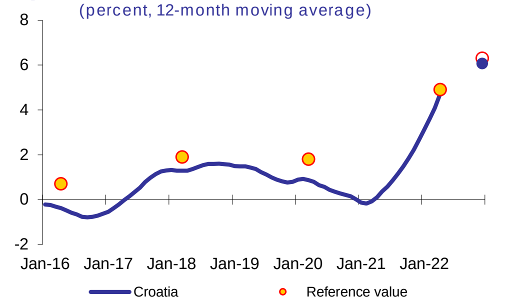
[62] Constitution as amended and published in the Official Journal of the Republic of Croatia no. 56/90, 135/97, 113/2000, 123/2000, 124/2000, 28/2001, 55/2001 and 76/2010, 5/2014.

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

[64] Decision (EU) 2020/1016 of the European Central Bank of 24 June 2020 on the establishment of close cooperation between the European Central Bank and Hrvatska Narodna Banka (ECB/2020/31).

points. The corresponding inflation rate in Croatia was 4.7%, i.e. 0.2 percentage points below the reference value. The 12-month average inflation rate is projected to remain below the reference value in the months ahead.

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



Note: The dots at the right end of the chart show the projected reference value and 12-month average inflation rate of the country in December 2022. The reference values for 2016, 2018 and 2020 refer to the reference values calculated in the previous Convergence Reports.

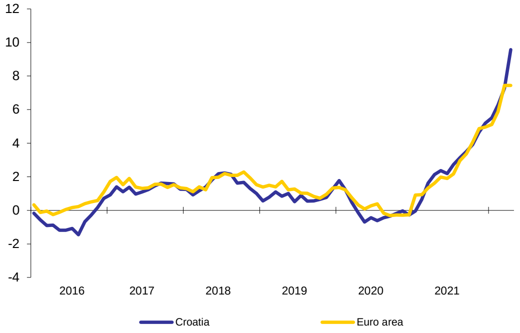
Source: Eurostat, Commission's Spring 2022 Economic Forecast.

4.2.2. Recent inflation developments

In 2021, the annual HICP inflation rate averaged 2.7%, significantly higher than in 2020, when it averaged 0%. The increase was mostly due to rising energy prices, which grew by 8.8% in 2021, after falling by 6.5% in 2020 in average yearly terms. Price increases in the services sector also contributed to the higher headline inflation, with service inflation averaging 2% in 2021 after 0.8% 2020. Processed food (including alcohol and tobacco) inflation averaged 3% in 2021, rising from a 2.1% average recorded in 2020. The inflation rate of unprocessed food and non-energy industrial goods remained subdued, below 1% in 2021. In April 2022, the inflation rate accelerated to 9.6% year-on-year, with the strongest contributions coming from energy and processed food prices, which increased by 23.1% and 22.9% and contributed by 3.0 and 2.3 percentage points to headline inflation, respectively. The April inflation rate in Croatia was above euro area average, where prices increased by 7.4%. This puts the average inflation rate in the trailing twelve months through April 2022 at 4.7% in Croatia, just above the EA average of 4.4%.

In 2021, the average core inflation rate (measured as the growth of HICP excluding energy and unprocessed food) accelerated to 1.8%, from 0.8% in 2020. In April 2022, core inflation rate stood at 7.3%, further accelerating compared to previous months. This figure was higher than the euro area average (3.9%), due to a stronger recovery from the COVID-19 crisis in Croatia together with the stronger growth of processed food prices, which also have a stronger weight in Croatia compared to euro area. The overall contribution of processed food prices to the core inflation rate stood at 2.8 percentage points.

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



Source: Eurostat.

4.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and growth developments

Economic developments in 2021 point to a V-shaped recovery of the Croatian economy. After a drop of 8.1% in 2020, real GDP recorded a yearly growth of 10.2% in 2021, bringing output above its pre-pandemic level. Looking at the GDP components, the recovery in 2021 was supported by exports of goods and services – with tourism playing a key role – and by private consumption. Strong growth of final demand spurred imports growth, but the overall growth contribution of net exports was positive.

According to the Commission's Spring 2022 Economic Forecast, GDP growth in 2022 is forecast at 3.4%, due to rising inflationary pressures and other indirect effects of Russia's invasion of Ukraine. Private consumption is expected to grow by 2.4%, driven by the expected implementation of the RRP and the acceleration of earthquake-related-reconstruction investment should remain strong, rising by 6.5%, in spite of the rising costs of materials, potential supply bottlenecks and rising uncertainty, Government consumption should continue to contribute positively to growth. On the external side, weaker demand in main trading partners is expected to affect goods exports, but the growth rate should remain solid 5.3%. Growth rate of exports of services should be mostly driven by tourist

Table 4.1:
Croatia - Components of inflation

	(percentage change)[1)]							weights in total
	2016	**2017**	**2018**	**2019**	**2020**	**2021**	**Apr-22**	**2022**
HICP	-0.6	1.3	1.6	0.8	0.0	2.7	4.7	1000
Non-energy industrial goods	0.6	0.7	0.3	-0.2	-0.2	0.6	2.4	266
Energy	-5.7	-0.1	5.6	0.9	-6.5	8.8	13.5	132
Unprocessed food	-0.9	2.9	0.2	-4.0	3.1	1.0	5.3	59
Processed food	0.2	2.6	1.4	2.0	2.1	3.0	5.3	229
Services	0.0	1.2	1.4	1.5	0.8	2.0	2.6	315
HICP excl. energy and unproc. food	0.2	1.4	1.1	1.1	0.8	1.8	3.3	809
HICP at constant tax rates	-0.8	1.2	1.5	1.4	0.3	2.4	4.6	1000
Administered prices HICP	-1.0	-0.3	1.2	1.4	0.1	1.9	2.3	123

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

Source: Eurostat, European Commission calculations.

activity, which is expected to converge towards pre-crisis levels in spite of current global developments. Import dynamics should follow developments of final demand and overall contribution of net exports to growth in 2022 is expected to be mildly positive.

In 2020-2021, the government's policy response to the COVID-19 crisis provided significant support to the healthcare sector, households and companies hit by the pandemic, including incentives to retain the workforce. This response was facilitated by new European instruments like loans from SURE (Support to mitigate Unemployment Risks in an Emergency) and grants from Next Generation EU/RRF. In 2021, the fiscal stance ([65]) remained supportive (-0.2 percentage point of GDP, after -2.3 percentage points of GDP in 2020), based on the Commission's Spring 2022 Economic Forecast. The fiscal stance is expected to remain supportive in 2022 (-1.8 percentage points of GDP) partly due to the expenditure financed through the RRF and other EU grants and temporary support to mitigate the impact of high energy prices on vulnerable households and firms. Net nationally-financed primary current expenditure in 2022 is projected to provide an expansionary contribution of 1.0 percentage point of GDP to the overall fiscal stance. The budgetary costs related to refugees from Ukraine is assumed at 0.1 percentage point of GDP. The forecast for 2023 shows a further supportive stance (-0.7 percentage point of GDP) due to the increasing expenditure financed by RRF and other EU grants and despite the assumed phasing out of energy crisis measures. Net nationally-financed primary current expenditure is projected to have a broadly neutral contribution to the fiscal stance of -0.2 percentage point of GDP.

In 2020, the HNB took a range of measures to ensure the stability of the financial sector in the aftermath of COVID-19 pandemic. The Croatian central bank used various standard and non-standard measures, including purchases of government bonds on the secondary market, direct purchases of foreign currency from the Ministry of finance, sales of foreign currency on the FX market and a cut in reserve requirement ratio ([66]). The HNB also agreed upon establishing a precautionary currency swap line with the ECB in April 2020. The currency swap line allows for the exchange of the kuna for up to EUR 2bn that could be used to provide additional euro liquidity to Croatian financial institutions without using the HNB own international reserves, if needed. While the swap line was initially set to expire on 31 December 2020, it had been extended thereafter to 31 March 2022. The HNB continued to pursue accommodative monetary policy throughout 2021, ensuring high levels of liquidity in the banking system and simultaneously maintaining a broadly stable exchange rate of the kuna against the euro.

[65] The fiscal stance is measured as the change in primary expenditure (net of discretionary revenue measures), excluding Covid-19 crisis-related temporary emergency measures but including expenditure financed by non-repayable support (grants) from the Recovery and Resilience Facility and other EU funds, relative to medium-term potential growth. A negative (positive) sign of the indicator corresponds to an excess (shortfall) of primary expenditure growth compared with medium-term economic growth, indicating an expansionary (contractionary) fiscal policy.

[66] Croatian National Bank (2021). Tri desetljeća izazova, brochure prepared for the celebration of the 30th anniversary of CNB.

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

	2016	2017	2018	2019	2020	2021	2022[1)]	2023[1)]
HICP inflation								
Croatia	-0.6	1.3	1.6	0.8	0.0	2.7	6.1	2.8
Euro area	0.2	1.5	1.8	1.2	0.3	2.6	6.1	2.7
Private consumption deflator								
Croatia	-1.1	0.9	1.4	1.1	0.3	2.7	6.0	2.5
Euro area	0.4	1.3	1.5	1.1	0.5	2.3	5.8	2.7
Nominal compensation per employee								
Croatia	0.3	0.2	3.9	0.4	2.1	5.6	3.0	2.7
Euro area	1.2	1.7	2.1	2.1	-0.7	4.1	3.6	3.5
Labour productivity								
Croatia	3.3	0.9	0.3	0.4	-7.0	8.9	1.8	1.1
Euro area	0.4	1.0	0.2	0.3	-4.9	4.2	1.4	1.5
Nominal unit labour costs								
Croatia	-2.8	-0.7	3.6	0.0	9.8	-3.1	1.1	1.5
Euro area	0.8	0.7	2.0	1.9	4.4	0.0	2.2	2.0
Imports of goods deflator								
Croatia	-2.5	2.6	1.1	0.2	-0.3	7.4	8.0	4.0
Euro area	-3.3	3.3	2.6	-0.5	-3.8	9.6	13.2	0.8

1) Commission Spring 2022 Economic Forecast.

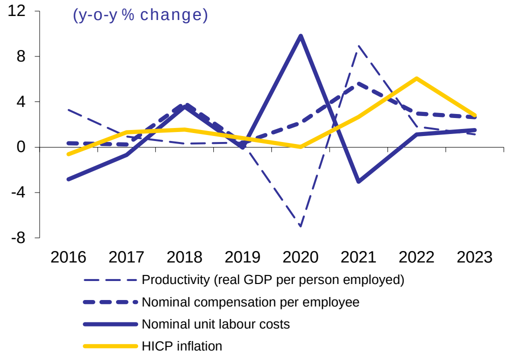
Source: Eurostat, Commission's Spring 2022 Economic Forecast.

Wages and labour costs

After a sharp economic downturn caused by the COVID-19 pandemic in 2020, the labour market recovered in 2021. Thanks in part to the government labour support schemes and liquidity measures, employment levels in 2021 were the same as those registered in 2019. Meanwhile, changes in the active population brought about by more accurate population statistics led to a 1.5 percentage points increase in the employment rate. However, the employment dynamics varied across sectors. Due to the measures put in place to curb COVID-19 transmission, activities characterised by close social contact were the most affected, e.g. accommodation and food services. The unemployment rate stood at 7.6% in 2021, 1 percentage point above the all-time low reached in 2019. Continued employment growth and demographic trends in 2022 and 2023 are expected to bring the unemployment rate to 6.0% by the end of 2023.

Relatively strong wage growth in 2020-2021 can largely be attributed to the employment support measures and personal income tax cuts. Subdued nominal unit labour costs (ULC) dynamics in 2021 partially offset the increase registered in 2020, as productivity growth outpaced nominal compensation per employee growth (8.9% vs. 5.6%) [67]. However, a tighter labour market and continued wage growth will result in a slight rise in ULC in 2022 and 2023. As a result, risks of second-round effects of wages on inflation are expected to be limited.

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



Source: Eurostat, Commission's Spring 2022 Economic Forecast.

External factors

After falling mildly by 0.3% in 2020, import price inflation (measured by the deflator of imports of goods) accelerated to 7.4% in 2021. This change mainly reflected increasing energy price

[67] However, it is important to emphasize that unlike many other countries Croatia recorded a strong fall of productivity based on hours of work in 2020, as employers in Croatia recorded full time hours despite the fact that workers were not working or they were working less hours.

developments. Pressures on import prices were somewhat offset by a mild appreciation of the kuna, which had a dampening effect on domestic prices.

Administered prices and taxes

The weight of administered prices in the Croatian HICP basket increased from 20% in 2020 to 28% in 2021. This change can be partially explained by the government decision to put a cap on gasoline prices at the end of 2021. In 2021, administered prices grew at 1.9% compared to a 2.7% rise in the overall price level.

As of 1 April 2022, administered prices of gas and electricity for households increased, following a surge of international energy prices since the summer of the previous year. Consequently, the average price of electricity for households increased by around 10% and that of gas by around 16%. In April 2022 administered prices accelerated to 3.6% on yearly basis, up from average 1.9% in Jan-Mar period.

Medium-term prospects

After reaching 2.7% in 2021, HICP inflation is expected to accelerate to 6.1% in 2022. Thus, inflation in Croatia is expected to be in line with the expected inflation in the euro area in 2022, in some parts reflecting the various measures taken by the Croatian government since the end of 2021 to tame the inflationary pressures coming from rising energy and food prices. These measures include cuts in the VAT rate for gas and various non-energy products, reduction of fees of state-owned electrical distributer (HEP) and direct transfers to vulnerable households and SMEs. In 2023, inflation should decelerate to around 2.7%, mostly supported by expected decline on international commodity prices.

Risks to the inflation outlook are skewed to the upside, due to uncertainties related to developments on international commodity markets, supply chain bottlenecks and to the increases of administered prices mentioned above.

The price level in Croatia stood at 67% of the euro-area average in 2020. There is a potential for gradual price level convergence in the long term. However, it should be noted that Croatia has already achieved the highest level of price convergence with the euro area compared to other member states at the moment of their euro accession.

Medium-term inflation prospects are largely expected to depend on price developments on global commodity and food markets. In particular, in line with Croatia’s deepening integration in EU value chains, domestic price developments should primarily be affected by price developments in its main trading partners (Austria, Slovenia, Italy and Germany). Inflation cycles in Croatia are already highly synchronised with the inflation cycle of the euro area and wage developments are expected to continue to underpin this synchronisation. As for idiosyncratic factors, RRP-related investments and reforms could also be important driver of price developments but are expected to have a muted if not disinflationary effect on the Croatian economy in the long run. On the one hand, RRP investments will boost aggregate demand in the economy, which could put some upside pressures on prices in the short term. On the other hand, many reforms (e.g. reduction of administrative burden and para-fiscal charges, deregulation of services etc.) could enhance competition on the market and reduce costs for companies, thus putting some downward pressures on prices of final products in the long run.

4.3. PUBLIC FINANCES

4.3.1. Recent fiscal developments

After a surplus in 2019, the general government balance turned into a deficit in 2020 (7.3% of GDP) due to the COVID-19 crisis. The deficit in 2020 was directly impacted by the COVID-19 job preservation support, different measures for companies and expenditure on medical supplies. These measures amounted overall to around 3.3% of GDP. After a strong increase in 2020 (8.7%), total expenditures further increased by 2.8% in 2021. Most notably, subsidies to companies and social expenditures grew on account of the COVID-19 support measures. Despite a substantial accumulation of new debt during the crisis, interest expenditure decreased in 2020 and 2021 as maturing debt was refinanced at lower interest rates. Total revenues remained stable as a share of GDP between 2019 and 2021, supported by the increase in EU grants (from 1.5% to 2.7% of GDP).

Table 4.3:

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

Outturn and forecast [1]	2016	2017	2018	2019	2020	2021	2022[1]	2023[1]
General government balance	-0.9	0.8	0.0	0.2	-7.3	-2.9	-2.3	-1.8
- Total revenue	45.9	45.5	45.5	46.3	47.2	46.4	46.4	46.7
- Total expenditure	46.9	44.7	45.5	46.1	54.5	49.2	48.6	48.5
of which:								
- Interest expenditure	3.1	2.6	2.3	2.2	2.0	1.6	1.4	1.3
p.m.: Tax burden	37.3	37.2	37.5	37.6	37.0	36.2	35.9	35.9
Primary balance	2.1	3.4	2.3	2.4	-5.3	-1.3	-0.9	-0.5
Fiscal stance [2]					-1.8	-0.2	-1.8	-0.7
Government gross debt	79.8	76.7	73.3	71.1	87.3	79.8	75.3	73.1
p.m: Real GDP growth (%)	3.5	3.4	2.9	3.5	-8.1	10.2	3.4	3.0

1) Commission's Spring 2022 Economic Forecast.

2) A negative (positive) sign of the indicator corresponds to an excess (shortfall) of primary expenditure growth compared with medium-term economic growth, indicating an expansionary (contractionary) fiscal policy.

Source: European Commission.

The 2021 general government deficit was 2.9% of GDP. The improvement relative to 2020 is mainly explained by the strong economic recovery and the decreasing impact of the COVID-19 temporary emergency measures, which are estimated to have amounted to 2.1% of GDP. The 2021 deficit outturn was significantly lower than the 3.8% of GDP estimated in the 2021 Convergence programme, mainly on account of a lower than expected investment spending.

After increasing by more than 16 percentage points to over 87% of GDP in 2020, the public debt-to-GDP ratio decreased to slightly below 80% in 2021. Debt dynamics in 2021 was driven by the solid GDP recovery, which largely offset the debt-increasing impact of interest expenditure and the primary deficit, with an overall debt-decreasing snow-ball effect of more than 9% of GDP (after +8.4% in 2020). The stock-flow adjustment provided a marginal debt-increasing impact in 2021 (after +2.5% in 2020).

4.3.2. Medium-term prospects

The 2022 budget was adopted by the Parliament on 8 December 2021. Based on the expectation of a general government deficit of 4.5% of GDP in 2021, the budget foresaw a deficit of 2.6% of GDP in 2022. The 2022 budget envisaged a withdrawal of temporary emergency measures. However, considering the effects of the COVID-19 Omicron variant, some measures to retain jobs have been kept in place for the first part of the year. In light of the rising prices in energy products, the Government adopted measures to help the households and companies to cope with the economic and social impact of rising prices. After freezing the petrol and diesel prices already at the end of 2021, authorities temporarily cut excise duties on petrol and diesel in March 2022 until end of May. On the top of these measures, the authorities adopted on 9 March 2022 a comprehensive set of measures, effective as of 1 April amounting to 1% of GDP. This package includes a temporary reduction of VAT on gas from 25% to 5% (from April 1st 2022 to March 31st 2023) and a permanent reduction of the VAT rate on electricity, gas (after March 2023 VAT rate on gas will remain at 13% versus previous 25%), heating, pellet, wood chippings and firewood, and support measures designed for population and companies. The package also includes a permanent cut of VAT rates on non-energy products, including food, hygienic products and tickets for sport and cultural events. There are also temporary support measures (until end of March 2022) for households and companies to help alleviate part of the increase in energy prices.

On 29 April 2022, Croatia submitted its 2022 Convergence Programme, in line with Article 4 of Regulation (EC) No 1466/97. The government projects real GDP to grow by 3% in 2022 and 4.4% in 2023. By comparison, the Commission's Spring 2022 Economic Forecast projects a higher real GDP growth of 3.4% in 2022 and a lower growth of 3.0% in 2023. The difference between the two forecasts comes from a lower expectation by the Croatian authorities concerning growth in real household consumption in 2022. The Government expects in the Convergence Programme that the headline deficit will slightly decrease to 2.8 % of GDP in 2022, mainly reflecting the growth in economic activity and the unwinding of most emergency measures. Due to Russia's invasion of Ukraine, the Croatian authorities expect around twenty thousand refugees and an increase in expenditure related to costs of accommodation, food, education, social welfare and health care. Thereafter, the government deficit is expected to gradually decline to 1.6% of GDP in 2023, 1.6% of GDP in 2024 and to 1.2% by 2025. Therefore, the general government deficit is planned to remain below 3% of GDP over the programme horizon. Compared to the Commission's Spring 2022 Economic Forecast, these deficit projections are higher in 2022 and lower in 2023, mainly due to a lower level of expenditure expected by the Commission in 2022 for gross fixed capital formation and other expenditure. Furthermore the Commission's forecast entails somewhat lower level shift in both revenues and expenditures compared to the Convergence Programme attributed to a difference in the inflation outlook, where government's inflation projection is notably higher than that of the Commission.

The Commission's Spring 2022 Economic Forecast expects the headline deficit to narrow further to 2.3% of GDP in 2022 and to 1.8% in 2023 as revenues are expected to grow strongly on the back of the economic recovery and the support from the RRF for investments, while COVID-19 temporary emergency measures are expected to be completely phased out.

In 2022, the fiscal stance is projected in the Commission's Spring 2022 Economic Forecast to continue to be supportive, at -1.8 percentage points of GDP ([68]). The additional positive contribution to economic activity of expenditure financed by the Recovery and Resilience Facility grants and other EU funds is projected at 0.5 percentage point of GDP in 2022, after 0.3 percentage point of GDP in 2021. Nationally financed investment is projected to provide a expansionary contribution to the fiscal stance in 2022 of 0.4 percentage point. At the same time, the growth in nationally financed primary current expenditure (net of discretionary revenue measures) in 2022 is projected to provide an expansionary contribution of 1.0 percentage point of GDP to the overall fiscal stance, as current expenditure is set to grow at a faster pace than medium-term potential growth. However, most of this expansion is due to measures related to the energy crisis (0.4 percentage point of GDP) and the assistance to those fleeing Ukraine (0.1 percentage point of GDP).

In 2023, the fiscal stance is projected at -0.7 percentage point of GDP. The additional positive contribution to economic activity of expenditure financed by Recovery and Resilience Facility (RRF) grants and other EU funds is projected at 0.5 percentage point of GDP in 2023. Nationally financed investment is projected to provide a slightly expansionary contribution to the fiscal stance of 0.1 percentage point of GDP ([69]). The growth in nationally financed primary current expenditure (net of discretionary revenue measures) is projected to provide a broadly neutral contribution of -0.2 percentage point of GDP to the overall fiscal stance in 2023 as part of the support measures to face the energy crisis in 2022 are assumed to be phased out.

Debt sustainability risks appear medium over the medium run. Government debt is projected to remain on a downward path until 2026 but increase again afterwards, reaching around 69% of GDP in 2032. This projection assumes that the structural primary balance (except for the impact of ageing) remains constant at the forecast level for 2023 of -1.0% of GDP, hence below the 2019 level.

The sensitivity to possible macro-fiscal shocks contributes to this assessment. In particular, if the interest-growth rate differential were permanently 1 percentage point higher than in the baseline, this would lead to a higher debt ratio by about 5 percentage points of GDP by 2032 compared with the baseline and put debt on a steeper increasing path.

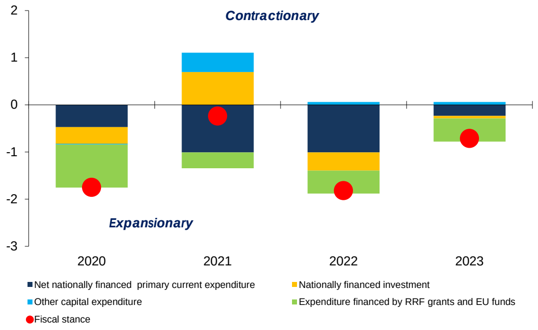
Some factors mitigate risks, including the lengthening of debt maturity in recent years and relatively stable financing sources (with a diversified and large investor base) and the expected positive impact on long-term growth of reforms under the recovery and resilience plan.

([68]) For a definition of the fiscal stance used in this report, see footnote in Section 4.2.3 on underlying factors and sustainability of inflation.

([69]) Other nationally financed capital expenditure is projected to provide a neutral contribution.

Risk-increasing factors include Croatia's negative net international investment position and the recently evidenced decline in population ([70]).

Graph 4.4: **Croatia - Fiscal stance and its components**
(percent of GDP)



Source: Commission's Spring 2022 Economic Forecast.

The Croatian fiscal framework has been significantly strengthened recently, largely thanks to the transposition of outstanding requirements of the Council Directive on Budgetary Frameworks (2011/85/EU). The New Budget Act adopted in December 2021 brought, inter alia, significant improvements with regard to the forecasting process and the consistency and level of detail of the medium-term fiscal plans. Requirements for the publication of forecast methodologies and assumptions, comparisons with independent forecasts (i.e., the European Commission's forecast) and sensitivity analysis contribute to making the forecasting process more transparent and robust. Likewise, multi-annual budgetary objectives that are specified in more detail and with a clearer link to the annual budget process are bound to strengthen the medium-term orientation of fiscal policy. In particular, a new dedicated document (i.e. a Government Decision) will translate the multiannual objectives set in the Convergence Programme into specific limits for budgetary users that can be used in the annual budget process. Finally, the chair of the Fiscal Policy Commission – the independent fiscal council set-up since 2018 – was eventually nominated in late 2021, following several failed attempts.

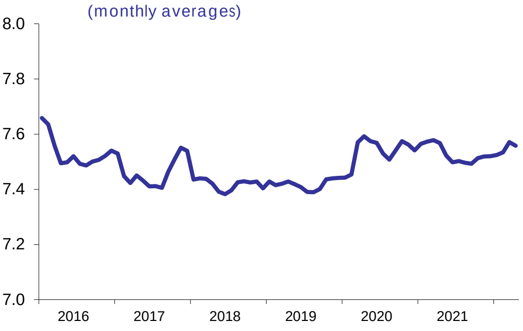
4.4. EXCHANGE RATE STABILITY

The HNB operates de jure a managed floating exchange rate regime, using the exchange rate against the euro as the main nominal anchor to achieve its primary objective of price stability. The HNB does not target a specific level or band for the kuna exchange rate against the euro but, through its foreign exchange transactions, it aims to prevent excessive exchange rate fluctuations.

The Croatian kuna joined ERM II on 10 July 2020 and observes a central rate of 7.53450 to the euro with a standard fluctuation band of ±15%. Upon its ERM II entry, Croatia committed to implement a set of policy measures, the so-called post-entry commitments, with the aim of achieving a high degree of sustainable economic convergence ahead of the euro adoption. The commitments cover four policy areas: the anti-money laundering framework, the business environment, state-owned enterprises (SOEs) and the insolvency framework.

The kuna depreciated against the euro by up to 2% in the first two months of the pandemic in March and April 2020. Since joining the ERMII, the kuna has fluctuated in a narrow band of less than +/-1% against its central rate against the euro. The kuna's exchange against the euro has continued to exhibit a seasonal pattern of temporary appreciation in the summer thanks to foreign currency inflows related to the tourism sector. In the last two years, it usually went below the central rate against the euro in the summer months and moved just above it in the remaining months of each year.

Graph 4.5: **Croatia - HRK/EUR exchange rate**
(monthly averages)



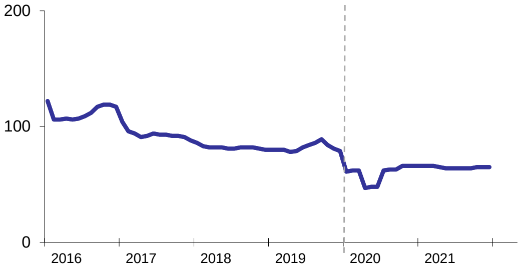
Source: ECB.

International reserves held by the HNB stood at EUR 25 billion (or 44% of GDP) at the end of 2021. After declining by about EUR 2 billion in the first quarter of 2020 due to the foreign exchange interventions conducted by the NHB to maintain the stability of kuna exchange rate against the euro in midst of the pandemic-induced crisis, international reserves increased to close to EUR 19 billion at the end of the year. The HNB' international reserves rose by about EUR 6 billion in 2021. This increase was due to larger inflows of

[70] For further details see the 2021 Fiscal Sustainability Report.

foreign currency to the government account from EU funds and RRP pre-financing an increased volume of repo transactions, and a new allocation of special drawing rights with the International Monetary Fund (IMF).

Graph 4.6: **Croatia - 3-M Zibor(1) and 3-M NRR(2) spread to 3-M Euribor**
(basis points, monthly values until Dec.2019, quarterly values since Q1 2020)



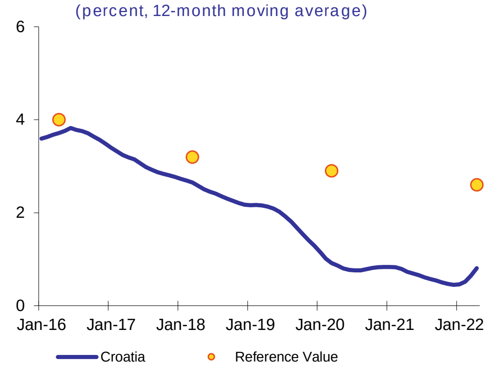
(1) The production of the previously used ZIBOR reference rate was discontinued by the national central bank as of 1 January 2020.
(2) NRR is the national reference rate of average finacing expenses of the banking sector
Source: Eurostat, Thomson Reuters and Croatian National Bank

As foreign exchange interventions are the main monetary policy instrument, the HNB does not frequently change interest rates on its lending and deposit facilities and developments in the short-term rates mainly reflects changes in kuna liquidity in the banking system. Following the decision of the Croatian Banking Association to discontinue the calculation of the Zagreb Interbank Offered Rate (Zibor) benchmarks at the end of December 2019, the HNB has started to publish a new 3-month national reference rate (NRR) on a quarterly basis since the end of the first quarter of 2020. The NRR is a rate representing the average funding expenses of the Croatian banking sector (banks, savings banks and branches of foreign banks). The 3-month NRR stood at 0.20% in the first quarter of 2020 and declined very gradually thereafter throughout 2020 and 2021, mostly in line with developments in the 3-month Euribor rate. As a result, the interest rate differential of the 3-month NRR against the 3-month Euribor rate was broadly flat, averaging about 60 basis points over the 2020-2021 period.

4.5. LONG-TERM INTEREST RATES

The long-term interest rates in Croatia used for the convergence assessment reflect the secondary market yield on a single benchmark government bond with a residual maturity of about 7.5 years. The Croatian 12-month average long-term interest rate relevant for the assessment of the Treaty criterion was below the reference value at the time of the 2020 convergence assessment of Croatia. After having stabilised around those levels in the remaining months of 2020, it declined very gradually throughout 2021, standing just below 0.5% in December, before starting to rise gradually in the first months of 2022. In April 2022, the reference value, given by the average of long-term interest rates in France, Finland and Greece, plus 2 percentage points, stood at 2.6%. In that month, the 12-month moving average of the yield on the Croatian benchmark bond stood at 0.8%, i.e. 1.8 percentage points below the reference value.

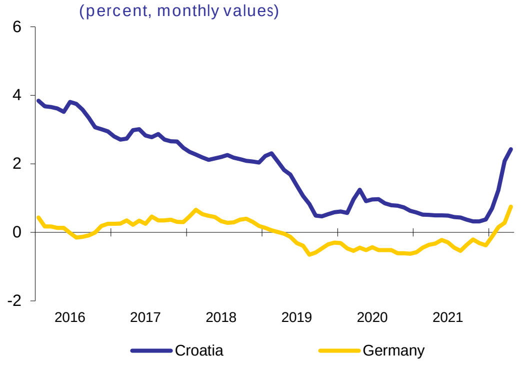
Graph 4.7: **Croatia - Long-term interest rate criterion**
(percent, 12-month moving average)



Source: European Commission.

Following the first two months of the pandemic, the long-term interest rate of Croatia rose by over 60 basis points to stand at 1.2% in April 2020. It declined then very gradually, falling to as low as 0.3% in October 2021. The long-term interest rate of Croatia picked up slightly in December 2021 and moved higher in the first months of 2022 amid increasing geopolitical risks at the global level and a deterioration of the inflation outlook in the context of an already high inflation in most advanced economies. The spread relative to the German long-term benchmark bond widened to around 170 basis points in the first months of the COVID-19 pandemic, it narrowed gradually subsequently, falling to as low as 50 basis points in October 2021 against the backdrop of a strong economic recovery of the Croatian economy. Since November 2021, the spread has widened again to some extent in the context of a deterioration in the Croatian economic outlook related to the spread of the Omicron variant and of an increased risk aversion due to heightened geopolitical risks and the beginning of the Russia's invasion of Ukraine in February 2022. In April 2022, the spread to the German long-term benchmark bond stood at 168 basis points, declining slightly from a recent years' peak of 180 basis points reached in the previous month.

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



Source: Eurostat.

4.6. ADDITIONAL FACTORS

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

In November 2021, the Commission published its ninth Alert Mechanism Report (AMR 2022) under the Macroeconomic Imbalance Procedure (MIP see also Box 1.7), which concluded that an In-Depth Review (IDR) was warranted for Croatia. In the updated scoreboard including figures until 2020, the net international investment position (NIIP), unit labour cost (ULC) growth, house price growth and general government gross debt indicators are above their indicative thresholds.

However, the findings of the Commission’s 2022 In-Depth Review (IDR) indicate that the unwinding of macroeconomic imbalances resumed in 2021, following a relatively contained deterioration in 2020. The public debt ratio decreased owing to strong economic recovery and partial phasing out of pandemic-related fiscal measures. The recovery also reduced the private debt ratio, which returned close to the pre-pandemic level. Both household and corporate debt are below prudential thresholds, although still above the levels suggested by fundamentals. External balances improved, with the current account balance returning to positive territory and the net international investment position (NIIP) returning to an upward trajectory. Croatia’s RRP should facilitate reforms in different areas and thus support the unwinding of macroeconomic imbalances in the medium term. A range of RRP reforms should help improve the fiscal framework, the cost effectiveness in the public sector, access to financing and the business environment. They are also expected to increase the export potential of the economy, participation on the labour market and boost long-term productivity.

After a strong increase of 7.3% in 2020, the growth of real house prices decelerated to 4.6% in 2021, thus moving below the prudential threshold. At the same time, lending for house purchases continued to grow at a robust pace in 2021, supported by the government subsidy program for first-time home owners (among other factors). Due to signs of house price overvaluation, elevated house price growth, high mortgage credit growth and signs of loosening of lending standards, the ESRB issued a warning to Croatia in February 2022, indicating risks as medium and policy as only partially appropriate and partially sufficient. Although the ESRB recognised and supported current CNB macro-prudential measures, it emphasised that borrower-based measures should be activated. However, on the basis of the 2022 in-depth review undertaken under Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances, the Commission considered in its Communication COM(2022) 600 that Croatia is no longer experiencing macroeconomic imbalances. Important progress has been made in reducing private indebtedness and net external liabilities. General government debt remains high but has resumed the downward trajectory that delivered marked improvements before the pandemic. The banking sector remains stable and liquid, with a decreasing non-performing loans ratio. Potential output growth has increased, building on strong policy action, and a further strengthening based on a strong implementation of Croatia’s recovery and resilience plan can address remaining vulnerabilities. On current forecasts, both private and government indebtedness are expected to continue falling with the external position strengthening further benefiting also from the RRF funds.

Croatia submitted its recovery and resilience plan (RRP) on 14 May 2021. The Commission’s positive assessment on 8 July 2021 and Council’s approval on 28 July 2021 paved the way for the implementation of the RRP and the disbursement

Table 4.4:

Croatia - Balance of payments (percentage of GDP)

	2016	2017	2018	2019	2020	2021
Current account	2.2	3.5	1.8	3.0	-0.1	3.1
of which: Balance of trade in goods	-16.1	-16.9	-18.3	-18.8	-17.3	-18.3
Balance of trade in services	17.2	17.5	17.5	18.5	10.5	17.1
Primary income balance	-1.9	-0.4	-0.5	-0.1	2.3	0.3
Secondary income balance	3.0	3.3	3.2	3.4	4.4	4.0
Capital account	1.4	0.9	1.3	1.6	2.1	2.3
External balance [1)]	3.6	4.4	3.1	4.6	2.1	5.5
Financial account	3.1	4.6	3.4	4.4	1.3	4.9
of which: Direct investment	-4.2	-2.3	-1.6	-6.1	-1.3	-3.9
Portfolio investment	2.9	0.8	1.9	2.4	-0.2	-0.1
Other investment [2)]	4.9	0.9	0.1	6.3	1.6	-1.5
Change in reserves	-0.6	5.2	2.9	1.8	1.2	10.5
Financial account without reserves	3.7	-0.6	0.4	2.6	0.1	-5.6
Errors and omissions	-0.5	0.2	0.3	-0.2	-0.8	-0.5
Gross capital formation	20.7	21.7	23.2	22.8	23.9	20.0
Gross saving	23.0	25.1	25.0	25.6	23.0	23.4
Net international investment position	-72.4	-64.2	-55.7	-46.7	-47.8	-33.9

1) The combined current and capital account.

2) Including financial derivatives.

Sources: Eurostat, European Commission calculations, Croatian National Bank.

of EUR 6.3 billion in grants over the period 2021-2026, which is equivalent to 11.5 % of 2019 GDP.

Croatia's plan includes an extensive set of mutually reinforcing reforms and investments (146 investments and 76 reforms) that should contribute to effectively addressing all or a significant subset of the economic and social challenges outlined in the country-specific recommendations (CSRs) addressed to Croatia by the Council in the European Semester in 2019 and 2020.

The plan will address among others key macro-economic challenges such as low employment and activity rates, a burdensome and complex business environment and the low quality of education. Key investments are included on energy efficiency and post-earthquake reconstruction of buildings, sustainable transport, the digital transition of the public administration and 5G infrastructure. Reforms include early childhood education and care, healthcare system, anti-corruption and anti-money laundering, judiciary, and the business environment, by reducing administrative barriers.

The plan devotes 40.3% of its total allocation to measures supporting climate objectives, 20.4% to the digital transition and 23% on social expenditure, all while respecting the do no significant harm principle.

The implementation of the investments in the Croatian plan, along with other investments under Next Generation EU (NGEU), is estimated to raise Croatia's GDP by 2.9% by 2026, of which 0.5% due to the positive spillover effects of the coordinated implementation of NGEU across Member States ([71]). This does not take into account the positive impact of structural reforms on growth.

4.6.1. Developments of the balance of payments

Croatia's current account balance was deeply affected by the COVID-19 pandemic in 2020, but it recovered swiftly during 2021. After registering a surplus of 3% of GDP in 2019, the current

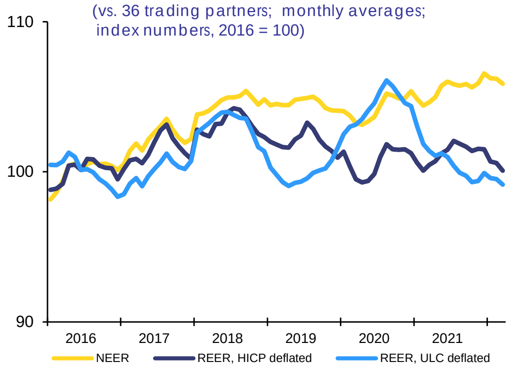
[71] Pfeiffer P., Varga J. and in 't Veld J. (2021), "Quantifying Spillovers of NGEU investment", European Economy Discussion Papers, No. 144 and Afman et al. (2021), "An overview of the economics of the Recovery and Resilience Facility", Quarterly Report on the Euro Area (QREA), Vol. 20, No. 3 pp. 7-16.

account balance fell into negative territory for the first time since 2013, at -0.1% of GDP in 2020. However, a strong recovery of tourism export services and a robust performance in exports of goods, drove the current account balance back to a surplus of 3.1% of GDP in 2021. Despite the economic fallout of the COVID-19 crisis, the capital account continued improving in 2020 and 2021 amid an increasing inflow of EU funds. Thanks to this evolution, the external balance (i.e. the combined current and capital account balance) reached 5.5% of GDP surplus in 2021.

During 2020, exports of services fell by more than 40% compared to 2019, while exports of goods were much less affected by the COVID-19 pandemic as they posted a growth of 0.3%. In 2021, a better-than-expected tourism season helped exports of services to quickly recover, although they remained 10% behind pre-pandemic levels. As a result, the balance of trade in services improved over the year reaching 17.1% of GDP. In terms of trade in goods, both exports and imports exceeded 2019 levels in 2021, experiencing a quick and strong recovery despite supply chain disruptions. However, the trade balance of goods deteriorated by 1 percentage points in 2021, reaching -18.3% of GDP.

Graph 4.9: **Croatia - Effective exchange rates**

(vs. 36 trading partners; monthly averages; index numbers, 2016 = 100)



Source: European Commission.

In 2020, the financial account balance surplus fell to 1.3% of GDP, down from 4.4% recorded in 2019, mostly due to a reduction in portfolio investments, lower reserves and, in particular, to changes in other investments. However, in 2021 the surplus increased to 4.9% of GDP, heavily supported by a strong accumulation of reserves. Consequently, the financial account balance without reserves decreased to -5.6% of GDP.

Based on national accounts, external cost competitiveness, as measured by the ULC-deflated real effective exchange rate, has increased since the beginning of the pandemic. However, the evolution of ULC-deflated REER in 2020 should be interpreted with caution due to challenges in calculating ULC. ([72]). On the other hand, the HICP based REER indicates a slight deterioration in external price competitiveness since 2020.

According to the Commission’s Spring 2022 Economic Forecast, the current account is expected to record a milder surplus of 1.5% of GDP in 2022, with rising energy prices playing an important role, and 0.1% of GDP in 2023. Further reduction of surplus in 2023 should be mostly driven by pressures on imports of goods coming from increasing domestic demand, especially investments, which have high import component.

4.6.2. Market integration

The Croatian economy is well integrated with the euro area through trade, financial and investment linkages. The degree of openness stood at 58% in 2021 increasing significantly after having declined to as low as 51% in 2020 as international trade and Croatia’s exports of tourism and travel services were particularly hit by the pandemic. Trade with the euro area amounted to 31.7% of GDP in 2021, with Germany, Italy, Slovenia, Hungary and Austria, Croatia's largest trade partners, accounting for half of total trade.

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

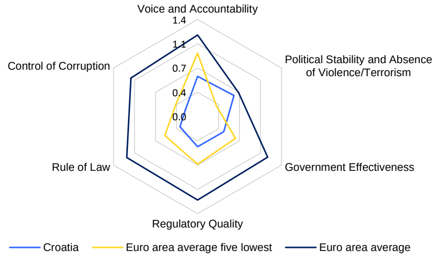
With regard to the business environment, Croatia performs worse than most euro-area Member States according to several commonly used indicators (e.g. the World Bank's Ease of Doing Business Index or the IMD World Competitiveness Index). In the World Bank's Ease of Doing Business, Croatia's worst rankings concern dealing with construction permits and starting a business ([73]). According to the World Bank's

([72]) The ULC-deflated REER should be interpreted with prudence as unit labour costs were distorted by the uneven approach to recording working hours in the presence of labour retention schemes.

([73]) The World Bank Doing Business (DB) program was paused in 2021. The programme will continue with a new

Worldwide Governance Indicators (2020), Croatia ranks low in voice and accountability, regulatory quality and rule of law compared with the average of the five euro area Member States with the lowest scores. Croatia ranks higher than the average five lowest euro area Member States for political stability and absence of violence. ([74]) On the other hand, Croatia stepped up its transposition of EU internal market directives. In addition, there has been renewed effort to improve the business environment, in particular to reduce the administrative burden and regulatory restrictions, especially supported by RRP funds and post-entry ERM II commitments.

Graph 4.10: **Croatia - 2020 World Bank's Worldwide Governance Indicators**



Note: Estimate of governance ranges from -2.5 (weak) to 2.5 (strong).

Source: World Bank.

Corruption represents an important issue in Croatia, which is reflected in the poor performance in the perception of corruption index. This points to a need to strengthen the framework to prevent, detect and correct corruption. Related, Croatia faces challenges in addressing Sustainable Development Goal 16 – Peace, justice and strong institutions. The proportion of people who perceive their justice system to be very or fairly independent has been decreasing in recent years and is the lowest in the EU. The Recovery and Resilience Plan includes reforms and investments in the justice system, for a combined total of EUR 100 million, which is expected to significantly improve the efficiency of the justice and anti-corruption systems, shorten the length of court proceedings and reduce the backlog of court cases, enhancing the transparency and efficiency of public procurement system and put in place a reliable management and control of the EU funds.

The 4th Anti-money Laundering Directive imposed transposition by 26 June 2017 and during 2017-2018 Croatia communicated to the Commission the adoption of several transposition measures. The Commission's analysis of the communicated measures concluded that the Directive had been fully transposed. An assessment of the concrete implementation and effective application of the 4th Anti-money Laundering Directive in Croatia is at present ongoing.

As regards the 5th Anti-money Laundering Directive, whose transposition deadline elapsed on 10 January 2020, Croatia has notified national transposition measures and declared the transposition to be complete. The Commission is at present completing its analysis of whether there are any potential completeness or conformity issues in the transposition or implementation of the Directive.

The economic expansion in Croatia prior to the pandemic supported a steady increase in the employment rate (20-64), which reached 66.7% in 2019. Unscathed during the crisis, the employment rate increased to 68.2% in 2021, but remained well below the EA average of 72.5% (age class from 20 to 64 years). Although the job preservation schemes, also supported by SURE, ESF and REACT-EU, helped cushion the impact on employment levels, the COVID-19 crisis strongly affected the youth (16-24 year olds). This is shown by the particularly high levels of involuntary temporary employment in this age group (30.9% in 2020 compared to 12.2% in 15-64) indicating low levels of job security. However, several RRP reforms and investments related to active labour market policies aim to support the labour market in Croatia, reduce skills gaps and increase activity and employment rates, which should help Croatia speed up convergence to the EU averages.

governance and improved accountability and transparency under the name Business Enabling Environment (BEE). The first edition of the BEE is expected in 2023.

[74] A Member State is considered to have a 'low' ('high') ranking compared with the average of the five euro area Member States with the lowest scores for each indicator if its score is at least 0.3 percentage points lower (higher) than that of the average of this euro area group.

Table 4.5:
Croatia - Market integration

	2016	2017	2018	2019	2020	2021
Trade openness [1] (%)	50.3	53.3	54.3	54.9	51.0	58.0
Trade with EA in goods & services [2]+[3] (%)	28.6	29.6	30.4	30.7	28.1	31.7
World Bank's Ease of Doing Business Index rankings [4]	43	51	58	51	51	-
IMD World Competitiveness Ranking [5]	58	59	61	60	60	59
Internal Market Transposition Deficit [6] (%)	2.2	1.3	0.3	0.2	1.2	-
Real house price index [7]	102.0	105.0	109.8	118.4	127.0	132.8

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

2) (Imports + Exports of goods with EA-19 / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).

3) Trade in services with EA-19 (average credit and debit in % of GDP at current prices) (Balance of Payments).

4) Data not available for 2021. The Ease of Doing Business report by the World Bank was discontinued in September 2021.

5) International Institute for Management Development (IMD).

6) Percentage of internal market directives not yet communicated as having been transposed, relative to the total. (November data, as of 2016 date refers to the year of publication).

7) Deflated house price index (2015=100) (Eurostat).

Sources: Eurostat, World Bank, International Institute for Management Development, European Commission calculations.

Although the size of the financial sector in Croatia reached 229% of its GDP in 2020, it was smaller than that of the euro area. At the same time, its size was comparable to that of the five euro area Member States with the smallest financial sector. As in the euro area, the banking sector dominates the Croatian financial sector but its share was much larger than in the euro area, representing about 56% of the financial sector's assets against just 40% in the euro area in 2020. The central bank and the sector of insurance and pension funds were the second and the third largest holders of financial assets with a share of 20% and 19% respectively. As a result, these three sectors (i.e. monetary financial institutions, central bank and insurance companies and pension funds) concentrated about 95% of financial sector assets, indicating a higher concentration of financial assets than in the euro area but also than in the five smallest euro area financial sectors. Reflecting on one hand the impact of the pandemic on the financial sector stability and on the other hand the measures taken by the central bank in response to the crisis, the importance of the central bank in the financial sector increased to 20% of GDP in 2020 from 15% of GDP in 2016. At the same time, the importance of the banking system declined to 56% of GDP from 62% in 2016, reflecting a subdued credit growth to the real economy and in particular to the non-financial sector. The importance of the insurance and pension funds appears to have been more stable, standing to 19% of the total assets of the financial sector in 2020, which broadly compares to its importance of 17% in 2016.

Table 4.6:
Croatia - Allocation of assets by financial sub-sector

						Ratio to GDP (%)
	HR		EA		EA 5 smallest	
	2016	2020	2016	2020	2016	2020
Financial corporations (total)	196	229	722	796	177	215
Central bank	30	45	45	78	37	61
Monetary financial institutions	122	128	286	311	97	98
Other financial intermediaries	9	7	202	179	20	28
Non-MMF investment funds[1]	3	6	100	127	4	5
Insurance co. and Pension Funds	33	43	90	102	18	23
						Share of total (%)
	HR		EA		EA 5 smallest	
	2016	2020	2016	2020	2016	2020
Central bank	15	20	6	10	21	29
Monetary financial institutions	62	56	40	39	55	46
Other financial intermediaries	5	3	28	22	11	12
Non-MMF investment funds	1	3	14	16	2	2
Insurance co. and Pension Funds	17	19	12	13	10	11

1) MMF stands for money market funds.

Source: Eurostat.

As for the funding structure of the Croatian economy, this is dominated by bank loans and trade credits to a larger extent than in the euro area. The outstanding bank loans and trade credits amounted to over 164% of Croatia's GDP and the majority of bank loans was denominated in euro. Possibly reflecting the large use of limited liability companies and the importance of SOEs in Croatia, other equity [75] represented the second most important source of funding of the Croatian economy, amounting to 124% of GDP. At the same time, the listed and unlisted shares represented about 64% of GDP, broadly in line with the importance of government debt market in terms of GDP. However, the importance of listed shares amounted to just 36% of GDP in 2020, declining somewhat compared to 2016 when it stood at 41% and being thus just half of its

[75] Other equity refers to equity claims such as equity in incorporated partnerships, equity in limited liability companies whose owners are partners, capital invested in cooperative societies or investment by the government in the capital of public corporations whose capital is not divided into shares.

importance in the euro area. Overall, Croatia has less developed equity and debt markets in terms of GDP than the euro area average. Although these markets appear relatively larger in terms of GDP than the five smallest national capital markets in euro area, their relative importance as a funding source remained limited and broadly in line with the euro area average.

Table 4.7:

Croatia - Financing of the economy1)

	HR		EA		EA 5 smallest	
Ratio to GDP (%)	**2016**	**2020**	**2016**	**2020**	**2016**	**2020**
Liabilities (total)	441	461	743	770	324	335
Loans	163	164	238	236	115	112
Non-financial co. debt securities	5	4	12	15	3	4
Financial co. debt securities	0	0	74	68	11	12
Government debt securities	57	65	83	95	51	57
Listed shares	41	36	65	73	17	18
Unlisted shares	28	28	186	193	55	56
Other equity	109	124	51	56	42	48
Trade credits and advances	38	39	33	35	29	29

	HR		EA		EA 5 smallest	
Share of total (%)	**2016**	**2020**	**2016**	**2020**	**2016**	**2020**
Loans	37	36	32	31	35	33
Non-financial co. debt securities	1	1	2	2	1	1
Financial co. debt securities	0	0	10	9	3	3
Government debt securities	13	14	11	12	16	17
Listed shares	9	8	9	9	5	5
Unlisted shares	6	6	25	25	18	18
Other equity	25	27	7	7	13	14
Trade credits and advances	9	8	4	5	9	9

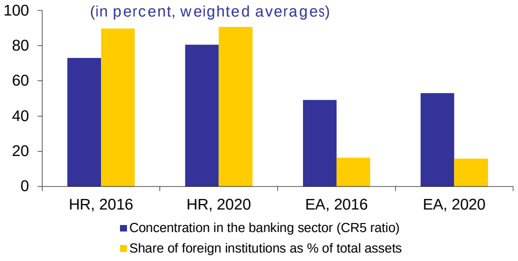
1) The table focuses on the financing needs of a country and how these are met by the financial system. The table is constructed from the liabilities of all economic sectors, but only considers loans, debt securities, equity and trade credits. The sum of liabilities in the table only reflects the total for the liabilities considered.

Source: Eurostat.

The banking sector in Croatia is highly integrated into the EU financial sector, in particular through foreign ownership of the banking sector, as around 90% of its assets are held by subsidiaries of foreign banks. Concentration in the banking sector is much higher than in the euro area, with the largest five banking institutions reaching 80% of sector's total assets in 2020, against 50% in the euro-area. In parallel with the inclusion of the Croatian kuna in the ERM II, the Croatian National Bank entered into a close cooperation with the ECB, effectively joining the Banking Union. As of 1 October 2020, Croatia also joined the Single Resolution Mechanism, and the ECB has become responsible of the direct supervision of the significant banking institutions in Croatia as well as the oversight of less significant institutions.

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

(in percent, weighted averages)

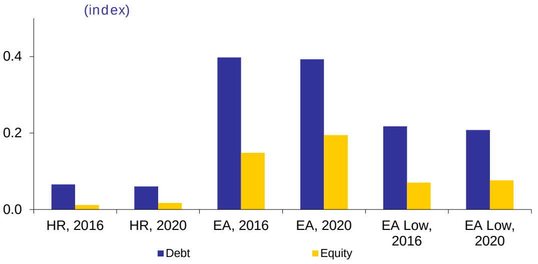


Source: ECB, Structural financial indicators and HNB Banks Bulletin.

Measures of intra-EU integration in equity and debt markets, as based on the home bias in portfolio investments, [76] indicate that the level of integration of Croatia is very low in both segments and in particular in equity markets. Although intra-EU financial integration, by the same measure, is in general relatively low across EU Member States, Croatia's integration is well below that of the euro-area Member States exhibiting low integration. The very large home bias indicates that almost all investments in financial markets takes place domestically.

Graph 4.12: **Croatia - Intra-EU integration in equity and debt portfolio investment**

(index)



Note: The chart shows the extent of home bias in debt and equity markets. A value index of 1 implies 'full integration' with the financial markets of other Member States, while 0 denotes 'no integration'.

Source: FinFlows database: European Commission, Joint Research Centre (JRC).

4.7. SUSTAINABILITY OF CONVERGENCE

This concluding section draws together elements that are key for gauging the sustainability of Croatia's convergence vis-à-vis the euro area. The analysis reviews sustainability from a number of angles.

[76] Home bias in portfolio investments measures the average propensity of investors in a Member State to invest domestically as compared with investing in other EU countries. The indicator ranges between 0 and 1, with a value of 0 indicating that investors prefer domestic over foreign assets. The inverse of the home bias can be interpreted as one measure of financial integration among EU countries.

First, the sustainability dimension is inherent in the individual convergence criteria themselves. This holds most explicitly for the price stability criterion, which includes the requirement of a ’sustainable price performance’. In principle, the fiscal criterion (EDP) also involves a forward-looking aspect, providing a view on the durability of the correction of fiscal imbalances. While the exchange and interest rate criteria are, by construction, backward-looking, they aim at capturing an economy’s ability to operate durably under conditions of macroeconomic stability, hence indicating whether the conditions for sustainable convergence following euro adoption are in place.

Second, the assessment of additional factors (balance of payments, product and financial market integration) required by the Treaty broadens the view on sustainability of convergence and allows for a more complete picture, complementing the quantitative criteria. In particular, a sound external competitiveness position, effectively functioning markets for goods and services and a robust financial system are key ingredients to ensure that the convergence process remains smooth and sustainable.

Third, the convergence assessment should be informed by the results and findings of enhanced policy co-ordination and surveillance procedures (MIP, fiscal governance) put in place after the Global Financial Crisis. The aim is not to add to the existing requirements for euro adoption, but to make full use of the comprehensive economic and financial analysis undertaken under the so-called European Semester. While some elements drawn from the European Semester (e.g., related to AMR scoreboard indicators) are included in the relevant chapters on convergence above, this section uses this framework more systematically to provide an integrated view of the sustainability dimension.

Any assessment of the sustainability of convergence has limits and must be based on a judgement of the likely future evolution of the economy. In particular, as experience has shown, the sustainability and robustness of the convergence process after euro adoption is to a significant extent endogenous, i.e., it depends on a Member State’s domestic policy orientations after it has joined the euro area. Therefore, while the assessment of sustainability is an essential element in determining a Member State’s readiness to adopt the euro based on initial conditions and existing policy frameworks, the outcome of such an assessment should be seen as a snapshot at a specific point in time, whereas the long-term sustainability of the convergence process will also depend on the adoption of appropriate policies over time. In this respect, the on-going surveillance carried out in the context of the European Semester will play a major part in ensuring that such policies are implemented by the Member State after euro adoption.

The analysis below looks at sustainability from four different perspectives: price stability; fiscal performance and governance; structural resilience and growth sustainability; and financial resilience.

Price stability

While inflation has increased significantly in Croatia since the beginning of 2021, the upward trend has been broadly comparable to what has been observed in the euro area. As a result, Croatia’s present 12-month inflation rate is below the reference value. Looking ahead, the 12-month inflation rate is expected to remain below the reference value in the next few months and close to the euro area average in both 2022 and 2023.

Beyond the outlook for headline inflation, assessing the sustainability of price stability also requires looking at underlying price and cost fundamentals. The analysis presented in Section 4.2.3 does not point to any source of concern related to the sustainability of price stability when examining labour costs, imported prices, the macroeconomic policy mix or risks related to price level convergence.

Furthermore, it is important to stress that inflation developments in Croatia have been closely aligned with those of the euro area over the decade preceding the COVID-19 crisis. On average, both headline and core inflation have been very close to the euro area average over this period, with annual deviations never exceeding 1 percentage point. This reflects a number of interrelated factors, including the kuna’s exchange rate regime, high trade and financial integration with the euro area and a business cycle that is generally broadly aligned with that of the euro area.

Nevertheless, in view of the high uncertainty currently surrounding the inflation outlook in the EU, Croatia’s successful integration in the euro area will require the continued monitoring of a number of upside risks in terms of inflation.

First, underlying inflation has accelerated more strongly in Croatia than in the euro area in recent months, reflecting the stronger recovery from the COVID-19 crisis and a surge in the price of processed food. Despite currently stronger core inflation relative to the euro area there are no indications that the drivers would be of a structural nature, given its historic alignment with the euro area trends. Thus, current deviation of core inflation rate compared to the euro area is expected to be transitory with the inflation gap fading in the upcoming period. However, underlying inflation pressures will need to be monitored closely looking ahead.

Second, longer-term inflation prospects will hinge in particular on wages growing in line with productivity. Although the 2013 and 2014 labour market reforms have substantially increased the level of flexibility in the labour market, wage-setting in Croatia remains imperfectly aligned with productivity developments, which is partly linked to the role of the public sector as the wage leader. While this represents a risk, the issue could be alleviated by the reforms envisaged in the context of the RRP (see also next paragraph).

RRP-related investments and reforms could also be important drivers of price developments looking ahead. On the one hand, RRP investments will boost aggregate demand in the economy, which could put upside pressures on prices in the short term. On the other hand, many reforms (e.g. reduction of administrative burden and para-fiscal charges, deregulation of services etc.) should enhance competition on the market and reduce costs for companies, thus putting downward pressures on prices of final products in the long run. Moreover, two RRP reforms could contribute to a better productivity-wage relation in the medium-term. The first one is the new wage and work models in civil and public service, which should introduce a fair, transparent and sustainable wage system in the state administration and public services. The second one is the Amendment to the Labour Act, tackling unjustified temporary employment and incentivising workers to remain active, among others. On balance, the RRP-related investments and reforms are expected to have a muted if not disinflationary effect on the Croatian economy in the long run.

Fiscal sustainability

After a timely abrogation of the excessive deficit procedure in 2016, Croatia's public finances performed well in the preventive arm of the Stability and Growth Pact until 2020, when they took a hit as a result of the pandemic. A decline in economic activity adversely affected revenues, which coincided with substantial expenditure measures needed to protect employment and jump-start the recovery. As a result, Croatia's headline general government balance went from a surplus of 0.2% of GDP in 2019 to a deficit of 7.3% of GDP in 2020. At the same time, the public debt ratio rise by more than 16 percentage points. However, already in 2021, the deficit was brought below 3%, driven by a full economic recovery and a progressive but substantial phasing-out of the expenditure measures.

Croatia's 2022 Convergence Programme was adopted on 27 April and submitted to the Commission on 29 April. The programme projects the general government deficit to narrow from 2.9% of GDP in 2021 to 2.8% of GDP in 2022 and 1.6% of GDP in 2023. This is expected to bring general government public debt down to 71.7% of GDP in 2023, very close to its pre-COVID level recorded in 2019. The macroeconomic outlook underpinning the Convergence programme differs from the Commission's Spring 2022 Economic Forecast. The main difference is related to the inflation figures in 2022 and 2023, which are notably higher compared to Commission's forecast. The targets in the Convergence programme appear prudent and achievable.

At the same time, Croatia is classified at medium fiscal sustainability risk over the medium term, according to the Commission Debt Sustainability Analysis. ([77]). The debt ratio is projected to decline from its 2021 level of 79.8% of GDP until the mid-2020s, assuming a favourable interest-growth rate differential, but it will increase again as from 2027 unless measures are taken to correct the projected structural primary deficit, especially given the projected increase in the cost of ageing in coming years. Under less favourable macro-financial assumptions, debt could revert close to its 2021 level by 2032. Additional factors may aggravate sustainability risks, including the large share of debt held in foreign currency, the impact of the

([77]) The classification based on the Commission DSA takes into account in particular the projected debt level and trajectory under the baseline, stress test scenarios and stochastic simulations.

recent decline in population and the country's negative net international investment position.

On the positive side, however, the structure of Croatia's debt mitigates the risks, notably as the debt maturity has been lengthened in recent years. Furthermore, reforms under the recovery and resilience plan should have a positive impact on long-term growth, contributing to improving debt sustainability.

Structural resilience and growth sustainability

The last report by the Commission on Croatia's macroeconomic imbalances [78] noted that the country was still experiencing imbalances related to elevated private and public debt levels in the context of low potential growth. However, in recent years indebtedness of private and public sector has declined notably. Public debt declined from the peak of around 84% of GDP in 2014 to slightly above 71% in 2019, while private sector debt decreased from a peak of 120% of GDP to around 88% of GDP in 2019. This deleveraging has come against the backdrop of years of solid economic growth and prudent fiscal policy. The COVID-19 crisis in 2020 temporarily halted the downward trajectory of debt, which resumed already in 2021 in both private and public sector. Despite the current uncertainties surrounding the economic situation, debt ratios should continue to decline steadily, supported by solid economic growth but also by some MIP-relevant policies included in Croatia's recovery and resilience plan, such as changes in bankruptcy and solvency framework and new equity-based financial instruments which should reduce the dependence of firms on bank loans.

External balances have also improved notably in recent years. After six consecutive years of current account surpluses, the COVID-19 shock pushed the balance slightly into negative territory, but Croatia managed to record again a surplus of 3.2% of GDP in 2021. At the same time, the net international investment position (NIIP) improved from –87% of GDP to -34% of GDP, which brought it in conformity with the indicative -35% of GDP threshold in the scoreboard of the Macroeconomic Imbalance Procedure. Moreover, Croatia's NIIP excluding non-defaultable instruments (NENDI) was virtually balanced in 2021 and foreign exchange reserves reached 44% of GDP, thus mitigating exchange-rate risks. Current commodity price shocks are expected to negatively affect Croatia's goods trade balance, but stable tourism inflows, remittances and accelerating inflows of EU funds should keep the current account balance in surplus. A strong inflow of EU funds on the capital account should also support continued improvement of NIIP.

All these developments make the Croatian economy more resilient to shocks. This increase in resilience was already visible during the COVID-19 crisis, after which the Croatian economy strongly recovered, with GDP reaching pre-pandemic level already in 2021. Despite the progress made in recent years, the Croatian economy is still facing various structural deficiencies on labour and product markets. Various reports (such as World Bank's Doing Business Report or IMD's World Competitiveness Report, OECD's Product Market Regulation) still point to a relatively unfavourable business environment, rigidities on the labour and product markets and high administrative burden. In addition, the public sector's strong role in the economy weighs on the allocative efficiency on the market. Worldwide Governance Indicators suggest that the quality of institutions has increased in recent years, but Croatia still ranks below most euro area countries for indicators such as the Rule of Law, Control of Corruption, Regulatory Quality and Government Effectiveness. Similar conclusions can be drawn from the Transparency International's Corruption Perception Index.

Measures aimed at addressing these rigidities and improving the quality of institutions have featured in Croatia's prior and post-entry ERM II commitments as well as its Recovery and Resilience Plan. These measures include cutting the administrative and fiscal burden, improving SOEs governance and the anti-money-laundering framework (AML), increasing the efficiency of the judiciary and liberalising regulated professions.

In July 2019, Croatia committed to implementing policy measures prior to joining the ERM II in the following six areas: i) banking supervision (close cooperation with the ECB), ii) the macroprudential framework, iii) the anti-money laundering framework, iv) statistics, v) public sector governance and vi) business environment. In June

[78] European Commission (2021), Alert Mechanism Report 2022. Available at: https://ec.europa.eu/info/sites/default/files/economy-finance/2022_european_semester_alert_mechanism_report.pdf

2020, the Croatian authorities notified the ERM II parties of the fulfilment of these commitments, which the ECB and the Commission assessed as effectively implemented. [79]

At the time of its ERM II entry in July 2020, Croatia committed to implementing further measures in the following four areas: i) anti-money laundering, ii) business environment, iii) SOEs and iv) insolvency framework.

As regards AML, the implemented measures consisted of awareness raising among stakeholders through regular education, improved cooperation between the Anti-Money Laundering Office and the supervisory authorities and the implementation of the Action Plan to reduce the risk of money laundering and financing of terrorism based on the updated National risk assessment. In the area of Business environment, Croatia followed through on its commitments to simplify and digitalise administrative procedures as specified in the Action Plan for Administrative Burden Reduction 2020 and further reduce parafiscal charges. With a view to improving public sector governance, Croatia proceeded to revise and align regulation and practices in accordance with the OECD Guidelines on Corporate Governance of SOEs. Finally, commitments to improve the insolvency framework took the form of amendments to key legislation governing corporate and personal insolvency procedures and the operationalisation of an interim data collection system for restructuring and insolvency procedures.

Notwithstanding the AML measures implemented by Croatia in the context of its prior and post-entry commitments, the Mutual Evaluation Report assessing Croatia's framework for combatting money laundering and terrorist financing [80] identified a number of remaining shortcomings with regard to the effective implementation of Croatia's AML framework. The Croatian authorities are currently focusing their efforts in swiftly addressing the recommended actions listed in the report with a view to achieve a satisfactory level of progress within the next year.

The aforementioned structural deficiencies are weighing on the long-term potential growth by stifling competitiveness and business activity, which in turn hampers investment and discourages employment growth. The numerous reforms in the RRP are expected to address the structural weaknesses of the economy, increase the efficiency of the public sector and the competitiveness and productivity of the Croatian economy. Governance in SOEs is envisaged to be enhanced by implementing OECD standards. At the same time, divestments of government-owned shares in companies should reduce the level of government intervention in the market and facilitate the administration of remaining shares. Private sector productivity and investment activity are expected to benefit from the planned continuation of the reduction of administrative burden, reform of the R&D incentive system, measures aimed at strengthening the R&D capacity, funds aimed at digitalisation of companies, export promotion activities and new financial instruments based on grants and interest rate subsidies but also equity-funding aimed at SMEs. Croatia's RRP also contains various active labour market policies that should increase labour market participation and measures aimed at improving workers' skills that should additionally increase productivity. All these measures should boost the productive potential of the economy and contribute to the acceleration of potential growth rate in the mid run.

Financial resilience

Although the resilience of Croatia's financial sector has been tested by the outbreak of the pandemic, prompt policy support and regulatory measures [81] have so far alleviated the impact of the crisis on the financial sector. Overall banking system capital adequacy ratio actually increased in 2020 and reached a record high in the second quarter of 2021.

The Croatian banking sector entered the COVID-19 pandemic in an already strong position as shown by the positive results of the comprehensive assessment of major Croatian banks conducted by the ECB ahead of its decision to establish close cooperation in the field of banking supervision

[79] https://ec.europa.eu/info/business-economy-euro/euro-area/introducing-euro/adoption-fixed-euro-conversion-rate/erm-ii-eus-exchange-rate-mechanism_en

[80] The report was adopted in December 2021 by the Council of Europe's Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (MONEYVAL).

[81] The measures of support during the pandemic included an expansionary monetary policy, fiscal support to companies and favourable regulatory treatment of the moratoriums to mitigate to an extent the problem of non-performing loans, coupled with other regulatory reliefs and the temporary restriction of banks' profit distribution.

with the Croatian National Bank (HNB). Following Croatia's request for close cooperation with the ECB in May 2019, the ECB adopted a favourable decision in July 2020 after conducting a comprehensive assessment of five Croatian banks ([82]), which comprised an asset quality review (AQR) and a stress test. ([83]) The comprehensive assessment showed that the five banks did not face any capital shortfalls as they did not fall below the relevant thresholds used in the AQR and the stress test. However, the assumptions used for the stress test scenarios could not take into account the COVID-19 crisis given that this exercise started well before the outbreak of the pandemic.

A more recent stress test exercise conducted by the HNB and published in May 2021, uses as a starting point the situation of Croatian banks' balance sheets at the end of 2020 ([84]). It concludes that the overall banking system is resilient and ready to bear increased credit losses even under an adverse scenario ([85]), which envisaged further unfavourable developments in the pandemic from the second quarter of 2021. Moreover, the observed economic developments in 2021 turned out to be much more favourable than envisaged in the stress test exercise scenario, with the economy expanding by over 10% as opposed to a hypothetical cumulative contraction of about 6.6% over the 2021-2023 period in the adverse scenario.

However, Croatia's strong economic recovery in 2021 and the increased loss-absorption capacity of the overall banking system compared to the pre-COVID situation mask a considerable heterogeneity across Croatian banks. While systemically important banks should be able to continue to operate even under very unfavourable conditions, the results of HNB's stress tests for other credit institutions show that the latter are much more vulnerable to adverse economic conditions, with the aggregate capital surplus being all but fully exhausted in the first year of the adverse scenario. However, these credit institutions account for less than 5% of the total banking system assets (HNB, 2021).

In addition to the more bank-specific vulnerabilities discussed above, a number of pandemic-induced developments and policy measures are likely to have increased some pre-existing vulnerabilities of the Croatian banking system. Thus, its exposure to the government and the real estate market has risen. With over 20% of total bank assets placed on Croatian government bonds, Croatia is among the EU countries with the largest government exposures of credit institutions. While the overall banking system can be considered resilient in light of the results of recent stress tests, this strong sovereign-bank-nexus could pose risks to its resilience as Croatia stands out in terms of the level of public debt in GDP. Even before the outbreak of the pandemic, Croatia had the highest level of public debt in GDP of all Central and Eastern European countries. The growing imbalances in the real estate sector is also a risk factor for the Croatian banking system. ([86]) Thus, around 45% of loans to the private sector are covered by real estate collateral and a possible decrease in real estate prices may raise credit risk costs (HNB, 2021). Finally, the banking sector in Croatia remains also highly exposed to a currency-induced credit risk but the risks themselves are contained given the historical stability of the kuna exchange rate vis-à-vis the euro and the sizeable foreign exchange reserves of the CNB. Overall, the above-mentioned high exposures of the Croatian banking system could represent a risk for its resilience to the extent they continue to weigh on its profitability looking ahead.

([82]) The comprehensive assessment covered Zagrebačka banka, Privredna banka Zagreb, Erste & Steiermärkische Bank, OTP banka Hrvatska and Hrvatska poštanska banka, all of which consented to the disclosure of the exercise's findings.

([83]) Such assessment is required as part of the process of establishing close cooperation between the ECB and the national competent authority of an EU Member State whose currency is not the euro. For more details please see https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200605~ca8b62e58f.it.html

([84]) See Croatian National Bank (2021), Financial Stability, No. 22: https://www.hnb.hr/documents/20182/3899508/e-fs-22.pdf/c82deec6-2de6-1d35-d4fb-849d8a5c15d9

([85]) The adverse scenario envisages further unfavourable developments in the pandemic from the second quarter of 2021 and a hypothetical fall in economic activity of 1.2% in 2021, 4.0% in 2022 and 1.4% in 2023 as well as a high unemployment rate throughout the observed adverse scenario horizon. In addition to the assumption of difficulties and delays in global response to the pandemic, the adverse scenario also includes a materialisation of additional sources of systemic risks such as a sharp fall in residential real estate prices and depreciation of the exchange rate that would rise to HRK 8.0/EUR following the escalation of the pandemic (CNB, 2021).

([86]) As a result of the continued accumulation of cyclical systemic risks amid economic recovery following the crisis caused by the pandemic, the growth in the prices of residential real estate and the pickup in lending activity, the CNB adopted on 28 March 2022 the decision to increase the countercyclical buffer rate to 0.5% as of 31 March 2023.

Conclusion

The broad-based analysis of underlying factors relevant for the sustainability of Croatia's convergence suggests that sufficiently robust conditions are in place for the country to be able to maintain a sustainable convergence path in the medium term, thus supporting a positive assessment. However, significant challenges remain, and policy discipline will need to be maintained in a determined manner to fully exploit the benefits of participation in the euro area and minimise risks to the convergence path going forward. Recent measures and policy orientations included in Croatia's RRP should contribute to ensure that it remains on a sustainable convergence path in the medium term.

5. HUNGARY

5.1. LEGAL COMPATIBILITY

5.1.1. Introduction

The main rules governing the Magyar Nemzeti Bank (MNB – Hungarian national bank, hereafter MNB) are laid down in Article 41 of the Hungarian Fundamental Law and Act CXXXIX 2013 on the MNB (hereafter: MNB Act). No amendments to these legal acts were passed with regard to the incompatibilities and imperfections mentioned in the Commission's 2020 Convergence Report. Therefore, the comments provided in the Commission's 2020 Convergence Report are repeated also in this year's assessment.

5.1.2. Central Bank independence

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

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

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

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

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

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

5.1.3. Prohibition of monetary financing and privileged access

Pursuant to Article 36 of the MNB Act and subject to the prohibition of monetary financing set out under Article 146 of the MNB Act, the MNB can provide an emergency loan to credit institutions in the event of any circumstance arising in which the operation of a credit institution jeopardises the stability of the financial system. In order to comply with the prohibition on monetary financing of Article 123 of the TFEU, it should be clearly specified that the loan is granted against adequate collateral to ensure that the MNB would not suffer any loss in case of debtor's default.

Pursuant to Article 37 the MNB may grant loans to the National Deposit Insurance Fund and Investor Protection Fund in emergency cases, subject to prohibition of monetary financing under Article 146 of the Act. Though the Act adequately reflects conditions for central bank financing provided to a deposit guarantee scheme a specific requirement should be included to ensure that the loans granted to the National Deposit Insurance Fund are provided against adequate collateral (e.g. a claim on future cash contributions, government securities, etc.) to secure the repayment of the loan. Therefore, Article 37 is incompatible with the prohibition on monetary financing as laid down in Article 123 of the TFEU.

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

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

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

5.1.4. Integration in the ESCB

Objectives

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

Tasks

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

- definition of monetary policy and the monetary functions, operations and instruments of the ESCB (Articles 1 (2), 4(1), 9, 16 – 21, 159 and 171 of the MNB Act);

- conduct of foreign exchange operations (Articles 1(2), 4(3), (4) and (12), 9 and 159(2) of the MNB Act) and the definition of foreign exchange policy (Articles 1(2), 4(4) and (12), 9, 22 and 147 of the MNB Act);

- competences of the ECB and of the Council for banknotes and coins (Article K of the Fundamental Law and Articles 1(2), 4(2) and (12), 9, 23, 26 and 171(1) of the MNB Act).

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

- non-accurate reflection of the principle of central bank independence in the MNB Act (Article 1(2) and (3) of the MNB Act);

- non-recognition of the role of the ECB in the functioning of the payment systems (Articles 1(2), 4(5) and (12), 9, 27-28, and 159(2), 171 (2) of the MNB Act);

- non-recognition of the role of the ECB and of the EU in the collection of statistics (Article 1(2), 30(1) and 171(1) of the MNB Act);

- non-recognition of the role of the ECB in the field of international cooperation (Article 135(5) of the MNB Act));

- absence of an obligation to comply with the Eurosystem's regime for the financial reporting of NCB operations (Article 12(4)(b) and Law C of 2000/95 (IX.21.) in conjunction with Government Decree 221/2000 (XII.19.));

- non-recognition of the role of the ECB and the Council in the appointment of external auditors (Articles 6(1) (b), 15 and 144 of the MNB Act).

5.1.5. Assessment of compatibility

As regards central bank independence of the MNB, the prohibition on monetary financing and the integration of the MNB into the ESCB at the time of euro adoption, existing Hungarian legislation is not fully compatible with the Treaties and the Statute of the ESCB and the ECB pursuant to Article 131 of the TFEU. The Hungarian authorities are invited to remedy the abovementioned incompatibilities.

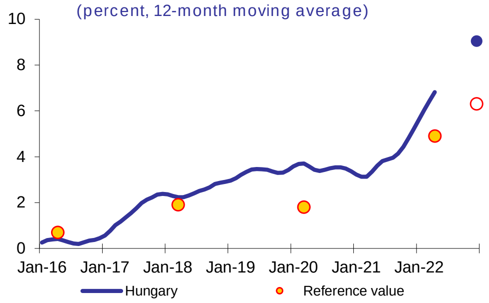
5.2. PRICE STABILITY

5.2.1. Respect of the reference value

The 12-month average inflation rate, which is used for the convergence assessment, has been above the reference value since the convergence assessment of Hungary in 2018. It has remained above 3% since early 2019 and started moving further up in spring 2021, surpassing the 5% threshold in December. In April 2022, the reference value was 4.9%, calculated as the average of the 12-month average inflation rates in France, Finland and Greece, plus 1.5 percentage points. The corresponding inflation rate in Hungary was 6.8%, i.e. 2.9 percentage points above the reference value. The 12-month average inflation rate is projected to remain well above the reference value in the months ahead.

Graph 5.1: **Hungary - Inflation criterion**

(percent, 12-month moving average)



Note: The dots at the right end of the chart show the projected reference value and 12-month average inflation rate of the country in December 2022. The reference values for 2016, 2018 and 2020 refer to the reference values calculated in the previous Convergence Reports.

Source: Eurostat, Commission's Spring 2022 Economic Forecast.

5.2.2. Recent inflation developments

Over the last two years, HICP inflation was on an upward path in Hungary, with unprocessed food and energy prices adding volatility to the headline figure. Annual HICP inflation accelerated from 3.4% in 2020 to 5.2% on average for 2021, and was as high as 9.6% in April 2022. During the last two years, annual HICP inflation in Hungary remained above that of the euro area with the differential narrowing somewhat in 2021.

Energy price inflation, which was negative for much of 2020, reached double digits in 2021, due to rising crude oil prices. The government introduced a temporary price cap on motor fuel between November 2021 and July 2022. Since residential energy is supplied at regulated prices to households and these remained unchanged in 2020 and 2021, the recent higher prices on European wholesale gas and electricity markets have had no direct effect on consumer prices yet. Instead, the higher wholesale price have been absorbed by the (mostly state-owned) utility sector, creating a fiscal burden. However, the wholesale energy price increases have had an indirect impact on consumer prices, through the rising costs of companies.

Processed food price inflation accelerated in 2021, reflecting adverse commodity price developments. The price of processed food was also affected by successive increases of the excise duty on tobacco. As of 1 February 2022, the government introduced a temporary price cap on some basic food items in effect until July 1, 2022.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) eased slightly to 3.2% in March 2021 due to the COVID-19 crisis, but then increased to 9.2% in April 2022, signalling broad-based price increases in the wake

Table 5.1:
Hungary - Components of inflation

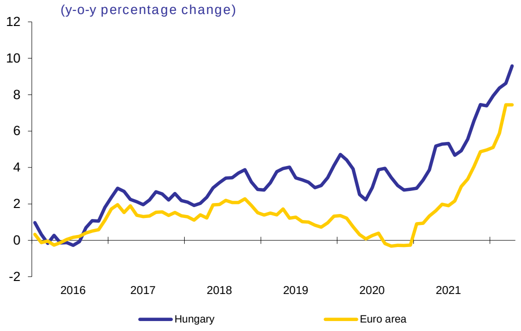
	2016	2017	2018	2019	2020	2021	Apr-22	weights in total 2022
	(percentage change)[1)]							
HICP	0.4	2.4	2.9	3.4	3.4	5.2	6.8	1000
Non-energy industrial goods	1.0	0.4	0.4	1.1	1.2	3.2	5.0	255
Energy	-3.7	4.2	4.8	0.5	-3.2	12.4	13.2	113
Unprocessed food	0.0	1.4	6.4	7.0	12.9	2.1	5.7	55
Processed food	1.0	4.0	4.1	5.7	5.9	6.6	8.2	265
Services	1.8	1.9	2.4	4.0	3.8	3.8	5.2	312
HICP excl. energy and unproc. food	1.4	2.1	2.3	3.7	3.7	4.5	6.0	832
HICP at constant tax rates	0.6	2.9	3.4	3.2	3.3	4.7	6.5	1000
Administered prices HICP	0.3	0.3	0.3	1.0	0.3	0.9	2.0	119

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

Source: Eurostat, European Commission calculations.

of the reopening of the economy after the pandemic, and also related to the indirect effects of the energy price increases. Rising excise duties on tobacco added to inflation in 2020 and 2021.

Graph 5.2: **Hungary - HICP inflation**



Source: Eurostat.

The prices of non-energy industrial goods have been on the rise following the currency depreciation that has taken place since early 2020. More recently, supply chain disruptions and rising commodity prices further exacerbated these trends leading to increases in producer and consumer prices of industrial goods.

Overall, service inflation increased in 2020-2021 due to the rapid recovery of consumer demand, fast wage growth and rising energy costs. However, this figure has to be taken with some caution. The measurement of service prices was temporarily disrupted by the pandemic-related restrictions on economic activity in spring 2020, because the prices of several services could not be observed. Service inflation was also affected by various government measures ([87]).

5.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and growth developments

Hungary's economy rebounded swiftly after the pandemic-induced recession. After contracting by 4.7% in 2020, real GDP rose by 7.1% in 2021. The strong recovery was partly due to the limited restrictions related to the COVID-19 crisis after spring 2020, and strongly accommodating fiscal and monetary policies in 2021. Private consumption was boosted by strong wage and employment growth. Fiscal stimulus measures included the refund of 2021 personal income tax payments to families with children children in February 2022, the reintroduction of the 13th month's pension in 2021-2022 and wage increases in the public sector. Business investment was spurred by strong demand, low financing costs and investment subsidies from the budget. Public investment also remained high. Exports recovered after their sharp contraction in spring 2020, but they were hampered by supply chain disruptions from the second half of 2021.

Hungary's economic prospects are strongly affected by Russia's war of aggression against Ukraine, due to Hungary's geographical proximity, its high dependence on energy imports from Russia, and its relatively strong trade links to both countries. High inflation erodes consumers' purchasing power, while investments are hindered

([87]) Examples are the temporary introduction of free parking in Budapest during the pandemic, and the extension of free school textbooks to secondary education.

by weaker demand, uncertainty and tighter financing conditions. Exports face headwinds from weaker global growth, sanctions against Russia, and recurring supply chain bottlenecks. According to the Commission's Spring 2022 Economic Forecast, GDP growth is projected slow down to 3.6% in 2022 and by 2.6% in 2023.

In 2020-2021, the government provided a large fiscal stimulus that helped to mitigate the health consequences of the COVID-19 pandemic, supported households' incomes, provided support to companies and increased public investment activity. The fiscal stance was strongly expansionary in 2021, at -3.4% of GDP ([88]). According to the Commission's Spring 2022 Economic Forecast, which is based on a no policy change assumption, the fiscal stance will continue to be broadly neutral in 2022 (at -0.1% of GDP). The positive contribution to economic activity of expenditure financed by Recovery and Resilience Facility grants and other EU funds is projected to decrease by 1.0 percentage point of GDP compared to 2021 due to expected slowdown in the EU funds absorption ([89]). At the same time, the growth in nationally-financed primary current expenditure (net of new revenue measures) in 2022 is projected to provide an expansionary contribution of 0.4 percentage points to the overall fiscal stance. This includes the additional impact of the measures to address the economic and social impact of the increase in energy prices (0.1% of GDP) as well as the costs to offer temporary protection to displaced persons from Ukraine (0.2% of GDP). The no policy-change forecast for 2023 shows a contractionary stance (1.9%).

Monetary policy, conducted within an inflation targeting framework ([90]), began tightening in summer 2021 in response to rising inflation after the use of many policy instruments had ensured abundant liquidity in response to the COVID-19 crisis, in particular via FX liquidity swaps ([91]) and long-term collateralised loans, asset purchase programs and funding schemes. The base rate ([92]), which had been cut by 30 basis points in the first half of 2020, increased from 0.6% to 5.4% between June and April 2022. Since this instrument is limited in size, monetary conditions are rather influenced by the interest rate on the one-week deposit rate, which is available without limit. The one- week deposit rate was raised from 0.75% to 6.45% between June 2021 and April 2022.

The central bank also took steps to reduce the excess liquidity in the financial sector, particularly to improve the transmission of higher interest rates to the currency market. The FX swap tenders that boosted forint liquidity were discontinued from November 2021. On the other hand, on March 28, in relation to the Russia's invasion of Ukraine, the ECB has decided to extend its temporary bilateral repo line to the central bank of Hungary, which was due to expire at the end of March 2022, even if the size of the agreement will remain unchanged. By the end of 2021, the central bank also phased out its unconventional monetary policy instruments, such as government and corporate bond purchases and subsidised lending to small and medium sized enterprises.

Wages and labour costs

Domestic employment declined by 4.7% in the second quarter of 2020, but recovered quickly in line with the rebound of output. The employment rate rose to a historically high 78.8% in 2021,

[88] The fiscal stance is measured as the change in primary expenditure (net of discretionary revenue measures), excluding COVID-19 crisis-related temporary emergency measures but including expenditure financed by non-repayable support (grants) from the Recovery and Resilience Facility and other EU funds, relative to medium-term potential growth. A negative (positive) sign of the indicator corresponds to an excess (shortfall) of primary expenditure growth compared with medium-term economic growth, indicating an expansionary (contractionary) fiscal policy.

[89] The Commission has not yet assessed the Recovery and Resilience Plan for Hungary. The figures in the text are based on the projections by the European Commission.

[90] As explained below, the Hungarian central bank set a target inflation of 3% with a symmetric tolerance band of 1%.

[91] Given the limited effectiveness of the base rate explained in the next footnote, the MNB, in order to loosen monetary conditions by boosting liquidity, offered to banks the possibility to use swaps to buy forint in exchange for foreign currency from 2016 until 2021. The forints then entered the money market providing liquidity and lowering market rates. Indeed market rates were well below the base rate until March 2020. Moreover, to support the liquidity in euros where needed, the MNB offered to banks the possibility to use swaps to buy foreign currency for forint on short maturities, to help them meet the regulatory requirements on FX position and liquidity at the end of each quarter. It should be noted that the MNB, in order to support FX liquidity for the companies and bank in need of foreign currency, has also established repo agreements with the ECB and they function in a similar manner to FX support in many countries.

[92] The main policy instrument used by MNB is the 3-month deposit, a liability of the central bank, and the base policy rate is the rate on 3-month central bank deposits. The size of the deposit is limited. Therefore, this instrument has limited effectiveness in controlling market liquidity and other instruments become necessary, among which the FX liquidity swaps discussed above.

while the unemployment rate remained at 4.1%. After a temporary decrease in 2020, the number of vacancies returned to earlier levels by the end of 2021.

The growth of labour costs slowed down sharply in 2020 partly reflecting the lower number of hours worked. They rose again in 2021 as these temporary factors were reversed and labour shortages began to re-emerge. Wage growth is projected to remain strong in 2022 on the back of a 20% minimum wage rise, and salary increases in the public sector. Wage growth in manufacturing and services could diverge, with manufacturing wages held back by trade and supply chain disruptions, while service sector wages lifted to a larger extent by the minimum wage increase and also boosted by strong domestic demand in 2022. Employers' social contributions were cut by 2 percentage points in 2020, and by another 4 percentage points in 2022. However, the economic slowdown is forecast to lead to lower employment and wage growth in 2023.

Labour productivity, measured in terms of GDP per worker, declined temporarily in 2020 because of labour hoarding during the economic downturn, but this trend was reversed in 2021 as the recovery gathered steam. These trends led to a fast growth of unit labour cost in 2020 (despite slowing wage growth), followed by a slowdown in 2021. Large wage increases are expected to boost unit labour cost again in 2022, but the cooling of the labour market is projected to moderate ULC growth again in 2023.

External factors

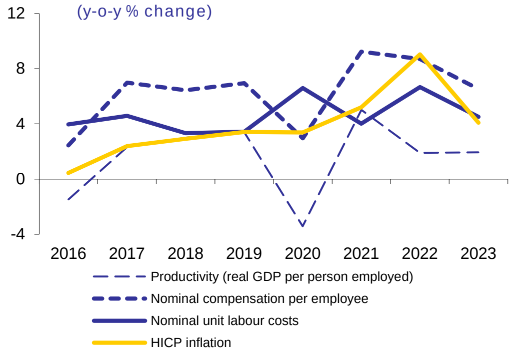
Due to the high degree of openness of the Hungarian economy, developments in import prices play an important role in domestic price formation. Import prices contributed to inflation in 2020 and 2021, first due to the pass-through of currency depreciation, and later reflecting the rise of global commodity prices. The forint's nominal effective exchange rate (measured against a group of 36 trading partners) depreciated by 6.3% in 2020, and by a further 1.3% in 2021.

Administered prices and taxes

The share of administered prices in the Hungarian HICP basket (12.4%) is somewhat below the euro area average. The share has decreased over past years because many administered prices, notably for residential energy and other utilities, have remained unchanged for several years. Administered prices increased by 0.3% in 2020 and 0.9% in 2021. Overall, administered prices had a minor effect on headline inflation, contributing between 0-0.1 percentage point in 2020 and 2021.

Changes in indirect taxation increased headline inflation by 0.1 percentage point in 2020 and by 0.5 percentage point in 2021. This is mainly due to rising on excise duty on tobacco.

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



Source: Eurostat, Commission's Spring 2022 Economic Forecast.

Furthermore, the excise duty on motor fuel temporarily rose in 2020 when the crude oil price fell persistently below 50 USD/barrel. This increase was reversed in 2021, in line with the legislated formula for the excise duty. The excise duty on motor fuel was reduced further in two steps in February and March 2022. This measure is set to remain in effect until the expiration of the price cap on motor fuel currently foreseen on 1 July 2022.

Medium-term prospects

According the Commission's Spring 2022 Economic Forecast, inflation is forecast to remain high in 2022, reaching 9.0% on average. It is then projected to ease to 4.1% in 2023, once the pass though of commodity price increases to consumer prices is completed and slowing demand begins to weigh on core inflation. Inflation is projected to return to the central bank's target towards the end of 2023.

Energy-related policy measures have a significant impact on inflation in 2022. In April 2022, the price cap on petrol and gasoline was estimated to be on average 22% below the levels warranted by market conditions, reducing inflation by approximately 1.5 percentage point in April. The

Table 5.2:

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

	2016	2017	2018	2019	2020	2021	2022[1)]	2023[1)]
HICP inflation								
Hungary	0.4	2.4	2.9	3.4	3.4	5.2	9.0	4.1
Euro area	0.2	1.5	1.8	1.2	0.3	2.6	6.1	2.7
Private consumption deflator								
Hungary	1.0	3.3	3.3	4.6	3.3	6.3	9.0	4.1
Euro area	0.4	1.3	1.5	1.1	0.5	2.3	5.8	2.7
Nominal compensation per employee								
Hungary	2.4	7.0	6.4	6.9	3.0	9.2	8.7	6.5
Euro area	1.2	1.7	2.1	2.1	-0.7	4.1	3.6	3.5
Labour productivity								
Hungary	-1.5	2.3	3.0	3.4	-3.4	5.0	1.9	1.9
Euro area	0.4	1.0	0.2	0.3	-4.9	4.2	1.4	1.5
Nominal unit labour costs								
Hungary	4.0	4.6	3.3	3.4	6.6	4.0	6.7	4.5
Euro area	0.8	0.7	2.0	1.9	4.4	0.0	2.2	2.0
Imports of goods deflator								
Hungary	-2.5	1.9	4.0	1.2	2.7	11.7	10.4	-1.7
Euro area	-3.3	3.3	2.6	-0.5	-3.8	9.6	13.2	0.8

1) Commission Spring 2022 Economic Forecast.

Source: Eurostat, Commission's Spring 2022 Economic Forecast.

price cap on certain food items lowered inflation further, although the weight of the affected products is smaller in the HICP basket.

There are upside risks to the inflation outlook. The current level of administered residential energy prices creates significant losses in the largely state-owned utility sector. If wholesale energy prices remain persistently high, the pressure to raise consumer prices could also increase significantly. The tight labour market and high inflation expectations are further sources of inflationary risk even if this was not visible yet.

The level of consumer prices in Hungary stood at about 63% of the euro area average in 2020, with the relative price gap larger for services than for goods. This suggests that there is significant potential for price level convergence in the long term, as GDP per capita in PPS (72.4% of the euro area average in 2021) increases towards the euro area average.

Medium-term inflation prospects will depend strongly on wage and productivity developments, notably in the non-traded sector and on the success with anchoring inflation expectations at the central bank's 3% target.

5.3. PUBLIC FINANCES

5.3.1. Recent fiscal developments

The general government deficit remained high over the 2020-2021 period, reaching 7.8% of GDP in 2020 up from 2.1 in 2019, before declining somewhat to 6.8% of GDP in 2021.

Revenues as a share of GDP remained broadly stable in 2020 at 43.4% but dropped to 41.1% in 2021. The considerable decline in the revenue ratio in 2021 reflects largely the impact of deficit-increasing recovery measures, such as a permanent cut in employers' social contribution rate, a one-off refund of income tax to families in early 2022, a lowering of the VAT rate for newly built houses and a cut in business tax. The expenditure-to-GDP ratio surged to 51.2% in 2020, from 46% in 2019, due to increased discretionary spending and lower GDP (denominator effect). The nominal growth of expenditure moderated in 2021 but the ratio remained at 47.9%, significantly above the pre-crisis level. The increase in expenditure in 2020 reflected the introduction of temporary emergency measures in response to COVID-19 crisis (4.5% of GDP) and additional spending from the Country Protection Fund. In 2021, spending was gradually directed away from the COVID-related measures (only 0.6% of GDP in 2021) and towards recovery measures (0.4% of GDP).

Table 5.3:

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

Outturn and forecast [1]	2016	2017	2018	2019	2020	2021	2022[1]	2023[1]
General government balance	-1.8	-2.5	-2.1	-2.1	-7.8	-6.8	-6.0	-4.9
- Total revenue	45.0	44.3	44.0	43.9	43.4	41.1	41.3	41.4
- Total expenditure	46.8	46.7	46.1	46.0	51.2	47.9	47.3	46.4
of which:								
- Interest expenditure	3.1	2.6	2.3	2.2	2.3	2.3	2.7	3.0
p.m.: Tax burden	39.2	38.0	36.9	36.5	36.2	33.8	35.0	34.9
Primary balance	1.3	0.2	0.2	0.1	-5.5	-4.4	-3.3	-1.9
Fiscal stance [2]					1.4	-3.4	-0.1	1.9
Government gross debt	74.8	72.1	69.1	65.5	79.6	76.8	76.4	76.1
p.m: Real GDP growth (%)	2.2	4.3	5.4	4.6	-4.5	7.1	3.6	2.6

1) Commission's Spring 2022 Economic Forecast.

2) A negative (positive) sign of the indicator corresponds to an excess (shortfall) of primary expenditure growth compared with medium-term economic growth, indicating an expansionary (contractionary) fiscal policy.

Source: European Commission.

The 2021 budgetary outturn was below the 7.5% GDP deficit target set in the 2021 Convergence Programme essentially due to stronger-than expected growth, and this despite significantly higher expenditure. The real GDP growth of 7.1% was well above 4.3% expected in the Convergence Programme. The stronger-than-expected rebound in economic activity was broad-based, with investments and exports considerably exceeding expectations. However, the additional fiscal space generated by higher revenues and higher denominator were offset by higher-than-projected expenditure, especially on social benefits, intermediate consumption and compensation of employees. Additionally, following the submission of the Convergence Programme, the authorities also extended some of the temporary tax relief measures and introduced new expansionary measures such as a refund of income tax to families in early 2022 and a one-off income support for self-employed.

The government debt-to-GDP ratio rose from 65.5% in 2019 to 79.8% in 2020 and stabilised at 76.8% by the end of 2021. The increase in 2020 was driven mainly by the high primary balance and debt-increasing stock-flow adjustment due to growing fiscal reserves in the form of government deposits held by the central bank. In 2021, the debt-decreasing impact of high GDP growth and inflation was largely offset by the high budget deficit.

5.3.2. Medium-term prospects

The 2022 budget was adopted by the Hungarian Parliament on 15 June 2021. It targeted a headline deficit of 5.9% of GDP, and included emergency reserves of 0.4% of GDP to cover potential slippages based on risk scenarios. As in 2021, the 2022 budget included large budgetary reserves to finance additional investment activity and support the economic recovery, notably appropriations for the Investment Fund and Economic Restart programmes. The budget allowed for the continuation of several debt-increasing spending measures such as subsidies for housing renovation for families (0.3% of GDP), partial reinstatement of the 13th month's pension and increase in doctors' wages (0.8% of GDP). It also envisaged new tax measures, notably further cuts to employers' social contributions (0.3% of GDP) and exemption from personal income tax for those under 25 years old (0.2% of GDP).

Since the adoption of the budget, several new measures have been introduced by government decrees on the back of better-than expected growth. Those include further cuts to social security contributions and the abolition of the training levy (0.9% of GDP), a full reinstatement of the 13th month's pension already in 2022 (0.6% of GDP), and a service benefit for military and law enforcement employees brought forward to 2022 (0.4% of GDP). In late 2021, amid rising macroeconomic uncertainty, the government revised the deficit target from 5.9% to 4.9%. The achievement of the lower deficit target was supported by the decision to postpone investment projects in the size of 1.3% GDP, notably those funded by the Investment Fund.

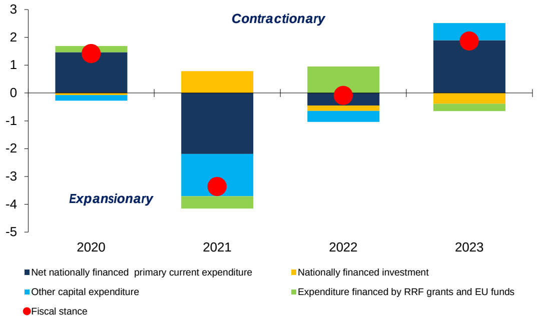
The government deficit in 2022 is also impacted by the fiscal costs of the measures taken by the government to counter the social and economic impact of the increase in energy prices, as well as the provision of humanitarian assistance to refugees from Ukraine. These measures mainly consist of permanent price caps on retail gas and electricity prices, a temporary cut in excise duties on fuels, a temporary cap on fuel prices and compensations for independent petrol stations.

On 29 April 2022, Hungary submitted its 2022 Convergence Programme. According to the Programme, the headline deficit is projected to decline steadily to 4.9% of GDP in 2022 and 3.5% in 2023. The government deficit in 2022 is impacted by the introduction of several expansionary measures, notably the full re-introduction of the 13th monthly pension, a one-off service benefit for military and law enforcement employees, cuts to social security contributions and abolition of the training levy.

Based on the Commission's Spring 2022 Economic Forecast, the deficit is projected to decrease to 6.0% of GDP in 2022, above the official target set out in the 2022 Convergence Programme reflecting the introduction of several expansionary measures and additional spending related to high energy prices. According to the Commission’s Spring 2022 Economic Forecast, the fiscal stance is projected to be broadly neutral in 2022 at -0.1% of GDP ([93]). The contribution to economic activity of expenditure financed by Recovery and Resilience Facility grants and other EU funds is projected to be contractionary at 1.0% percentage point of GDP in 2022, compared to the contribution of -0.4% in 2021. Nationally financed investments are projected to provide a slightly expansionary contribution to the fiscal stance of -0.2 percentage point of GDP in 2022. At the same time, the growth in nationally financed primary current expenditure (net of new revenue measures) in 2022 is projected to provide an expansionary contribution of -0.4 percentage point of GDP to the overall fiscal stance, as current expenditure is set to grow at a faster pace than medium-term potential growth. However, most of this expansion is due to measures related to the energy crisis (1.2% of GDP) and the humanitarian aid for people fleeing Ukraine (0.2% of GDP). The measures in response to rising energy prices mainly consist of permanent price caps on retail gas introduced in and electricity prices introduced in 2013, a temporary cut in excise duties on fuels, a temporary cap on fuel prices and compensations for independent petrol stations. The large fiscal impact of the energy measures in the Commission’s Spring 2022 Economic Forecast stems from the assumption that the losses of the utility companies resulting from the regulated energy prices are compensated by the government with capital transfers at the end of the year. All measures other than the permanent price caps on retail gas and electricity prices have been announced as temporary. Some of these measures are not targeted in nature, notably the general price cap on retail prices of energy and cuts in excise duties.

The phasing out of several temporary measures and an expected overall decrease in nationally financed current expenditure in 2023 will contribute to a strongly contractionary fiscal stance of 1.9% of GDP in 2023.

Graph 5.4: **Hungary - Fiscal stance and its components**
(percent of GDP)



Source: Commission's Spring 2022 Economic Forecast.

The contribution to economic activity of expenditure financed by Recovery and Resilience Facility grants and other EU funds is projected to be expansionary at -0.3 percentage point of GDP in 2023. Nationally financed investment is projected to provide an expansionary contribution to the fiscal stance of -0.4 percentage point of GDP, whereas the growth in nationally financed primary current expenditure is projected to provide a contractionary contribution of 1.9 percentage point of GDP to the overall fiscal stance in 2023.

[93] For a definition of the fiscal stance used in this report, see footnote in in Section 5.2.3 on underlying factors and sustainability of inflation.

Based on the Commission's Spring 2022 Economic Forecast, the general government debt is set to decrease gradually from 79.2% of GDP in 2021 to 76.4% in 2022 and 76.1% in 2023. The 2022 Convergence Programme projects a more rapid decline in the debt-to-GDP ratio to 76.1% in 2022 and 73.8% in 2023. The difference is driven by higher primary deficit in 2023 in the Commission's forecast.

Debt sustainability risks appear medium over the medium run. Government debt is projected to decrease reaching around 73% of GDP in 2032. This projection assumes that the structural primary balance (except for the impact of ageing) remains constant at the forecast level for 2023 of -1.4% of GDP, which is close to its 2019 level.

The sensitivity to possible macro-fiscal shocks also contributes to this assessment. In particular, if only half of the projected improvement in the structural primary balance in 2022-2023 were to occur, the projected debt ratio in 2032 would be close to 13 percentage points of GDP higher than in the baseline, and would not be on a decreasing path anymore.

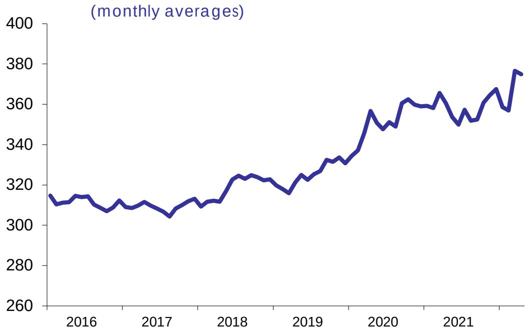
Some factors mitigate risks, including the lengthening of debt maturity in recent years (although it remains relatively low), relatively stable financing sources (with a diversified and large investor base) a stable and moderate share of government debt denominated in foreign currency and the expected positive impact on long-term growth of reforms under the Recovery and Resilience Plan. Risk-increasing factors include the possible materialisation of state guarantees granted to firms and self-employed during the COVID-19 crisis ([94]).

In recent years, the Hungarian fiscal framework has seen certain improvements. With reforms starting after 2011, the national fiscal rules were brought more in line with EU requirements, for example on the way the public debt ratio is calculated. The national Hungarian debt rule was later reformed in order to include a stronger role for the Fiscal Council (Hungary's independent fiscal institution) in ensuring compliance with the debt rule. In some cases however, the role of the Fiscal Council in shaping fiscal policies could be reinforced, in particular when it comes to ex-post evaluations and endorsement of the budgetary forecasts. The medium-term budgetary framework has been further developed since 2011, but could still be improved in order to reduce the volatility of the medium-term plans. The link between the targets in annual budgets and the medium-term framework can be strengthened, as well as the involvement of the independent fiscal institution and national parliament in the preparation of this medium-term framework.

5.4. EXCHANGE RATE STABILITY

The Hungarian forint does not participate in ERM II. Between mid-2001 and early 2008, the MNB operated a mixed framework that combined an inflation target with a unilateral peg of the forint to the euro, with a fluctuation band of +/-15%. On 26 February 2008, the exchange rate band was abolished and a free-floating exchange rate regime was adopted that however allows for foreign exchange interventions by MNB. In March 2015, a +/-1 percentage point ex ante tolerance band was designated around the continuous medium-term inflation target of 3 percent (that is in place since 2005).

Graph 5.5: **Hungary - HUF/EUR exchange rate**
(monthly averages)



Source: ECB.

The long-term depreciation tendency of the last years continued in 2020 and 2021. In particular, a steep depreciation movement of the forint against the euro started in spring 2019, when the forint traded below 320 HUF/EUR, following the MNB signal to keep loose monetary conditions longer than other regional central banks. As a result of the COVID-19 crisis, it continued until October 2020 when the forint surpassed the 360 HUF/EUR. Afterwards, the forint oscillated around this value until Russia's invasion of Ukraine in February 2022. After the invasion, the forint initially depreciated strongly to near 400 HUF/EUR but it then returned to the range of 370-380 HUF/EUR after the central bank raised interest rates further.

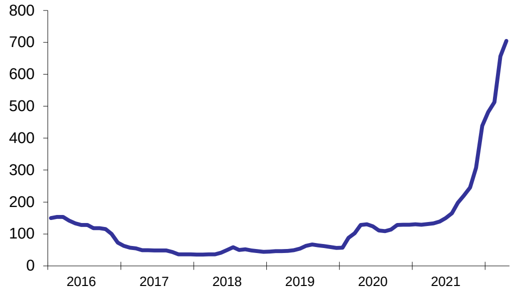
[94] For further details see the 2021 Fiscal Sustainability Report.

In April 2022 it traded against the euro on average at about 375 HUF/EUR.

International reserves held by the MNB that had already reached around EUR 28bn end-2019, moved above EUR 30bn mid-2020 and above EUR 38bn in September 2021. International reserves were lifted by successive foreign currency bond issuances, EU fund inflows and an increase in special drawing rights by some EUR 2.3 bn in August 2021. At the same time, the outstanding stocks of liquidity-providing FX swaps in euros are gradually unwinding, which reduces the international reserves at the central bank ([95]). International reserves, decreased to EUR 34bn in April 2022, which corresponded to about 22% of GDP.

Short-term interest rate differentials vis-à-vis the euro area increased substantially after the beginning of the COVID-19 crisis, when the previous upward movement was strongly accentuated. The spread trespassed the 100 basis points in March 2020, to reach the 130 basis points two months later. After a temporary decrease in summer 2020, the spread started increasing again and it came back to 130 basis point in January 2021. There it stabilised until June 2021 when it started increasing steeply, with euro area 3-months rates remaining at around -0.55% while the 3-months Bubor was increasing very fast, reflecting the rapid tightening of monetary policy and later the interventions following Russia's invasion of Ukraine. The spread continued reached 705 basis points in April 2022.

Graph 5.6: **Hungary - 3-M Bubor spread to 3-M Euribor**
(basis points, monthly values)



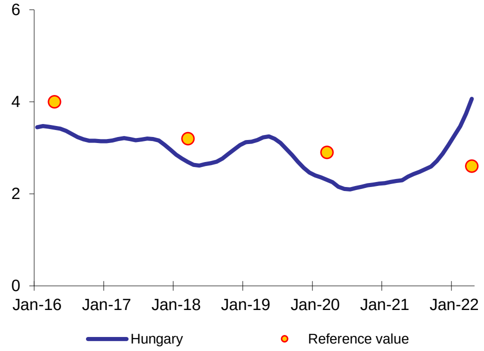
Source: National Bank of Hungary, Eurostat and Thomson Reuters.

5.5. LONG-TERM INTEREST RATES

The long-term interest rate in Hungary used for the convergence assessment reflects the secondary market yields on a single benchmark bond with a residual maturity of about 10 years.

The Hungarian 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion was below the reference value at the time of the 2020 convergence assessment of Hungary. It decreased from the 3.3% of May 2019 to reach 2.1% in July 2020 and then started to increase again. In April 2022, the latest month for which data are available, the reference value, given by the average of long-term interest rates in France, Finland and Greece, plus 2 percentage points, stood at 2.6%. In April, the 12-month moving average of the yield on the Hungarian benchmark bond stood at 4.1%, i.e. 1.5 percentage points above the reference value.

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

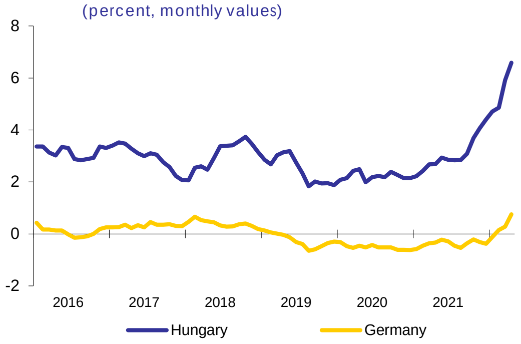


Source: European Commission.

The long-term interest rate of Hungary, which stood just around 2.0% in January 2020, peaked in April at 2.5% and has been oscillating below this level until January 2021, reflecting also the monetary easing conducted by major central banks. Hungary's long-term interest rate started increasing again in 2021, in particular since September 2021, reflecting the tightening of monetary policy, to surpass 4% in November. This mirrored the rapid tightening of monetary policy and accelerating inflation pressures in Hungary.

[95] The reduction concerns the swaps used by banks to buy forint in exchange for foreign currency from 2016 until 2021.

Graph 5.8: **Hungary - Long-term interest rates**



Source: Eurostat.

The increase in long-term rates continued, and accelerated further since March 2022, on the back of Russia's invasion of Ukraine. The long-term rate reached 6.6% in April 2022. Despite the slight increase of rates on the German benchmark bond over the same period, the long-term spread vis-à-vis the German benchmark bond increased over the last two years and reached 584 basis points in April 2022.

5.6. ADDITIONAL FACTORS

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

In November 2021, the Commission published its latest Alert Mechanism Report (AMR 2022) under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.7), which highlighted issues related to unit labour costs, government debt financing and the housing market in Hungary. Unit labour cost growth is projected to pick up after the pandemic, as productivity growth continues to lag behind substantial wage rises that are driven by the tightening labour market and administrative measures. Although the maturity of government debt increased, the gross financing need remains high, which could create risks if global financing conditions deteriorate. Real house prices continued to grow after the pandemic, supported by various government subsidies for home buying. A debt moratorium was introduced during the pandemic and a temporary cap on mortgage rates in the first half of 2022. They both expire on 1 July 2022. The

Table 5.4:

Hungary - Balance of payments **(percentage of GDP)**

	2016	2017	2018	2019	2020	2021
Current account	4.5	2.0	0.2	-0.7	-1.0	-2.9
of which: Balance of trade in goods	3.4	1.4	-1.7	-2.5	-0.9	-2.5
Balance of trade in services	5.3	5.5	5.9	4.9	2.9	3.2
Primary income balance	-2.6	-3.9	-3.7	-2.5	-2.5	-3.0
Secondary income balance	-1.5	-0.9	-0.4	-0.5	-0.6	-0.7
Capital account	0.0	0.8	2.3	1.9	2.0	2.5
External balance [1)]	4.5	2.8	2.5	1.2	1.0	-0.4
Financial account	3.0	1.4	0.8	0.2	-1.7	-3.1
of which: Direct investment	-2.3	-1.6	-2.2	-0.2	-1.9	-1.3
Portfolio investment	4.2	3.0	-0.1	1.0	-1.9	0.2
Other investment [2)]	6.4	0.0	0.5	-0.8	-2.4	-4.4
Change in reserves	-5.3	0.0	2.7	0.2	4.5	2.4
Financial account without reserves	8.3	1.4	-1.9	0.0	-6.2	-5.5
Errors and omissions	-1.5	-1.4	-1.7	-0.9	-2.7	-2.7
Gross capital formation	21.5	23.1	26.8	28.5	27.3	30.6
Gross saving	25.7	24.7	26.8	27.6	26.2	27.7
Net international investment position	-59.0	-54.4	-50.7	-49.1	-48.9	-44.8

1) The combined current and capital account.

2) Including financial derivatives.

Sources: Eurostat, European Commission calculations, Magyar Nemzeti Bank.

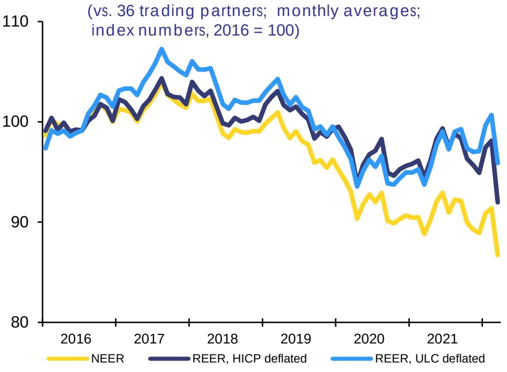
phase-out of these measures could pose challenges for some borrowers and thus for the banking sector whose tier-1 capital ratio is lower than the EU average. The profitability of banks is also affected by increasing funding costs and losses on their government bond holdings due to the rise in yields. Some Hungarian banks have Russian and Ukrainian exposures either directly or through their parent companies, and this might also weigh on the banking sector's profitability and capital situation. However, since overall risks remained limited, no In-Depth Review (IDR) was warranted.

Hungary submitted its Recovery and Resilience plan on 11/05/2021. The submitted plan has a total allocation of EUR 7.175bn and contains proposed investments and reforms to strengthen primary care and hospitals, increase the capacity of suburban rail and increase renewable energy production at residential level. The plan is currently being assessed by the Commission to make sure that all assessment criteria are being fulfilled.

5.6.1. Developments of the balance of payments

According to balance of payments data, the surplus of Hungary's external balance (i.e. the combined current and capital account) turned negative in 2020. It decreased from a surplus 0.2% of GDP in 2018 to a deficit of 2.9% of GDP in 2021. Exports fell in 2020 due to the pandemic. Goods exports then staged a robust recovery until mid-2021, but they were held back by growing supply chain disruptions (e.g. semiconductor shortages) in the second half of 2021. Service exports declined more than goods exports in 2020. Their rebound in 2021 also proved slower as the pandemic hindered the recovery of international tourism. Imports decreased in 2020 but robust domestic demand led to their strong recovery in 2021. Following global energy prices, the terms of trade improved in 2020 but worsened in 2021. The primary income balance deteriorated especially in 2021, as the inward investment income flows recovered slower than outward flows. The capital account remained in surplus due to the absorption of EU funds.

Graph 5.9: **Hungary - Effective exchange rates**



Source: European Commission.

Price and cost competitiveness indicators improved in early 2020 due to a nominal currency depreciation at the outbreak of the COVID-19 pandemic. Apart from some fluctuations, real effective exchange rates remained stable in the remainder of 2020 and in 2021. While the growth of ULC and consumer prices was higher in Hungary than in its trade partners, this was mostly offset by nominal depreciation over the course of 2020 and 2021 ([96]). Hungary's export market share increased in 2020 and 2021.

According to the Commission's Spring 2022 Economic Forecast, which is based on national accounts data, the external balance is expected to deteriorate in 2022 and 2023. This is mainly driven by rising commodity prices, which worsen Hungary's terms of trade and swell its net energy imports that amounted to 4.4% of GDP in 2021. The current account deficit is projected to peak at 5.5% of GDP in 2022 before improving to 3.6% in 2023 due to somewhat lower energy import prices.

As the deteriorating external balance was due to higher budget deficits, it was mostly financed by the external borrowing of the government sector. The government also used freshly raised funds to bolster foreign currency reserves. Consequently, the inflows of portfolio and other investments rose in 2020 and 2021, and gross external debt rose. Meanwhile, direct investments continued to register net inflows in 2020 and 2021. The net international investment position posted slight improvements in 2020 and 2021.

([96]) REER based on unit labour costs should be interpreted with prudence as unit labour costs were distorted by labour retention schemes.

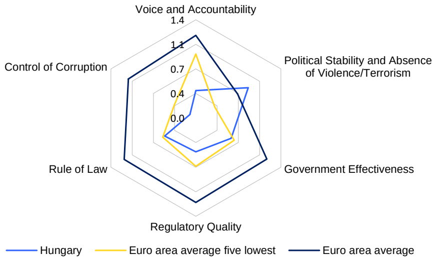
5.6.2. Market integration

Hungary's economy is highly integrated with the euro area through trade and investment linkages. The economy is strongly embedded into continental and global value chains. Trade openness increased somewhat in 2021 to 89.5%, after the strong decrease of 2020 when international trade and Hungary's exports of tourism and travel services were temporarily hit by the pandemic. Flows with the euro area dominate trade, accounting for more half of the total trade in goods and services in 2021. Hungary's main euro area goods trading partners in 2021 were Germany, Austria, Slovakia and Italy. Outside the euro area, the main trading partners were China and Poland.

The stock of FDI in Hungary amounted to about 63% of GDP in 2020 (excluding special purpose entities, 'SPEs' ([97])), with FDI mainly originating from Germany, the Netherlands and Austria. Manufacturing and services each accounted for about 45% of inward FDI, suggesting that FDI plays an important role in enhancing Hungary's export capacity and contributes significantly to economic integration with the euro area.

Concerning the business environment, Hungary performs in general worse than many euro-area Member States in international rankings, even if certain features of Hungary's business environment, such as low corporate taxes, flexible labour market regulations and the authorities' supportive attitude towards export-oriented FDI, make the country attractive for the more labour-intensive and cost-sensitive tasks within global value chains. However, Hungary scores poorly according to the World Bank's Ease of Doing Business and the Global Competitiveness Index rankings by the International Institute for Management Development ([98]). According to the World Bank's Worldwide Governance Indicators (2020), Hungary ranks low in voice and accountability, and control of corruption compared with the average of the five euro area Member States with the lowest scores. Hungary ranks higher than the average five lowest euro area Member States for political stability and absence of violence ([99]). The Commission's 2021 Rule of Law Report, elaborated on the challenges that Hungary faces in areas such as the control of corruption, judicial independence and the quality of decision-making. Shortcomings in the anti-corruption framework include the unaddressed links between businesses and political actors, such as the lack of effective checks and oversight of asset and interest declarations. Concerns remain over cases of high-level corruption. In December 2021, the government postponed the implementation of most measures in its anti-corruption strategy for 2020-22, which would have helped to more effectively detect and prosecute of corruption in public institutions and state-owned enterprises. Access to public information, which is essential for the independent oversight of decision-making and anti-corruption framework, was made more difficult by special rules introduced by Hungary during the state of danger. These issues can be particularly detrimental to innovative companies. In addition, several barriers hamper competition in services, including the large number of regulated occupations, untransparent state interventions and inefficient insolvency procedures. According to the latest data, Hungary's transposition deficit of EU Directives was at 1.0%, similar to the EU average but above the target (0.5%) proposed by the European Commission in the Single Market Act (2011).

Graph 5.10: **Hungary - 2020 World Bank's Worldwide Governance Indicators**



Note: Estimate of governance ranges from -2.5 (weak) to 2.5 (strong).
Source: World Bank.

[97] The Hungarian statistics introduced the notion of special purpose enterprise (SPE) for those passive financial intermediaries that have financial relations only with non-residents, and allocated them to the financial corporations sector as private financial intermediaries (S.127)." They are typically related to tax optimization by holdings. See a-nem-penzugyi-vallalatok-penzugyi-szamlai-en.PDF (mnb.hu), page 8.

[98] The World Bank Doing Business (DB) program was paused in 2021. The programme will continue with a new governance and improved accountability and transparency under the name Business Enabling Environment (BEE). The first edition of the BEE is expected in 2023.

[99] A Member State is considered to have a 'low' ('high') ranking compared with the average five euro area Member States with the lowest scores for each indicator if its score is at least 0.3 percentage points lower (higher) than that of the average of this euro area group.

Table 5.5:
Hungary - Market integration

	2016	2017	2018	2019	2020	2021
Trade openness [1] (%)	91.9	93.3	92.5	91.1	87.9	89.6
Trade with EA in goods & services [2]+[3] (%)	53.1	53.2	52.3	51.7	49.8	50.5
World Bank's Ease of Doing Business Index rankings [4]	41	48	53	52	52	-
IMD World Competitiveness Ranking [5]	46	52	47	47	47	42
Internal Market Transposition Deficit [6] (%)	0.8	0.3	0.9	0.5	1.0	-
Real house price index [7]	112.3	121.9	135.0	150.9	153.4	166.5

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

2) (Imports + Exports of goods with EA-19 / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).

3) Trade in services with EA-19 (average credit and debit in % of GDP at current prices) (Balance of Payments).

4) Data not available for 2021. The Ease of Doing Business report by the World Bank was discontinued in September 2021.

5) International Institute for Management Development (IMD).

6) Percentage of internal market directives not yet communicated as having been transposed, relative to the total. (November data, as of 2016 date refers to the year of publication).

7) Deflated house price index (2015=100) (Eurostat).

Sources: Eurostat, World Bank, International Institute for Management Development, European Commission calculations.

The 4th Anti-Money Laundering Directive imposed transposition by 26 June 2017, and Hungary notified the Commission of the adopted measures within that deadline. New measures were notified during 2019 and 2020. The Commission has analysed the communicated measures and concluded that the directive has been fully transposed. As regards the 5th Anti-Money Laundering Directive, whose transposition deadline elapsed on 10 January 2020, Hungary has notified national transposition measures and declared a partial transposition. In view of some missing transposition measures the Commission has addressed a letter of formal notice (“LFN”) to Hungary on 13/02/2020 and a Reasoned Opinion on 09/06/2021 as the reply to the LFN was not satisfactory. At the same time, new transposition measures were notified in June 2021 and the Commission is currently assessing whether they address the gaps in transposition.

The size of the financial sector, measured as the ratio of assets managed by the financial sector to GDP, is in Hungary slightly more than half of the comparable euro area average, while being less than half in 2016, indicating a faster growth than in the euro area in recent years. However, when excluding SPEs that perform no financial intermediation in the domestic economy, the size of the total financial sector grew from 162% of GDP in 2016 to 193% in 2020, indicating both a much lower level of financial development and convergence with the euro area. Taking into account this correction, Hungary can be considered similar in terms of financial sector size to the euro area members with the least developed financial sectors.

Table 5.6:
Hungary - Allocation of assets by financial sub-sector

						Ratio to GDP (%)
	HU		EA		EA 5 smallest	
	2016	2020	2016	2020	2016	2020
Financial corporations (total)	335	435	722	796	177	215
Central bank	27	41	45	78	37	61
Monetary financial institutions	98	109	286	311	97	98
Other financial intermediaries	185	259	202	179	20	28
Non-MMF investment funds [1]	14	14	100	127	4	5
Insurance co. and Pension Funds	12	11	90	102	18	23
						Share of total (%)
	HU		EA		EA 5 smallest	
	2016	2020	2016	2020	2016	2020
Central bank	8	9	6	10	21	29
Monetary financial institutions	29	25	40	39	55	46
Other financial intermediaries	55	60	28	22	11	12
Non-MMF investment funds	4	3	14	16	2	2
Insurance co. and Pension Funds	4	3	12	13	10	11

1) MMF stands for money market funds.

Source: Eurostat.

Due to the presence of SPEs, the structure of the financial sector is different from the euro area average, where the banking sector is the largest sub-sector in the financial sector. In Hungary banking accounts for a quarter of the financial sector’s assets (109% of GDP), decreasing from almost 30% (98% of GDP) in 2016, against a 39% (311% of GDP) in the euro area. Other financial intermediaries, which cover SPEs, make up for 60% of total financial assets and 259% of GDP ([100]). Without SPEs, the banking sector shows a large and relatively stable weight, with around 60% of total assets in 2016 (around 160% of GDP) and 58% in 2020 (around 190% of GDP). With this correction, the financial system can be assessed as even more bank-based than the EU average. The weight of the central bank is also higher than the EU average if SPEs are excluded, as it accounted for 16% (27% of GDP) of total

([100]) As indicated above, this likely reflects the large presence of foreign holdings in Hungary for tax optimization purposes.

non-consolidated assets in 2016, which rose to 21% by 2020 (40% of GDP).

Insurance companies and pension funds are clearly underdeveloped compared to the euro area, with assets representing 3% of total assets of the financial sector, for an amount of 11% of GDP. This is very small also compared to the countries with the smallest shares in the euro area. Since end-2016, the Hungarian sector has decreased its holdings of financial assets by 1 percentage point of GDP, while in the euro area it increased by more than 12 percentage points of GDP to reach 13% of total assets.

This structure of the financial sector is reflected in the financing of the economy, which traditionally shows relatively low intermediated and market credit to households and non-financial corporations. Funding via other equity, possibly reflecting the relevant presence of foreign holdings and SPEs in Hungary, remained at 40% of total liabilities in 2020, representing 261% of GDP. This compares to an average of 7% for the euro area (56% of GDP). Considering also the role of unlisted shares, one almost reaches 50% of total liabilities, which are not allocated via the banking sector. This is still much higher than the average euro area and compares with countries like Estonia or Cyprus.

For the rest, loans are the dominant source of funding and made up 29% of total liabilities, which represented almost 190% of GDP in 2020, posting a very large increase compared to the 25% of 2016. This figure is inflated by the presence of SPEs, and is not only reflecting loans to Hungarian households and non-financial companies. Even so, this compares to 31% in the euro area, where it represents more than 235% of GDP. Debt and equity markets relative to GDP are smaller than the respective average in the euro area and market financing (debt securities and listed shares) is relatively underdeveloped, with the market for private debt smaller than in the smallest euro area members. Equity and private-sector debt markets represent 3% and 1% of total liabilities respectively. This compares to 9% of total liabilities for both listed stocks and private-sector debt in the euro area. Government debt is also significantly lower than in the euro area.

Table 5.7:
Hungary - Financing of the economy[1)]

Ratio to GDP (%)

	HU		EA		EA 5 smallest	
	2016	2020	2016	2020	2016	2020
Liabilities (total)	550	647	743	770	324	335
Loans	136	189	238	236	115	112
Non-financial co. debt securities	2	3	12	15	3	4
Financial co. debt securities	5	8	74	68	11	12
Government debt securities	74	75	83	95	51	57
Listed shares	18	17	65	73	17	18
Unlisted shares	52	58	186	193	55	56
Other equity	229	261	51	56	42	48
Trade credits and advances	34	35	33	35	29	29

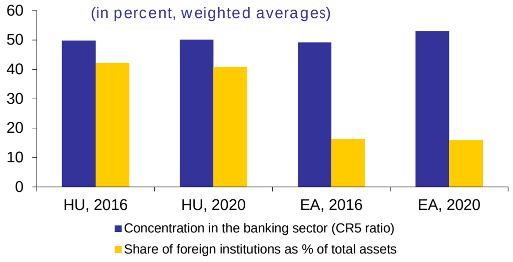
Share of total (%)

	HU		EA		EA 5 smallest	
	2016	2020	2016	2020	2016	2020
Loans	25	29	32	31	35	33
Non-financial co. debt securities	0	0	2	2	1	1
Financial co. debt securities	1	1	10	9	3	3
Government debt securities	13	12	11	12	16	17
Listed shares	3	3	9	9	5	5
Unlisted shares	10	9	25	25	18	18
Other equity	42	40	7	7	13	14
Trade credits and advances	6	5	4	5	9	9

1) The table focuses on the financing needs of a country and how these are met by the financial system. The table is constructed from the liabilities of all economic sectors, but only considers loans, debt securities, equity and trade credits. The sum of liabilities in the table only reflects the total for the liabilities considered.
Source: Eurostat.

The Hungarian banking sector is well integrated into the euro area financial sector, posting a level of foreign ownership in its banking system that is well above the one of the euro area. The share of foreign-owned institutions in total bank assets was around 40% both in 2016 and in 2020, with the corresponding figure for the euro area being at around 16%. Bank concentration, as measured by the market share of the five largest credit institutions in total assets, was stable at around 50% since 2016, and in 2020, a value comparable to the euro area average (53% in 2020).

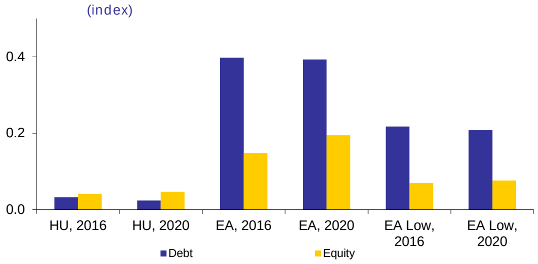
Graph 5.11: **Hungary - Foreign ownership and concentration in the banking sector**
(in percent, weighted averages)



Source: ECB, Structural financial indicators.

In 2020, the banking sector in Hungary posted a Core tier 1 ratio just above 16%, one point below the average of the euro area. This ratio has been decreasing after 2018 and has been accompanied in 2020 by lower profitability. Nonetheless, it remains well above the lows of the 2010s. The ratio of non-performing loans to total loans is slightly above the euro area average but continued to decrease. For these reasons, the unfolding of the COVID-19 crisis and of the consequences of Russia’s invasion of Ukraine could have a significant impact on the financial stability and profitability indicators over the coming months.

Graph 5.12: **Hungary - Intra-EU integration in equity and debt portfolio investment**
(index)



Note: The chart shows the extent of home bias in debt and equity markets. A value index of 1 implies 'full integration' with the financial markets of other Member States, while 0 denotes 'no integration'.

Source: FinFlows database: European Commission, Joint Research Centre (JRC).

Measures of intra-EU integration in equity and debt markets, as based on the home bias in portfolio investments, indicate that the level of integration of Hungary is very low in both segments and in particular in debt markets. ([101]) Although intra-EU financial integration, by the same measure, is in general relatively low across EU Member States, Hungary's integration is well below also the countries where the home bias is the largest in the euro area. The very large home bias indicates that almost all investments in financial markets takes place domestically.

([101]) Home bias in portfolio investments measures the average propensity of investors in a Member State to invest domestically as compared with investing in other EU countries. The indicator ranges between 0 and 1, with a value of 0 indicating that investors prefer domestic over foreign assets. The inverse of the home bias can be interpreted as one measure of financial integration among EU countries.

6. POLAND

6.1. LEGAL COMPATIBILITY

6.1.1. Introduction

The main rules governing the Narodowy Bank Polski (NBP – Polish national bank, hereafter NBP) are laid down in the Act on the Narodowy Bank Polski (the NBP Act) which was adopted on 29 August 1997. The consolidated version of the NBP Act was published in Dziennik Ustaw of 2020, item 2027. The NBP Act has been slightly amended since the Commission's 2020 Convergence Report ([102]). In absence of any legislative action regarding the issues mentioned in the Commission's 2020 Convergence Report, the comments provided in the latter report are repeated also in the 2022 assessment.

6.1.2. Central Bank independence

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

The Commission recalls the recent rulings of the Polish Constitutional Tribunal which considered certain provisions of the EU Treaties incompatible with the Polish Constitution, expressly challenging the primacy of EU law ([103]). The primacy of EU law is instrumental for assessing the compatibility between the national legislation, including the statute of its national central bank, and Articles 130 and 131 and the Statute of the ESCB and of the ECB. The Commission considers that these rulings of the Constitutional Tribunal are in breach of the general principles of autonomy, primacy, effectiveness and uniform application of Union law and the binding effect of rulings of the Court of Justice of the European Union. Moreover, the Commission considers that the Constitutional Tribunal no longer meets the requirements of an independent and impartial tribunal previously established by law ([104]). It should be ensured that the primacy of Articles 130 and 131 and the Statute of the ESCB and of the ECB over national law is fully observed by Polish public authorities and courts. Article 23(1)(2) of the NBP Act provides that the NBP's Governor has, inter alia, to provide draft monetary policy guidelines to the Council of Ministers and the Minister of Finance. This procedure provides for the opportunity for the Government to exert influence on the monetary and financial policy of the NBP and thus constitutes an incompatibility in the area of independence with Article 130 of the TFEU and Article 7 of the ESCB/ECB Statute.

Article 9(3) of the NBP Act foresees that the Governor of the NBP shall assume his/her duties after taking an oath before the Parliament. This oath refers to the observation of the provisions of the Polish Constitution and other laws, the economic development of Poland and the well-being of its citizens. The Governor of the NBP acts in dual capacity as a member of NBP's decision-making bodies and of the relevant decision-making

([102]) The amendments stem from the Act of 31 March 2020 amending the Act on special arrangements for preventing, counteracting and combating COVID-19, other infectious diseases and crisis situations caused by them, and other laws (Dziennik Ustaw of 2020, item 568), the Act of 8 July 2021 amending the Act on the Bank Guarantee Fund, Deposit Guarantee Scheme and Resolution, and other laws (Dziennik Ustaw of 2021, item 1598) and the Act of 17 December 2021 amending the Act on Narodowy Bank Polski and the Executive Penal Code (Dziennik Ustaw of 2022, item 22).

([103]) Polish Constitutional Tribunal, Judgment No. P 7/20 of 14 July 2021; Polish Constitutional Tribunal, Judgment No. K 3/21 of 7 October 2021.

([104]) On 22 December 2021, the Commission launched an infringement procedure concerning the Constitutional Tribunal and its case-law; see Commission press release IP/21/7070. The procedure is ongoing.

bodies of the ECB. Article 9(3) of the NBP Act needs to be adapted to reflect the status and the obligations and duties of the Governor of the NBP as member of the relevant decision-making bodies of the ECB. Moreover, the oath does not contain a reference to central bank independence as enshrined in Article 130 of the TFEU. The oath as it stands now is an imperfection and should be adapted to be fully in line with the TFEU and the ESCB/ECB Statute.

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

The State Tribunal Act ([105]) provides for the suspension of the Governor from his/her duties following a procedure, which raises questions regarding its compatibility with the principle of central bank independence and Article 14.2 of the ESCB/ECB Statute. Pursuant to the second sentence of Article 11(1) of the State Tribunal Act read in conjunction with its Articles 3 and 1.1(3), the Governor of the NBP can be suspended as a result of an indictment by the Parliament for violating the Constitution or an act of law when performing his/her duties even before the State Tribunal has delivered its judgment on the removal from the office. While suspending a Governor for the purpose of a (criminal) investigation may be necessary, the Governor concerned should be able to bring an action for annulment of a temporary measure before the Court of Justice of the European Union (CJEU) pursuant to Article 14.2 of the ESCB/ECB Statute. The purpose of such action is to enable the CJEU to verify that a temporary prohibition of performing a Governor's duties is taken only if there are sufficient indications that he/she has engaged in serious misconduct capable of justifying such a measure ([106]). Such a guarantee is a reflection of the principle of central bank independence and of great importance, especially in case of a suspension from office on grounds of serious misconduct further to an indictment by a parliamentary body depriving the Governor of the possibility to continue exercising the duties. In the absence of any clear reference in the NBP Act or Constitution to the principle of central bank independence the NBP Act would benefit from an explicit clarification that the Governor of the NBP has the possibility to seek legal redress against his/her dismissal, including suspension before the CJEU, as enshrined in Article 14.2 of the ESCB/ECB Statute.

According to Article 203(1) of Poland's Constitution, the Supreme Audit Office (Najwyższa Izba Kontroli (NIK)) is entitled to examine the NBP's activities as regards its legality, economic prudence, efficiency and diligence. The NIK controls are not performed in the capacity of an independent external auditor, as laid down in Article 27.1 of the ESCB/ECB Statute and thus, should for legal certainty reasons be clearly defined so as to respect Article 130 of the TFEU and Article 7 of the ESCB/ECB Statute. Furthermore, the provision's relationship with Article 69.1 of the NBP Act is also unclear. The relevant provision of the Constitution is therefore incompatible and needs to be adapted in order to comply with Article 130 of the TFEU and Article 7 of the ESCB/ECB Statute.

6.1.3. Prohibition of monetary financing and privileged access

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

[105] State Tribunal Act, Dziennik Ustaw of 2019, item 2122.

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

Article 43 of the NBP Act in conjunction with Articles 270 and 306 of the Act on the Bank Guarantee Fund, deposit guarantee system and forced restructuring ([107]) provides for NBP's powers to grant short-term credit to the Bank Guarantee Fund related to the financing of its deposit guarantee function, if a threat to financial stability arises and in view of its urgent needs. The Bank Guarantee Fund qualifies as a 'body governed by public law' within the meaning of Article 123(1) of the TFEU. The Bank Guarantee Fund is closely dependent on public sector entities referred to in Article 123(1) of the TFEU, as the majority of the members of the Bank Guarantee Fund's Council are appointed by the Minister competent for financial institutions and the Chairman of the Financial Supervisory Authority (Article 7(4) of the Act on the Bank Guarantee Fund, deposit guarantee system and forced restructuring). Therefore, the provisions laid down in the NBP Act and the Act on the Bank Guarantee Fund, deposit guarantee system and forced restructuring regarding the possibility of NBP granting loans to the Bank Guarantee Fund are not compatible with the monetary financing prohibition and the relevant legal framework should be amended accordingly.

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

6.1.4. Integration in the ESCB

Objectives

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

Tasks

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

- limitation of the NPB's activities to the territory of the Republic of Poland (Article 2(3) of the NBP Act) and absence of a general reference to the BNB as an integral part of the ESCB (Article 227(1) of the Constitution and Article 1 of the NBP Act);

- definition and implementation of monetary policy (Articles 227(1) and (6) of the Constitution, Articles 3(2)(5), 12, 23, 38-50a, and 53 of the NBP Act);

- holding of foreign reserves; management of foreign exchange and the definition of foreign exchange policy (Articles 3(2)(2), 3(2)(3), 17(4)(2), 24 and 52 of the NBP Act);

- competences of the ECB and of the EU for banknotes and coins (Article 227(1), second sentence of the Constitution and Articles 4, 31-37 of the NBP Act). The NBP shall exercise its responsibility for issuing currency as part of the ESCB/Eurosystem;

- appointment of independent auditors - Article 69(1) of the NBP Act foresees that NBP accounts are examined by external auditors. The NBP Act does not take into account that the auditing of a central bank has to be carried out by independent external auditors recommended by the Governing Council and approved by the Council. It is incompatible with Article 27.1 of the ESCB/ECB Statute.

[107] system and forced restructuring of 10 June 2016. Consolidated version published in Dziennik Ustaw of 2020, item 842, with further amendments.

Table 6.1:
Poland - Components of inflation

	2016	2017	2018	2019	2020	2021	Apr-22	weights in total 2022
						(percentage change)[1]		
HICP	-0.2	1.6	1.2	2.1	3.7	5.2	7.0	1000
Non-energy industrial goods	-1.5	-1.0	-0.3	0.4	0.9	2.4	3.7	332
Energy	-3.7	2.9	3.7	0.0	-1.0	12.2	18.2	145
Unprocessed food	1.6	5.6	3.0	5.4	6.9	2.8	7.1	47
Processed food	0.7	2.7	1.8	3.7	3.9	2.7	4.5	200
Services	1.8	2.4	0.8	3.5	7.8	7.3	7.6	276
HICP excl. energy and unproc. food	0.3	1.2	0.6	2.3	4.2	4.2	5.3	808
HICP at constant tax rates	-0.2	1.6	1.2	2.1	3.5	5.1	7.8	1000
Administered prices HICP	2.1	1.2	0.8	1.2	6.7	5.9	7.0	124

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

Source: Eurostat, European Commission calculations.

There are also some imperfections regarding:

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

6.1.5. Assessment of compatibility

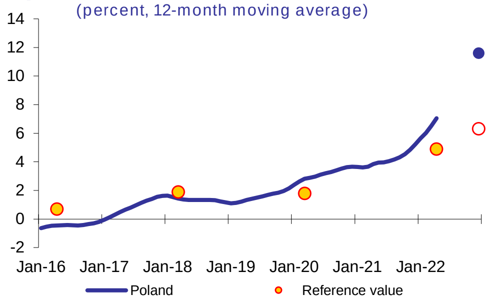
As regards the independence of the central bank, the prohibition on monetary financing and the central bank integration into the ESCB at the time of euro adoption, the legislation in Poland, in particular the NBP Act and the Constitution of the Republic of Poland are not fully compatible with the compliance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

6.2. PRICE STABILITY

6.2.1. Respect of the reference value

The 12-month average inflation rate, which is used for the convergence assessment, was above the reference value at the time of the last convergence assessment of Poland in 2020. It then increased almost uninterruptedly to reach 3.7% by end 2020 and 5.2% by end-2021. In April 2022, the reference value was 4.9%, calculated as the average of the 12-month average inflation rates in France, Finland and Greece plus 1.5 percentage points. The corresponding inflation rate in Poland was 7.0%, i.e. 2.1 percentage points above the reference value. The 12-month average inflation rate is projected to remain well above the reference value in the months ahead.

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



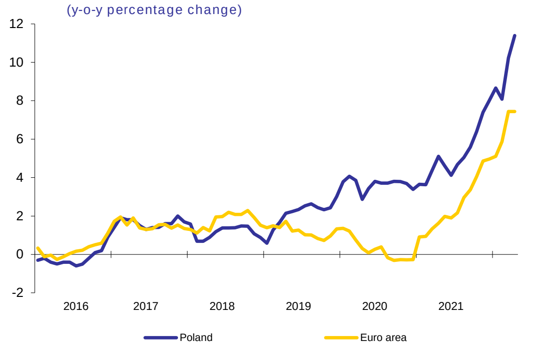
Note: The dots at the right end of the chart show the projected reference value and 12-month average inflation rate of the country in December 2022. The reference values for 2016, 2018 and 2020 refer to the reference values calculated in the previous Convergence Reports.

Source: Eurostat, Commission's Spring 2022 Economic Forecast.

6.2.2. Recent inflation developments

Poland recorded a significant and broad-base increase in annual HICP inflation over the past two years. Annual inflation fell to 2.9% in April following the first wave of the pandemic. It picked up to 3.8% in June and remained broadly constant until February 2021. Annual inflation then increased sharply throughout 2021, driven by rising energy and food prices as well as accelerating core inflation. Overall, headline inflation averaged 3.7% in 2020 and 5.2% in 2021. During the last two years, annual HICP inflation in Poland was consistently higher than in the euro area.

Graph 6.2: **Poland - HICP inflation**



Source: Eurostat.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) increased significantly in the first half of 2020, reaching 4.8% in June 2020. It remained significantly above headline inflation until February 2021, before decreasing until June 2021. Core inflation then increased steadily again, albeit staying below headline inflation, reaching 5.7% in December 2021. The upward trend on core inflation in the past two years was broadly spread across all HICP categories. Demand and supply factors such as rising wages, higher input prices and booming domestic demand following the end of the pandemic were the main contributors to this broad-base increase. Labour shortages also played a role, in particular for service inflation, which increased from 5.6% in March 2020 to 7.5% in December 2021. After several years of low inflation, prices of non-energy industrial goods also increased significantly, with annual inflation for this category reaching 4.2% in 2021, mainly due to global supply bottlenecks and rising production costs. Processed food inflation decreased steadily between March 2020 and May 2021, and then increased at a fast pace, reaching 5.7% in December 2021, reflecting increasing production costs, especially related to higher energy prices.

6.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and growth developments

Following the start of the COVID-19 pandemic, Poland's real GDP dropped by 2.2% in 2020, the first recession in nearly two decades. It then rebounded by 5.9% in 2021. The main drivers of the recovery were domestic demand, in particular private consumption and investment. After a significant fall of 2.8% in 2020, private consumption recovered swiftly in 2021, growing by 6.0%, supported by a high level of accumulated savings and a strong recovery in the labour market, which weathered the crisis well due to sizeable fiscal support. The recovery in investment was more gradual, with investment levels still below pre-crisis levels by the end of 2021. According to the Commission's Spring 2022 Economic Forecast, GDP is projected to increase by 3.7% in 2022, as the effects of the COVID-19 pandemic are expected to ease and economic activity is expected to normalise. In 2023, GDP is expected to continue decelerating, growing by a projected 3.0%.

The fiscal stance was strongly expansionary in 2020, driven by fiscal measures adopted to contain the economic impact of the pandemic, but it recovered in 2021 as the expenditure measures were partially withdrawn and revenues increased on the back of the economic recovery ([108]). According to the Commission's Spring 2022 Economic Forecast, the fiscal stance is expected to be supportive at -3.4% of GDP in 2022, due to growth in nationally-financed primary current expenditure, including the impact of measures compensating for high energy prices and the cost of aid to refugees.

Monetary policy, conducted within an inflation targeting framework ([109]) remained accommodative for most of the past two years, before tightening sharply from October 2021. The COVID-19 crisis led to a substantial monetary easing: after decreasing the policy rate twice by 50 basis points in March and in April 2020, the Monetary Policy Council (MPC) decreased the policy rate further to 0.1% in May 2020. In addition, the MPC launched the purchase of government securities and government-guaranteed debt securities on the secondary market. It also started the provisioning of additional liquidity to the banking sector through repo operations and a discount facility. Yet, as inflation accelerated, the

([108]) The fiscal stance is measured as the change in primary expenditure (net of discretionary revenue measures), excluding Covid-19 crisis-related temporary emergency measures but including expenditure financed by non-repayable support (grants) from the Recovery and Resilience Facility and other EU funds, relative to medium-term potential growth. A negative (positive) sign of the indicator corresponds to an excess (shortfall) of primary expenditure growth compared with medium-term economic growth, indicating an expansionary (contractionary) fiscal policy.

([109]) Since the beginning of 2004, the NBP has pursued a continuous inflation target of 2.5% with a permissible fluctuation band of +/- 1 percentage point.

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

	2016	2017	2018	2019	2020	2021	2022[1)]	2023[1)]
HICP inflation								
Poland	-0.2	1.6	1.2	2.1	3.7	5.2	11.6	7.3
Euro area	0.2	1.5	1.8	1.2	0.3	2.6	6.1	2.7
Private consumption deflator								
Poland	-0.4	2.0	1.7	2.4	3.4	5.4	11.8	7.3
Euro area	0.4	1.3	1.5	1.1	0.5	2.3	5.8	2.7
Nominal compensation per employee								
Poland	4.8	5.8	8.1	7.3	5.6	5.0	9.5	8.0
Euro area	1.2	1.7	2.1	2.1	-0.7	4.1	3.6	3.5
Labour productivity								
Poland	2.3	3.4	4.8	4.8	-2.1	4.4	3.3	2.7
Euro area	0.4	1.0	0.2	0.3	-4.9	4.2	1.4	1.5
Nominal unit labour costs								
Poland	2.4	2.3	3.2	2.4	7.9	0.6	6.0	5.1
Euro area	0.8	0.7	2.0	1.9	4.4	0.0	2.2	2.0
Imports of goods deflator								
Poland	-0.3	1.3	2.9	1.7	-0.4	11.5	15.5	5.0
Euro area	-3.3	3.3	2.6	-0.5	-3.8	9.6	13.2	0.8

1) Commission Spring 2022 Economic Forecast.

Source: Eurostat, Commission's Spring 2022 Economic Forecast.

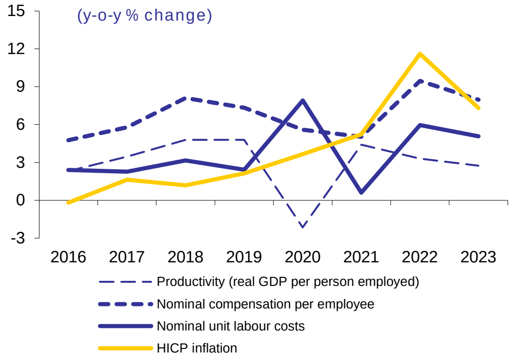
Monetary Policy Council (MPC) increased the reference rate from October 2021, reaching 5.25% in May 2022, i.e. levels last seen at the end of 2008.

Wages and labour costs

The impact of the crisis on the labour market was mostly reflected in declining hours worked, as public job retention schemes shielded employment. In line with this, the unemployment rate remained broadly stable around 3.0-3.5% for most of the past two years. As the recovery gathered pace, the labour market has been showing signs of overheating, with companies reporting significant labour shortages and wage growth rising strongly at the end of 2021 and beginning of 2022.

Labour productivity decreased by 2.1% in 2020 due to the sharp drop in economic activity following the COVID-19 crisis. It then increased sharply by 4.4% in 2021. Growth in compensation per employee decelerated in 2020 to 5.6% and to 5.0% in 2021. This translated into nominal ULC growth of 7.9% in 2020 and 0.6% in 2021. Acute labour shortages are expected to lead to a rapid increase in compensation per employee over the forecast horizon, with a projected increase of 9.5% in 2022 and 8.0% in 2023. Labour productivity is expected to continue posting strong growth rates, increasing by 3.3% in 2022 and 2.7% in 2023. This is expected to result in nominal ULC growth of 6.0% and 5.1% in 2022 and 2023, respectively, according to the Commission's Spring 2022 Economic Forecast.

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



Source: Eurostat, Commission's Spring 2022 Economic Forecast.

External factors

Although external trade represents a lower share of GDP in Poland than in regional peers like Hungary or Czechia, prices of imported goods and services play an important role in domestic price formation. After a small decrease in 2020, the imports of goods deflator raised by 11.5% in 2021, driven inter alia by an increase in global commodity prices. The zloty's nominal effective exchange rate (measured against a group of 36 trading partners) depreciated on average by 2.1% in 2020 and 2.3% in 2021 contributing to push up import prices. Low inflation in Poland's trade partners in 2020 weighted on import price increases that year. However, as inflation accelerated in Poland's trade partners and the zloty kept depreciating in 2021, import prices excluding commodity prices also hiked. Imported inflation is forecast to increase strongly during 2022-2023.

Administered prices and taxes

The increase in administered prices, with a weight of around 12% in the HICP basket (similar to that of the euro area), was above HICP inflation both in 2020 and 2021. The average annual increase in administered prices was 6.7% in 2020 and 5.9% in 2021 against 3.7% and 5.2% for headline inflation, respectively. The fast growth of administered prices was the result of increased waste collection fees, sugar tax, capacity fees as well as higher regulated energy prices.

The impact of tax measures on overall price developments has been close to zero as constant tax inflation was in line with headline inflation in both 2020 and 2021.

Medium-term prospects

Looking ahead, inflation is expected to accelerate significantly in 2022, peaking in the first quarter of the year. Energy prices are expected to increase strongly amid a hike in regulated energy prices at the beginning of 2022, although the increase will be somewhat counterbalanced by a policy package put in place in November 2021 by the government to reduce rates paid in energy and food products. Processed and unprocessed food prices are projected to increase from mid-2022 onwards, as rising prices of fertilisers are set to increase production costs, especially for agricultural products. Core inflation is set to remain elevated on the back of acute labour shortages, which are set to put upward pressure on wage growth. The Commission's Spring 2022 Economic Forecast projects annual HICP inflation to average 11.6% in 2022 and 7.3% in 2023.

Despite a number of policy measures introduced to lower tax rates paid on certain goods, strong price dynamics are forecast to persist in 2022, mainly due to surging energy prices and unit labour costs. The inflation outlook remains highly uncertain, with risks appearing to be tilted to the upside. Wage growth is expected to be elevated over the forecast horizon, and risks of a stronger wage-price spiral cannot be ruled out, which could put significant upward pressure on core inflation. More fiscal expansion could further fuel demand pressure and the risk of higher energy prices stemming from poor meteorological conditions could increase energy prices even further.

The level of consumer prices in Poland was at around 56% of the euro-area average in 2020. This suggests a significant potential for price level convergence in the long term, as GDP per capita in PPS (about 73% of the euro-area average in 2021) increases towards the euro-area average.

Medium-term inflation prospects in Poland will hinge upon wage and productivity trends as well as on the functioning of product markets. Further structural measures to increase labour supply, to make better use of increased labour immigration and to facilitate the effective allocation of labour market resources will play an important role in limiting wage pressures, resulting inter alia from negative demographic developments. As to product markets, there is scope to enhance the competitive environment, especially in the services and energy sectors. At the macro level, an appropriate monetary policy response to macroeconomic developments and a prudent fiscal stance will be essential to contain inflationary pressures.

6.3. PUBLIC FINANCES

6.3.1. Recent fiscal developments

The general government deficit increased sharply in 2020 to 6.9% of GDP. The economic recession triggered by the pandemic had a negative impact on public finances via two main channels: it slowed down the dynamics of the revenue due to lower economic activity, and it led to a sharp increase in expenditure. Fiscal measures to contain the economic impact of the pandemic played a significant role in this increase. They included amongst others non-refundable loans to companies, short-time work schemes, subsidies for businesses and a special allowance for parents. As a result, the total government expenditure increased from 41.8% of GDP in 2019 to 48.2% of GDP in 2020, an increase close to the EU average. However, it should be noted that in nominal terms Poland recorded a positive GDP growth in 2020, thus the increase in expenditure ratio was not driven by contracting nominal GDP. In turn, as a

Table 6.3:

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

Outturn and forecast [1]	2016	2017	2018	2019	2020	2021	2022[1]	2023[1]
General government balance	-2.4	-1.5	-0.2	-0.7	-6.9	-1.9	-4.0	-4.4
- Total revenue	38.7	39.8	41.3	41.0	41.3	42.3	39.9	38.6
- Total expenditure	41.1	41.3	41.5	41.8	48.2	44.2	43.9	43.0
of which:								
- Interest expenditure	1.7	1.6	1.4	1.4	1.3	1.1	1.5	1.8
p.m.: Tax burden	34.3	35.0	36.0	36.0	36.4	37.7	35.4	34.4
Primary balance	-0.7	0.1	1.2	0.6	-5.6	-0.8	-2.5	-2.6
Fiscal stance [2]					0.1	1.7	-3.4	1.7
Government gross debt	54.2	50.6	48.8	45.6	57.1	53.8	50.8	49.8
p.m: Real GDP growth (%)	3.1	4.8	5.4	4.7	-2.2	5.9	3.7	3.0

1) Commission's Spring 2022 Economic Forecast.

2) A negative (positive) sign of the indicator corresponds to an excess (shortfall) of primary expenditure growth compared with medium-term economic growth, indicating an expansionary (contractionary) fiscal policy.

Source: European Commission.

share of GDP, the total general government revenue increased slightly as compared to 2019, despite the pandemic. In 2021, the general government headline deficit narrowed to 1.9% of GDP. Revenue (mainly from taxes and social contributions) increased, driven by the economic recovery, a good situation on the labour market and cyclical factors. On top of this, new taxes implemented in 2021 also contributed to the revenue growth. In turn, expenditure decreased. While the cost of fiscal measures to contain the impact of the pandemic was lower than in 2020, this was partly offset by some new expenditure items (for instance an additional one-off pension benefit payment in 2021).

The 2021 headline deficit (1.9% of GDP) turned out to be lower than forecast in the 2021 edition of the Convergence Programme (6.9% of GDP). This difference stemmed mainly from a significant decrease in public expenditure (by 4.0% of GDP) and an increase in revenues (by 1.0% of GDP).

The general government debt increased significantly in 2020, driven by a high deficit triggered by the pandemic-driven recession (see above). It reached 57.1% of GDP, as compared to 45.6% of GDP in 2019. It then decreased to 53.8% of GDP in 2021. The decrease of the debt-to-GDP ratio occurred despite a deficit of 1.9% of GDP in 2021. This is explained by a strong nominal GDP growth in 2021, reaching 12.1%. In terms of valuation effects, the falling share of Polish government debt denominated in foreign currencies was counterbalanced by weakening złoty.

6.3.2. Medium-term prospects

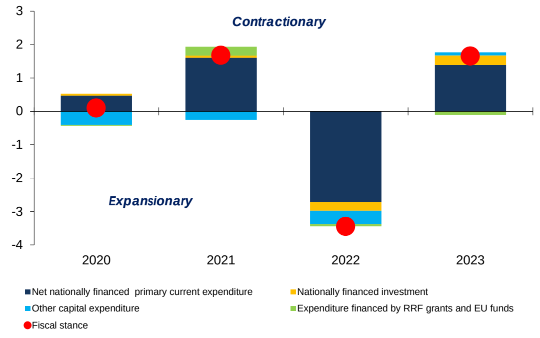
The 2022 budget was adopted on 17 December 2021. It targets a general government deficit of 2.9% of GDP. Following the budget law, the support to the economy to cushion the impact of the crisis will be substantially lower than in the two previous years. At the same time, while the so-called 14th pension benefit was only a one-off expenditure item in 2021, the budget law broadly assumes a continuation of major policies carried out in previous years, in particular in the area of social spending. On the revenue side, an implementation of a major tax overhaul is expected to lower the revenue from the personal income tax.

On 28 April 2022, Poland submitted its 2022 Convergence Programme. According to the Programme, the headline deficit is projected to increase to 4.3% of GDP in 2022 and decrease to 3.7% in 2023. The government deficit in 2022 is impacted by the additional measures taken by government to counter the social and economic impact of the increase in energy prices, as well as the humanitarian and security expenditure following the war in Ukraine. Based on the Commission's Spring 2022 Economic Forecast, the measures to cushion the impact of the increase in energy prices are estimated at 1.0% of GDP in 2022, most of which are currently expected to be temporary and to be withdrawn in 2023, while the annual cost of humanitarian assistance is assumed at 0.6% of GDP in 2022 and 0.8% of GDP in 2023. The Programme targets a reduction of the government deficit to under 3% of GDP by 2025.

The Commission’s Spring 2022 Economic Forecast projects the general government headline deficit in 2022 at 4.0% of GDP. The deficit is set to increase to 4.4% of GDP in 2023. The ratio of general government debt to GDP is set to decrease to 49.8% in 2023. However, as above a quarter of the sovereign debt is denominated in foreign currencies, the debt projections are subject to uncertainty due to possible valuation effects.

In 2022, the fiscal stance is projected in the Commission’s Spring 2022 Economic Forecast to be supportive, at -3.4% of GDP ([110]). The positive contribution to economic activity of expenditure financed by RRF grants and other EU funds is projected at 0.1 percentage point of GDP in 2022, the first year of expected implementation of the Polish Recovery and Resilience Plan. Nationally financed investment is projected to provide expansionary contribution to the fiscal stance of -0.3 percentage points of GDP in 2022. At the same time, the growth in nationally financed primary current expenditure (net of new revenue measures) in 2022 is projected to provide an expansionary contribution of -2.7 percentage points of GDP to the overall fiscal stance, as current expenditure is set to grow at a faster pace than medium-term potential growth.

Graph 6.4: **Poland - Fiscal stance and its components**
(percent of GDP)



Source: Commission's Spring 2022 Economic Forecast.

In 2023, the fiscal stance is projected to be contractionary at +1.7% of GDP. The expansionary contribution to economic activity of expenditure financed by RRF grants and other EU funds is projected to be -0.1 percentage points of GDP in 2023. Nationally financed investment is projected to provide a contractionary contribution to the fiscal stance of 0.3 percentage points of GDP ([111]), whereas the growth in nationally financed primary current expenditure is projected to provide a contractionary contribution of 1.4 percentage points of GDP to the overall fiscal stance in 2023.

Debt sustainability risks appear low over the medium run. Government debt is projected to remain below 60% of GDP, albeit on an increasing path as from 2027, reaching around 54% of GDP in 2032. This projection assumes that the structural primary balance (except for the impact of ageing) remains constant at the forecast level for 2023 of -2.3% of GDP, hence below the 2019 level.

The limited sensitivity to possible macro-fiscal shocks also contributes to this assessment. In particular, if only half of the improvement in the structural primary balance projected for 2022-2023 were to occur, the debt ratio would be about 6 percentage points of GDP higher by 2032 compared with the baseline, reaching 60% of GDP.

Some factors mitigate risks, including the currency denomination of debt and the expected positive impact on long-term growth of reforms under the Recovery and Resilience Plan. Risk-increasing factors include a tightening of financing conditions, the share of non-performing loans and Poland’s negative net international investment position ([112]).

The fiscal framework in Poland is overall strong, but recently it was slightly relaxed to take into account the pressures emerging from the COVID-19 pandemic. The numerical fiscal rules are at the centre of the framework. While the debt ceilings anchored in the Constitution cover the central government, a separate debt rule concerns local government units (LGUs). The latter rule was loosened in 2020 by allowing LGUs to exclude from their calculations liabilities equivalent to the loss of revenue linked to the pandemic; in addition, for 2020, the debt limit was lowered to 80% of the total revenue. The expenditure rule applied to the

([110]) The measurement of the fiscal stance is explained in section 6.2.3 on underlying factors and sustainability of inflation.

([111]) Other nationally financed capital expenditure is projected to provide a contractionary contribution of 0.1 percentage points of GDP.

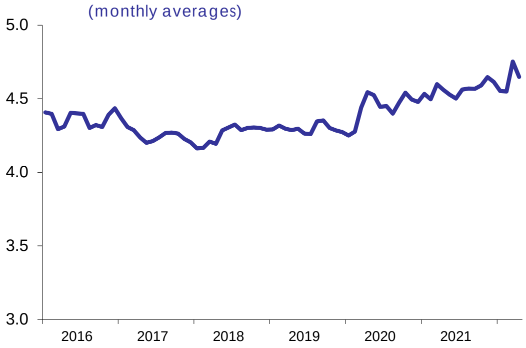
([112]) For further details see the 2021 Fiscal Sustainability Report.

general government, which aims at preventing overspending, has been temporarily suspended, with a mechanism for an automatic return to the conventional rule over two to four years. Similarly, the budget balance rule applied to the LGUs has also been suspended. The constitutional debt limit was circumvented by channelling most of the pandemic economy support measures through a special off-the-budget fund. In turn, in 2021 the stabilising expenditure rule was strengthened by covering all special purpose funds but its effective implementation for the pandemic-specific fund was effectively delayed until 2022 (when a draft 2023 budget will be prepared). Medium-term budgetary planning is based on the four year Multiannual State Financial Plan, which serves as a basis for the preparation of annual budgets but does not provide targets for them. Poland does not have a fully-fledged fiscal council and activities related to the monitoring of fiscal rules are scattered among several bodies, with the Supreme Audit Office taking a more central role.

6.4. EXCHANGE RATE STABILITY

The Polish zloty does not participate in ERM II. Since April 2000, Poland has been operating *de jure* a floating exchange rate regime, with the NBP preserving the right to intervene in the foreign exchange market, if it deems this necessary, in order to achieve the inflation target.

Graph 6.5: **Poland - PLN/EUR exchange rate**
(monthly averages)

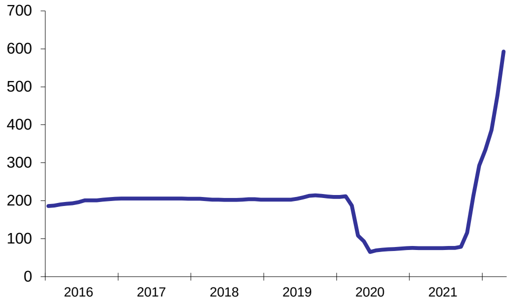


Source: ECB.

The zloty depreciated sharply after the onset of COVID-19 crisis in early 2020. This was reflected in large by the easing of monetary policy as NBP started to cut interest rates until levels unseen before and substantially enlarged amounts of open market operations. Afterwards it went through a period of fluctuations but indicated no clear trend. Tightening of the NBP's monetary policy strengthened the zloty from October 2021 up to February 2022. However, the outbreak of war in Ukraine weakened the zloty substantially as in some days in March 2022 it reached 5.0 against the euro, i.e. the highest level for more than two decades. Moreover, at the end of March 2022 NBP entered a swap line arrangement with ECB in order to address potential euro liquidity needs.

International reserves held by the NBP increased from EUR 114 billion in early 2020 to around EUR 147 billion by end-2021. The reserve-to-GDP ratio was at around 26% at end-2021.

Graph 6.6: **Poland - 3-M Wibor spread to 3-M Euribor**
(basis points, monthly values)



Source: Polish National Bank, Eurostat and Thomson Reuters.

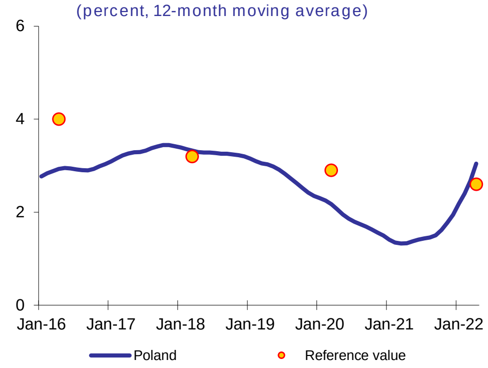
Short-term interest rate differential vis-à-vis the euro area remained stable at around 210 basis points up to early 2020. In March, the NBP began to ease monetary policy and cut interest rates three consecutive times to levels unseen before. This fed into the Polish interbank market and three-month rate fell to the lowest levels on record. Changes in euro money market were more limited as the three-month euro rate picked-up only temporary in April and May and further continued its downward path to stabilise at historically low levels. Consequently, short-term interest rate differential shrank to 65 basis points in June and fluctuated at around 75 basis points until October 2021 when NBP started to tighten monetary policy. After seven consecutive increases of interest rates the short-term interest rate differential reached 593 basis points in April 2022.

6.5. LONG-TERM INTEREST RATES

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

Graph 6.7: **Poland - Long-term interest rate criterion**

(percent, 12-month moving average)

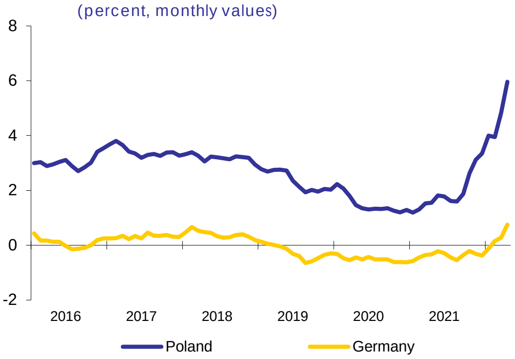


Source: European Commission.

The Polish 12-month average long-term interest rate relevant for the assessment of the Treaty criterion was below the reference value at the time of the last convergence assessment in 2020. It gradually decreased from 2.2% at that time to about 1.3% by April-2021 and started to increase reaching 2.0% by end-2021. In April 2022, the latest month for which data are available, the reference value, given by the average of long-term interest rates in France, Finland and Greece plus 2 percentage points, stood at 2.6%. In that month, the 12-month moving average of the yield on the Polish benchmark bond stood at 3.0%, i.e. 0.4 percentage point above the reference value.

Graph 6.8: **Poland - Long-term interest rates**

(percent, monthly values)



Source: Eurostat.

Developments in long-term interest rate in Poland since 2020 reflect in large part changes in the monetary policy stance of the NBP. The easing of monetary policy after the onset of the pandemic in 2020 contributed to a significant decrease of the long-term interest rates, which remained at the 1.3% level until the end of 2020. In January 2021 the long-term interest rate reached the lowest level on the record (1.2%) before starting to increase moderately until the summer. The tightening of monetary policy, which started in October 2021, then contributed to a considerable increase in the long-term interest rate. Poland's long-term interest rate was around 6.0% in April 2022.

The long-term interest rate spread vis-à-vis the German benchmark bond narrowed strongly during the early months of the COVID-19 crisis and fluctuated around 180 basis points between April 2020 and April 2021. In mid-2021, it started to increase slightly and by October, when NBP began its tightening cycle, the spread started to widen. By the end-2021 the long-term interest rate spread reached around 373 basis points and during the first quarter of 2022 continued to widen up-to 521 basis points in April 2022.

6.6. ADDITIONAL FACTORS

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

In November 2021, the Commission published its eleventh Alert Mechanism Report (AMR 2021) under the Macroeconomic Imbalance Procedure (MIP – see also Box 1.7), which highlighted issues related to the international investment position (NIIP) and house price growth in Poland. However, since overall risks remain limited, the report concluded that no In-Depth Review (IDR) was warranted. External vulnerabilities remained contained, given that foreign direct investment accounted for a major part of foreign liabilities. The growth of house prices was strong in 2021, reaching 9.2% in the last quarter of 2021, but risks of overheating were seen as limited with price indicators suggesting almost no overvaluation. At the same time, household debt remains low at 55.3% of income. Significant labour shortages are limiting investment growth and putting upward pressure on unit labour costs, which might impact the competitiveness of Polish businesses over the medium term.

Poland submitted its recovery and resilience plan on 3 May 2021, which is equivalent to 4.5% in 2019 GDP ([113]). The plan has a total allocation of

([113]) 2019 GDP and RRP total amount in current prices.

Table 6.4:

Poland - Balance of payments **(percentage of GDP)**

	2016	2017	2018	2019	2020	2021
Current account	-0.8	-0.3	-1.3	0.5	2.9	-0.6
of which: Balance of trade in goods	0.5	-0.1	-1.2	0.3	2.4	-0.1
Balance of trade in services	3.2	3.8	4.3	4.5	4.3	4.6
Primary income balance	-4.1	-4.1	-4.0	-4.0	-3.5	-4.4
Secondary income balance	-0.3	0.0	-0.3	-0.3	-0.3	-0.7
Capital account	1.0	1.3	2.1	2.0	2.3	1.6
External balance [1]	0.3	0.9	0.8	2.4	5.2	1.0
Financial account	0.3	-0.5	0.2	1.1	3.8	0.2
of which: Direct investment	-0.9	-1.4	-2.6	-2.0	-2.1	-3.6
Portfolio investment	-0.8	-0.9	0.8	2.0	1.3	1.7
Other investment [2]	-2.8	3.4	0.8	-0.7	1.6	-0.6
Change in reserves	4.8	-1.5	1.3	1.7	3.1	2.8
Financial account without reserves	-4.5	1.1	-1.0	-0.7	0.8	-2.6
Errors and omissions	0.1	-1.4	-0.5	-1.4	-1.4	-0.8
Gross capital formation	19.7	19.9	20.8	19.7	17.5	20.3
Gross saving	19.4	19.6	19.8	20.6	20.3	21.9
Net international investment position	-61.5	-61.2	-55.9	-49.8	-44.3	-39.9

1) The combined current and capital account.

2) Including financial derivatives.

Sources: Eurostat, European Commission calculations, National Bank of Poland.

EUR 23.9 billion in grants and contains proposed investments and reforms to decarbonise the Polish economy, make the transport sector more sustainable, address challenges related to the investment climate, notably with regard to the Polish judicial system as well as decision- and law-making processes, improve IT connectivity and improve the resilience of the healthcare system.

6.6.1. Developments of the balance of payments

Poland's external balance (i.e. the combined current and capital account) stayed positive for most of 2020-2021, before turning slightly negative at the end of 2021. The current account increased visibly throughout 2020 due to a strong drop in imports, which boosted the trade balance. However, as domestic demand recovered, import growth hiked, causing the current account to turn negative from May 2021 onwards. The income balance turned even more negative over 2020-2021. The primary income balance stayed negative and deteriorated throughout 2021, partly driven by an improvement in the profitability of foreign companies. The secondary income balance remained negative and somewhat deteriorated as the high inflow of returning foreign workers, mainly Ukrainians, led to significantly higher transfers abroad.

In the financial account of the balance of payments, the balance of direct investment stabilised in 2020 before rebounding in 2021 with a net inflow of 3.8% of GDP. The rebound was driven by a recovery of reinvested earnings, which has been the main source for new FDI inflows in recent years. In 2020, net portfolio investment recorded an outflow of 1.2% of GDP, most likely driven by non-residents' investment treasury bonds, and in 2021 it reached 1.7% of GDP. During the observed period, the other investment account switched from net outflow of 1.7% GDP in 2020 to a net inflow of 0.6% of GDP in 2021.

According to the Commission's Spring 2022 Economic Forecast, which is based on national accounts data, the external balance is expected to move into negative territory, with around -0.5% of GDP in 2022 and -0.2% in 2023.

Poland's external competitiveness has remained robust. Poland's export performance (as measured by the growth of its exports relative to its foreign

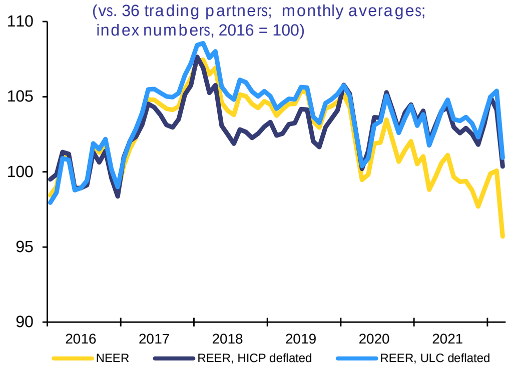
Table 6.5:
Poland - Market integration

	2016	2017	2018	2019	2020	2021
Trade openness [1] (%)	51.4	53.5	54.8	54.2	53.3	59.5
Trade with EA in goods & services [2]+[3] (%)	29.2	30.4	31.0	30.4	30.5	33.9
World Bank's Ease of Doing Business Index rankings [4]	24	27	33	40	40	-
IMD World Competitiveness Ranking [5]	33	38	34	38	39	47
Internal Market Transposition Deficit [6] (%)	1.5	1.4	1.0	0.8	1.8	-
Real house price index [7]	102.3	104.1	109.2	115.9	124.0	128.6

1) (Imports + Exports of goods and services / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics, Balance of Payments).
2) (Imports + Exports of goods with EA-19 / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).
3) Trade in services with EA-19 (average credit and debit in % of GDP at current prices) (Balance of Payments).
4) Data not available for 2021. The Ease of Doing Business report by the World Bank was discontinued in September 2021.
5) International Institute for Management Development (IMD).
6) Percentage of internal market directives not yet communicated as having been transposed, relative to the total.
(November data, as of 2016 date refers to the year of publication).
7) Deflated house price index (2015=100) (Eurostat).
Sources: Eurostat, World Bank, International Institute for Management Development, European Commission calculations.

markets) improved in 2020 and 2021, driven by Poland's diversified export structure, which helped cushion the impact of the crisis. The nominal effective exchange rate depreciated throughout 2020 and 2021 but the real effective exchange rate remained broadly stable over the same period and can therefore not explain the good export performance ([114]).

Graph 6.9: **Poland - Effective exchange rates**
(vs. 36 trading partners; monthly averages; index numbers, 2016 = 100)



Source: European Commission.

The net international investment position (NIIP) improved significantly from -49.8% in 2019 to -39.9% in 2021. Although this remains beyond the indicative threshold set in the MIP scoreboard (-35% of GDP), external vulnerabilities remain contained, as major part of the NIIP consists of the accumulated stock of foreign direct investments.

6.6.2. Market integration

Poland's economy is well integrated with the euro area through both trade and investment linkages. Trade openness increased from 51.4% in 2016 to 59.5% of GDP in 2021. The share of trade with euro-area partners expressed in percentage of GDP was broadly stable in recent years, although in 2021 it increased to around 34%. Poland's main goods trading partners in 2021 were Germany, China, the Netherlands, Czechia and Italy.

FDI inflows to Poland have mainly originated from the Netherlands, Germany, Luxembourg and France, which together provided nearly two-thirds of the FDI stock at the end of 2020. The significant size and growth of the domestic market as well as good access to large regional markets have supported the attractiveness of the country for FDI.

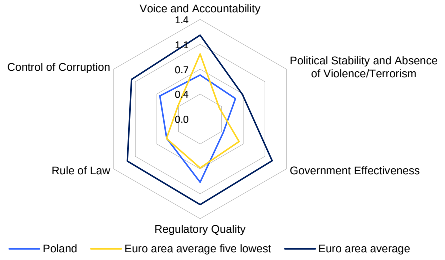
On the basis of selected indicators relating to the business environment, Poland ranks slightly below the average of euro-area Member States. In the 2020 World Bank's Ease of Doing Business index, Poland scored comparatively poorly with regard to starting a business, followed by the sub-index related to registering property ([115]). According to the World Bank's Worldwide Governance Indicators (2020), Poland ranks low in voice and accountability, and government effectiveness compared with the average of the five euro area Member States with the lowest scores. Poland

([114]) The REER based on unit labour costs should be interpreted with prudence as unit labour costs were distorted by labour retention schemes in some countries, including Poland.

([115]) The World Bank Doing Business (DB) program was paused in 2021. The programme will continue with a new governance and improved accountability and transparency under the name Business Enabling Environment (BEE). The first edition of the BEE is expected in 2023.

ranks higher than the average five lowest euro area Member States for political stability and absence of violence, and control of corruption. According to the latest data, Poland lags behind in the transposition of EU directives as the deficit was at 1.8% in 2020, which is above the target (0.5%) proposed by the European Commission in the Single Market Act (2011) ([116]).

Graph 6.10: **Poland - 2020 World Bank's Worldwide Governance Indicators**



Note: Estimate of governance ranges from -2.5 (weak) to 2.5 (strong).
Source: World Bank.

The legal and institutional framework to prevent and combat corruption is largely in place in Poland, although with some weaknesses. The 2021 Rule of Law Report points to several risks regarding the effectiveness of the fight against high-level corruption in Poland, including a risk of undue influence on corruption prosecutions for political purposes. Specifically, the Report mentions concerns over the independence of the main anti-corruption bodies, with, for instance, the subordination of the Central Anti-Corruption Bureau to the executive. Poland is lagging behind in addressing Sustainable Development Goal 16 – Peace, Justice and Strong Institutions, although it has seen some progress in recent years.

Poland has achieved a satisfactory level of transparency of legal persons, arrangements, and their beneficial ownership. However, more efforts are required to identify and assess certain ML/TF threats and vulnerabilities. The authorities should acknowledge and demonstrate with measures that terrorism financing is a stand-alone crime, not just a by-product of terrorism. The cash control mechanisms at the border should be strengthened by providing a legal basis to stop and restrain suspicious assets. A supervisory and sanctioning system on proliferation financing must be urgently put in place. Its transposition of the 5th AMLD is not yet complete and still under assessment by the European Commission.

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

The financial sector in Poland is smaller and less developed than in the euro area. Relative to GDP, assets managed by the financial sector are a fifth of that of the euro area. The financial sector has increased slightly since 2016, but considerably less than in the euro area. Banking dominates the Polish financial sector and make up 58% of the financial sector's assets. The central bank is the second largest holder of financial assets with a share of 18%. Although these shares are larger and more dominating than in the euro area, they compare well with the five euro-area Member States with the smallest financial sectors.

Table 6.6:
Poland - Allocation of assets by financial sub-sector

						Ratio to GDP (%)
	PL		EA		EA 5 smallest	
	2016	2020	2016	2020	2016	2020
Financial corporations (total)	163	167	722	796	177	215
Central bank	26	30	45	78	37	61
Monetary financial institutions	93	97	286	311	97	98
Other financial intermediaries	9	10	202	179	20	28
Non-MMF investment funds[1)]	16	14	100	127	4	5
Insurance co. and Pension Funds	19	16	90	102	18	23
						Share of total (%)
	PL		EA		EA 5 smallest	
	2016	2020	2016	2020	2016	2020
Central bank	16	18	6	10	21	29
Monetary financial institutions	57	58	40	39	55	46
Other financial intermediaries	6	6	28	22	11	12
Non-MMF investment funds	10	8	14	16	2	2
Insurance co. and Pension Funds	12	10	12	13	10	11

1) MMF stands for money market funds.
Source: Eurostat.

The insurance and the pension-fund sector in Poland is much smaller than in the euro area, relative to GDP and it has decreased contrary to

[116] A Member State is considered to have a 'low' ('high') ranking compared with the average five euro area Member States with the lowest scores for each indicator if its score is at least 0.3 percentage points lower (higher) than that of the average of this euro area group.

the euro area. Since end-2016, it has decreased holdings of financial assets by 3.0 percentage points in relation to GDP, in the euro area it increased by 12.3 percentage points. The sector’s share of the total financial sector has decreased as well and widened the spread with the euro area. The investment-funds sector plays relevant role in the Polish financial system and its size is well above (by four times) to those of the five euro-area Member States with the smallest financial sectors.

Table 6.7:
Poland - Financing of the economy1)

Ratio to GDP (%)

	PL		EA		EA 5 smallest	
	2016	**2020**	**2016**	**2020**	**2016**	**2020**
Liabilities (total)	288	275	743	770	324	335
Loans	105	99	238	236	115	112
Non-financial co. debt securities	7	4	12	15	3	4
Financial co. debt securities	7	10	74	68	11	12
Government debt securities	48	52	83	95	51	57
Listed shares	29	22	65	73	17	18
Unlisted shares	27	24	186	193	55	56
Other equity	43	44	51	56	42	48
Trade credits and advances	23	21	33	35	29	29

Share of total (%)

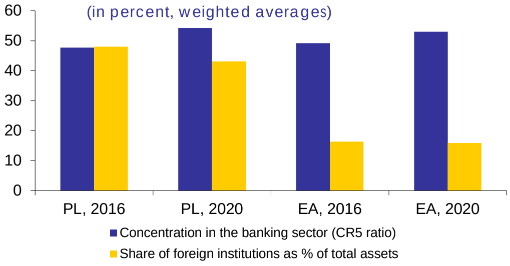
	PL		EA		EA 5 smallest	
	2016	**2020**	**2016**	**2020**	**2016**	**2020**
Loans	37	36	32	31	35	33
Non-financial co. debt securities	2	1	2	2	1	1
Financial co. debt securities	3	4	10	9	3	3
Government debt securities	17	19	11	12	16	17
Listed shares	10	8	9	9	5	5
Unlisted shares	9	9	25	25	18	18
Other equity	15	16	7	7	13	14
Trade credits and advances	8	8	4	5	9	9

1) The table focuses on the financing needs of a country and how these are met by the financial system. The table is constructed from the liabilities of all economic sectors, but only considers loans, debt securities, equity and trade credits. The sum of liabilities in the table only reflects the total for the liabilities considered.

Source: Eurostat.

As to the financing of the economy, Poland has less developed credit and equity markets relative to GDP than countries in the euro area, and market financing (debt securities and listed shares) is relatively under developed. However, Poland is still fully comparable to the five euro-area Member States with the smallest national capital markets with only exception of the unlisted shares is it remained twice smaller in 2020.

Graph 6.11: **Poland - Foreign ownership and concentration in the banking sector**
(in percent, weighted averages)

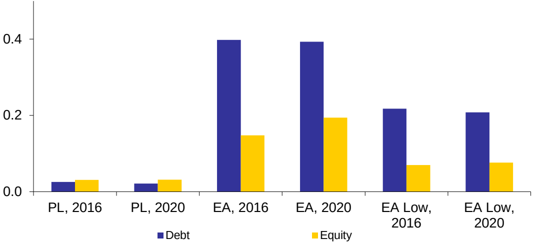


Source: ECB, Structural financial indicators.

Loans are the dominant source of funding and make up 99% of GDP in 2020, compared to 236% of GDP in the euro area. Equity and private sector debt markets are very small compared to those of the euro area and represent 36% of GDP altogether. This compares to 83% for private-sector debt and 73% for listed stocks in the euro area. Government debt is almost twice less than in the euro area. In terms of share of the sum of liabilities, loans in Poland are near to that of five euro-area Member States with the smallest financial sectors. For the securities, it is broadly in line with mentioned countries.

Poland's banking sector is well integrated into the euro-area financial sector, in particular through a high level of foreign ownership in its banking system. The share of foreign-owned institutions in total bank assets stood at 43% in 2020. Bank concentration, as measured by the market share of the five largest credit institutions in total assets, has increased since 2016, and reached 54% in 2020, which equals the same measure as of euro area.

Graph 6.12: **Poland - Intra-EU integration in equity and debt portfolio investment**
(index)



Note: The chart shows the extent of home bias in debt and equity markets. A value index of 1 implies ‘full integration’ with the financial markets of other Member States, while 0 denotes ‘no integration’.

Source: FinFlows database: European Commission, Joint Research Centre (JRC).

Intra-EU integration in equity and debt markets, as measured by the home bias [117] in portfolio investments, are in general relatively low across EU Member States. The integration levels of these markets in Poland are even smaller if compared to euro-area Member states and to that of five euro-area Member States with the smallest financial sectors. Integration in the debt market segment has weakened somewhat between 2016 and 2020. Concerning portfolio investments in equity, the home bias is remained unchanged and very strong in Poland relative to euro-area Member States. Almost all investments in equity markets takes place domestically.

[117] Home bias in portfolio investments measures the average propensity of investors in a Member State to invest domestically as compared with investing in other EU countries. The indicator ranges between 0 and 1, with a value of 0 indicating that investors prefer domestic over foreign assets. The inverse of the home bias can be interpreted as one measure of financial integration among EU countries.

7. ROMANIA

7.1. LEGAL COMPATIBILITY

7.1.1. Introduction

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

The BNR law has not been amended since the Commission's 2020 Convergence Report. Therefore, the comments provided in the Commission's 2020 Convergence Report are repeated also in this year's assessment.

7.1.2. Central Bank independence

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

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

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

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

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

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

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

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

7.1.3. Prohibition of monetary financing and privileged access

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

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

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

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

7.1.4. Integration in the ESCB

Objectives

Pursuant to Article 2(3) of the BNR Law, the secondary objective of the BNR is to support the State's general economic policy. Article 2(3) of the BNR Law contains an imperfection as it should contain a reference to the general economic policies in the Union as per Article 127(1) of the TFEU and Article 2 of the ESCB/ECB Statute.

Tasks

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

- absence of a general reference to the BNR as an integral part of the ESCB (Article 1 of the BNR Law);
- definition of monetary policy and monetary functions, operations and instruments of the ESCB (Articles 2(2)(a), 5, 6(3), 7(1), 8, 19, 20, 21 (1) and (2), 22(3) and 33(1)(a) and (e) of the BNR Law);
- conduct of foreign exchange operations and the definition of foreign exchange policy (Articles 2(2)(a) and (d), 9 and 33(1)(a) of the BNR Law);
- holding and management of foreign reserves (Articles 2(2)(e), 9(2)(c), 30 and 31 of the BNR Law);
- right to authorise the issue of banknotes and the volume of coins (Articles 2(2)(c), 12 to 18 of the BNR Law);
- non-recognition of the role of the ECB and of the Council in regulating, monitoring and controlling foreign currency transactions (Articles 10 and 11 of the BNR Law);
- lack of reference to the role of the ECB in payment systems (Articles 2(2)(b), 22 and 33(1)(b) of the BNR Law).

There are also imperfections regarding the:

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

7.1.5. Assessment of compatibility

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

7.2. PRICE STABILITY

7.2.1. Respect of the reference value

At the time of the last convergence assessment of Romania in 2020, the twelve-month average inflation rate, which is used for the convergence assessment, was above the reference value. From 3.6% in April 2020, the twelve-month average inflation rate decreased steadily to 2.1% by March 2021, but rose sharply to 4.1% by the end of 2021. In April 2022, the reference value was 4.9%, calculated as the average of the 12-month average inflation rates in France, Finland and Greece plus 1.5 percentage points. The corresponding inflation rate in Romania was 6.4%, which was 1.5 percentage points above the reference value. The 12-month average inflation rate is projected to remain well above the reference value in the months ahead.

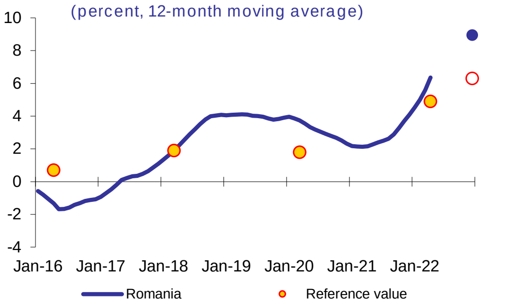
Table 7.1:
Romania - Components of inflation

(percentage change)[1]	2016	2017	2018	2019	2020	2021	Apr-22	weights in total 2022
HICP	-1.1	1.1	4.1	3.9	2.3	4.1	6.4	1000
Non-energy industrial goods	-0.7	0.9	1.7	2.4	2.3	2.6	3.1	292
Energy	-4.4	0.4	12.2	2.7	-7.4	15.2	23.7	121
Unprocessed food	-2.5	3.9	5.3	6.2	5.3	1.8	5.3	113
Processed food	-0.9	2.2	3.7	5.5	5.0	4.0	6.2	251
Services	0.7	-0.5	2.7	3.6	2.7	2.7	3.8	223
HICP excl. energy and unproc. food	-0.2	0.9	2.7	3.8	3.3	3.1	4.3	766
HICP at constant tax rates	2.1	2.0	3.8	3.7	2.3	3.9	6.3	1000
Administered prices HICP	-2.5	0.5	4.2	2.6	1.2	1.8	3.0	94

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

Source: Eurostat, European Commission calculations.

Graph 7.1: **Romania - Inflation criterion**



Note: The dots at the right end of the chart show the projected reference value and 12-month average inflation rate of the country in December 2022. The reference values for 2016, 2018 and 2020 refer to the reference values calculated in the previous Convergence Reports.

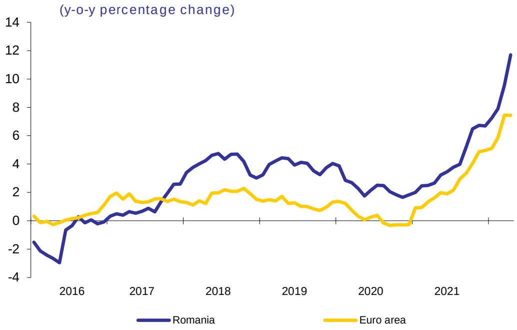
Source: Eurostat, Commission's Spring 2022 Economic Forecast.

7.2.2. Recent inflation developments

Annual HICP inflation in Romania stood at 4.1% in 2021, up from 2.3% in 2020. The low annual average rate of inflation in 2020 reflected the effect of lockdown and mobility restriction measures, which were felt throughout the economy in terms of reduced demand for goods and services. The year-on-year inflation rate fell from 3.9% in January 2020 to 1.8% in May 2020, which was its lowest level since September 2017, also reflecting the sharp drop in the international price of crude oil in the first four months of 2020. After a temporary rise to 2.5% in July 2020, reflecting strong food price inflation, it decreased to 1.7% by November 2020. Subsequently, inflation rose uninterruptedly, reaching 3.5% in June 2021, 5.2% in September 2021 and 6.7% in November 2021, driven by high energy price inflation throughout 2021 and, in the later part of 2021, also sustained by higher inflation for processed food and, to a lesser extent, non-energy industrial goods and services. Over the past two years, annual HICP inflation in Romania was higher than in the euro area by around 1.75 percentage points on average.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) declined slightly from 3.3% in 2020 to 3.1% in 2021. If fell from a high of 4.0% in January 2020 to 2.4% by July 2021, before increasing sharply during the subsequent months to 4.5% in November 2021. Higher prices for processed food, which increased by more than 4% in both years, contributed significantly to core inflation, while the annual price changes for non-energy industrial goods (2.3% and 2.6% in 2020 and 2021 respectively) and services (2.7% for both 2020 and 2021) were more muted. Wage growth was moderate in 2020 due to falling economic activity, but went up again in 2021 against the background of a robust economic recovery and high inflation.

Graph 7.2: **Romania - HICP inflation**



Source: Eurostat.

While lower energy demand resulted in a decrease in the energy component of HICP inflation of almost 7.5% in 2020, relatively high increases were recorded in the prices for processed and unprocessed food that year, by 5% and 5.3% respectively. In 2021 when the economy fully recovered and pent-up demand was released, inflation picked up again. Energy price inflation was particularly high in the second half of the year,

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

	2016	2017	2018	2019	2020	2021	2022[1]	2023[1]
HICP inflation								
Romania	-1.1	1.1	4.1	3.9	2.3	4.1	8.9	5.1
Euro area	0.2	1.5	1.8	1.2	0.3	2.6	6.1	2.7
Private consumption deflator								
Romania	0.7	2.7	3.8	5.4	2.4	5.5	9.1	5.3
Euro area	0.4	1.3	1.5	1.1	0.5	2.3	5.8	2.7
Nominal compensation per employee								
Romania	15.5	14.8	12.9	10.9	2.6	5.7	8.3	7.0
Euro area	1.2	1.7	2.1	2.1	-0.7	4.1	3.6	3.5
Labour productivity [2]								
Romania	5.9	4.8	4.4	4.1	-2.0	16.2	1.7	2.8
Euro area	0.4	1.0	0.2	0.3	-4.9	4.2	1.4	1.5
Nominal unit labour costs [2]								
Romania	9.1	9.6	8.2	6.6	4.7	-9.0	6.4	4.1
Euro area	0.8	0.7	2.0	1.9	4.4	0.0	2.2	2.0
Imports of goods deflator								
Romania	-7.2	5.3	4.8	0.2	-2.3	10.5	12.0	4.0
Euro area	-3.3	3.3	2.6	-0.5	-3.8	9.6	13.2	0.8

[1] Commission's Spring 2022 Economic Forecast.

[2] Due to a break in the historical employment data for Romania in 2021, employment-related variables have been affected.

Source: Eurostat, Commission's Spring 2022 Economic Forecast.

up from 13.5% y-o-y in June to 25% in December. The support measures addressed to vulnerable consumers, households and SMEs moderated to a certain extent the increase in energy prices, as prices for electricity, gas, and heating energy were capped. Nevertheless, energy prices registered a 12-month average increase of 21.7% in March 2022. This was partly due to the fact that the HICP sub-component for liquid fuels and fuels and lubricants for personal transport equipment was not capped and recorded a 12-month average increase of 29.5% in March. International trade bottlenecks affecting supply-chains, as well as higher energy prices translated into marked increases in producer prices in manufacturing, averaging about 10.4% in 2021.

7.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and growth developments

Real GDP dropped by 3.7% in 2020, but recovered in 2021 with a 5.9% increase. In 2020, due to the COVID-19 crisis, private consumption, imports and exports were particularly negatively affected, but investments and government consumption continued to grow. In 2021, real GDP was back to pre-pandemic levels by the end of the first half of the year, but the growth momentum declined in the third quarter and turned negative in the final one.

Private consumption and investment represented the main growth drivers in 2021. After a 5.1% drop in the preceding year, private consumption grew at 7.9% in 2021. Gross fixed capital formation maintained a steady positive trend, even during the COVID-19 crisis. In particular, equipment investments were a strong growth driver as the economy quickly adapted to the new pandemic environment. Construction, on the other side, moderated its growth in 2020, but recorded a 6.1% increase the next year. Strong domestic demand in 2021 fuelled import growth. As a consequence, despite a relatively strong export performance, net exports made a negative contribution to real GDP growth that year. The growing trade deficit worsened the current account balance. According to the Commission's Spring 2022 Economic Forecast, real GDP growth is expected to increase by 2.6% this year, as private consumption is projected to be more subdued on account of higher inflation and uncertainty. At the same time, investment, supported by the RRF and other EU funds, is set to increase robustly. For 2023, real output growth is projected at 3.6%, as inflationary pressures and supply-side bottlenecks are expected to gradually abate.

In 2020-2021, as part of the policy response to the COVID-19 crisis, the government provided support to the healthcare sector and to households and companies hit by the pandemic, including incentives to retain the workforce. This response was facilitated by new European instruments, namely loans from SURE (Support to mitigate Unemployment Risks in an Emergency) and loans and grants from NextGenerationEU/RRF.

In 2021, the fiscal stance ([118]), was contractionary, at 0.5% of GDP , after a supportive stance of -1.6% in 2020. Going forward, the Commission's Spring 2022 Economic Forecast projects a supportive fiscal stance at -1.0% of GDP in 2022, driven by higher nationally-financed investment, expenditure financed through the RRF and other EU grants and the temporary support to mitigate the impact of high energy prices (estimated around 0.7% of GDP. The budgetary costs related to assisting people fleeing Ukraine is assumed at close to 0.1% of GDP. The no policy-change forecast for 2023 shows a contractionary stance (1.3% of GDP) reflecting the withdrawal of the support measures introduced in response to the increase in energy prices.

The BNR, operating within an inflation targeting framework ([119]), gradually reduced the key policy rate by 125 basis points between March 2020 and January 2021, as part of the measures taken in response to COVID-19 crisis. The policy rate remained stable at 1.25% until October 2021. In response to rising inflation, the BNR tightened its monetary policy stance by steadily raising the policy rate by a total of 250 basis points between October 2021 and May 2022. In May 2022, the policy rate stood at 3.75%.

In April 2020, the BNR also started purchasing government bonds in the secondary market to consolidate the structural liquidity in the banking system, thereby supporting favourable financing conditions for the economy. It continued to purchase government securities on an irregular basis throughout 2020, 2021 and in the first months of 2022. The reserve requirement ratio on accounts opened with BNR for the foreign currency holdings of the credit institutions, which stood at 6% in February 2020, has been reduced to 5% since November of the same year. The reserve requirement ratio for leu denominated holdings has been unchanged since May 2015 at 8%.

The overall credit to the economy continued to expand in 2020 and 2021, sustained by government support measures. These increases were primarily supported by the expansion of credit to households for housing (9.9% in 2020 and 12.9% in 2021) and to Non-Financial Corporations (5.3% in 2020 and 19.8% in 2021). Consumer loans to households were down by 2.2% at the end of 2020 compared to the preceding year, before rebounding by 4.9% by the end of 2021. Loans to the general government grew by close to 116% in 2021, reflecting the overall need of the government to finance its sizeable budget deficit.

Wages and labour costs

Labour market conditions improved in the second half of 2020 and in 2021 after the initial deterioration due to the COVID-19 shock in early 2020, in line with robust economic growth and government's support measures. Also through the help of measures financed from SURE, the employment rate improved, from a low of 64% in the second quarter of 2020 to more than 67% at the end of 2021, while the unemployment rate continued to decrease from 6.7% in June 2020 to 5.7% in December 2021. Unemployment is projected to decrease and stay at levels close to 5.5% in the next two years, as the economy continues to grow ([120]). Undeclared work remains a challenge, but its negative impact on social contribution system and government revenues is expected to be partly addressed by RRP reforms such as the introduction of work cards for domestic work and improvements of tax administration processes.

The increase in labour market slack, coupled with the relatively low inflation and the drop in productivity that took place in 2020, toned down wage pressures. As a result, nominal compensation per employee increased by only 2.6%. In 2021, wage growth remained stable, also as a result of

([118]) The fiscal stance is measured as the change in primary expenditure (net of discretionary revenue measures), excluding Covid-19 crisis-related temporary emergency measures but including expenditure financed by non-repayable support (grants) from the Recovery and Resilience Facility and other EU funds, relative to medium-term potential growth. A negative (positive) sign of the indicator corresponds to an excess (shortfall) of primary expenditure growth compared with medium-term economic growth, indicating an expansionary (contractionary) fiscal policy.

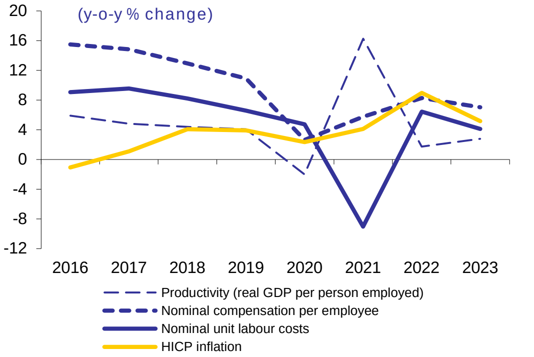
([119]) As from 2013, the BNR follows a flat multi-annual inflation target of 2.5% (± 1 percentage point).

([120]) Due to the change in the Labour Force Survey methodology, the figures in the 2022 Convergence Report are not comparable with the ones in the 2020 Report.

the freezing of public sector wages (expected to continue in 2022), whereas for 2022 the combination of a tighter labour market, skill shortages, higher productivity and inflationary pressures are expected to push wages up again, especially in the services sector. On the other hand, supply chain bottlenecks could negatively affect wages in the manufacturing sector. Minimum wage increases of 3.1% in mid-2021 and 10.9% in January 2022 were legislated to compensate households for the loss of purchasing power due to higher inflation. As of 2024, Romania committed in the RRP to create a new mechanism formula to objectively set the minimum wage level.

Labour productivity per person contracted by 2.2% in 2020, reflecting efforts to retain workers in employment notwithstanding the contraction in economic activity, but recorded an increase in the year after. In 2022, labour productivity is forecast to improve by just 2%, in line with the more subdued output growth. During the pandemic, while wage growth moderated, labour compensation still grew more than productivity, resulting in an increase in nominal unit labour costs (ULC). According to the Commission's Spring 2022 Economic Forecast, the ULC growth rate in Romania is expected to slowly pick-up in 2022 and 2023 and to remain above the average growth rates in the euro area, mirroring the projected growth in wages continuing to outpace productivity increases.

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



Note: Due to a break in the historical employment data for Romania in 2021, employment-related variables have been affected.

Source: Eurostat, Commission's Spring 2022 Economic Forecast.

External factors

Due to the openness of the Romanian economy and its deep integration into the global and the EU economy, developments in import prices play a significant role in domestic price formation. In particular, energy and food import prices have been a significant determinant of price inflation in Romania, given the large weight of these categories in the Romanian HICP and the fact that Romania is a net importer of energy. Import price inflation (measured by the imports of goods deflator) was significantly lower than consumer price inflation in 2020, reflecting the reduction in the price of fuel commodities. In 2021, however, import price inflation exceeded by almost 6.4 percentage points the HICP inflation, reflecting the sudden increase in the prices of the same commodities.

The leu's nominal effective exchange rate (measured against a group of 36 trading partners) remained broadly stable in the past two years, depreciating only moderately, by less than 1% between the beginning of 2020 and the end of 2021. Looking ahead, imported inflation is expected to remain high and above HICP inflation, in line with expected developments in global commodity and energy prices.

Administered prices and taxes

The weight of administered prices in the 2021 Romanian HICP basket (9.4%) is below the euro area average (15.5%). The average annual change in administered prices was 1.2% in 2020, below the headline inflation rate by 1.1 percentage points. In 2021, administered prices increased by just 1.8%, which was much below the 4.1% headline figure, mainly reflecting the slow increase in the non-energy administered prices component and decreases of the energy one in the first half of the year. Following legislative changes adopted at the beginning of 2020, the liberalisation of gas and electricity prices for households has been completed as of 1 July 2020 and 1 January 2021, respectively. However, in the context of marked price increases in late 2021, the government adopted legislation capping gas and electricity prices, with reduced tariffs for lower energy consumption brackets. The support measures were extended until April 2023.

Tax changes had a marginal influence on inflation in Romania in the last two years. HICP inflation measured at constant taxes was similar to headline HICP inflation. For 2020, the former stood at 2.3%, equal to the headline inflation figure, whereas it was 3.9% in 2021, 0.2 percentage point lower than the headline HICP inflation rate.

Table 7.3:

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

Outturn and forecast 1)	2016	2017	2018	2019	2020	2021	2022 1)	2023 1)
General government balance	-2.6	-2.6	-2.8	-4.3	-9.3	-7.1	-7.5	-6.3
- Total revenue	32.0	30.8	32.0	31.9	32.7	32.8	33.6	33.3
- Total expenditure	34.6	33.5	34.8	36.2	42.0	39.9	41.1	39.6
of which:								
- Interest expenditure	1.5	1.3	1.0	1.1	1.4	1.4	1.5	1.6
p.m.: Tax burden	26.7	25.8	26.8	26.8	27.1	27.3	27.9	27.7
Primary balance	-1.1	-1.4	-1.8	-3.2	-8.0	-5.7	-6.0	-4.7
Fiscal stance 2)					-1.6	0.5	-1.0	1.3
Government gross debt	37.3	35.1	34.7	35.3	47.2	48.8	50.9	52.6
p.m: Real GDP growth (%)	4.7	7.3	4.5	4.2	-3.7	5.9	2.6	3.6

1) Commission's Spring 2022 Economic Forecast.

2) A negative (positive) sign of the indicator corresponds to an excess (shortfall) of primary expenditure growth compared with medium-term economic growth, indicating an expansionary (contractionary) fiscal policy.

Source: European Commission.

Medium-term prospects

According to the Commission’s Spring 2022 Economic Forecast, annual HICP inflation is projected to increase further to 8.9% in 2022 before falling to 5.1% in 2023. The significant increase in 2022 is mainly due to the hike in energy prices, with pass-through into other components, but also due to a rise in food prices. Services’ inflation is also projected to pick-up, reflecting a surge in transport services inflation due to higher fuel prices. Inflation in non-energy industrial goods is projected to show a similar dynamic as HICP energy inflation, but of a considerably lower magnitude.

Risks to the inflation outlook are mainly on the upside, stemming from the implications of Russian’s invasion of Ukraine for global food and energy prices. Other aspects, such as an increasingly tight labour market, contribute to the uncertainty of the inflation forecast.

In 2020, the level of consumer prices in Romania was about 52% of the euro area average. The GDP per capita was around 70% of the euro area average in PPS terms in 2021. Due to the process of catching-up of the Romanian economy, price level convergence is expected over the next years.

7.3. PUBLIC FINANCES

7.3.1. Recent fiscal developments

The general government deficit decreased from 9.3% of GDP in 2020 to 7.1% in 2021. The markedly high deficit in 2020 was mainly driven by a combination of additional expenditure due to the COVID-19 outbreak (healthcare spending and support measures to the economy and labour market) and a denominator effect given the 3.9% drop in real output. In 2021, the government enacted some limited consolidation measures, including a freeze in public sector wages, while revenues increased due to the economic recovery. Still, COVID-19 support measures continued in 2021.

Romania is subject to an excessive deficit procedure ([121]). On 18 June 2021, the Council adopted a recommendation under Article 126(7) of the Treaty (TFEU), with a view to bringing an end to the situation of an excessive government deficit in Romania by 2024 at the latest. Romania was recommended to reduce the general government deficit to 8.0% of GDP in 2021, 6.2% of GDP in 2022, 4.4% of GDP in 2023, and 2.9% of GDP in 2024. On 23 May 2022, the Commission concluded that Romania’s deficit outturn of 7.1%

([121]) Following the expansionary fiscal stance and the high fiscal deficit recorded in 2019 and previous years, Romania entered an Excessive Deficit Procedure (EDP) in the spring of 2020.

of GDP in 2021 and the fiscal effort are in line with the Article 126(7) recommendation of the Council and, therefore, the excessive deficit procedure was kept in abeyance.

The general government debt-to-GDP ratio rose from 35.3% of GDP in 2019 to 47.2% in 2020 and 48.8% in 2021. The increases in 2020 and 2021 were mainly driven by the high primary deficit. The snow-ball effect and stock-flow adjustments both contributed to the increase in the debt ratio in 2020, whereas in 2021 they had a diminishing effect on the debt ratio. Liquidity support for households and companies in the form of guarantees and tax deferrals did not have a direct budgetary impact, but the guarantees represent contingent liabilities, estimated by the Commission services at around 3.2% of GDP as of December 2021.

7.3.2. Medium-term prospects

The 2022 budget, published on 28 December 2021, targets a reduction of the general government deficit to 6.2% of GDP in 2022. Several deficit-increasing expenditure measures were announced, such as an increase in the pension point value, an increase in minimum pensions by 20%, the one-off top-up of pensions in the RON 1,600-2,200 bracket for people with disabilities and the growth of children’s allowance by 16%. The planned improvement of the headline budget balance for 2022 is mainly due to automatic stabilisers, as the economy’s growth is set to stay robust, and to the expiry of the emergency health and labour market support measures. Moreover, a number of deficit-reducing measures will come into effect in 2022, such as the levying of social security contributions for health for pensions higher than RON 4,000.

In light of the increase in energy prices, the government approved measures to support measures to particular groups, such as poorer households and SMEs, to shield them against the increase in energy prices. These measures amounted to 0.7 of GDP in 2022 and consisted of allowances to vulnerable consumers, compensation schemes for households’ energy bills, and energy and gas price caps on the expenditure side, and a measure to tax the energy and gas domestic producers’ windfall revenues on the revenue side. In view of the humanitarian crisis following the invasion of Ukraine by Russia, the Commission estimates a budgetary cost of the support measures adopted by the Romanian government of 0.1% of GDP in 2022 and 0.1% in 2023.

On 5 May 2022, Romania submitted its 2022 Convergence Programme. According to the Programme, the headline deficit is projected to decline steadily to 6.2% of GDP in 2022 and 4.4% in 2023. The Programme targets a reduction of the government deficit to under 3% of GDP by 2024, in line with the Council recommendation.

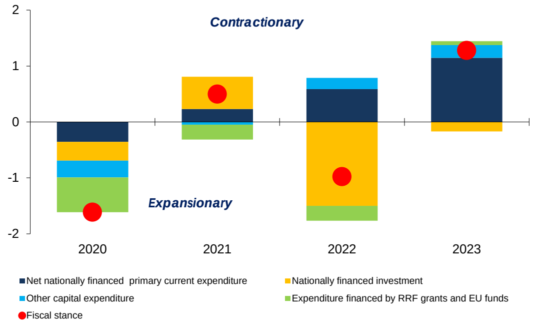
The Commission Spring 2022 Economic Forecast, which is based on a no-policy change assumption, projects a general government deficit of around 7.5% of GDP in 2022. The difference from the planned deficit in the Convergence Programme stems, in particular, from a difference in the underlying macroeconomic projections, an increase of some revenue items in the 2022 budget (and the Convergence Programme) that are not fully supported by enacted measures and therefore not taken into account in the Commission’s forecast, increased social expenditure and support to the economy and the measures to deal with the surge in energy prices and the flow of refugees. The Commission projects the general government deficit to further decrease to around 6.3% of GDP in 2023, as revenues are expected to grow strongly on the back of the economic recovery, while COVID-19 temporary emergency measures are expected to be phased out and the cost of the measures to deal with the surge of energy price are assumed to decrease. Romania is at risk of non-compliance with the fiscal targets for 2022 established in the Council Recommendation of 18 June 2021.

In 2022, the fiscal stance is projected in the Commission’s Spring 2022 Economic Forecast to be supportive, at -1.0% of GDP ([122]). The additional positive contribution to economic activity of expenditure financed by Recovery and Resilience Facility grants and other EU funds is projected to increase by 0.3 percentage point of GDP in 2022. Nationally financed investment is projected to provide an expansionary contribution to the fiscal stance of 1.5 percentage points of GDP in 2022. At the same time, the growth in nationally financed primary current expenditure (net of new revenue measures) in 2022 is projected to provide a contractionary contribution of 0.6 percentage point of GDP to the overall fiscal

([122]) For a definition of the fiscal stance used in this report, see footnote in Section 7.2.3 on underlying factors and sustainability of inflation.

stance, as current expenditure is set to grow at a slower pace than medium-term potential growth. This contribution is contractionary notwithstanding the expansionary impact of the measures related to the energy crisis (0.7% of GDP) and the assistance to those fleeing Ukraine (less than 0.1% of GDP).

Graph 7.4: **Romania - Fiscal stance and its components**
(percent of GDP)



Source: Commission's Spring 2022 Economic Forecast.

In 2023, the fiscal stance is projected to be contractionary at 1.3% of GDP. The additional positive contribution to economic activity of expenditure financed by Recovery and Resilience Facility grants and other EU funds is projected to decrease by 0.1 percentage points of GDP. Nationally financed investment is projected to provide an expansionary contribution to the fiscal stance of 0.2 percentage point of GDP ([123]), whereas the growth in nationally financed primary current expenditure is projected to provide a contractionary contribution of 1.1 percentage point of GDP to the overall fiscal stance in 2023, as the support measures to face the energy crisis in 2022 are assumed to be phased out.

The government debt-to-GDP ratio is forecast by the Commission to increase to 50.9% in 2022 and 52.6% in 2023. Debt sustainability risks appear medium over the medium term. Government debt is projected to increase reaching around 73% of GDP in 2032. This projection assumes that the structural primary balance (except for the impact of ageing) remains constant at the forecast level for 2023 of -3.8% of GDP, which is the same compared to the 2019 level.

The sensitivity to possible macro-fiscal shocks contributes to this assessment. In particular, if only half of the projected percentage point improvement in the structural primary balance in 2022-2023 were to occur, the projected debt ratio in 2032 would be about 5 percentage points of GDP higher than in the baseline.

Some factors mitigate risks, including the lengthening of debt maturity in recent years and relatively stable financing sources and the expected positive impact on long-term growth of reforms under the Recovery and Resilience Plan. Risk-increasing factors include the share of debt held by non-residents, the currency denomination of debt, and the country's negative net international investment position. An additional risk-increasing factor is the possible materialisation of state guarantees granted to firms and self-employed during the COVID-19 crisis, though this risk remains currently limited due to relatively low take-up ([124]).

Romania has a strong fiscal framework in place, consisting of in principle well-designed fiscal rules, a medium-term budgetary framework and an independent fiscal council. However, the track record in the application of the framework has been generally poor, as noted in previous Convergence Reports (2020 and 2018). In particular, the annual budget laws have repeatedly been in contradiction with national fiscal rules and not guided by the medium-term budgetary strategies following significant delays in the adoption of the latter. Faced with the COVID-19 shock in 2020, fiscal rules were equipped with the required flexibility to allow for a large deviation from targets.

7.4. EXCHANGE RATE STABILITY

The Romanian leu does not participate in ERM II. Romania has been operating a *de jure* managed floating exchange rate regime since 1991 with no preannounced path for the exchange rate ([125]). De facto, the exchange rate regime moved gradually from a strongly managed float – including through the use of administrative measures until 1997 – to a more flexible one. In 2005, Romania shifted to a direct inflation targeting framework combined with a floating exchange rate regime. The BNR has, nonetheless, stressed that currency

[123] Other nationally financed capital expenditure is projected to provide a contractionary contribution of 0.2 percentage point of GDP each year in 2022 and in 2023.

[124] For further details see the 2021 Fiscal Sustainability Report.

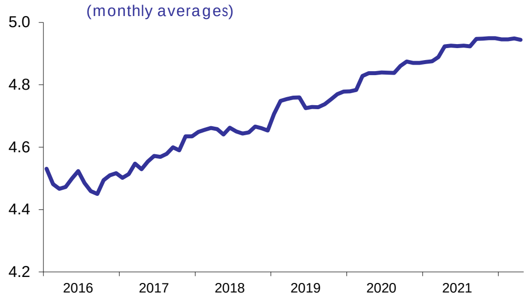
[125] On 1 July 2005 the Romanian Leu (ROL) was replaced by the new leu (RON), with a conversion factor of 1 RON = 10,000 ROL. For convenience, however, the text of this report consistently refers to leu, meaning ROL before and RON after the conversion.

intervention remains available as a policy instrument and has actively used this instrument.

The leu has depreciated steadily against the euro since 2017. Between the beginning of 2020 and April 2022, the leu weakened against the euro by around 3.5%. Over this period, the volatility of the leu's inter-day exchange rate was moderate compared to that of other floating currencies in Member States with a derogation. The leu weakened against the euro by around 1.0% between January and April 2021. It remained relatively stable on average in the subsequent four months, but in October 2021 the leu depreciated against the euro by 0.5%. It averaged around a RON/EUR level of 4.95 during the rest of 2021 and the first four months of 2022. In April 2022, the leu's exchange rate against the euro averaged around 4.94.

Graph 7.5: **Romania - RON/EUR exchange rate**

(monthly averages)

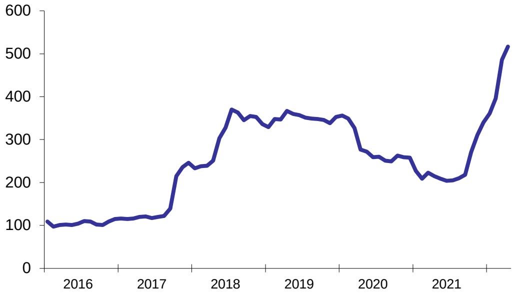


Source: ECB.

The gross international reserves held by the BNR declined to a low of around EUR 38bn in the third quarter of 2020 and recovered to around EUR 43bn at the end of 2020. The reserves continued to increase throughout most of 2021 to close to EUR 46bn at the end of 2021, reaching close to 19% of GDP and stood at around EUR 46bn in the first quarter of 2022. Over this period, movements in the level of international reserves were influenced by changes in the foreign exchange reserve requirements of credit institutions, sovereign debt management decisions, such as euro-denominated government bond issuances and, towards the end of 2021 and beginning of 2022, the first pre-financing payments under the EU's Recovery and Resilience Facility.

Graph 7.6: **Romania - 3-M Robor spread to 3-M Euribor**

(basis points, monthly values)



Source: National Bank of Romania, Eurostat and Thomson Reuters

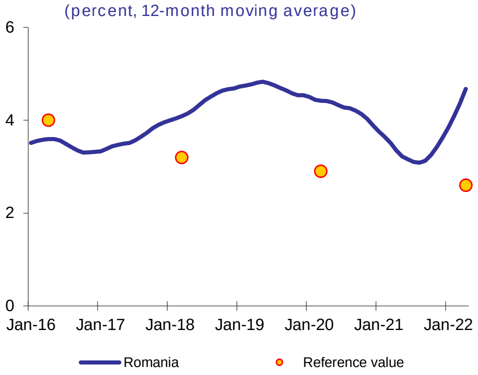
Short-term interest rate spreads vis-à-vis the euro area decreased by around 120 basis points between March 2020 and February 2021, mirroring the above-mentioned policy rate cuts by the Romanian central bank over this period. The three-month interest rate spread stabilised at around 210 basis points until September 2021, before steadily increasing to almost 500 basis points by March 2022. These developments in part reflected the tightening of monetary policy by the BNR in response to the increasing inflation, with the key policy rate raised from 1.25% in September 2021 to 3.75% in May 2022. The three-month interest rate spread relative to the euro stood at around 520 basis points in April 2022, well above its pre-pandemic levels.

7.5. LONG-TERM INTEREST RATES

The long-term interest rates in Romania used for the purpose of the convergence examination reflect secondary market yields on a single government benchmark bond with a residual maturity of around 10 years.

Graph 7.7: **Romania - Long-term interest rate criterion**

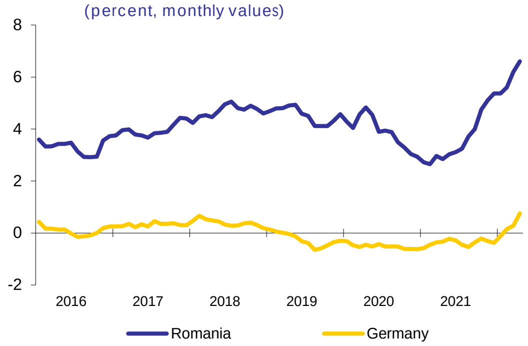
(percent, 12-month moving average)



Source: European Commission.

The Romanian twelve-month moving average long-term interest rate relevant for the assessment of the Treaty criterion was above the reference value at the time of the last convergence assessment of Romania in 2020. From 4.4% in April 2020, it fell to around 3.1% by July 2021 but increased again throughout the rest of 2021. In April 2022, the reference value, which is measured as the average of long-term interest rates in France, Finland and Greece plus 2 percentage points, stood at 2.6%. In that month, the twelve-month moving average of the yield on the Romanian benchmark bond was at 4.7%, i.e. 2.1 percentage points above the reference value.

Graph 7.8: **Romania - Long-term interest rates**
(percent, monthly values)



Source: Eurostat.

At the outset of the COVID-19 crisis, the long-term interest rate in Romania increased sharply from 4.0% in February 2020 to 4.8% in April 2020. Subsequently, the long-term interest rate decreased steadily, reaching a through of 2.7% in February 2021. The decline reflected the widespread monetary policy loosening measures by central banks, which depressed long-term yields. Interest rates started to increase again in March 2021 and were on an upward path throughout 2021, rising to 5.4% in December 2021, reflecting higher inflationary pressures and, as from October 2021, monetary policy tightening in Romania. The long-term interest rate of Romania increased further during the first four months of 2022, in the context of continued inflationary pressures, further monetary policy tightening, and heightened risk aversion following Russia’s invasion of Ukraine. It reached 6.6% in April 2022 and the long-term spread versus the German benchmark bond reached 586 basis points in that month, up from 310 basis points in February 2021.

7.6. ADDITIONAL FACTORS

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

In November 2021, the Commission published its eleventh Alert Mechanism Report (AMR 2022) under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.7), which concluded that an In-Depth Review (IDR) was warranted for Romania. In May 2022, the Commission published its annual country report on Romania and separately an In-Depth Review. These reports confirmed the existence of macroeconomic imbalances in Romania. Vulnerabilities relate to external accounts, linked to large fiscal deficits, and to competitiveness issues that are re-emerging.

The high current account deficit further worsened in 2021 and is not forecast to improve in 2022 or 2023. Large fiscal deficits pre-date the COVID-19 crisis and have driven up the current account deficit which poses risks to external debt sustainability. Sovereign borrowing costs have increased since early 2021. The expected acceleration in wages could weigh further on cost competitiveness. Nominal depreciation could mitigate competitiveness losses but add to inflationary pressures and increase the burden of serving debts in foreign currencies, which are significant for the government and the private sector. The negative net international investment position is expected to remain below its pre-pandemic levels. The external position is expected to benefit from significant RRF funds but external financing can otherwise become more challenging amid tighter global financial conditions. Recent policy initiatives, including the successful implementation of Romania’s RRP, can address some vulnerabilities, still further action is needed to improve competitiveness and potential growth.

Romania submitted its recovery and resilience plan (RRP) on 31 May 2021. The Commission’s positive assessment on 27 September 2021 and the Council’s approval on 29 October 2021 paved the way for the implementation of the RRP and the disbursement of EUR 14.25 billion in grants and

Table 7.4:

Romania - Balance of payments **(percentage of GDP)**

	2016	2017	2018	2019	2020	2021
Current account	-1.6	-3.1	-4.6	-4.9	-5.0	-7.0
of which: Balance of trade in goods	-5.7	-6.8	-7.5	-8.0	-8.7	-9.6
Balance of trade in services	4.6	4.4	4.1	3.9	4.3	4.0
Primary income balance	-1.3	-1.4	-1.8	-1.4	-1.5	-1.7
Secondary income balance	0.8	0.8	0.6	0.7	0.9	0.4
Capital account	2.5	1.2	1.2	1.3	1.9	2.2
External balance [1]	0.9	-1.9	-3.4	-3.6	-3.1	-4.8
Financial account	1.6	-1.7	-2.5	-2.3	-3.6	-5.4
of which: Direct investment	-2.7	-2.6	-2.4	-2.2	-1.4	-3.0
Portfolio investment	-0.6	-1.6	-1.4	-1.1	-6.1	-1.3
Other investment [2]	3.5	2.3	1.7	1.1	1.3	-2.0
Change in reserves	1.3	0.2	-0.4	-0.1	2.6	0.9
Financial account without reserves	0.2	-1.9	-2.1	-2.2	-6.1	-6.3
Errors and omissions	0.6	0.3	0.9	1.3	-0.5	-0.6
Gross capital formation	23.4	23.4	22.8	23.6	24.4	25.9
Gross saving	22.2	20.3	18.3	18.4	18.6	18.9
Net international investment position	-49.2	-47.4	-43.8	-43.6	-47.9	-45.7

1) The combined current and capital account.

2) Including financial derivatives.

Sources: Eurostat, European Commission calculations, National Bank of Romania.

14.97 billion in loans over the period 2021-2026, which is equivalent to 13.1% in 2019 GDP.

Romania’s plan includes an extensive set of mutually reinforcing reforms and investments (107 investments and 64 reforms) that should contribute to effectively addressing all or a significant subset of the economic and social challenges outlined in the country-specific recommendations (CSRs) addressed to Romania by the Council in the European Semester in 2019 and 2020. The plan will address key macro-economic challenges such as the sustainability of public finances, education, increasing greenhouse gas emissions and the lack of digital connectivity. Key investments are included for railway modernisation, the energy efficiency of buildings, the digitalisation of public administration and making the health system more resilient. Investments will also focus on increasing the quality and access to education, including digitalisation and overall infrastructure. Key reforms aim at addressing fiscal sustainability, improving access to financing, strengthening the public administration and modernising the social benefits system. By strengthening the independence and increasing the efficiency of the judiciary, improving access to justice, and stepping up the fight against corruption, the plan aims to address the main issues related to respect of the rule of law in Romania in accordance with the relevant case-law of the Court of Justice of the European Union and taking into account recommendations made in the Cooperation and Verification Mechanism (CVM) reports, the reports by the Group of States against Corruption (GRECO), the opinions of the Venice Commission, and the Rule of Law Reports.

The plan devotes 41% of its total allocation to measures supporting climate objectives, 20.5% to the digital transition and 25% on social expenditure, all while respecting the ‘do no significant harm’ principle.

The implementation of the investments in the Romanian plan, along with other investments under Next Generation EU (NGEU), is estimated to raise Romania’s GDP by 2.9% by 2026, of which 0.2% due to the positive spillover effects of the coordinated implementation of NGEU across Member States [126]. This does not take into

[126] See Pfeiffer P., Varga J. and in ’t Veld J. (2021), “Quantifying Spillovers of NGEU investment”, European Economy Discussion Papers, No. 144 and Afman et al. (2021), “An overview of the economics of the Recovery

account the positive impact of structural reforms on growth.

7.6.1. Developments of the balance of payments

Romania's external balance (i.e. the combined current and capital account) improved from -3.6% of GDP in 2019 to -3.1% in 2020, before deteriorating to -4.8% in 2021. In 2021, the capital account remained in surplus and actually increased, but this was more than offset by the worsening of the current account deficit, which increased from -5.0% of GDP in 2020 to -7.0% of GDP in 2021.

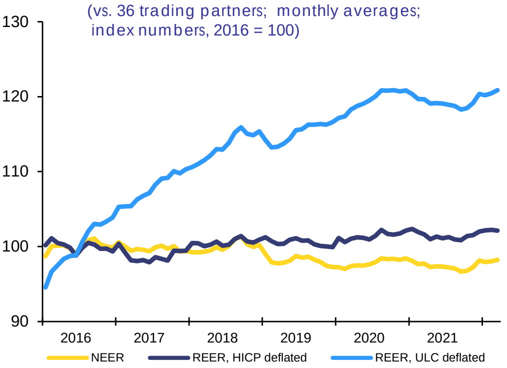
Despite growth in export market shares in 2021, the growth of imports spurred by booming private consumption has outpaced that of exports. The balance of trade in goods deteriorated markedly, particularly in 2020 and 2021 when it reached -8.7% of GDP and -9.6%, respectively. The balance of trade in services, driven mainly by exports of transportation and IT services, remained positive at 4.3% of GDP in 2020 and 4.0% in 2021, but did not offset the negative and widening deficit in the trade in goods.

The balance of primary income remained negative, slightly more so in 2020 compared to 2019, reflecting mainly the outflow of investment income linked to the country's negative net international investment position. The balance of secondary income, which consists mainly of remittances, continues to be positive, with a slight increase in 2020. The latter was outweighed however by the negative balance of primary income. The capital account surplus stood at 1.9% of GDP in 2020, an improvement compared to 2019, reflecting the slight increase in 2020 of the uptake of projects financed by EU funds under the 2014-2020 programming period. In 2021, the capital account surplus benefited from the positive impact of the RRP pre-financing flows received at the end of the year, thus increasing slightly to 2.2% of GDP.

Net FDI inflows took a hit in 2020 due to the COVID crisis, and the net portfolio inflows accounted for the largest contribution to the external financing of the current account. Over 2020, net FDI inflows amounted to 1.3% of GDP, while the portfolio investments represented 6.1%. In 2021, however, the mix between the two sources of financing reversed again, with FDI amounting to 3.0% of GDP and portfolio investments 1.3%. Other investments including financial derivatives continued to record net outflows. Against the background of a slight widening current account deficit in 2020 and due to a denominator effect, Romania's net international investment position as a share of GDP deteriorated by more the 4 percentage points. In 2021, however, and despite the larger current account deficit, the net international investment position (NIIP) marginally improved due to the denominator effect of a high GDP growth rate. It rose from -47.8% of GDP in 2020 to -45.7% in 2021.

Romania’s external cost competitiveness, as measured by ULC-deflated real effective exchange rate (REER), plateaued and even recorded periods of improvement between 2020 and 2021, after a span of rapid deterioration from 2016 to 2019 ([127]). This came as a result of a toning down of wage pressures, as public sector wages were frozen and the private sector suffered reductions in earnings in the context of the pandemic. At the same time, the HICP-based REER indicates broadly stable external price competitiveness, although maintaining a spread with respect to the nominal effective exchange rate, reflecting Romania’s positive inflation differential relative to its trading partners broadly offsetting the gain in competitiveness from the moderate nominal RON depreciation.

Graph 7.9: **Romania - Effective exchange rates**



Source: European Commission.

According to the Commission’s Spring 2022 Economic Forecast, the external deficit is expected to widen in 2022, mainly due to price increase for

and Resilience Facility”, Quarterly Report on the Euro Area (QREA), Vol. 20, No. 3 pp. 7-16.

[127] The REER based on unit labour costs should be interpreted with prudence as unit labour costs were distorted by labour retention schemes in some countries, including Romania.

Table 7.5:
Romania - Market integration

	2016	2017	2018	2019	2020	2021
Trade openness [1] (%)	45.4	46.4	46.5	45.0	41.1	45.0
Trade with EA in goods & services [2]+[3] (%)	25.7	26.2	26.3	25.1	23.0	24.6
World Bank's Ease of Doing Business Index rankings [4]	36	45	52	55	55	-
IMD World Competitiveness Ranking [5]	49	50	49	49	51	48
Internal Market Transposition Deficit [6] (%)	2.0	1.5	1.1	1.1	1.1	-
Real house price index [7]	105.2	108.6	110.5	108.4	110.8	109.6

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

2) (Imports + Exports of goods with EA-19 / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).

3) Trade in services with EA-19 (average credit and debit in % of GDP at current prices) (Balance of Payments).

4) Data not available for 2021. The Ease of Doing Business report by the World Bank was discontinued in September 2021.

5) International Institute for Management Development (IMD).

6) Percentage of internal market directives not yet communicated as having been transposed, relative to the total. (November data, as of 2016 date refers to the year of publication).

7) Deflated house price index (2015=100) (Eurostat).

Sources: Eurostat, World Bank, International Institute for Management Development, European Commission calculations.

energy commodities, such as gas and oil, for which Romania is a net importer. These negative dynamics are set to be partially offset by dynamics in the capital account, as the RRP funds will start flowing in.

7.6.2. Market integration

Romania's economy is well integrated with the euro area through both trade, including through participation in supply chains, and foreign investment. The relatively low trade openness (see Table 7.5 for a definition) of Romania decreased further in 2020, reflecting the domestic and global contraction in demand due to the COVID-19 crisis. Trade openness in 2020 stood at 41.1% of GDP and increased in 2021 to around 45% of GDP. In 2021, Romania's main trading partners within the euro area were Germany, Italy and France, while outside the euro area Romania mainly traded with Hungary, Poland, China and Turkey. Trade with the euro area increased from 23% of GDP in 2020 to 24.6% of GDP in 2021.

Romania attracted substantial amounts of FDI in the past decade. Net FDI inflows, originating mainly from euro-area Member States, such as the Netherlands, Germany and Austria, decreased markedly by close to 40% in 2020, but made a strong comeback in 2021, recording an increase of almost 150%.

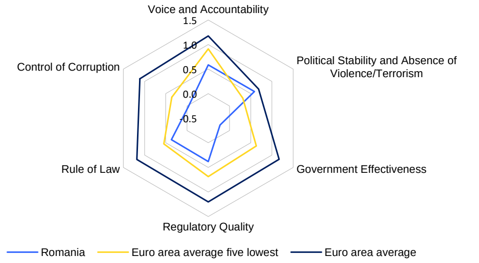
Romania’s regulatory framework has scope for improvements. The use of Government Emergency Ordinances (GEOs) - for which there is neither mandatory ex-ante impact assessment nor public consultations - is still widespread: their number increased from 91 in 2019 to 226 in 2020 (also due to the extraordinary measures that had to be taken against the pandemic) and decreased to 145 in 2021. Frequent legislative changes coupled with inadequate impact assessments harm investments and the business environment. The recovery and resilience plan foresees measures enhancing the capacity of the central government to better steer and monitor the legislative process, the quality of the laws, as well as coherence and transparency throughout the regulatory framework.

Romania’s performance in international rankings of competitiveness and ease of doing business is relatively weak compared to many euro-area Member States. In the IMD’s World Competitiveness Index, Romania's position is still low although it has slightly improved lately, moving from a placing of 51 in 2020 to 48 in 2021 from a total of 64 surveyed economies. A patchy legal and regulatory framework, an inefficient justice system and at times opaque corporate governance of State Owned Enterprises are some of the main obstacles to competitiveness. According to the World Bank's Ease of Doing Business indicator, Romania maintained the same rank in 2020, as in 2019, i.e. 55, but a relative worsening can be noticed with respect to 2018, when it ranked 52 ([128]). According to the World Bank's Worldwide Governance Indicators (2020), Romania ranks low in voice and accountability, government effectiveness, regulatory quality and control of corruption compared with the average of

([128]) The World Bank Doing Business (DB) program was paused in 2021. The programme will continue with a new governance and improved accountability and transparency under the name Business Enabling Environment (BEE). The first edition of the BEE is expected in 2023.

the five euro area Member States with the lowest scores. Romania ranks higher than the average five lowest euro area Member States for political stability and absence of violence ([129]). On a more positive note, according to the 2020 Single Market Scoreboard, Romania's transposition deficit of EU Directives was at 1.1%, a stable result for the 3rd consecutive year, very close to the EU average (1%) and the target (0.5%) proposed by the European Commission in the Single Market Act (2011).

Graph 7.10: **Romania - 2020 World Bank's Worldwide Governance Indicators**



Note: Estimate of governance ranges from -2.5 (weak) to 2.5 (strong).
Source: World Bank.

As part of the 2022 Country Report, the Commission has identified four main obstacles undermining Romania's competitiveness and capacity to innovate. First, services markets, in particular many professions servicing companies (such as lawyers, accountants and notaries) remain highly regulated. This may translate into high prices for low quality services. Second, the fragmented coordination of Research and Development and Innovation policy at the central level and weak linkages between science and industry discourage entrepreneurship and catching up. Third, the cadastre is underdeveloped and can result in insufficient protection of property rights. Finally, access to credit especially for SMEs and start-ups remains problematic, both because of companies' weak balance sheets and relatively underdeveloped capital markets.

The 2022 Country Report highlights that some concerns remain on the rule of law. In particular, the justice system is facing efficiency challenges, and there are concerns about judicial independence. This reflects on lengthy administrative proceedings and low clearance rates, and a relatively low trust in courts. Furthermore, frequent changes in legislation undermine the protection of companies' investments by the law and courts. The RRP aims to address these issues by increasing the independence and efficiency of the justice system, and the quality of legislative process.

The 4th Anti-Money Laundering Directive (AML) imposed transposition by 26 June 2017. After being referred before the Court of Justice for not having notified any transposition measures on July 2018 (Case C-2018/549), Romania has communicated to the Commission the adoption of transposition measures, which ensure a complete transposition of the Directive. An assessment of the concrete implementation and effective application of the 4th Anti money Laundering Directive in Romania is at present ongoing.

As regards the 5th Anti-Money Laundering Directive, whose transposition deadline elapsed on 10 January 2020, a letter of formal notice from the Commission was sent in February 2020 regarding the absence of notification of national transposition measures by the expected date. Since then, further transposition measures have been notified, enabling the Commission to conclude that transposition is now complete. As regards the conformity of this transposition, a letter of formal notice was sent on 18 February 2021 concerning the transposition of the provisions related to beneficial ownership registers (Articles 30(1) and 30(3) AMLD5). Romania formally responded on 18 June 2021. The Commission is currently analysing this reply and the formal follow-up to be proposed. At the same time, the Commission is assessing whether there are any potential conformity issues regarding the other provisions of the 5th AML Directive or effectiveness issues in the transposition or implementation of the entire legal act.

The Romanian labour market continues to face significant structural challenges. Adverse demographics are expected to worsen. Aging population, limited internal labour mobility and continued emigration are a drag on potential economic growth. Despite recent improvements, employment and activity rates remain below EU averages. Skills shortages and mismatches also continue to affect the labour market. Although the latest minimum wage increases in 2020, 2021 and 2022 were based on several economic indicators, an objective mechanism has not yet been properly established. The Romanian recovery and resilience plan contains a reform setting a new mechanism

[129] A Member State is considered to have a 'low' ('high') ranking compared with the average five euro area Member States with the lowest scores for each indicator if its score is at least 0.3 percentage points lower (higher) than that of the average of this euro area group.

for determining the minimum wage, based on objective criteria, consistent with job creation and competitiveness. The functioning of social dialogue remains weak and social partners' involvement in policymaking continues to be very limited.

The financial sector in Romania is smaller and less developed than in the euro area. Relative to GDP, assets managed by the financial sector are around 12% of that of the euro area. The size of the financial sector has remained broadly unchanged since 2016. Banking dominates the Romanian financial sector and makes up around 56% of the financial sector’s assets in 2020. The central bank is the second largest holder of financial assets with a share of 21%. Although these shares are larger than in the euro area, they are relatively similar to those of the five euro-area Member States with the smallest financial sectors. Non-money-market funds and other financial intermediaries hold a small share of total financial assets.

Table 7.6:
Romania - Allocation of assets by financial sub-sector

						Ratio to GDP (%)
	RO		EA		EA 5 smallest	
	2016	2020	2016	2020	2016	2020
Financial corporations (total)	97	97	722	796	177	215
Central bank	23	21	45	78	37	61
Monetary financial institutions	54	54	286	311	97	98
Other financial intermediaries	7	8	202	179	20	28
Non-MMF investment funds[1]	6	4	100	127	4	5
Insurance co. and Pension Funds	7	10	90	102	18	23
						Share of total (%)
	RO		**EA**		**EA 5 smallest**	
	2016	**2020**	**2016**	**2020**	**2016**	**2020**
Central bank	24	21	6	10	21	29
Monetary financial institutions	56	56	40	39	55	46
Other financial intermediaries	7	8	28	22	11	12
Non-MMF investment funds	6	4	14	16	2	2
Insurance co. and Pension Funds	7	10	12	13	10	11

1) MMF stands for money market funds.
Source: Eurostat.

The insurance and the pension-fund sector in Romania is much smaller than in the euro area, relative to GDP. However, the sector’s share of the total financial sector assets, at around 10%, is only slightly less than in the euro area (13%) and comparable with the five euro-area Member States with the smallest financial sectors. Since end-2016, the Romanian sector has increased its holdings of financial assets relative to GDP by 2.7 percentage points, compared to an increase by 12.3 percentage points in the euro area. The investment-funds sector plays a very small role in the Romanian financial system, but its size relative to GDP is comparable to that of the five euro-area Member States with the smallest financial sectors.

As to the financing of the economy, Romania has less developed credit and equity markets relative to GDP than countries in the euro area, and market financing (debt securities and listed shares) is relatively underdeveloped. However, Romania is still comparable to the five euro-area Member States with the smallest financial sectors. Loans are the dominant source of funding and make up 60% of GDP in 2020, compared to 240% of GDP in the euro area. Trade credits and advances are another important source of funding and stand at 41% of GDP in 2020, compared to 35% in the euro area. Financing through private debt markets is practically inexistent, while equity markets are very small compared to those of the euro area and represent 9% of GDP. This compares to 83% for private-sector debt and 73% for listed stocks in the euro area. Government debt is also lower than in the euro area. In terms of the share of the sum of liabilities, loans in Romania are comparable to that of the euro area, while the government debt and trade credits and advances are higher than in the euro area. For security and equity financing, the large differences reflect the smaller share of market funding available in Romania compared to the euro area.

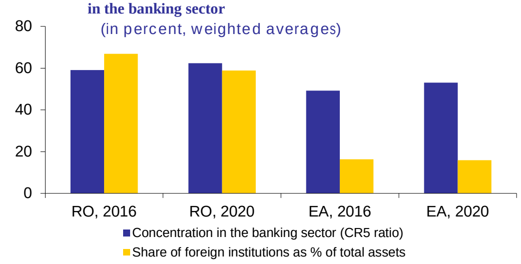
Table 7.7:
Romania - Financing of the economy1)

						Ratio to GDP (%)
	RO		EA		EA 5 smallest	
	2016	2020	2016	2020	2016	2020
Liabilities (total)	204	220	743	770	324	335
Loans	68	60	238	236	115	112
Non-financial co. debt securities	0	0	12	15	3	4
Financial co. debt securities	0	0	74	68	11	12
Government debt securities	31	44	83	95	51	57
Listed shares	9	9	65	73	17	18
Unlisted shares	30	29	186	193	55	56
Other equity	27	37	51	56	42	48
Trade credits and advances	39	41	33	35	29	29
						Share of total (%)
	RO		**EA**		**EA 5 smallest**	
	2016	**2020**	**2016**	**2020**	**2016**	**2020**
Loans	33	27	32	31	35	33
Non-financial co. debt securities	0	0	2	2	1	1
Financial co. debt securities	0	0	10	9	3	3
Government debt securities	15	20	11	12	16	17
Listed shares	4	4	9	9	5	5
Unlisted shares	15	13	25	25	18	18
Other equity	13	17	7	7	13	14
Trade credits and advances	19	19	4	5	9	9

1) The table focuses on the financing needs of a country and how these are met by the financial system. The table is constructed from the liabilities of all economic sectors, but only considers loans, debt securities, equity and trade credits. The sum of liabilities in the table only reflects the total for the liabilities considered.
Source: Eurostat.

Romania’s banking sector is well integrated with the euro area financial sector, in particular through a high level of foreign ownership in its banking system. Foreign-owned banks, the majority of which are subsidiaries of parent banks based in the euro area, had a share of assets in the total held by the Romanian banking sector of 58.9% in 2020, well above the euro area average of nearly 16%. Bank concentration, as measured by the market share of the five largest credit institutions in total assets, has increased since 2016, and reached almost 62% in 2020. This is 9 percentage points above the euro area average in 2020.

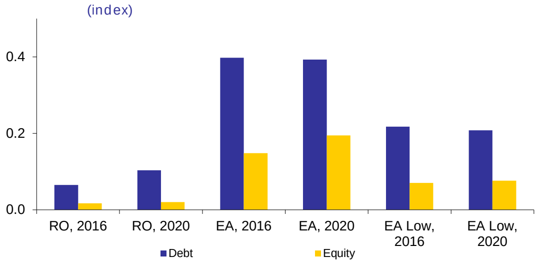
Graph 7.11: **Romania - Foreign ownership and concentration in the banking sector**
(in percent, weighted averages)



Source: ECB, Structural financial indicators.

Although intra-EU integration in equity and debt markets, as measured by the home bias in portfolio investments, are in general relatively low across EU Member States, Romania has levels of integration in debt markets below that of the average euro-area Member State ([130]). However, integration in this market segment has improved between 2016 and 2020. Concerning portfolio investments in equity, the home bias is also significantly stronger in Romania relative to euro-area Member States. The very large home bias indicates that almost all investments in equity markets take place domestically.

Graph 7.12: **Romania - Intra-EU integration in equity and debt portfolio investment**
(index)



Note: The chart shows the extent of home bias in debt and equity markets. A value index of 1 implies 'full integration' with the financial markets of other Member States, while 0 denotes 'no integration'.

Source: FinFlows database: European Commission, Joint Research Centre (JRC).

[130] Home bias in portfolio investments measures the average propensity of investors in a Member State to invest domestically as compared with investing in other EU countries. The indicator ranges between 0 and 1, with a value of 0 indicating that investors prefer domestic over foreign assets. The inverse of the home bias can be interpreted as one measure of financial integration among EU countries.

8. SWEDEN

8.1. LEGAL COMPATIBILITY

8.1.1. Introduction

The legal rules governing the Swedish Central Bank (Riksbank) are laid down in the Instrument of Government (as part of the Swedish Constitution), the Riksbank Act from 1988, as amended, and the Law on Exchange Rate Policy from 1998. No amendments to these legal acts were passed with regard to the incompatibilities and the imperfections mentioned in the Commission’s 2020 Convergence Report. Therefore, this year’s assessment repeats the comments provided in the previous report.

8.1.2. Central Bank independence

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

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

Pursuant to Article 4 of Chapter 10 of the Riksbank Act, the Swedish Parliament approves the Central Bank's profit and loss account and its balance sheet and determines the allocation of the Central Bank's profit. This practice impinges on the financial independence of the Riksbank and is incompatible with Article 130 of the TFEU. The Parliament must not be involved in the relevant decision-making process. Its right should be limited to approving the Central Bank's decision on the profit allocation. ([131])

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

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

8.1.3. Prohibition of monetary financing and privileged access

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

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

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

The provisions of Article 4 of Chapter 10 on the allocation of the Riksbank’s profit are supplemented by non-statutory guidelines on profit distribution, according to which the Riksbank should pay 80% of its profit to the Swedish State, after adjustment for exchange rate and gold valuation effects and based on a five-year average, with the remaining 20% used to increase its contingency and balancing funds. Although these guidelines are not legally binding but accepted as a practice by Parliament for calculating profit allocation and as there is no statutory provision limiting the amount of profit that may be paid out, such practice could constitute an incompatibility with the principle on the prohibition of monetary financing under Article 123 of the TFEU. The law should ensure that the reserve capital of Riksbank is left unaffected in any case and that the actual contribution to the State budget does not exceed the amount of the net distributable profit.

8.1.4. Integration in the ESCB

Objectives

Chapter 1, Article 2 of the Riksbank Act should include a reference to the secondary objective of the ESCB, while the promotion of a safe and efficient payment system as a task should be subordinated to the primary and secondary objectives of the ESCB.

Tasks

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

- absence of a general reference to the Riksbank as an integral part of the ESCB and to its subordination to the ECB’s legal acts (Chapter 1, Articles 1 and 2 of the Act and Chapter 9, Article 13 of the Instrument of Government);
- definition of monetary policy and monetary functions, operations and instruments of the ESCB (Chapter 1, Article 2 and Chapter 6, Articles 2, 3 and 5 and 6, Chapter 11, Article 1 and 2a of the Act; Chapter 9, Article 13 of the Instrument of Government);
- conduct of foreign exchange operations and the definition of foreign exchange policy (Chapter 7 of the Act; Chapter 8, Article13 and Chapter 9, Article 12 of the Instrument of Government); Articles 1 to 4 of the Law on Exchange Rate Policy of 1998;
- right to authorise the issue of banknotes and the volume of coins and definition of the monetary unit (Chapter 5 of the Act; Chapter 9, Article 14 of the Instrument of Government);

- ECB's right to impose sanctions (Chapter 11, Articles 2a, 3 and 5 of the Act).

There are furthermore some imperfections regarding the:

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

- non-recognition of the role of the ECB in the functioning of payment systems (Chapter 1, Article 2; Chapter 6, Article 7 of the Act);

- non-recognition of the role of the ECB and of the Council in the appointment of an external auditor;

- non-recognition of the role of the ECB in the field of international cooperation (Chapter 7, Article 6).

8.1.5. Assessment of compatibility

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

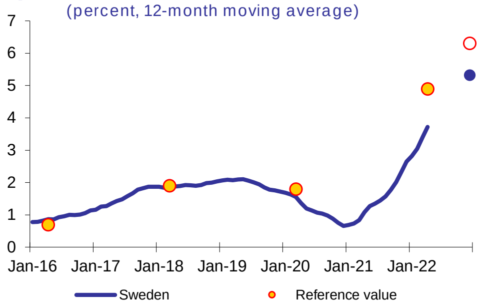
The Swedish authorities are invited to remedy the abovementioned incompatibilities.

8.2. PRICE STABILITY

8.2.1. Respect of the reference value

The twelve-month average inflation rate, which is used for the convergence assessment, was below the reference value at the time of the last convergence assessment of Sweden in 2020. The twelve-month average inflation rate in Sweden then gradually decreased to a low of 0.7% in December 2020, after which it increased throughout 2021. In April 2022, the reference value was 4.9%, calculated as the average of the 12-month average inflation rates in France, Finland and Greece plus 1.5 percentage points. The corresponding inflation rate in Sweden was 3.7%, i.e. below the reference value. The 12-month average inflation rate is projected to increase, but stay below the reference value in the months ahead.

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



Note: The dots at the right end of the chart show the projected reference value and 12-month average inflation rate of the country in December 2022. The reference values for 2016, 2018 and 2020 refer to the reference values calculated in the previous Convergence Reports.

Source: Eurostat, Commission's Spring 2022 Economic Forecast.

8.2.2. Recent inflation developments

HICP inflation in Sweden dropped markedly at the beginning of 2020 as COVID-19 took hold, driven down by declining energy prices and moderating services inflation. This resulted in an average inflation rate of 0.7% in 2020. In 2021, HICP inflation rose to 2.7% on average. The pick-up in headline inflation began in early 2021, mainly due to the combined impact of markedly higher energy prices dominating strong negative base effects for unprocessed food prices, while other inflation components showed marked volatility. After a few months of declining inflation in the middle of 2021, the inflation rate accelerated from August onwards, initially mainly driven by sharply higher energy prices — foremost electricity prices. In the second half of 2021, price increases broadened across various categories of the consumer price index, lifting core inflation. In the first part of 2022 headline HICP inflation picked up, with more broadly entrenched price increases for a wide range of other goods and services. In April 2022, HICP inflation reached 6.6%, the highest rate on record since the harmonised consumer price index was first published in 1996, on the back of strong increases across a wide range of goods and services in the consumption basket.

In 2020 and 2021, core inflation (measured as HICP inflation excluding energy and unprocessed food) remained relatively subdued at around 1.5%, despite pandemic-induced sharp swings in import prices and nominal unit labour costs, the latter affected by the impact of temporary unemployment support schemes. Underlying labour costs remained muted on the back of

Table 8.1:
Sweden - Components of inflation

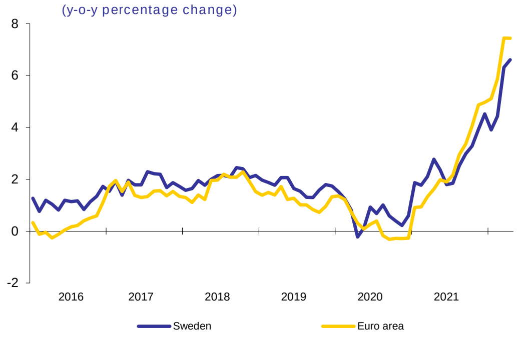
	2016	2017	2018	2019	2020	2021	Apr-22	weights in total 2022
						(percentage change)[1]		
HICP	1.1	1.9	2.0	1.7	0.7	2.7	3.7	1000
Non-energy industrial goods	1.1	0.0	0.0	0.3	0.9	1.0	1.4	322
Energy	1.0	5.3	9.6	2.9	-8.8	15.3	22.7	96
Unprocessed food	2.6	2.0	4.5	2.3	2.6	-0.4	2.1	34
Processed food	0.5	2.0	1.8	2.8	1.9	0.9	1.8	163
Services	1.3	2.3	1.8	2.0	1.8	2.5	2.7	385
HICP excl. energy and unproc. food	1.1	1.5	1.2	1.6	1.5	1.6	2.0	870
HICP at constant tax rates	1.0	1.7	1.8	1.6	0.6	2.6	3.7	1000
Administered prices HICP	0.9	2.2	1.3	2.0	2.4	1.7	1.9	160

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

Source: Eurostat, European Commission calculations.

moderate multi-annual wage agreements, which extend, into 2023. Firms absorbed part of the cost increases caused by supply chain disruptions in their margins, while the rate of increase of administered prices fluctuated around 2%, a similar rate as before the onset of the pandemic.

Graph 8.2: **Sweden - HICP inflation**



Source: Eurostat.

From the second quarter of 2020 to the first quarter of 2022, the behaviour of inflation components exhibited larger-than-usual volatility, reflecting the impact of the pandemic on supply chains, consumption patterns (which in turn affected index weights) and seasonal patterns. The lagged impact of the strengthening of the effective exchange rate of the krona during most of 2020 helped achieve a moderate increase in prices for non-energy industrial goods. In 2020, unprocessed food prices registered strong gains as the pandemic started, while in 2021 demand for and prices of contact-related services received impetus from the easing of restrictions. The strong initial downturn and subsequent acceleration in energy prices accounted for the largest part of the marked swings in HICP inflation from 2020 through 2021. These dynamics were also a key determinant of the observed pattern for import and producer prices. In the first months of 2022, inflation rates increased markedly to the highest harmonised inflation rate on record, with price increases across a broad range of goods and services, mirrored in rising core inflation.

8.2.3. Underlying factors and sustainability of inflation

Macroeconomic policy mix and growth developments

The Swedish economy experienced an unprecedented, but relatively short-lived decline in real GDP in the immediate wake of the COVID-19 pandemic, followed by a strong but unevenly paced recovery from the third quarter of 2020 onwards, as the initial recovery was interrupted by new COVID waves. Overall, the economy contracted by 2.9% in 2020, driven by a simultaneous fall in domestic demand and exports, as disruptions in global supply chains aggravated the initial downturn. Sweden's real GDP rebounded strongly in the second half of 2020 with the recovery continuing in 2021, mainly driven by strong gains in private consumption and investment, while exports also recovered markedly and helped lift economic growth. Sweden returned to the pre-crisis output level in the second quarter of 2021. In the second half of 2021 demand picked up for contact-related services such as restaurant and hotel services with the lifting of restrictions, facilitated by the progress in vaccination. Real GDP growth reached 4.8% for the year 2021. The slowdown at the beginning of 2022 reflects the combined impact of another wave of the pandemic, elevated inflation, the war in Ukraine and coincident persistent supply chain problems that had its roots in the pandemic affecting purchasing power, business and consumer confidence. This further lifted inflation with negative consequences

Table 8.2:

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

	2016	2017	2018	2019	2020	2021	2022[1)]	2023[1)]
HICP inflation								
Sweden	1.1	1.9	2.0	1.7	0.7	2.7	5.3	3.0
Euro area	0.2	1.5	1.8	1.2	0.3	2.6	6.1	2.7
Private consumption deflator								
Sweden	0.9	1.8	2.5	2.1	1.1	1.9	5.7	4.0
Euro area	0.4	1.3	1.5	1.1	0.5	2.3	5.8	2.7
Nominal compensation per employee								
Sweden	2.6	2.1	3.8	3.0	2.5	4.3	2.7	3.7
Euro area	1.2	1.7	2.1	2.1	-0.7	4.1	3.6	3.5
Labour productivity								
Sweden	0.2	0.1	0.3	1.4	-1.7	3.5	0.1	0.5
Euro area	0.4	1.0	0.2	0.3	-4.9	4.2	1.4	1.5
Nominal unit labour costs								
Sweden	2.4	1.9	3.5	1.5	4.3	0.8	2.6	3.2
Euro area	0.8	0.7	2.0	1.9	4.4	0.0	2.2	2.0
Imports of goods deflator								
Sweden	-2.2	4.6	6.7	2.3	-5.4	5.1	14.5	5.5
Euro area	-3.3	3.3	2.6	-0.5	-3.8	9.6	13.2	0.8

1) Commission Spring 2022 Economic Forecast.

Source: Eurostat, Commission's Spring 2022 Economic Forecast.

for household purchasing power and costs to businesses. Moreover, it also induced further supply bottlenecks and falls in confidence among households and businesses. Real GDP growth is poised to recover in the course of 2022, as the Swedish economy adjusts to the changed global environment. However, the pace of expansion, would remain comparatively modest in 2023. Overall, real GDP is forecast to grow by around 2¼% in 2022 and 1½% in 2023.

The fiscal stance turned contractionary in 2020 and remained broadly neutral in 2021 ([132]). It is expected to turn expansionary in 2022, due to additional expenditure aimed at addressing the economic impact of the pandemic, strengthening health care, easing some of the consequences of higher energy prices, and strengthening the military defence. In 2023, the fiscal stance is expected to be contractionary.

Monetary policy, conducted within an inflation targeting framework ([133]), has remained expansionary in the period covered by the report. The Riksbank raised its main policy rate to 0% in January 2020, and has not changed it since. However, in response to the COVID crisis, the Riksbank cut the interest rate on the standing loan facility, which is defined in terms of a deviation above the policy rate, i.e. the repo rate plus 0.2 of a percentage point to the repo rate plus 0.1 of a percentage point. However, at its latest meeting on 28 April 2022, the Riksbank raised its main policy rate, the repo rate, by 25 basis points to 0.25%. The Executive Board’s forecast is that the repo rate will be raised gradually going forward, and that it will be somewhat below 2 % in three year’s time.

The Riksbank maintained an expansionary policy, also in view of its extensive purchases of government bonds. In order to limit the impact of the COVID-19 crisis, the Riksbank took a series of measures in several monetary policy meetings in March 2020. These decisions involved: (i) further purchases of securities up to SEK 300 billion in 2020, including government, municipal and mortgage bonds; (ii) a first reduction in the lending rate for overnight loans to banks from 0.75 to 0.20

([132]) The fiscal stance is measured as the change in primary expenditure (net of discretionary revenue measures), excluding Covid-19 crisis-related temporary emergency measures but including expenditure financed by non-repayable support (grants) from the Recovery and Resilience Facility and other EU funds, relative to medium-term potential growth. A negative (positive) sign of the indicator corresponds to an excess (shortfall) of primary expenditure growth compared with medium-term economic growth, indicating an expansionary (contractionary) fiscal policy.

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

percentage points above the repo rate; (iii) allowing banks to borrow unlimited amounts on a weekly basis against collateral at three months' maturity at an interest rate of 0.20 percentage point above the repo rate; (iv) purchasing commercial paper issued in Swedish kronor by Swedish non-financial corporations; and (v) offering loans in dollars thanks to the swap arrangement of up to 60 billion USD that the Riksbank agreed with the US Federal Reserve ([134]). The Riksbank also increased the flexibility of the collateral framework, giving banks more scope to use mortgage bonds as collateral and subsequently temporarily enlarged the circle of monetary policy counterparties. The Riksbank extended the framework for asset purchases from SEK 300 billion to SEK 500 billion in July 2020, and again to SEK 700 billion in November 2020. The Riksbank's total holdings of domestic government bills and bonds amounted to a cumulative SEK 415 billion in January 2022, more than 40% of the outstanding stock of central government debt instruments. The Riksbank also held SEK 420 billion of covered bonds, about one fifth of the market. However, on 28 April 2022, the Executive Board decided to reduce the pace of the Riksbank's asset purchases during the second half of 2022, so that the holdings starts to decrease. Moreover, the Riksbank ceased purchasing treasury bills as of 28 April 2022.

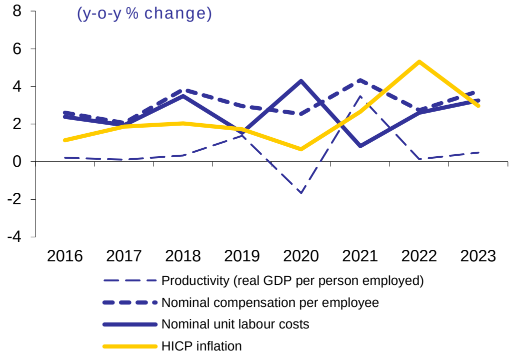
Wages and labour costs

In the years before 2019, employment growth had been quite strong. However, this did not lead to a marked decline in the unemployment rate, due to the relatively strong growth of the labour force. The initial slump in the labour market after the pandemic had started was countered by sizable and frontloaded policy support, including support to households affected by temporary unemployment and to businesses suffering from turnover losses. During the recovery from the pandemic, employment growth picked up markedly, unemployment fell, and the number of vacancies rose to all-time highs by the first quarter of 2022 as employed shifted away from contact-intensive services to other branches of activity. The unemployment rate is expected to fall to 7% on average in 2023, around the 2019 level.

The growth in nominal compensation per employee stood at close to 3% on average in 2019. In Sweden, social partners typically first negotiate a benchmark agreement for exporting sectors aimed at maintaining cost competitiveness vis-a-vis major trading partners; other sectors, including services, tend to follow this benchmark rather closely. Against the backdrop of the COVID-19 crisis, social partners deferred the collective bargaining round foreseen for the first half of 2020. With a delay, a new multi-annual wage agreement was reached, which extends into 2023 and provides for relatively moderate overall compensation growth. The current collective agreements should be a dampening factor for underlying inflation in 2022 and into the first months of 2023. Notwithstanding this, wage demands and wage drift might rise in response to the tightening labour market and the sharp increase in inflation that started in the second half of 2021, and gathered pace in the first months of 2022. Overall, the risks of significant second round effects of wage increases on inflation appears to be contained.

Sweden had moderate labour productivity growth in the years before 2019. In 2020 and 2020, the pandemic induced strong swings in economic activity while employment was supported by temporary unemployment schemes and various support schemes. As a result, aggregate measures of changes in labour productivity and unit labour costs for 2020 and 2021 are distorted.

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



Source: Eurostat, Commission's Spring 2022 Economic Forecast.

External factors

Given the openness of the Swedish economy, developments in import prices traditionally play an important role in domestic price formation. Import price growth (measured by the deflator of imports of goods) has fluctuated markedly over the past years. This was chiefly due to large swings in energy and other commodity prices, but also mirrors the price effects of pandemic-related trade, supply and demand disruptions, as well as

[134] The Riksbank has a standing swap line with the ECB.

exchange rate fluctuations. In 2020, the import deflator for goods fell sharply by 5.4%, due to lower commodity prices. This development was reversed in 2021, as import prices grew by 5.1%, largely because of energy prices, even though the rate of increase stayed below that in the euro area, which in turn was partly due to the lagged effect of exchange rate appreciation. The impact of changes in import prices on consumer price inflation is difficult to gauge. There is evidence that the pass-through had been weakening before the pandemic in view of, for instance, changes in competitive conditions related to the rise of global value chains. However, during the pandemic it became very difficult to assess the pass-through of trade prices to consumer price inflation, given their high volatility and complex interactions with price effects of supply chain disruptions, exchange rate movements, inventory adjustments, sales restrictions, and other pandemic-related factors. Nevertheless, the recent marked increase in inflation indicates that import prices have been among the significant determinants of consumer price increases.

After an initial weakening at the onset of the COVID-19 crisis, the real effective exchange rate of the krona (measured against a group of 36 trading partners) strengthened in the course of 2020, having fallen over a number of previous years. The real effective exchange rate then slightly weakened in the course of 2021. For both years, there were no major discrepancies between the growth in domestic prices and the growth in domestic prices of Sweden's main trading partners. Likewise, for 2022 and 2023, major discrepancies between nominal and real effective exchange rates are not expected to occur. Overall, Swedish cost developments do not pose major challenges to competitiveness.

Administered prices and taxes

The share of administered prices in the Swedish HICP basket amounts to just above 15%, a value more than 2 percentage points above the euro-area average. The most important item in the administrated price basket is rents. In 2020, at 2.4%, administered price inflation exceeded headline HICP inflation. By contrast, in 2021 administered price increases were more subdued at 1.7% and fell appreciably below the overall inflation rate. The changes in this component are largely accounted for by a marked increase in fully administered prices.

Tax changes contributed only marginally to in headline inflation in both 2020 and 2021, as the pace at which HICP at constant taxes increased over these two years was just below the headline number.

Medium-term prospects

According to the Commission's Spring 2022 Economic Forecast, inflation is set to remain elevated in 2022, mirroring broad-based price increases across a range of goods and services as trade and production bottlenecks persist. Domestic wage pressures are projected to remain relatively contained over the forecast period, despite the sharp increase in headline inflation, and some expected rise in compensation growth in 2023, reflecting the upcoming round of collective wage bargaining. Risks to the labour cost outlook appear skewed to the upside. However, the country has a long tradition of social partners taking into account competiveness in their wage agreements. Overall, Sweden should not experience major changes in cost competitiveness. However, increases in energy and food prices in particular, along with broad-based increases in other components of core inflation are expected to keep headline inflation at a relatively elevated rate. In all, HICP inflation is forecast to average 5.3% in 2022 and decrease to 3% in 2023. Underlying inflation is set to rise markedly from 1.6% in 2021 to 4.1% in 2022, before decreasing to 3% in 2023 on the back of base effects.

The amending budgets for 2022 contain measures to compensate households and, in particular, the agricultural sector for increases in energy prices (energy tax deductions as well as an electricity allowance) amounting to 0.4% of GDP.

Overall, as of 2023 inflation is expected to meet the Riksbank's target, as the economy is normalising, despite some persistence in underlying price pressures. Risks to the inflation outlook are on the upside, in view of a stronger-than-expected pass-through of cost increases and war-related supply disruptions, possibly coupled with higher wage increases due to the tight labour market. While it is hard to interpret surveys on inflation expectations at this juncture, market expectations show a progressive rise of inflation above the Riksbank's target over the medium term.

Table 8.3:

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

Outturn and forecast [1]	2016	2017	2018	2019	2020	2021	2022[1]	2023[1]
General government balance	1.0	1.4	0.8	0.6	-2.7	-0.2	-0.5	0.5
- Total revenue	50.7	50.6	50.7	49.7	49.9	50.0	48.7	47.7
- Total expenditure	49.7	49.2	49.8	49.1	52.6	50.2	49.1	47.2
of which:								
- Interest expenditure	0.5	0.4	0.5	0.4	0.3	0.2	0.1	0.2
p.m.: Tax burden	44.7	44.7	44.4	43.5	43.6	43.7	42.7	42.2
Primary balance	1.5	1.9	1.3	1.0	-2.4	0.0	-0.3	0.7
Fiscal stance [2]					1.5	0.1	-0.6	1.3
Government gross debt	42.3	40.7	38.9	34.9	39.6	36.7	33.8	30.5
p.m: Real GDP growth (%)	2.1	2.6	2.0	2.0	-2.9	4.8	2.3	1.4

1) Commission’s Spring 2022 Economic Forecast.

2) A negative (positive) sign of the indicator corresponds to an excess (shortfall) of primary expenditure growth compared with medium-term economic growth, indicating an expansionary (contractionary) fiscal policy.

Source: European Commission.

The level of consumer prices in Sweden relative to the euro area has increased since Sweden joined the EU in 1995. In 2020, the Swedish price level stood at 123% of the euro-area average. At the same time, the relative real GDP per capita level in Sweden has risen since 2019, reaching about 117% of the euro-area average in PPS terms in 2021.

In the medium term, inflation could prove to remain relatively high for longer, given the size and possible persistence of price and cost pressures (also reflecting the energy transition), possible persistence of supply constraints, weak productivity trends, high vacancy rates, and reported skill shortages. However, as resource utilisation is expected to abate somewhat over the forecast period, there is uncertainty on how resource pressures will feed into inflation. In particular, if wage expectations would remain relatively moderate in their response to upside inflation surprises, which has been the case in the prevailing wage bargaining system, there is no reason to believe that wage increases will add a push towards higher inflation.

8.3. PUBLIC FINANCES

8.3.1. Recent fiscal developments

Sweden’s general government balance improved from a deficit of 2.7% of GDP in 2020 to a deficit of 0.2% of GDP in 2021. The expenditure-to-GDP ratio decreased from 52.6% of GDP in 2020 to 50.2% in 2021, whereas the revenues-to-GDP ratio stabilised at around 50% of GDP during the same period. This reflected mainly the phasing out of several COVID-19 measures during the autumn of 2021, dominating continued expenditure support in some areas, as well as a denominator effect as growth rebounded strongly in 2021.

After an increase of close to 5 percentage points in the public debt-to-GDP ratio from 2019 to 2020, the debt level resumed its downward path in 2021, falling back to 36.7% of GDP, which is lower than what it was in 2018. Apart from the impact of an improving nominal balance with the recovery in economic activity, some of the decrease reflects the stepwise debt-reducing repayment of a Riksbank loan for foreign currency reserves during the 2021-2023 period, equivalent to around 3.5% of GDP.

8.3.2. Medium-term prospects

The 2022 budget, adopted in November 2021, includes new spending and revenue measures amounting to around 1.5% of GDP. On the expenditure side, it contains measures to strengthen social benefits (notably during sick leave), increased grants to local governments and regions (to cover pandemic-related costs), strengthened active labour market policies (focused on the young and the long-term unemployed), and measures to strengthen law enforcement. Significant outlays also stem from extended COVID support in the first months of the year, including in sick pay. In addition, the 2022 budget includes spending on green and digital items financed by grants from the Recovery and Resilience Facility, amounting to 0.2% of GDP. On the revenue side, the draft budget entails a generalised income tax cut as well as targeted reductions for people on sickness and disability benefits. Nevertheless, tax receipts are expected to hold up, in line with the resilient labour market and healthy corporate profitability.

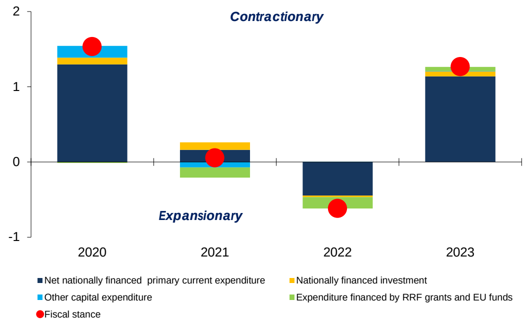
In addition, the parliament adopted a set of amending budgets in the first months of the year. Further measures were announced on 19 April 2022 in the Spring amending budget bill, which remains to be adopted. On balance, these additional measures amount to an increase in net expenditures of close to 1.5% of GDP to address the continuing impact of the pandemic, introduce extraordinary compensation to households and firms for soaring energy prices, cover the costs of refugees from Ukraine, and provide for structurally higher spending on defence. In all, the general government balance is expected to register a small deficit of 0.5% of GDP in 2022, in light of the planned expenditure increases.

On 29 April 2022, Sweden submitted its 2022 Convergence Programme. According to the Programme, the headline deficit is projected to increase somewhat to 0.5% of GDP in 2022 and turn into a surplus of 0.7% of GDP in 2023. The government deficit in 2022 is impacted by the additional measures taken by the government to counter the social and economic impact of the pandemic and the increase in energy prices. Based on the Commission’s Spring 2022 Economic Forecast, the measures to cushion the impact of the increase in energy prices are estimated at 0.4% of GDP in 2022, which are currently expected to be temporary and to be withdrawn in 2023. The annual cost of humanitarian assistance is projected at 0.1% of GDP in 2022 and 2023.

The Commission’s Spring 2022 Economic Forecast projects the general government deficit to reach 0.5% of GDP in 2022 and turn into a surplus of 0.5% of GDP in 2023. The projections for public finances in the 2022 Convergence Programme are thus close to the Commission’s Spring 2022 forecast.

For 2022, the Commission’s Spring 2022 Economic Forecast projects the fiscal stance to be supportive at 0.6% of GDP ([135]). The Forecast projects that expenditures financed by the Recovery and Resilience Facility grants and other EU funds will contribute positively to economic activity at 0.2 of a percentage point of GDP in 2022, higher by 0.1 of a percentage point of GDP compared to 2021. Nationally financed investment is projected to provide a neutral contribution to the fiscal stance. At the same time, the growth in nationally financed primary current expenditure (net of new revenue measures) in 2022 is projected to provide an expansionary contribution of 0.4 of a percentage point of GDP to the overall fiscal stance, as current expenditure is set to grow at a faster pace than medium-term potential growth. However, much of this expansion is due to temporary measures to support the economy in facing current headwinds.

Graph 8.4: **Sweden - Fiscal stance and its components**
(percent of GDP)



Source: Commission's Spring 2022 Economic Forecast.

In 2023, the fiscal stance is projected to turn contractionary at 1.3% of GDP. The positive contribution to economic activity of expenditure financed by Recovery and Resilience Facility grants and other EU funds is projected at 0.1 of a percentage point of GDP in 2023, reflecting the frontloaded financial support from the Recovery and Resilience Facility in 2021 and 2022. Nationally financed investment is projected to provide a slightly contractionary contribution to the fiscal stance ([136]). The growth in nationally financed primary current expenditure is projected to provide a contractionary GDP contribution to the overall fiscal stance in 2023.

Debt sustainability risks appear low over the medium term. Government debt is projected to decrease reaching around 11% of GDP in 2032.

[135] For a definition of the fiscal stance used in this report, see footnote in Section 8.2.3 on underlying factors and sustainability of inflation.

[136] Other nationally financed capital expenditure is projected to provide a neutral GDP contribution.

This projection assumes that the structural primary balance (except for the impact of ageing) remains constant at the forecast level for 2023 of 1.3% of GDP, which constitutes an improvement compared to the 2019 level.

The low sensitivity to possible macro-fiscal shocks also contributes to this assessment. In particular, if only half of the projected improvement in the structural primary balance in 2022-2023 were to occur, the projected debt ratio in 2032 would be only some 1 percentage points of GDP higher than in the baseline, i.e. still substantially below 60% of GDP.

Some factors mitigate risks, including the stability of debt maturity in recent years, relatively stable financing sources (with a diversified and large investor base), historically low borrowing costs reflecting a long-standing strong creditor status, Sweden's positive net international investment position and the expected positive impact on long-term growth of reforms under the Recovery and Resilience Plan. Risk-increasing factors include the possible materialisation of state guarantees granted to firms and self-employed during the COVID-19 crisis, though currently this risk remains limited due to relatively low take-up ([137]).

Building on a strong institutional set-up and a robust fiscal track-record, revisions to the fiscal framework took effect in 2019. Among the novelties, the government introduced a debt anchor, set at 35% of GDP with a 5-percentage-point tolerance margin, and the net lending target was lowered from 1% of GDP over the cycle to 0.33% of GDP. The expenditure ceiling and the balanced budget requirement for local authorities were left unchanged. The fulfilment of the net lending target will be assessed based on a single indicator, the structural balance in the current and subsequent year, replacing a system of several indicators with undefined weights. The government also decided to conduct regular reviews of the adequacy of the framework every eight years, in the final year of every second parliament. Despite the relaxation of the target, the authorities still consider there to be an adequate safety margin to allow for normal economic fluctuations without breaching the 3% of GDP deficit benchmark of the Stability and Growth Pact.

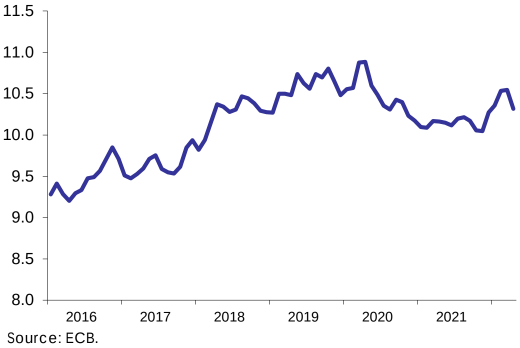
The revisions to the fiscal framework also entailed a widened mandate for the Fiscal Policy Council (Finanspolitiska rådet), set up in 2007. The Council was tasked to evaluate the official macroeconomic forecasts and to perform costing of reform proposals. It also received the explicit task to assess whether there is a deviation from the net lending target and, if so, to assess the reasons for the deviation, and to propose how fast the government should eliminate it. Furthermore, in order to increase the diversity of the Council, the member selection process was changed. Instead of current Council members nominating new candidates, this task now resides with a nomination committee, which among its members has the Chair and Deputy Chair of the parliamentary Finance Committee. It is still the government that formally appoints the new members.

Some of the new elements in the fiscal framework contribute to bringing the framework in line with the Budgetary Frameworks Directive ([138]), such as introducing the debt anchor as an explicit multi-annual debt objective, or mandating the Fiscal Council with the regular assessment of the government's economic forecasts.

8.4. EXCHANGE RATE STABILITY

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

Graph 8.5: **Sweden - SEK/EUR exchange rate**
(monthly averages)



Source: ECB.

The long-term trend of the krona depreciating against the euro started in 2013 and ended in early April 2020, after a cumulated depreciation of more

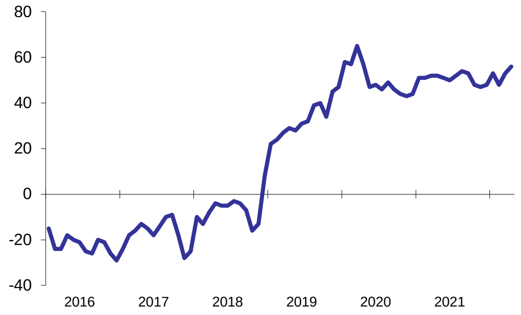
[137] For further details see the 2021 Fiscal Sustainability Report.

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

than 30%. With the onset of the COVID-19 crisis, the krona first weakened, but then started to appreciate, on the back of the resilience of the economy, with Sweden implementing less strict measures than most euro-area Member States in response to the pandemic. Between April 2020 and November 2021, the krona appreciated by almost 8% against the euro, and reached a new peak at 10.05 SEK/EUR. As the euro-area economy recovered, and Member States gradually loosened their restrictions, the krona fell back by 3% in December 2021 and January 2022. In February and March 2022, the krona depreciated by another 1.8%, as Russia's invasion of Ukraine spurred safe-haven flows. This was followed by a 2.2% reversal in April. Volatility in the exchange rate is significant, where short-term fluctuations reflect changes in risk appetite and short-term funding flows, as well as changing perceptions of the future direction of monetary policy.

The 3-month STIBOR-EURIBOR spread has remained broadly stable since June 2020. The spread averaged 50 basis points in 2020 and 51 basis points in 2021. Since June 2020, the spread has remained in a range of 43-56 basis points, without any large swings. Thus, the episode of appreciation and subsequent depreciation of the Swedish krona between 2020 and early 2022 cannot be accounted for by changes in the spreads on short-term interest rates.

Graph 8.6: **Sweden - 3-M Stibor spread to 3-M Euribor**
(basis points, monthly values)



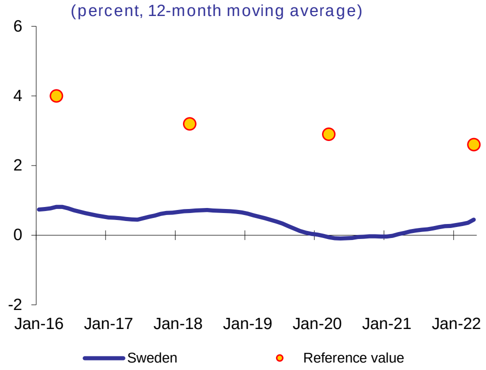
Source: Eurostat and Thomson Reuters.

Since December 2015, the Riksbank can intervene on foreign exchange markets in order to prevent a de-anchoring of inflation expectations due to a strengthening krona. The level of foreign currency reserves and gold decreased by almost 9% in krona between December 2019 and December 2020 and increased by more than 5% between December 2020 and December 2021, when it stood at around SEK 461 billion. At the beginning of 2022, international reserves stood just below the level of SEK 460 billion, or around 8.5% of GDP. The change in 2020 reflects changes in the exchange rate and the Riksbank decisions to lower the level of foreign exchange reserves, which had increased substantially after the global financial crisis. The post-crisis increase was financed by loans from the Swedish National Debt Office. However, the Riksbank has decided to repay the loans and instead obtain dollars and euros using Swedish krona.

8.5. LONG-TERM INTEREST RATES

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

Graph 8.7: **Sweden - Long-term interest rate criterion**
(percent, 12-month moving average)

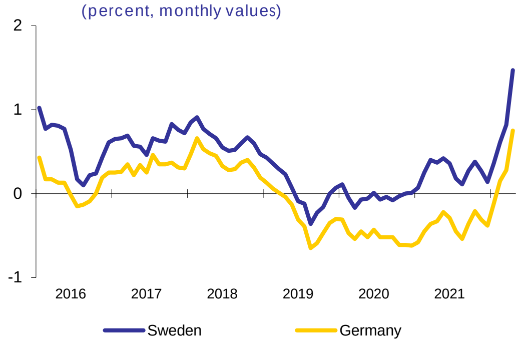


Source: European Commission.

The Swedish 12-month moving average long-term interest rate, relevant for the assessment of the Treaty criterion was well below the reference value at the time of the 2020 convergence assessment of Sweden. The 12-months average continued to stay below 1% over the last two years, where it has been since June 2015. It remained stable during 2020, and the first quarter of 2021 at around -0.04%. Since March 2021, the 12-month average interest rate has edged up into positive territory and reached 0.3% in January 2022. In April 2022, the latest month for which data are available, the reference value, given by the average of long-term interest rates in France, Finland and Greece plus 2 percentage points, stood at 2.6%. In that month, the 12-month moving average of the yield on the Swedish benchmark bond stood at 0.4%, i.e. 2.2 percentage points below the reference value.

As regards monthly data, long-term interest rates were very stable during 2020, with small fluctuations around 0%. The highest rate in 2020 was 0.1% and the lowest was -0.2%. Since the beginning of 2021, the interest rate has been fluctuating around a slightly higher level of 0.3%. Volatility increased somewhat in 2021, but overall the long-term interest rate continued to be broadly stable in a range of 0.1-0.4%. The compression of Swedish long-term interest rates in 2020-2021 reflected the continuation of the non-standard monetary policy measures, with continued acquisition and reinvestment of governments bonds as a response to the low domestic inflation environment. The Riksbank decided to increase its asset-purchase programme in response to the COVID-19 crisis. The yields of the Swedish benchmark government bond remained relatively closely aligned to the German benchmark bond, in line with the safe-haven status of Swedish government bonds. However, long-term interest spreads vis-à-vis the German benchmark bond increased during 2020 and 2021, from a low of 37 basis points to a high of 76 basis points in March 2021. Since then the spread declined until February 2002, before increasing to 72 basis points in April 2022.

Graph 8.8: **Sweden - Long-term interest rates**
(percent, monthly values)



Source: Eurostat.

8.6. ADDITIONAL FACTORS

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

In November 2021, the Commission published its latest Alert Mechanism Report (AMR 2022) under the Macroeconomic Imbalance Procedure (MIP - see also Box 1.7), which concluded that an In-Depth Review was warranted for Sweden. Taking into account the assessment in its In-Depth Review, the Commission, in its Communication 'European Semester – 2022 Spring Package' ([139]), considers that Sweden is experiencing imbalances with vulnerabilities that relate to high and rising house prices and high household indebtedness. In 2021, house prices moved further away from fundamental values with supportive financial conditions continuing to fuel housing demand. High household debt exposes Sweden to the risk of adverse shocks and a disorderly correction of housing prices, with potential harmful implications for the real economy and the banking sector. Private debt has risen further, a large share of which is concentrated in real estate, both commercial and housing, and most of household mortgage debt is at variable interest rates. Policy measures have not sufficiently addressed vulnerabilities relating to housing debt and potential house price overvaluations. Tax incentives for debt-financed housing remain, along with shortages in supply and identified shortcomings in the functioning of the rental market. Measures in the RRP only address the vulnerabilities in a partially satisfactory manner.

Sweden submitted its recovery and resilience plan (RRP) on 28 May 2021. The Commission's positive assessment on 29 March 2022 and Council's approval on 4 May 2022 paved the way for the implementation of the RRP and the disbursement of EUR 3.3 billion in grants, which is equivalent to 0.7% of 2019 GDP, over the period 2022-2026.

Sweden's plan includes a set of mutually reinforcing reforms and investments (12 investments and 15 reforms) that contribute to effectively addressing all or a significant subset of the economic and social challenges outlined in the country-specific recommendations (CSRs) addressed to Sweden by the Council in the European Semester in 2019 and 2020.

The plan addresses among others key macro-economic challenges such as green and digital transition, demographic change, and strengthening the education and healthcare systems. Key investments are included to support the low carbon

[139] COM(2022)600 final.

Table 8.4:

Sweden - Balance of payments **(percentage of GDP)**

	2016	2017	2018	2019	2020	2021
Current account	2.4	3.0	2.7	5.5	6.1	5.5
of which: Balance of trade in goods	1.6	2.1	2.0	3.9	4.6	4.5
Balance of trade in services	1.5	0.6	0.3	0.6	0.0	-0.1
Primary income balance	0.5	1.7	2.0	2.9	3.5	3.0
Secondary income balance	-1.3	-1.5	-1.6	-1.9	-2.1	-1.9
Capital account	0.0	0.0	0.0	0.0	0.1	0.2
External balance [1)]	2.3	2.9	2.8	5.5	6.1	5.7
Financial account	-4.9	4.1	1.6	4.5	-9.5	1.7
of which: Direct investment	-2.8	2.7	2.5	1.3	0.9	-1.1
Portfolio investment	1.1	0.6	-1.8	2.2	-11.0	7.1
Other investment [2)]	-4.0	0.7	0.9	2.2	0.5	-5.2
Change in reserves	0.8	0.1	-0.1	-1.2	0.1	1.0
Financial account without reserves	-5.7	4.1	1.6	5.7	-9.7	0.8
Errors and omissions	-7.2	1.2	-1.2	-1.0	-15.7	-3.9
Gross capital formation	24.7	25.7	26.0	25.1	24.8	25.6
Gross saving	27.1	28.5	28.6	30.3	30.8	31.1
Net international investment position	-3.5	-0.9	8.1	16.2	14.1	17.8

1) The combined current and capital account.

2) Including financial derivatives.

Sources: Eurostat, Statistics Sweden, European Commission calculations.

and energy transitions, as well as sustainable infrastructure, such as broad subsidy schemes aimed at speeding up the decarbonisation of industry and transport via the promotion of investment in the development and application of innovative technologies for fossil-free solutions, acceleration of the roll out of high-speed broadband in sparsely populated areas and investing in continuous learning and digital skills. Key reforms include promoting decarbonisation by requiring fuel suppliers to blend in sustainable biofuels in petrol, diesel and jet fuel, improving the sustainability of the pension and social security system, combating money laundering, increasing the accessibility and capacity of the health care system, in particular through training of elderly care providers, as well as measures that aim to promote housing supply by reducing bottlenecks in permit procedures.

The plan devotes 44.4% of its total allocation to measures supporting climate objectives, 20.5% to the digital transition and 38.1% on social expenditure, all while respecting the do no significant harm principle.

The implementation of the investments in the Swedish plan, along with other investments under NextGenerationEU, is estimated to raise Sweden's GDP by 0.6% by 2026, of which 0.3% due to the positive spillover effects of the coordinated implementation of NextGenerationEU across Member States (Pfeiffer et al. 2021) ([140]). This does not take into account the positive impact of structural reforms on growth.

8.6.1. Developments of the balance of payments

According to Balance of Payments data, Sweden's current account surplus increased to 6% of GDP in 2020, as domestic demand retrenched and goods trade held up comparatively well, despite plant closures and other supply and production disruptions in the wake of the pandemic. A decline in the balance on services offset the further increase in the primary income balance that had trended up from 2015 onwards. In 2021, the current account broadly stabilised at 5.5% of GDP, driven by high surpluses in the goods and the

[140] See Pfeiffer P., Varga J. and in 't Veld J. (2021), "Quantifying Spillovers of NGEU investment", European Economy Discussion Papers, No. 144 and Afman et al. (2021), "An overview of the economics of the Recovery and Resilience Facility", Quarterly Report on the Euro Area (QREA), Vol. 20, No. 3 pp. 7-16.

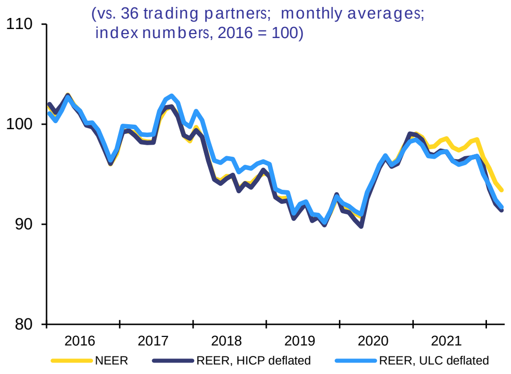
primary income balances. The solid export performance in goods was supported by the strong competitive position of Swedish exporters. By contrast, as in 2020, current transfers delivered a negative impact on the current account balance, reflecting Sweden's foreign aid and positive net contributions to international organisations, as well as remittances transferred by foreign workers in Sweden to their home countries.

Sweden's net international investment position improved markedly to nearly 15% of GDP in 2020, and is expected to have improved further in 2021. Sweden's financial account shows relatively large fluctuations over time. However, seen over a longer period, the financial account balance has been mostly in surplus and mainly reflects Sweden's role as a net FDI investor abroad. Similarly, the balance of portfolio investments fluctuated appreciably from year to year, mirroring the interplay of financial market conditions and perceptions, exchange rates and relative cyclical positions but remained mostly in surplus. External debt was on a declining trend, and decreased by more than 20 percentage points between 2014 and 2019, to around 170% of GDP in the latter year. The strong fiscal position with the concurrent decline in gross government debt has been a factor behind this decline. In 2020 and 2021, the ratio of external debt to GDP remained broadly stable.

Sweden's export market share has been declining overall since the early 2000s, a phenomenon shared with several other high-income countries. The trend decline in the export market shares is linked to changing global trade patterns, which affect most mature, industrialised economies with a similar focus on high-value-added exports. Thus, this downward trend does not suggest any underlying competitiveness issues per se. It is difficult to assess short-term fluctuations in export shares given the high degree of volatility in global trade since 2020. These make it even harder than in more stable phases of the cycle to separate specific factors that impact trade performance from cyclical composition effects of export specialisation and from changes in structural features.

This benign conclusion on competitiveness is buttressed by the developments in cost competitiveness indicators. The nominal and real effective exchange rates strengthened over 2020, but fell slightly in 2021. Unit labour costs exhibited large swings in 2020 and 2021 in view of the disparate behaviour of economic activity and employment metrics, all affected heavily by the pandemic as well as large-scale policy intervention ([141]). Allowing for such volatility, the underlying trend is that unit labour costs have been growing fairly moderately over the past number of years and broadly in line with Sweden's main trading partners.

Graph 8.9: **Sweden - Effective exchange rates**



Source: European Commission.

According to the Commission’s Spring 2022 Economic Forecast, which is based on National Accounts data, the current account surplus is projected to fall further in 2022, to 4.8% of GDP, in National Account terms, before rising again to 5.8% of GDP in 2023.

8.6.2. Market integration

Sweden is well integrated with the euro area through trade and investment linkages. Trade openness of the Swedish economy has been high, at over 40% (except in 2016, when it was just below that level) or more every year since 2005, although falling back in 2020 to somewhat over the 2016 level. However, trade openness recovered in 2021. The main euro-area trading partners are Germany, the Netherlands and Finland, while among non-euro-area countries Norway and Denmark are the main trade partners.

The stock of inward FDI has remained fairly stable relative to GDP in recent years (equivalent to 92.2% of GDP in 2020 and 92.9% in 2021). As regards net inward FDI in 2021, close to 56% originated from the euro area, whereas substantial flows originate from non-euro-area countries, primarily Denmark, Norway and the UK, a well-established pattern over a longer period.

([141]) The REER based on unit labour costs should be interpreted with prudence as unit labour costs were distorted by labour retention schemes in some countries, including Sweden.

Table 8.5:
Sweden - Market integration

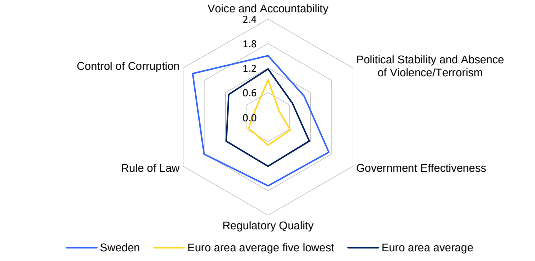
	2016	2017	2018	2019	2020	2021
Trade openness [1] (%)	39.8	41.2	43.4	44.3	40.7	42.4
Trade with EA in goods & services [2]+[3] (%)	17.4	18.2	19.0	19.2	17.7	18.6
World Bank's Ease of Doing Business Index rankings [4]	9	10	12	10	10	-
IMD World Competitiveness Ranking [5]	5	9	9	9	6	2
Internal Market Transposition Deficit [6] (%)	1.4	0.3	0.1	0.7	0.7	-
Real house price index [7]	107.3	112.4	108.7	109.1	112.4	121.5

1) (Imports + Exports of goods and services / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics, Balance of Payments).
2) (Imports + Exports of goods with EA-19 / (2 x GDP at current market prices)) x 100 (Foreign Trade Statistics).
3) Trade in services with EA-19 (average credit and debit in % of GDP at current prices) (Balance of Payments).
4) Data not available for 2021. The Ease of Doing Business report by the World Bank was discontinued in September 2021.
5) International Institute for Management Development (IMD).
6) Percentage of internal market directives not yet communicated as having been transposed, relative to the total.
(November data, as of 2016 date refers to the year of publication).
7) Deflated house price index (2015=100) (Eurostat).
Sources: Eurostat, World Bank, International Institute for Management Development, European Commission calculations.

Regarding the business environment, Sweden regularly scores top positions in international rankings, well above most euro-area Member State and currently ranks in the top ten at global level, with respect to the World Bank's Ease of Doing Business indicator and to the IMD World Competitiveness Ranking ([142]). According to the World Bank's Worldwide Governance Indicators (2020), Sweden ranks higher than the average of the euro-area Member States in all six categories, notably voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law and control of corruption. ([143]) Sweden's deficit in the transposition of EU directives in 2020 was at 0.7%, below the EU average and just above the 0.5% target as proposed by the European Commission in the Single Market Act (2011).

Sweden has notified a complete transposition of the 5th Anti-Money Laundering Directive, and the Commission is currently assessing whether there are any potential conformity or effectiveness issues in the transposition or implementation of the legal act.

Graph 8.10: **Sweden - 2020 World Bank's Worldwide Governance Indicators**



Note: Estimate of governance ranges from -2.5 (weak) to 2.5 (strong).
Source: World Bank.

The Swedish labour market, largely governed by negotiations between social partners at sectorial level, is characterised by high employment rates. Sweden has the largest labour force participation rate in the EU. Low nominal wage increases in recent years have been a factor behind muted underlying inflation. In the wake of the COVID-pandemic, modest multi-year wage agreements among social partners (which extend into 2023) have helped contain wage-induced inflation risks. Sweden has one of the lowest wage dispersions in the EU, with high entry wages and relatively little wage progression. According to the 2019 OECD employment protection indicator, the employment protection of permanent workers is rather high compared to that of temporary workers. The dispersion of regional unemployment rates is relatively low, but persistent imbalances in the housing market and high costs of housing, not only in the larger cities but also in new development poles, like in the north of the country, pose challenges to labour mobility. The integration of low-skilled workers and those born outside the EU remain a key challenge for the Swedish labour market, though, as the employment rate of both groups is significantly below the overall

[142] The World Bank Doing Business (DB) program was paused in 2021. The programme will continue with a new governance and improved accountability and transparency under the name Business Enabling Environment (BEE). The first edition of the BEE is expected in 2023.

[143] A Member State is considered to have a ‘low’ (‘high’) ranking compared with the average five euro area Member States with the lowest scores for each indicator if its score is at least 0.3 percentage points lower (higher) than that of the average of this euro area group.

employment rate. During the recovery from the initial COVID-19 shock, the number of unfilled vacancies rose sharply. In the first quarter of 2022, the vacancy ratio rose to the highest level on record since the statistic reporting on this variable started in 2009. While this high ratio partly reflects transitory shortages, given the high rate of labour market turnover and job-switching in the wake of the pandemic, it also points at mismatches extending to a wide range of branches of economic activity. Skills shortages remain particularly pronounced in education, health care, social work, information and communication technology, industry and construction.

The financial sector in Sweden is highly developed and is commensurate to that of the average in the euro area. Relative to GDP, assets managed by the financial sector are about 85% of that of the euro area. Since 2016, the Swedish financial sector has grown significantly more than it has in the euro area. Banking dominates the Swedish financial sector and makes up around 45% of the assets of the financial sector, which is more than in the euro area. Non-money-market funds are at par with the euro area, and despite the Riksbank’s extensive asset-purchase programme, it only holds a relatively small share of total financial assets (less than half of what the ECB accounts for).

Table 8.6:

Sweden - Allocation of assets by financial sub-sector

						Ratio to GDP (%)
	SE		EA		EA 5 smallest	
	2016	2020	2016	2020	2016	2020
Financial corporations (total)	577	677	722	796	177	215
Central bank	19	26	45	78	37	61
Monetary financial institutions	285	302	286	311	97	98
Other financial intermediaries	65	83	202	179	20	28
Non-MMF investment funds[1]	81	108	100	127	4	5
Insurance co. and Pension Funds	126	158	90	102	18	23
						Share of total (%)
	SE		EA		EA 5 smallest	
	2016	2020	2016	2020	2016	2020
Central bank	3	4	6	10	21	29
Monetary financial institutions	49	45	40	39	55	46
Other financial intermediaries	11	12	28	22	11	12
Non-MMF investment funds	14	16	14	16	2	2
Insurance co. and Pension Funds	22	23	12	13	10	11

1) MMF stands for money market funds.

Source: Eurostat.

The insurance and pension-fund sector in Sweden is the second largest manager of financial assets. It is almost twice as big as it is in the euro area, relative to GDP. This reflects the high degree of development of the funded pension system. Since end-2016, the sector has increased its holdings of financial assets by almost 29 percentage points in relation to GDP, while in the euro area it increased by only 12 percentage points. However, as a share of total assets managed by all financial corporations in the economy, the insurance and pension fund sector has been broadly stable. The investment-funds sector is of roughly equal size as in the euro area, and plays a similar role.

As to the financing of the economy, Sweden has among the most developed credit and equity markets relative to GDP, and market financing (debt securities and listed shares) is among the highest in the EU. Loans are still an important source of funding and make up 276% of GDP in 2020, compared to 240% of GDP in the euro area. This partially reflect the high degree of household indebtedness. Equity and private-sector-debt markets are very large compared to those of the euro area. Private-sector debt markets represent 134% of GDP, and listed stocks represents 182% of GDP. This compares to 83% for private-sector debt and 73% for listed stocks in the euro area. Government debt is significantly lower than in the euro area. In terms of share of the sum of liabilities, loans in Sweden are comparable to that of the euro area. For securities, the differences reflect the larger share of market funding available in Sweden, and the traditional recourse to this type of funding.

Table 8.7:

Sweden - Financing of the economy1)

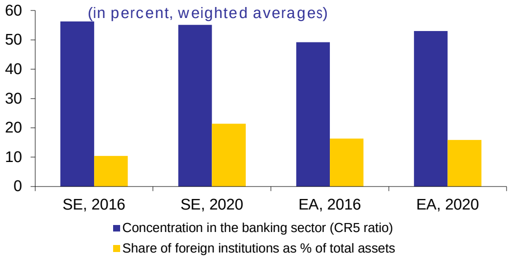
						Ratio to GDP (%)
	SE		EA		EA 5 smallest	
	2016	2020	2016	2020	2016	2020
Liabilities (total)	893	1016	743	770	324	335
Loans	247	278	238	236	115	112
Non-financial co. debt securities	21	30	12	15	3	4
Financial co. debt securities	115	112	74	68	11	12
Government debt securities	36	30	83	95	51	57
Listed shares	139	182	65	73	17	18
Unlisted shares	250	291	186	193	55	56
Other equity	64	73	51	56	42	48
Trade credits and advances	21	22	33	35	29	29
						Share of total (%)
	SE		EA		EA 5 smallest	
	2016	2020	2016	2020	2016	2020
Loans	28	27	32	31	35	33
Non-financial co. debt securities	2	3	2	2	1	1
Financial co. debt securities	13	11	10	9	3	3
Government debt securities	4	3	11	12	16	17
Listed shares	16	18	9	9	5	5
Unlisted shares	28	29	25	25	18	18
Other equity	7	7	7	7	13	14
Trade credits and advances	2	2	4	5	9	9

1) The table focuses on the financing needs of a country and how these are met by the financial system. The table is constructed from the liabilities of all economic sectors, but only considers loans, debt securities, equity and trade credits. The sum of liabilities in the table only reflects the total for the liabilities considered.

Source: Eurostat.

Sweden's banking sector is well integrated into the euro-area financial sector, through a high level of foreign ownership in its banking system, and because Stockholm acts as regional financial hub. The share of foreign-owned institutions in total bank assets stood at 21% in 2020, surpassing the euro-area average by 5 percentage points. The share more than doubled between 2016 and 2020, when Nordea’s headquarter moved to Finland in 2018. Bank concentration, as measured by the market share of the five largest credit institutions in total assets, has remained broadly stable at 55%, slightly above the euro-area average, which was 53% at the end of 2020.

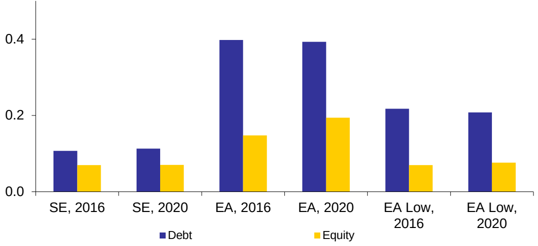
Graph 8.11: **Sweden - Foreign ownership and concentration in the banking sector**
(in percent, weighted averages)



Source: ECB, Structural financial indicators.

Intra-EU integration in equity and debt markets, as measured by the home bias in portfolio investments, are in general relatively low across EU Member States, but Sweden scores well below the euro-area averages for both equity and debt holdings. [144] In terms of equity-market integration, Sweden reaches a comparable level of integration to those of the five euro-area Member States with the lowest level of integration. Concerning portfolio investments in debt, the home bias is very strong in Sweden relative to euro-area Member States. The level of home bias in Sweden has not changed by much between 2016 and 2020. To some extent, these results reflect the high degree of development of Swedish financial markets and the country's large and diverse industry sector. This allows Swedish investors to hold liquid assets in a broad set of companies operating on world markets, letting them hold diversified portfolios exposed to world market risk without investing abroad.

Graph 8.12: **Sweden - Intra-EU integration in equity and debt portfolio investment**
(index)



Note: The chart shows the extent of home bias in debt and equity markets. A value index of 1 implies 'full integration' with the financial markets of other Member States, while 0 denotes 'no integration'.

Source: FinFlows database: European Commission, Joint Research Centre (JRC).

[144] Home bias in portfolio investments measures the average propensity of investors in a Member State to invest domestically as compared with investing in other EU countries. The indicator ranges between 0 and 1, with a value of 0 indicating that investors prefer domestic over foreign assets. The inverse of the home bias can be interpreted as one measure of financial integration among EU countries.

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Anlage 3

EUROPEAN CENTRAL BANK
EUROSYSTEM

Convergence Report

June 2022

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1 Introduction

Since 1 January 1999 the euro has been introduced in 19 EU Member States; this report examines seven of the eight EU countries that have not yet adopted the single currency. One of the eight countries, Denmark, in 1992 notified the Council of the European Union (EU Council) of its intention not to participate in Stage Three of Economic and Monetary Union (EMU).[1] As a consequence, Convergence Reports only have to be provided for Denmark if the country so requests. Given the absence of such a request, this report examines the following countries: Bulgaria, the Czech Republic, Croatia, Hungary, Poland, Romania and Sweden. All seven countries are committed under the Treaty on the Functioning of the European Union (hereinafter the "Treaty") to adopt the euro, which implies that they must strive to fulfil all the convergence criteria.[2]

In producing this report, the ECB fulfils its requirement under Article 140 of the Treaty. Article 140 says that at least once every two years, or at the request of an EU Member State with a derogation, the ECB and the European Commission must report to the EU Council "on the progress made by the Member States with a derogation in fulfilling their obligations regarding the achievement of economic and monetary union". The seven countries under review in this report have been examined as part of the regular two-year cycle. The European Commission has also prepared a report, and both reports are being submitted to the EU Council in parallel.

In this report, the ECB uses the framework applied in its previous Convergence Reports. It examines, for the seven countries concerned, whether a high degree of sustainable economic convergence has been achieved, whether the national legislation is compatible with the Treaties and the Protocol on the Statute of the European System of Central Banks and of the European Central Bank (hereinafter the "Statute of the ESCB"), and whether the statutory requirements are fulfilled for the relevant national central bank (NCB) to become an integral part of the Eurosystem.

This report includes a more in-depth assessment of Croatia than of the other countries under review. This is because the Croatian authorities have on various occasions announced their intention to adopt the euro as of 1 January 2023.

The examination of the economic convergence process is highly dependent on the quality and integrity of the underlying statistics. The compilation and reporting of statistics, particularly government finance statistics, must not be subject to political considerations or interference. EU Member States have been invited to consider the quality and integrity of their statistics as a matter of high priority, to ensure that a

[1] When the Maastricht Treaty was concluded in 1992, Denmark was granted an exemption clause or "opt-out" under which it does not have to participate in the third stage of EMU and, therefore, introduce the euro.

[2] Unless otherwise stated, all references in this report to the "Treaty" refer to the Treaty on the Functioning of the European Union, and the references to article numbers reflect the numbering in effect since 1 December 2009. Unless otherwise stated, all references in this report to the "Treaties" refer to both the Treaty on European Union and the Treaty on the Functioning of the European Union. See also the clarification of these terms in the ECB web glossary.

proper system of checks and balances is in place when these statistics are compiled, and to apply minimum standards in the domain of statistics. These standards are of the utmost importance in reinforcing the independence, integrity and accountability of the national statistical institutes and in supporting confidence in the quality of government finance statistics (see Chapter 6).

From 4 November 2014[3] it became mandatory for any EU Member State whose derogation is abrogated to join the Single Supervisory Mechanism (SSM) at the latest on the date on which it adopts the euro. At that point, all SSM-related rights and obligations start to apply to that country. Therefore, it is of the utmost importance that the necessary preparations are made. In particular, the banking system of any Member State joining the euro area, and therefore the SSM, is subject to a comprehensive assessment.[4] On 10 July 2020 the ECB announced that it had adopted the decisions to establish close cooperation with Българска народна банка (Bulgarian National Bank) and Hrvatska narodna banka, following the fulfilment of the necessary supervisory and legislative prerequisites.[5] With the entry into force of the close cooperation frameworks on 1 October that year, the ECB assumed responsibility for (i) the direct supervision of the significant institutions in the two countries, (ii) the common procedures for all supervised entities, and (iii) the oversight of less significant institutions, which continue to be supervised by their national supervisors. ECB Banking Supervision, Българска народна банка (Bulgarian National Bank) and Hrvatska narodna banka have collaborated very closely to ensure the smooth integration of the national competent authorities into the SSM.[6]

This report is structured as follows. Chapter 2 describes the framework used for the examination of economic and legal convergence. Chapter 3 provides a horizontal overview of the key aspects of economic convergence. Chapter 4 contains the country summaries, which provide the main results of the examination of economic and legal convergence. Chapter 5 examines in more detail the state of economic convergence in each of the seven EU Member States under review. Chapter 6 provides an overview of the convergence indicators and the statistical methodology used to compile them. Finally, Chapter 7 examines the compatibility of the national legislation of the Member States under review, including the statutes of their NCBs, with Articles 130 and 131 of the Treaty.

[3] This is the date on which the ECB assumed the tasks conferred on it by Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (OJ L 287, 29.10.2013, p.63). See Article 33(2) of that Regulation.

[4] See recital 10 of Regulation (EU) No 468/2014 of the European Central Bank of 16 April 2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities (SSM Framework Regulation) (ECB/2014/17) (OJ L 141, 14.5.2014, p.1).

[5] See Decision (EU) 2020/1015 of the European Central Bank of 24 June 2020 on the establishment of close cooperation between the European Central Bank and Българска народна банка (Bulgarian National Bank) (ECB/2020/30) (OJ L 224I, 13.7.2020, p. 1) and Decision (EU) 2020/1016 of the European Central Bank of 24 June 2020 on the establishment of close cooperation between the European Central Bank and Hrvatska narodna banka (ECB/2020/31) (OJ L 224I, 13.7.2020, p. 4). The agreement on the inclusion of the Bulgarian lev and the Croatian kuna in ERM II entered into force simultaneously.

[6] See the ECB Annual Report on supervisory activities 2020, in particular Section 4.1 “Enlarging the SSM through close cooperation”.

2 Framework for analysis

2.1 Economic convergence

To examine the state of economic convergence in EU Member States seeking to adopt the euro, the ECB makes use of a common framework for analysis. This common framework, which has been applied in a consistent manner throughout all European Monetary Institute (EMI) and ECB Convergence Reports, is based, first, on the Treaty provisions and their application by the ECB with regard to developments in prices, fiscal balances and debt ratios, exchange rates and long-term interest rates, as well as in other factors relevant to economic integration and convergence. Second, it is based on a range of additional backward and forward-looking economic indicators considered to be useful for examining the sustainability of convergence in greater detail. Some elements of this framework have been enhanced over time. The examination of the Member State concerned based on all these factors also provides important information which helps to ensure that its integration into the euro area will proceed without major difficulties. Boxes 1 to 5 below briefly outline the legal provisions and provide methodological details on the application of these provisions by the ECB.

This report builds on principles set out in previous reports published by the ECB (and prior to that by the EMI) in order to ensure continuity and equal treatment. In particular, a number of guiding principles are used by the ECB in the application of the convergence criteria. First, the individual criteria are interpreted and applied in a strict manner. The rationale behind this principle is that the main purpose of the criteria is to ensure that only those Member States with economic conditions conducive to the maintenance of price stability and the coherence of the euro area can participate in it. Second, the convergence criteria constitute a coherent and integrated package, and they must all be satisfied. The Treaty lists the criteria on an equal footing and does not suggest a hierarchy. Third, the convergence criteria have to be met on the basis of actual data. Fourth, the application of the convergence criteria should be consistent, transparent and simple. Moreover, when considering compliance with the convergence criteria, sustainability is an essential factor, as convergence must be achieved on a lasting basis and not just at a given point in time. For this reason, the country examinations elaborate on the sustainability of convergence.

In this respect, economic developments in the countries concerned are reviewed from a backward-looking perspective, covering, in principle, the past ten years. This helps to better determine the extent to which current achievements are the result of genuine structural adjustments, which in turn should lead to a better assessment of the sustainability of economic convergence.

In addition, and to the extent appropriate, a forward-looking perspective is adopted. In this context, particular attention is paid to the fact that the sustainability of favourable economic developments hinges critically on appropriate and lasting policy responses to existing and future challenges. Strong governance, sound institutions and sustainable public finances are also essential for supporting sustainable output growth over the medium to long term. Overall, it is emphasised that ensuring the sustainability of economic convergence depends on the achievement of a strong starting position, the existence of sound institutions, resilience to shocks and the pursuit of appropriate policies after the adoption of the euro.

The common framework is applied individually to the seven EU Member States under review. These examinations, which focus on each Member State's performance, should be considered separately, in line with the provisions of Article 140 of the Treaty.

The cut-off date for the statistics included in this Convergence Report was 25 May 2022. The statistical data used in the application of the convergence criteria are provided by the European Commission (see Chapter 6 as well as the tables and charts), in cooperation with the ECB in the case of exchange rates and long-term interest rates. In agreement with the European Commission, the reference period for both the price stability criterion and the long-term interest rate criterion is from May 2021 to April 2022. For exchange rates, the reference period is from 26 May 2020 to 25 May 2022. Historical data on fiscal positions cover the period up to 2021. Account is also taken of forecasts from various sources, together with the most recent convergence programme of the Member State concerned and other information relevant to a forward-looking examination of the sustainability of convergence. The European Commission's Spring 2022 Economic Forecast and the Alert Mechanism Report 2022[7], which are also taken into account in this report, were released on 16 May 2022 and 24 November 2021 respectively. This report was adopted by the General Council of the ECB on 27 May 2022.

This Convergence Report considers the impact of the Russia-Ukraine war on the convergence assessment only to a limited extent. It is too early to draw any firm conclusions about how the convergence paths will be affected and whether this effect will materialise in a symmetric or asymmetric way across the relevant countries. In particular, the forward-looking convergence assessment is surrounded by high uncertainty, and the full impact can only be evaluated ex post.

With regard to price developments, the legal provisions and their application by the ECB are outlined in Box 1.

Box 1
Price developments

1. Treaty provisions

Article 140(1), first indent, of the Treaty requires the Convergence Report to examine the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of the following criterion:

[7] European Commission, Alert Mechanism Report 2022 (COM(2021) 741 final).

"the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability".

Article 1 of Protocol (No 13) on the convergence criteria stipulates that:

"The criterion on price stability referred to in the first indent of Article 140(1) of the Treaty on the Functioning of the European Union 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 1½ 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".

2. Application of Treaty provisions

In the context of this report, the ECB applies the Treaty provisions as outlined below.

First, with regard to "an average rate of inflation, observed over a period of one year before the examination", the inflation rate has been calculated using the change in the 12-month average of the HICP in the reference period from May 2021 to April 2022 compared with the previous 12-month average. Inflation has been measured on the basis of the HICP, which was developed for the purpose of assessing convergence in terms of price stability on a comparable basis (see Section 6.2).

Second, the notion of "at most, the three best performing Member States in terms of price stability", which is used for the definition of the reference value, has been applied by taking the unweighted arithmetic average of the rates of inflation of the following three Member States: France (3.2%), Finland (3.3%) and Greece (3.6%). As a result, adding 1½ percentage points to the average rate, the reference value is 4.9%. It should be stressed that under the Treaty a country's inflation performance is examined in relative terms, i.e. against that of other Member States. The price stability criterion thus takes into account the fact that common shocks (stemming, for example, from global commodity prices) can temporarily drive inflation rates away from central banks' targets.

The inflation rates of Malta and Portugal have been excluded from the calculation of the reference value. Price developments in these countries over the reference period resulted in a 12-month average inflation rate in April 2022 of 2.1% and 2.6% respectively. These two countries have been treated as "outliers" for the calculation of the reference value, as inflation rates in both countries were significantly lower than the comparable rates in other Member States over the reference period and, in both countries, this was due to exceptional factors. In Malta, subdued inflation developments largely reflected stable energy prices, owing to the Government's financial support for the state-owned energy company and a reduction in the excise tax on fuel, as well as technical factors related to the computation of the index. In particular, the household consumption basket changed considerably in 2020, albeit temporarily, as a result of the COVID-19 pandemic, which brought about a large change in the weights of certain subcomponents of the index in 2021. This pattern was particularly pronounced for services inflation. In Portugal, the difference in inflation dynamics vis-à-vis the euro area is mainly the result of more subdued growth in both services and energy prices. While the former reflects a higher impact of depressed demand for tourism-related services, the latter is due to a lower pass-through of the increase in international oil prices and other energy costs.[8]

The average rate of HICP inflation over the 12-month reference period from May 2021 to April 2022 is reviewed in the light of the country's economic performance over the last ten years in terms of price stability. This allows a more detailed examination of the sustainability of price developments in the country under review. In this connection, attention is paid to the orientation of monetary policy, in particular to whether the focus of the monetary authorities has been primarily on achieving and maintaining price stability, as well as to the contribution of other areas of economic policy to this objective. Moreover, the implications of the macroeconomic environment for the achievement of price stability are taken into account. Price developments are examined in the light of supply and demand conditions, focusing on factors such as unit labour costs and import prices. Finally, trends in other relevant price indices are considered. From a forward-looking perspective, a view is provided of prospective inflationary developments in the coming years, including forecasts by major international organisations and market participants. Moreover, institutional and structural aspects relevant for maintaining an environment conducive to price stability after adoption of the euro are discussed.

With regard to fiscal developments, the legal provisions and their application by the ECB, together with procedural issues, are outlined in Box 2.

Box 2
Fiscal developments

1. Treaty and other legal provisions

Article 140(1), second indent, of the Treaty requires the Convergence Report to examine the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of the following criterion:

"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)".

Article 2 of Protocol (No 13) on the convergence criteria stipulates that:

"The criterion on the government budgetary position referred to in the second indent of Article 140(1) of the said Treaty shall mean 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".

[8] It should be noted that the concept of "outlier" has been referred to in previous ECB Convergence Reports as well as in the Convergence Reports of the EMI. In line with those reports, a Member State is considered to be an "outlier" if two conditions are fulfilled: first, its 12-month average inflation rate is significantly below the comparable rates in other Member States; and, second, its price developments have been strongly affected by exceptional factors. The identification of outliers does not follow any mechanical approach. The approach used was introduced to deal appropriately with potential significant distortions in the inflation developments of individual countries.

Article 126 sets out the excessive deficit procedure (EDP). In accordance with Article 126(2) and (3), the European Commission prepares a report if a Member State does not fulfil the requirements for fiscal discipline, in particular if:

1. the ratio of the planned or actual government deficit to GDP exceeds a reference value (defined in the Protocol on the EDP as 3% of GDP), unless either:

   (a) the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively,

   (b) the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;

2. the ratio of government debt to GDP exceeds a reference value (defined in the Protocol on the EDP as 60% of GDP), unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

In addition, the report prepared by the Commission must take into account whether the government deficit exceeds government investment expenditure and all other relevant factors, including the medium-term economic and budgetary position of the Member State. The Commission may also prepare a report if, notwithstanding the fulfilment of the criteria, it is of the opinion that there is a risk of an excessive deficit in a Member State. The Economic and Financial Committee formulates an opinion on the Commission's report. Finally, in accordance with Article 126(6), the EU Council, on the basis of a recommendation from the Commission and having considered any observations which the Member State concerned may wish to make, decides, acting by qualified majority and excluding the Member State concerned, and following an overall assessment, whether an excessive deficit exists in a Member State.

The Treaty provisions under Article 126 are further clarified by Regulation (EC) No 1467/97[9] as amended by Regulation (EU) No 1177/2011[10], which, among other things:

- confirms the equal footing of the debt criterion with the deficit criterion by making the former operational, while allowing for a three-year period of transition for Member States exiting EDPs opened before 2011. Article 2(1a) of the Regulation provides that when it exceeds the reference value, the ratio of the government debt to GDP shall be considered sufficiently diminishing and approaching the reference value at a satisfactory pace if the differential with respect to the reference value has decreased over the previous three years at an average rate of one twentieth per year as a benchmark, based on changes over the last three years for which the data are available. The requirement under the debt criterion shall also be considered to be fulfilled if the required reduction in the differential looks set to occur over a defined three-year period, based on the Commission's budgetary forecast. In implementing the debt reduction benchmark, the influence of the economic cycle on the pace of debt reduction shall be taken into account;

[9] Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure (OJ L 209, 2.8.1997, p. 6).

[10] Council Regulation (EU) No 1177/2011 of 8 November 2011 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure (OJ L 306, 23.11.2011, p. 33).

- details the relevant factors that the Commission shall take into account when preparing a report under Article 126(3) of the Treaty. Most importantly, it specifies a series of factors considered relevant in assessing developments in medium-term economic, budgetary and government debt positions (see Article 2(3) of the Regulation and, below, details on the ensuing ECB analysis).

Moreover, the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), which builds on the provisions of the enhanced Stability and Growth Pact, entered into force on 1 January 2013.[11] Title III (Fiscal Compact) provides, among other things, for a binding fiscal rule aimed at ensuring that the general government budget is balanced or in surplus. This rule is deemed to be respected if the annual structural balance meets the country-specific medium-term objective and does not exceed a deficit – in structural terms – of 0.5% of GDP. If the government debt ratio is significantly below 60% of GDP and risks to long-term fiscal sustainability are low, the medium-term objective can be set at a structural deficit of at most 1% of GDP. The TSCG also includes the debt reduction benchmark rule referred to in Regulation (EU) No 1177/2011, which amended Regulation (EC) No 1467/97. The signatory Member States are required to introduce in their constitution – or equivalent law of higher level than the annual budget law – the stipulated fiscal rules accompanied by an automatic correction mechanism in case of deviation from the fiscal objective.

2. Application of Treaty provisions

For the purpose of examining convergence, the ECB expresses its view on fiscal developments. With regard to sustainability, the ECB examines key indicators of fiscal developments from 2012 to 2021, the outlook and the challenges for general government finances, focusing on the links between deficit and debt developments. Regarding the impact of the COVID-19 pandemic on general government finances, the ECB refers to the Stability and Growth Pact's general escape clause, which was activated on 20 March 2020. In particular, for the preventive arm, Articles 5(1) and 9(1) of Regulation (EC) No 1466/97[12] state that "in periods of severe economic downturn for the euro area or the Union as a whole, Member States may be allowed temporarily to depart from the adjustment path towards the medium-term budgetary objective…, provided that this does not endanger fiscal sustainability in the medium term". For the corrective arm, Article 3(5) of Regulation (EC) No 1467/97 stipulates that "in the case of a severe economic downturn in the euro area or in the Union as a whole, the Council may also decide, on a recommendation from the Commission, to adopt a revised recommendation under Article 126(7) TFEU provided that this does not endanger fiscal sustainability in the medium term", while Article 5(2) of Regulation (EC) No 1467/97 stipulates that "in the case of a severe economic downturn in the euro area or in the Union as a whole, the Council may also decide, on a recommendation from the Commission, to adopt a revised notice under Article 126(9) TFEU, on condition that this does not endanger fiscal sustainability in the medium term". The ECB also provides an analysis with regard to the effectiveness of national budgetary frameworks, as referred to in Article 2(3)(b) of Regulation (EC) No 1467/97 and in Directive 2011/85/EU[13]. With regard to Article 126, the ECB, in contrast to the Commission, has no formal role in the EDP. Therefore, the ECB report only states whether the country is subject to an EDP.

[11] The TSCG also applies to those EU Member States with a derogation that have ratified it as from the date when the decision abrogating that derogation takes effect or as from an earlier date if the Member State concerned declares its intention to be bound at such earlier date by all or part of the provisions of the TSCG.

[12] Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies (OJ L 209, 2.8.1997, p.1).

[13] Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States (OJ L 306, 23.11.2011, p. 41).

With regard to the Treaty provision that a debt ratio of above 60% of GDP should be “sufficiently diminishing and approaching the reference value at a satisfactory pace”, the ECB examines past and future trends in the debt ratio. For Member States in which the debt ratio exceeds the reference value, the ECB provides the European Commission’s latest assessment of compliance with the debt reduction benchmark laid down in Article 2(1a) of Regulation (EC) No 1467/97.

The examination of fiscal developments is based on data compiled on a national accounts basis, in compliance with the European System of Accounts 2010 (ESA 2010) (see Chapter 6). Most of the figures presented in this report were provided by the Commission in April 2022 and include government financial positions from 2012 to 2021 as well as Commission forecasts for 2022-23.

With regard to the sustainability of public finances, the outcome in the reference year, 2021, is reviewed in the light of the performance of the country under review over the past ten years. First, the development of the deficit ratio is investigated. It is useful to bear in mind that the change in a country’s annual deficit ratio is typically influenced by a variety of underlying forces. These influences can be divided into “cyclical effects” on the one hand, which reflect the reaction of deficits to changes in the economic cycle, and “non-cyclical effects” on the other, which are often taken to reflect structural or permanent adjustments to fiscal policies. However, such non-cyclical effects, as quantified in this report, cannot necessarily be seen as entirely reflecting a structural change to fiscal positions, because they include temporary effects on the budgetary balance stemming from the impact of both policy measures and special factors. Indeed, assessing how structural budgetary positions have changed during the COVID-19 pandemic is particularly difficult in view of uncertainty over the level and growth rate of potential output.

As a further step, the development of the government debt ratio in this period is considered, as well as the factors underlying it. These factors are the difference between nominal GDP growth and interest rates, the primary balance and the deficit-debt adjustment. Such a perspective can offer further information on the extent to which the macroeconomic environment, in particular the combination of growth and interest rates, has affected the dynamics of debt. It can also provide more information on the contribution of the structural balance and the cyclical developments, as reflected in the primary balance, and on the role played by special factors, as included in the deficit-debt adjustment. In addition, the structure of government debt is considered, by focusing in particular on the shares of debt with a short-term maturity and foreign currency debt, as well as their development. By comparing these shares with the current level of the debt ratio, the sensitivity of fiscal balances to changes in exchange rates and interest rates can be highlighted.

Turning to a forward-looking perspective, national budget plans and recent forecasts by the European Commission for 2022-23 are considered, and account is taken of the medium-term fiscal strategy, as reflected in the convergence programme. This includes an assessment of the projected attainment of the country’s medium-term budgetary objective, as foreseen in the Stability and Growth Pact, as well as of the outlook for the debt ratio on the basis of current fiscal policies. In the context of the COVID-19 pandemic, the general escape clause has been activated and allows deviations from the medium-term budgetary objective as described in Box 2. In addition, long-term challenges to the sustainability of budgetary positions and broad areas for consolidation are emphasised, particularly those related to the issue of unfunded government pension systems in connection with demographic change and to contingent liabilities incurred by the government. Furthermore, in line with past practice, the analysis described above also covers most of the relevant factors identified in Article 2(3) of Regulation (EC) No 1467/97, as described in Box 2.

With regard to exchange rate developments, the legal provisions and their application by the ECB are outlined in Box 3.

Box 3
Exchange rate developments

1. Treaty provisions

Article 140(1), third indent, of the Treaty requires the Convergence Report to examine the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of the following criterion:

“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 Protocol (No 13) on the convergence criteria stipulates that:

“The criterion on participation in the Exchange Rate mechanism of the European Monetary System referred to in the third indent of Article 140(1) of the said Treaty shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism on 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”.

2. Application of Treaty provisions

With regard to exchange rate stability, the ECB examines whether the country has participated in ERM II (which superseded the ERM as of January 1999) for a period of at least two years prior to the convergence examination without severe tensions, in particular without devaluing against the euro. In cases of shorter periods of participation, exchange rate developments are described over a two-year reference period.

The examination of exchange rate stability against the euro focuses on the exchange rate being close to the ERM II central rate, while also taking into account factors that may have led to an appreciation, which is in line with the approach taken in the past. In this respect, the width of the fluctuation band within ERM II does not prejudice the examination of the exchange rate stability criterion.

Moreover, the issue of the absence of “severe tensions” is generally addressed by: (i) examining the degree of deviation of exchange rates from the ERM II central rates against the euro; (ii) using indicators such as exchange rate volatility vis-à-vis the euro and its trend, as well as short-term interest rate differentials vis-à-vis the euro area and their development; (iii) considering the role played by foreign exchange interventions; and (iv) considering the role of international financial assistance programmes in stabilising the currency.

The reference period in this report is from 26 May 2020 to 25 May 2022. All bilateral exchange rates are official ECB reference rates (see Chapter 6).

In addition to ERM II participation and nominal exchange rate developments against the euro over the period under review, evidence relevant to the sustainability of the current exchange rate is briefly reviewed. This is derived from the development of the real effective exchange rates and the current, capital and financial accounts of the balance of payments. The evolution of gross external debt and the net international investment position over longer periods is also examined. The section on exchange rate developments further considers measures of the degree of a country’s integration with the euro area. This is assessed in terms of both external trade integration (exports and imports) and financial integration. Finally, the section on exchange rate developments reports, if applicable, whether the country under examination has during the two-year reference period benefited from central bank liquidity assistance or balance of payments support, either bilaterally or multilaterally with the involvement of the IMF and/or the EU. Both actual and precautionary assistance are considered, including access to precautionary financing in the form of, for instance, the IMF’s Flexible Credit Line.

With regard to long-term interest rate developments, the legal provisions and their application by the ECB are outlined in Box 4.

Box 4
Long-term interest rate developments

1. Treaty provisions

Article 140(1), fourth indent, of the Treaty requires the Convergence Report to examine the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of the following criterion:

“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 Protocol (No 13) on the convergence criteria stipulates that:

“The criterion on the convergence of interest rates referred to in the fourth indent of Article 140(1) of the said Treaty shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than two percentage points that of, at most, the three best performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions”.

2. Application of Treaty provisions

In the context of this report, the ECB applies the Treaty provisions as outlined below.

First, with regard to "an average nominal long-term interest rate" observed over "a period of one year before the examination", the long-term interest rate has been calculated as an arithmetic average over the latest 12 months for which HICP data were available. The reference period considered in this report is from May 2021 to April 2022, in line with the reference period for the price stability criterion.

Second, the notion of "at most, the three best performing Member States in terms of price stability", which is used for the definition of the reference value, has been applied by using the unweighted arithmetic average of the long-term interest rates of the same three Member States included in the calculation of the reference value for the criterion on price stability (see Box 1). Over the reference period considered in this report, the long-term interest rates of the three countries with the lowest inflation rate included in the calculation of the reference value for the price stability criterion were 0.3% (France), 0.2% (Finland) and 1.4% (Greece). As a result, the average rate is 0.6% and, adding 2 percentage points, the reference value is 2.6%. Interest rates have been measured on the basis of available harmonised long-term interest rates, which were developed for the purpose of examining convergence (see Chapter 6).

As mentioned above, the Treaty makes explicit reference to the "durability of convergence" being reflected in the level of long-term interest rates. Therefore, developments over the reference period from May 2021 to April 2022 are reviewed against the background of the path of long-term interest rates over the past ten years (or otherwise the period for which data are available) and the main factors underlying differentials vis-à-vis the average long-term interest rate prevailing in the euro area. During the reference period, the average euro area long-term interest rate may have partly reflected high country-specific risk premia in several euro area countries. Therefore, the euro area AAA long-term government bond yield (i.e. the long-term yield of the euro area AAA yield curve, which includes the euro area countries with an AAA rating) is also used for comparison purposes. As background to this analysis, this report also provides information about the size and development of the financial market. This is based on three different indicators (the outstanding amount of debt securities issued by non-financial corporations, stock market capitalisation and MFI credit to the domestic non-financial private sector), which, together, provide a measure of the size of financial markets.

Finally, Article 140(1) of the Treaty requires this report to take account of several other relevant factors (see Box 5). In this respect, an enhanced economic governance framework in accordance with Article 121(6) of the Treaty entered into force on 13 December 2011 with the aim of ensuring a closer coordination of economic policies and the sustained convergence of EU Member States' economic performances. Box 5 below briefly outlines these legislative provisions and the way in which the above-mentioned additional factors are addressed in the assessment of convergence conducted by the ECB.

Box 5
Other relevant factors

1. Treaty and other legal provisions

Article 140(1) of the Treaty requires that: "The reports of the Commission and the European Central Bank shall also take account of the results of the integration of markets, the situation and development of the balances of payments on current account and an examination of the development of unit labour costs and other price indices".

In this respect, the ECB takes into account the legislative package on EU economic governance which entered into force on 13 December 2011. Building on the Treaty provisions under Article 121(6), the European Parliament and the EU Council adopted detailed rules for the multilateral surveillance procedure referred to in Article 121(3) and (4) of the Treaty. These rules were adopted "in order to ensure closer coordination of economic policies and sustained convergence of the economic performances of the Member States" (Article 121(3)) in view of the "need to draw lessons from the first decade of functioning of the economic and monetary union and, in particular, for improved economic governance in the Union built on stronger national ownership"[14]. The legislative package includes an enhanced surveillance framework (the macroeconomic imbalance procedure or MIP) aimed at preventing excessive macroeconomic and macro-financial imbalances by helping diverging EU Member States to establish corrective plans before divergence becomes entrenched. The MIP, with both preventive and corrective arms, applies to all EU Member States, except those which, being under an international financial assistance programme, are already subject to closer scrutiny coupled with conditionality. The MIP includes an alert mechanism for the early detection of imbalances, based on a transparent scoreboard of indicators with alert thresholds for all EU Member States, combined with economic judgement. This judgement should take into account, among other things, nominal and real convergence inside and outside the euro area.[15] When assessing macroeconomic imbalances, this procedure should take due account of their severity and their potential negative economic and financial spillover effects which aggravate the vulnerability of the EU economy and threaten the smooth functioning of Economic and Monetary Union.[16]

2. Application of Treaty provisions

In line with past practice, the additional factors referred to in Article 140(1) of the Treaty are reviewed in Chapter 5 under the headings of the individual criteria described in Boxes 1 to 4. For completeness, in Chapter 3 the scoreboard indicators are presented for the countries covered in this report (including in relation to the alert thresholds), thereby ensuring the provision of all available information relevant to the detection of macroeconomic and macro-financial imbalances that may be hampering the achievement of a high degree of sustainable convergence as stipulated in Article 140(1) of the Treaty. Notably, EU Member States with a derogation that are subject to an excessive imbalance procedure can hardly be considered as having achieved a high degree of sustainable convergence as stipulated in Article 140(1) of the Treaty.

[14] See recital 2 of Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances (OJ L 306, 23.11.2011, p. 25).

[15] See Article 4(4) of Regulation (EU) No 1176/2011.

[16] See recital 17 of Regulation (EU) No 1176/2011.

2.2 Compatibility of national legislation with the Treaties

2.2.1 Introduction

Article 140(1) of the Treaty requires the ECB (and the European Commission) to report, at least once every two years or at the request of a Member State with a derogation, to the Council on the progress made by the Member States with a derogation in fulfilling their obligations regarding the achievement of economic and monetary union. These reports must include an examination of the compatibility between the national legislation of each Member State with a derogation, including the statutes of its NCB, and Articles 130 and 131 of the Treaty and the relevant Articles of the Statute. This Treaty obligation of Member States with a derogation is also referred to as 'legal convergence'.

When assessing legal convergence, the ECB is not limited to making a formal assessment of the letter of national legislation, but may also consider whether the implementation of the relevant provisions complies with the spirit of the Treaties and the Statute. The ECB is particularly concerned about any signs of pressure being put on the decision-making bodies of any Member State's NCB which would be inconsistent with the spirit of the Treaty as regards central bank independence. The ECB also sees the need for the smooth and continuous functioning of the NCBs' decision-making bodies. In this respect, the relevant authorities of a Member State have, in particular, the duty to take the necessary measures to ensure the timely appointment of a successor if the position of a member of an NCB's decision-making body becomes vacant.[17] The ECB will closely monitor any developments prior to making a positive final assessment concluding that a Member State's national legislation is compatible with the Treaty and the Statute.

Member States with a derogation and legal convergence

Bulgaria, the Czech Republic, Croatia, Hungary, Poland, Romania and Sweden, whose national legislation is examined in this report, each have the status of a Member State with a derogation, i.e. they have not yet adopted the euro. Sweden was given the status of a Member State with a derogation by a decision of the Council in May 1998.[18] As far as the other Member States are concerned, Articles 4[19] and 5[20] of

[17] Opinions CON/2010/37 and CON/2010/91. All ECB opinions are available on EUR-Lex.

[18] Council Decision 98/317/EC of 3 May 1998 in accordance with Article 109j(4) of the Treaty (OJ L 139, 11.5.1998, p. 30). Note: The title of Decision 98/317/EC refers to the Treaty establishing the European Community (prior to the renumbering of the Articles of this Treaty in accordance with Article 12 of the Treaty of Amsterdam); this provision has been repealed by the Treaty of Lisbon.

[19] Act concerning the conditions of accession of the Czech Republic, the Republic of Estonia, the Republic of Cyprus, the Republic of Latvia, the Republic of Lithuania, the Republic of Hungary, the Republic of Malta, the Republic of Poland, the Republic of Slovenia and the Slovak Republic and the adjustments to the Treaties on which the European Union is founded (OJ L 236, 23.9.2003, p. 33).

the Acts concerning the conditions of accession provide that each of these Member States shall participate in the Economic and Monetary Union from the date of accession as a Member State with a derogation within the meaning of Article 139 of the Treaty.

This report does not cover Denmark, which is a Member State with a special status and which has not yet adopted the euro. Protocol (No 16) on certain provisions relating to Denmark, annexed to the Treaties, provides that, in view of the notice given to the Council by the Danish Government on 3 November 1993, Denmark has an exemption and that the procedure for the abrogation of the derogation will only be initiated at the request of Denmark. As Article 130 of the Treaty applies to Denmark, Danmarks Nationalbank has to fulfil the requirements of central bank independence. The EMI's Convergence Report of 1998 concluded that this requirement had been fulfilled. There has been no assessment of Danish convergence since 1998 due to Denmark's special status. Until such time as Denmark notifies the Council that it intends to adopt the euro, Danmarks Nationalbank does not need to be legally integrated into the Eurosystem and no Danish legislation needs to be adapted.

The aim of assessing legal convergence is to facilitate the Council's decisions as to which Member States fulfil 'their obligations regarding the achievement of economic and monetary union' (Article 140(1) of the Treaty). In the legal domain, such conditions refer in particular to central bank independence and to the NCBs' legal integration into the Eurosystem.

Structure of the legal assessment

The legal assessment broadly follows the framework of the previous reports of the ECB and the EMI on legal convergence.[21]

The compatibility of national legislation is considered in the light of legislation enacted before 25 March 2022.

[20] For Bulgaria and Romania, see Article 5 of the Act concerning the conditions of accession of the Republic of Bulgaria and Romania and the adjustments to the Treaties on which the European Union is founded (OJ L 157, 21.6.2005, p. 203). For Croatia, see Article 5 of the Act concerning the conditions of accession of the Republic of Croatia and the adjustments to the Treaty on European Union, the Treaty on the Functioning of the European Union and the Treaty establishing the European Atomic Energy Community (OJ L 112, 24.4.2012, p. 21).

[21] In particular the ECB's Convergence Reports of June 2020 (on Bulgaria, the Czech Republic, Croatia, Hungary, Poland, Romania and Sweden), May 2018 (on Bulgaria, the Czech Republic, Croatia, Hungary, Poland, Romania and Sweden), June 2016 (on Bulgaria, the Czech Republic, Croatia, Hungary, Poland, Romania and Sweden), June 2014 (on Bulgaria, the Czech Republic, Croatia, Lithuania, Hungary, Poland, Romania and Sweden), June 2013 (on Latvia), May 2012 (on Bulgaria, the Czech Republic, Latvia, Lithuania, Hungary, Poland, Romania and Sweden), May 2010 (on Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania and Sweden), May 2008 (on Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovakia and Sweden), May 2007 (on Cyprus and Malta), December 2006 (on the Czech Republic, Estonia, Cyprus, Latvia, Hungary, Malta, Poland, Slovakia and Sweden), May 2006 (on Lithuania and Slovenia), October 2004 (on the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia, Slovakia and Sweden), May 2002 (on Sweden) and April 2000 (on Greece and Sweden), and the EMI's Convergence Report of March 1998.

2.2.2 Scope of adaptation

Areas of adaptation

For the purpose of identifying those areas where national legislation needs to be adapted, the following issues are examined:

- compatibility with provisions on the independence of NCBs in the Treaty (Article 130) and the Statute (Articles 7 and 14.2);
- compatibility with provisions on confidentiality (Article 37 of the Statute);
- compatibility with the prohibitions on monetary financing (Article 123 of the Treaty) and privileged access (Article 124 of the Treaty);
- compatibility with the single spelling of the euro required by EU law; and
- legal integration of the NCBs into the Eurosystem (in particular as regards Articles 12.1 and 14.3 of the Statute).

‘Compatibility’ versus ‘harmonisation’

Article 131 of the Treaty requires national legislation to be ‘compatible’ with the Treaties and the Statute; any incompatibility must therefore be remedied. Neither the primacy of the Treaties and the Statute over national legislation nor the nature of the incompatibility affects the need to comply with this obligation.

The requirement for national legislation to be ‘compatible’ does not mean that the Treaty requires ‘harmonisation’ of the NCBs’ statutes, either with each other or with the Statute. National particularities may continue to exist to the extent that they do not infringe the competence in monetary matters that is irrevocably conferred on the EU. Indeed, Article 14.4 of the Statute permits NCBs to perform functions other than those specified in the Statute, to the extent that they do not interfere with the objectives and tasks of the ESCB.[22] Provisions authorising such additional functions in NCBs’ statutes are a clear example of circumstances in which differences may remain. Rather, the term ‘compatible’ indicates that national legislation and the NCBs’ statutes need to be adjusted to eliminate inconsistencies with the Treaties and the Statute and to ensure the necessary degree of integration of the NCBs into the ESCB. In particular, any provisions that infringe an NCB’s independence, as defined in the Treaty, and its role as an integral part of the ESCB, should be adjusted. It is therefore insufficient to rely solely on the primacy of EU law over national legislation to achieve this.

The obligation in Article 131 of the Treaty only covers incompatibility with the Treaties and the Statute. However, national legislation that is incompatible with secondary EU

[22] As regards tasks and powers that have been partially conferred upon the ECB, any national legislation must be without prejudice to the tasks and powers conferred upon the ECB. See Opinion CON/2020/15.

legislation relevant for the areas of adaptation examined in this Convergence Report should be brought into line with such secondary legislation. The primacy of EU law does not affect the obligation to adapt national legislation. This general requirement derives not only from Article 131 of the Treaty but also from the case law of the Court of Justice of the European Union.[23]

The Treaties and the Statute do not prescribe the manner in which national legislation should be adapted. This may be achieved by referring to the Treaties and the Statute, by incorporating provisions thereof and referring to their provenance, by removing any incompatibility, or by a combination of these methods.

Furthermore, among other things as a tool for achieving and maintaining the compatibility of national legislation with the Treaties and the Statute, the ECB must be consulted by the EU institutions and by the Member States on draft legislative provisions in its fields of competence, pursuant to Articles 127(4) and 282(5) of the Treaty and Article 4 of the Statute. Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions[24] expressly requires Member States to take the measures necessary to ensure compliance with this obligation.

2.2.3 Independence of NCBs

As far as central bank independence is concerned, national legislation in the Member States that joined the EU in 2004, 2007 or 2013 had to be adapted to comply with the relevant provisions of the Treaty and the Statute, and be in force on 1 May 2004, 1 January 2007 and 1 July 2013 respectively.[25] Sweden had to bring the necessary adaptations into force by the date of establishment of the ESCB on 1 June 1998.

Central bank independence

In November 1995, the EMI established a list of features of central bank independence (later described in detail in its 1998 Convergence Report) which were the basis for assessing the national legislation of the Member States at that time, in particular the NCBs' statutes. The concept of central bank independence includes various types of independence that must be assessed separately, namely: functional, institutional, personal and financial independence. Over the past few years there has been further refinement of the analysis of these aspects of central bank independence in the opinions adopted by the ECB. These aspects are the basis for assessing the level of convergence between the national legislation of the Member States with a derogation and the Treaties and the Statute.

[23] See, amongst others, *Commission of the European Communities* v *French Republic*, C-265/95, EU:C:1997:595.

[24] OJ L 189, 3.7.1998, p. 42.

[25] This also applies to the ESCB's confidentiality regime; see Section 2.1.4 of this Convergence Report.

Functional independence

Central bank independence is not an end in itself but is instrumental in achieving an objective that should be clearly defined and should prevail over any other objective. Functional independence requires each NCB's primary objective to be stated in a clear and legally certain way and to be fully in line with the primary objective of price stability established by the Treaty. The pursuit of this objective is served by providing the NCBs with the necessary means and instruments for achieving this objective independently of any other authority. The Treaty's requirement of central bank independence reflects the generally held view that the primary objective of price stability is best served by a fully independent institution with a precise definition of its mandate. Central bank independence is fully compatible with holding NCBs accountable for their decisions, which is an important aspect of enhancing confidence in their independent status. This entails transparency and dialogue with third parties.

As regards timing, the Treaty is not clear about when the NCBs of Member States with a derogation must comply with the primary objective of price stability set out in Articles 127(1) and 282(2) of the Treaty and Article 2 of the Statute. For those Member States that joined the EU after the date of the introduction of the euro in the EU, it is not clear whether this obligation should run from the date of accession or from the date of their adoption of the euro. While Article 127(1) of the Treaty does not apply to Member States with a derogation (see Article 139(2)(c) of the Treaty), Article 2 of the Statute does apply to such Member States (see Article 42.1 of the Statute). The ECB takes the view that the obligation of the NCBs to have price stability as their primary objective runs from 1 June 1998 in the case of Sweden, and from 1 May 2004, 1 January 2007 and 1 July 2013 for the Member States that joined the EU on those dates. This is based on the fact that one of the guiding principles of the EU, namely price stability (Article 119 of the Treaty), also applies to Member States with a derogation. It is also based on the Treaty objective that all Member States should strive for macroeconomic convergence, including price stability, which is the intention behind the regular reports of the ECB and the European Commission. This conclusion is also based on the underlying rationale of central bank independence, which is only justified if the overall objective of price stability has primacy.

The country assessments in this report are based on these conclusions as to the timing of the obligation of the NCBs of Member States with a derogation to have price stability as their primary objective.

Institutional independence

The principle of institutional independence is expressly referred to in Article 130 of the Treaty and Article 7 of the Statute. These two articles prohibit the NCBs and members of their decision-making bodies from seeking or taking instructions from EU institutions or bodies, from any government of a Member State or from any other body. In addition, they prohibit EU institutions, bodies, offices or agencies, and the governments of the Member States from seeking to influence those members of the NCBs' decision-making bodies whose decisions may affect the fulfilment of the NCBs'

ESCB-related tasks. For national legislation to mirror Article 130 of the Treaty and Article 7 of the Statute, it should reflect both prohibitions and not narrow the scope of their application.[26] The recognition that central banks have such independence does not have the consequence of exempting them from every rule of law or of shielding them from any kind of legislation.[27]

Whether an NCB is organised as a state-owned body, a special public law body or simply a public limited company, there is a risk that influence may be exerted by the owner on its decision-making in relation to ESCB-related tasks by virtue of such ownership.[28] Such influence, whether exercised through shareholders' rights or otherwise, may affect an NCB's independence and should therefore be limited by law.

The legal framework for central banking needs to provide a stable and long-term basis for a central bank's functioning. A legal framework that permits frequent changes to the institutional set-up of an NCB, thus affecting its organisational or governance stability, could adversely affect that NCB's institutional independence.[29]

Institutional independence should also be respected in cases of emergency. Only where the conditions under Article 347 of the Treaty are met, may national authorities be justified in exercising, on a temporary and exceptional basis, powers that fall within the exclusive competence of the ESCB. The critical time for this assessment is when the measure is adopted. Due to the exceptional nature of Article 347 of the Treaty, Member States should refrain from adopting preventive legislation in the absence of the conditions prescribed by Article 347 of the Treaty.[30]

Prohibition on giving instructions

Rights of third parties to give instructions to NCBs, their decision-making bodies or their members are incompatible with the Treaty and the Statute as far as ESCB-related tasks are concerned.

Any involvement of an NCB in the application of measures to strengthen financial stability must be compatible with the Treaty, i.e. NCBs' functions must be performed in a manner that is fully compatible with their functional, institutional, and financial independence so as to safeguard the proper performance of their tasks under the Treaty and the Statute.[31] To the extent that national legislation provides for a role of an NCB that goes beyond advisory functions and requires it to assume additional tasks, it must be ensured that these tasks will not affect the NCB's ability to carry out its ESCB-related tasks from an operational and financial point of view.[32] Additionally, the inclusion of NCB representatives in collegiate decision-making supervisory bodies or

[26] Opinion CON/2011/104.

[27] See paragraph 2.3 of Opinion CON/2019/15 and *Commission* v *European Central Bank*, C-11/00, EU:C:2003:395, paragraphs 134 to 136.

[28] Opinion CON/2019/23.

[29] See paragraph 2.2 of Opinion CON/2011/104 and paragraph 3.2.2 of Opinion CON/2017/34.

[30] See paragraph 2.2. of Opinion CON/2021/35.

[31] Opinion CON/2010/31.

[32] Opinion CON/2009/93.

other authorities would need to give due consideration to safeguards for the personal independence of the members of the NCB's decision-making bodies.[33]

Prohibition on approving, suspending, annulling or deferring decisions

Rights of third parties to approve, suspend, annul or defer an NCB's decisions are incompatible with the Treaty and the Statute as far as ESCB-related tasks are concerned.[34]

Prohibition on censoring decisions on legal grounds

A right for bodies other than independent courts to censor, on legal grounds, decisions relating to the performance of ESCB-related tasks is incompatible with the Treaty and the Statute, since the performance of these tasks may not be reassessed at the political level. A right of an NCB Governor to suspend the implementation of a decision adopted by the ESCB or by an NCB decision-making body on legal grounds and subsequently to submit it to a political body for a final decision would be equivalent to seeking instructions from third parties.

Prohibition on participation in decision-making bodies of an NCB with a right to vote

Participation by representatives of third parties in an NCB's decision-making body with a right to vote on matters concerning the performance by the NCB of ESCB-related tasks is incompatible with the Treaty and the Statute, even if such vote is not decisive. Such participation even without the right to vote is incompatible with the Treaty and the Statute, if such participation interferes with the performance of ESCB-related tasks by that decision-making bodies or endangers compliance with the ESCB's confidentiality regime.[35]

Prohibition on ex ante consultation relating to an NCB's decision

An express statutory obligation for an NCB to consult third parties ex ante relating to an NCB's decision provides third parties with a formal mechanism to influence the final decision and is therefore incompatible with the Treaty and the Statute.

However, dialogue between an NCB and third parties, even when based on statutory obligations to provide information and exchange views, is compatible with central bank independence provided that:

- this does not result in interference with the independence of the members of the NCB's decision-making bodies;
- the special status of Governors in their capacity as members of the ECB's decision-making bodies is fully respected; and

[33] Opinion CON/2010/94.

[34] Opinion CON/2016/33.

[35] Opinions CON/2014/25 and CON/2015/57.

- confidentiality requirements resulting from the Statute are observed.[36]

Discharge provided for the duties of members of the NCB's decision-making bodies

Statutory provisions regarding the discharge provided by third parties (e.g. governments) regarding the duties of members of the NCB's decision-making bodies (e.g. in relation to accounts) should contain adequate safeguards, so that such a power does not impinge on the capacity of the individual NCB member independently to adopt decisions in respect of ESCB-related tasks (or implement decisions adopted at ESCB level). Inclusion of an express provision to this effect in NCB statutes is recommended.

Personal independence

The Statute's provision on security of tenure for members of NCBs' decision-making bodies further safeguards central bank independence. NCB Governors are members of the General Council of the ECB and become members of the Governing Council upon adoption of the euro by their Member States. NCB Governors cannot be regarded as representatives of a Member State when they perform their duties as members of the Governing Council or the General Council of the ECB.[37] Article 14.2 of the Statute provides that NCB statutes must, in particular, provide for a minimum term of office of five years for Governors. It also protects against Governors being arbitrarily relieved from their office by providing that they may only be relieved from office if they no longer fulfil the conditions required for performing their duties or if they [have been found guilty of serious misconduct. In such cases, Article 14.2 of the Statute provides for the possibility of recourse to the Court of Justice of the European Union, which has the power to annul the national decision taken to relieve a Governor from office.[38] The suspension of a Governor may effectively amount to relieving a Governor from office for the purposes of Article 14.2 of the Statute.[39] NCB statutes must comply with this provision as set out below.

Article 130 of the Treaty prohibits national governments and any bodies from influencing the members of NCBs' decision-making bodies in the performance of their tasks. In particular, Member States may not seek to influence the members of the NCB's decision-making bodies by amending national legislation affecting their remuneration, which, as a matter of principle, should apply only for future appointments.[40]

[36] Opinion CON/2018/17.

[37] See *LR Ģenerālprokuratūra*, C-3/20, ECLI:EU:C:2021:969, paragraph 43.

[38] See *Rimšēvičs* v *Latvia*, C-202/18, EU:C:2019:139, paragraph 76.

[39] See *Rimšēvičs* v *Latvia*, C-202/18, EU:C:2019:139, paragraph 52, and Opinion CON/2011/9.

[40] See, for example, Opinions CON/2010/56, CON/2010/80, CON/2011/104, CON/2011/106 and CON/2021/9.

Minimum term of office for Governors

In accordance with Article 14.2 of the Statute, NCB statutes must provide for a minimum term of office of five years for a Governor. This does not preclude longer terms of office, while an indefinite term of office does not require adaptation of the statutes provided the grounds for the relieving a Governor from office are in line with those of Article 14.2 of the Statute. Shorter periods cannot be justified even if only applied during a transitional period.[41] National legislation which provides for a compulsory retirement age should ensure that the retirement age does not interrupt the minimum term of office provided by Article 14.2 of the Statute, which prevails over any compulsory retirement age, if applicable to a Governor.[42] When an NCB's statutes are amended, the amending law should safeguard the security of tenure of the Governor and of other members of decision-making bodies who are involved in the performance of ESCB-related tasks.[43]

Grounds for relieving Governors from office

NCB statutes must ensure that Governors may not be dismissed for reasons other than those mentioned in Article 14.2 of the Statute. The purpose of the requirement under that Article is to prevent the authorities involved in the appointment of Governors, particularly the relevant government or parliament, from arbitrarily dismissing a Governor. NCB statutes should either refer to Article 14.2 of the Statute, incorporate its provisions and refer to their provenance, delete any incompatibility with the grounds for relieving from office laid down in Article 14.2, or omit any mention of grounds for relieving from office (since Article 14.2 is directly applicable).[44] Once elected or appointed, Governors may not be relieved from office under conditions other than those mentioned in Article 14.2 of the Statute even if they have not yet taken up their duties. As the conditions under which a Governor may be relieved from office are autonomous concepts of Union law, their application and interpretation do not depend on national contexts.[45] Ultimately, it is for the Court of Justice of the European Union, in accordance with the powers conferred on it by the second subparagraph of Article 14.2 of the Statute, to verify that a decision taken to relieve a Governor of a national central bank from office is justified by sufficient indications that they have engaged in serious misconduct capable of justifying such a measure.[46]

Security of tenure and grounds for relieving from office of members of NCBs' decision-making bodies, other than Governors, who are involved in the performance of ESCB-related tasks

Applying the same rules for the security of tenure and grounds for relieving of Governors from office to other members of the decision-making bodies of NCBs involved in the performance of ESCB-related tasks will also safeguard the personal

[41] Opinion CON/2018/23.

[42] Opinion CON/2012/89.

[43] Opinions CON/2018/17, CON/2019/19 and CON/2019/36.

[44] Opinion CON/2018/53.

[45] See Opinion CON/2019/36 and the Opinion of Advocate General Kokott in *Rimšēvičs* v *Latvia*, C-202/18, EU:C:2018:1030, paragraph 77.

[46] See *Rimšēvičs* v *Latvia*, C-202/18, EU:C:2019:139, paragraph 96.

independence of those persons.[47] The provisions of Article 14.2 of the Statute are not restricted to the security of tenure of office to Governors, and Article 130 of the Treaty and Article 7 of the Statute refer to "members of the decision-making bodies" of NCBs, rather than to Governors specifically. This applies in particular where a Governor is "first among equals" with colleagues with equivalent voting rights or where such other members are involved in the performance of ESCB-related tasks.

Right of judicial review

Members of the NCBs' decision-making bodies must have the right to submit any decision to relieve them from their office to an independent court of law, in order to limit the potential for political discretion in evaluating the grounds for such a decision.

Article 14.2 of the Statute stipulates that NCB Governors who have been dismissed from office may refer such a decision to the Court of Justice of the European Union. National legislation should either refer to the Statute or remain silent on the right to refer such a decision to the Court of Justice of the European Union (as Article 14.2 of the Statute is directly applicable). The Court of Justice of the European Union has the power to annul the national measure of dismissal if it is found to be contrary to Union law.[48]

National legislation should also provide for a right of review by the national courts of a decision to dismiss any other member of the decision-making bodies of the NCB involved in the performance of ESCB-related tasks. This right can either be a matter of general law or can it take the form of a specific provision. Even though this right may be available under the general law, for reasons of legal certainty it could be advisable to provide specifically for such a right of review.

Safeguards against conflicts of interest

Personal independence also entails ensuring that no conflict of interest arises between the duties of members of NCB decision-making bodies involved in the performance of ESCB-related tasks in relation to their respective NCBs (and of Governors in relation to the ECB) and any other functions which such members of decision-making bodies may have and which may jeopardise their personal independence.[49] As a matter of principle, membership of a decision-making body involved in the performance of ESCB-related tasks is incompatible with the exercise of other functions that might create a conflict of interest. In particular, members of such decision-making bodies may not hold an office or have an interest that may influence their activities, whether through office in the executive or legislative branches of the state or in regional or local administrations, or through involvement in a business organisation. Particular care should be taken to prevent potential conflicts of interest on the part of non-executive members of decision-making bodies.

[47] Opinions CON/2004/35, CON/2005/26, CON/2006/32, CON/2006/44, CON/2007/6, CON/2019/19 and CON/2019/24.

[48] See *Rimšēvičs* v *Latvia*, C-202/18, EU:C:2019:139, paragraph 76.

[49] In this regard, Member States are free to set the conditions required for the appointment of the members of the decision-making bodies of their NCBs, provided that they do not conflict with the features of central bank independence flowing from the Treaties. See Opinions CON/2018/23, CON/2020/19 and CON/2021/9.

Financial independence

The overall independence of an NCB would be jeopardised if it could not autonomously avail itself of sufficient financial resources to fulfil its mandate, i.e. to perform the ESCB-related tasks required of it under the Treaty and the Statute.[50]

Member States may not put their NCBs in a position where they have insufficient financial resources and inadequate net equity[51] to carry out their ESCB or Eurosystem-related tasks, as applicable. It should be noted that Articles 28.1 and 30.4 of the Statute provide for the possibility of the ECB making further calls on the NCBs to contribute to the ECB's capital and to make further transfers of foreign reserves.[52] Moreover, Article 33.2 of the Statute provides[53] that, in the event of a loss incurred by the ECB which cannot be fully offset against the general reserve fund, the ECB's Governing Council may decide to offset the remaining loss against the monetary income of the relevant financial year in proportion to and up to the amounts allocated to the NCBs. The principle of financial independence means that compliance with these provisions requires an NCB to be able to perform its functions unimpaired.

Additionally, the principle of financial independence requires an NCB to have sufficient means not only to perform its ESCB-related tasks but also its national tasks (e.g. supervision of the financial sector, financing its administration and own operations, provision of Emergency Liquidity Assistance[54]).

For all the reasons mentioned above, financial independence also implies that an NCB should always be sufficiently capitalised. In particular, any situation should be avoided whereby for a prolonged period of time an NCB's net equity is below the level of its statutory capital or is even negative, including where losses beyond the level of capital and the reserves are carried over.[55][56] Any such situation may negatively impact on the NCB's ability to perform its ESCB-related tasks but also its national tasks. Moreover, such a situation may affect the credibility of the Eurosystem's monetary policy. Therefore, the event of an NCB's net equity becoming less than its statutory capital or even negative would require that the respective Member State provides the NCB with an appropriate amount of capital at least up to the level of the statutory capital within a reasonable period of time so as to comply with the principle of financial independence. As concerns the ECB, the relevance of this issue has already been recognised by the Council by adopting Council Regulation (EC) No 1009/2000 of 8 May 2000 concerning capital increases of the European Central Bank.[57] It enabled the Governing Council of the ECB to decide on an actual increase of the ECB's capital to sustain the adequacy

[50] Opinion CON/2021/7.

[51] Opinions CON/2014/24, CON/2014/27, CON/2014/56 and CON/2017/17.

[52] Article 30.4 of the Statute only applies within the Eurosystem.

[53] Article 33.2 of the Statute only applies within the Eurosystem.

[54] Opinions CON/2016/55, CON/2020/11 and CON/2020/13.

[55] Opinion CON/2020/13.

[56] Opinion CON/2018/17.

[57] OJ L 115, 16.5.2000, p. 1.

of the capital base to support the operations of the ECB;[58] NCBs should be financially able to respond to such ECB decision.

The concept of financial independence should be assessed from the perspective of whether any third party is able to exercise either direct or indirect influence not only over an NCB’s tasks but also over its ability to fulfil its mandate, both operationally in terms of manpower, and financially in terms of appropriate financial resources. The aspects of financial independence set out below are particularly relevant in this respect.[59] These are the features of financial independence where NCBs are most vulnerable to outside influence.

Determination of budget

If a third party has the power to determine or influence an NCB’s budget, this is incompatible with financial independence unless the law provides a safeguard clause so that such a power is without prejudice to the financial means necessary for carrying out the NCB’s ESCB-related tasks.[60]

The accounting rules

The accounts should be drawn up either in accordance with general accounting rules or in accordance with rules specified by an NCB’s decision-making bodies. If, instead, such rules are specified by third parties, the rules must at least take into account what has been proposed by the NCB’s decision-making bodies.

The annual accounts should be adopted by the NCB’s decision-making bodies, assisted by independent accountants, and may be subject to ex post approval by third parties (e.g. the government or parliament). The NCB’s decision-making bodies should be able to decide on the calculation of the profits independently and professionally.

Where an NCB’s operations are subject to the control of a state audit office or similar body charged with controlling the use of public finances, the scope of the control should be clearly defined by the legal framework,[61] should be without prejudice to the activities of the NCB’s independent external auditors[62] and further, in line with the principle of institutional independence, it should comply with the prohibition on giving instructions to an NCB and its decision-making bodies and should not interfere with the NCB’s ESCB-related tasks.[63] The state audit should be done on a non-political, independent and purely professional basis.[64]

[58] Decision ECB/2010/26 of 13 December 2010 on the increase of the ECB’s capital (OJ L 11, 15.1.2011, p. 53).

[59] The main formative ECB opinions in this area are: Opinions CON/2002/16, CON/2003/22, CON/2003/27, CON/2004/1, CON/2006/38, CON/2006/47, CON/2007/8, CON/2008/13, CON/2008/68 and CON/2009/32.

[60] Opinion CON/2019/12.

[61] Opinion CON/2019/19.

[62] For the activities of the independent external auditors of the NCBs see Article 27.1 of the Statute.

[63] Opinions CON/2011/9, CON/2011/53, CON/2015/57 and CON/2018/17.

[64] Opinions CON/2015/8, CON/2015/57, CON/2016/24, CON/2016/59 and CON/2018/17.

Distribution of profits, NCBs' capital and financial provisions

With regard to profit allocation, an NCB's statutes may prescribe how its profits are to be allocated. In the absence of such provisions, decisions on the allocation of profits should be taken by the NCB's decision-making bodies on professional grounds, and should not be subject to the discretion of third parties unless there is an express safeguard clause stating that this is without prejudice to the financial means necessary for carrying out the NCB's ESCB-related tasks as well as national tasks.[65]

Profits may be distributed to the State budget only after any accumulated losses from previous years have been covered[66] and financial provisions deemed necessary to safeguard the real value of the NCB's capital and assets have been created. Temporary or ad hoc legislative measures amounting to instructions to the NCBs in relation to the distribution of their profits are not permissible.[67] Similarly, a tax on an NCB's unrealised capital gains would also impair the principle of financial independence.[68]

A Member State may not impose reductions of capital on an NCB without the ex ante agreement of the NCB's decision-making bodies, which must aim to ensure that it retains sufficient financial means to fulfil its mandate under Article 127(2) of the Treaty and the Statute as a member of the ESCB. For the same reason, any amendment to the profit distribution rules of an NCB should only be initiated and decided in close cooperation with the NCB, which is best placed to assess its required level of reserve capital.[69] As regards financial provisions or buffers, NCBs must be free to independently create financial provisions to safeguard the real value of their capital and assets. Member States may also not hamper NCBs from building up their reserve capital to a level which is necessary for a member of the ESCB to fulfil its tasks.[70]

Financial liability for supervisory authorities

Most Member States place their financial supervisory authorities within their NCB. This is unproblematic if such authorities are subject to the NCB's independent decision-making. However, if the law provides for separate decision-making by such supervisory authorities, it is important to ensure that decisions adopted by them do not endanger the finances of the NCB as a whole. In such cases, national legislation should enable the NCB to have ultimate control over any decision by the supervisory authorities that could affect an NCB's independence, in particular its financial independence.[71]

Autonomy in staff matters

Member States may not impair an NCB's ability to employ and retain the qualified staff necessary for the NCB to perform independently the tasks conferred on it by the

[65] Opinions CON/2017/17 and CON/2018/17.

[66] Opinions CON/2009/85 and CON/2017/17.

[67] Opinions CON/2009/26 and CON/2013/15.

[68] Opinions CON/2009/59 and CON/2009/63.

[69] Opinions CON/2009/53, CON/2009/83 and CON/2019/21.

[70] Opinions CON/2009/26,CON/2012/69 and CON/2020/13.

[71] Opinion CON/2021/7.

Treaty and the Statute.[72] Also, an NCB may not be put into a position where it has limited control or no control over its staff, or where the government of a Member State can influence its policy on staff matters.[73] Any amendment to the legislative provisions on the remuneration for members of an NCB’s decision-making bodies and its employees should be decided in close and effective cooperation with the NCB,[74] taking due account of its views, to ensure the ongoing ability of the NCB to independently carry out its tasks.[75] Autonomy in staff matters extends to issues relating to staff pensions. Further, amendments that lead to reductions in the remuneration for an NCB's staff should not interfere with that NCB’s powers to administer its own financial resources, including the funds resulting from any reduction in salaries that it pays.[76]

Ownership and property rights

Rights of third parties to intervene or to issue instructions to an NCB in relation to the property held by an NCB are incompatible with the principle of financial independence.

2.2.4 Confidentiality

The obligation of professional secrecy for ECB and NCB staff as well as for the members of the ECB and NCB governing bodies under Article 37 of the Statute may give rise to similar provisions in NCBs’ statutes or in the Member States’ legislation. The primacy of Union law and rules adopted thereunder also means that national laws on access by third parties to documents should comply with relevant Union law provisions, including Article 37 of the Statute, and may not lead to infringements of the ESCB’s confidentiality regime.[77] The access of a state audit office or similar body to an NCB’s confidential information and documents must be limited to what is necessary for the performance of the statutory tasks of the body that receives the information and must be without prejudice to the ESCB’s independence and the ESCB’s confidentiality regime to which the members of NCBs’ decision-making bodies and staff are subject.[78] NCBs should ensure that such bodies protect the confidentiality of information and documents disclosed at a level corresponding to that applied by the NCBs.

2.2.5 Prohibition on monetary financing and privileged access

On the monetary financing prohibition and the prohibition on privileged access, the national legislation of the Member States that joined the EU in 2004, 2007 or 2013 had to be adapted to comply with the relevant provisions of the Treaty and the Statute and

[72] Opinion CON/2019/19.

[73] Opinions CON/2008/9, CON/2008/10 and CON/2012/89.

[74] Opinion CON/2019/19.

[75] Opinions CON/2010/42, CON/2010/51, CON/2010/56, CON/2010/69, CON/2010/80, CON/2011/104, CON/2011/106, CON/2012/6, CON/2012/86 and CON/2014/7.

[76] Opinion CON/2014/38.

[77] Opinion CON/2021/16.

[78] Opinions CON/2015/8 and CON/2015/57.

be in force on 1 May 2004, 1 January 2007 and 1 July 2013 respectively. Sweden had to bring the necessary adaptations into force by 1 January 1995.

Prohibition on monetary financing

Article 123(1) of the Treaty prohibits overdraft facilities or any other type of credit facility with the ECB or with the NCBs in favour of EU institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States.

It also prohibits the purchase directly from these public sector entities by the ECB or NCBs of debt instruments. The Treaty contains one exemption from this monetary financing prohibition: it does not apply to publicly-owned credit institutions which, in the context of the supply of reserves by central banks, must be given the same treatment as private credit institutions (Article 123(2) of the Treaty). Moreover, the ECB and the NCBs may act as fiscal agents for the public sector bodies referred to above (Article 21.2 of the Statute). The precise scope of application of the monetary financing prohibition is further clarified by Council Regulation (EC) No 3603/93 of 13 December 1993 specifying definitions for the application of the prohibitions referred to in Articles 104 and 104b (1) of the Treaty,[79] according to which the prohibition includes any financing of the public sector's obligations vis-à-vis third parties.

The monetary financing prohibition is of essential importance to ensuring that the primary objective of monetary policy (namely to maintain price stability) is not impeded. Furthermore, central bank financing of the public sector lessens the pressure for fiscal discipline. Therefore the prohibition must be interpreted extensively in order to ensure its strict application, subject only to the limited exemptions contained in Article 123(2) of the Treaty and Regulation (EC) No 3603/93. Thus, even if Article 123(1) of the Treaty refers specifically to 'credit facilities', i.e. with the obligation to repay the funds, the prohibition applies a fortiori to other forms of funding, i.e. without the obligation to repay.

The ECB's general stance on the compatibility of national legislation with the prohibition has primarily been developed within the framework of consultations of the ECB by Member States on draft national legislation under Articles 127(4) and 282(5) of the Treaty.[80]

National legislation referring to the monetary financing prohibition

In cases where national legislative provisions mirror Article 123 of the Treaty or Regulation (EC) No 3603/93, they may not narrow the scope of application of the monetary financing prohibition or extend the exemptions available under EU law. For example, national legislation providing for the financing by the NCB of a Member State's financial commitments to international financial institutions or to third countries

[79] OJ L 332, 31.12.1993, p. 1. Articles 104 and 104b(1) of the Treaty establishing the European Community are now Articles 123 and 125(1) of the Treaty on the Functioning of the European Union.

[80] See Convergence Report 2008, footnote 13, containing a list of formative EMI/ECB opinions in this area adopted between May 1995 and March 2008.

is, in principle, incompatible with the monetary financing prohibition. As an exemption, Regulation (EC) No 3603/93 allows for the financing by the NCBs of obligations falling upon the public sector vis-à-vis the IMF provided that it results in foreign claims which have all the characteristics of reserve assets.[81] The relevant characteristics that determine the reserve asset quality of the claims concern their availability on demand to meet balance of payments financing needs and other related purposes, which implies that the credit quality and liquidity of the claims must be ensured.[82]

Financing of the public sector or of public sector obligations to third parties

National legislation may not require an NCB to finance either the performance of functions by other public sector bodies or the public sector's obligations vis-à-vis third parties. This is equally applicable to the conferral of new tasks upon NCBs. For this purpose, it is necessary to assess on a case-by-case basis, whether the task to be conferred upon an NCB qualifies as a central bank task or a government task, i.e. a task within the responsibility of the government.[83] In other words, sufficient safeguards must be in place to ensure that no circumventions of the objective of the monetary financing prohibition occur. The Governing Council has endorsed criteria for determining what may be seen as falling within the scope of a public sector's obligation within the meaning of Regulation (EC) No 3603/93 or, in other words, what constitutes a government task.[84] To ensure compliance with the monetary financing prohibition, a new task entrusted to an NCB must be fully and adequately remunerated if it is: (a) not a central bank task or an action that facilitates the performance of a central bank task; or (b) linked to a government task and performed in the government's interest.[85] Important criteria for qualifying a new task as a government task are: (a) its atypical nature; (b) the fact that it is discharged on behalf of and in the exclusive interest of the government; and (c) its impact on the institutional, financial and personal independence of the NCB. In particular, a task may be qualified as a government task if the performance of the new task meets one of the following conditions: (a) it creates inadequately addressed conflicts of interests with existing central bank tasks; (b) it is disproportionate to the NCB's financial or organisational capacity; (c) it does not fit into the NCB's institutional set-up; (d) it harbours substantial financial risks; and (e) it exposes the members of the NCB decision-making bodies to political risks that are disproportionate and that may also negatively impact on them in terms of their personal independence.[86]

Some of the new tasks conferred on NCBs that the ECB considered to be government tasks are: (a) tasks relating to financing resolution funds or financial arrangements as well as deposit guarantee or investor compensation schemes;[87] (b) tasks relating to

[81] Recital 14 and Article 7 of Regulation (EC) No 3603/93. See, for example, Opinions CON/2016/21, CON/2017/4, CON/2020/37 and CON/2021/23.

[82] See Opinion CON/2021/39.

[83] Such an assessment may not be necessary if the task to be conferred on the NCB only complements an existing function of the NCB and does not qualify as a genuinely new task.

[84] See, for example, Opinion CON/2016/54.

[85] Opinions CON/2011/30, CON/2015/36, CON/2015/46 and Opinion CON/2021/29.

[86] See, for example, Opinion CON/2015/22.

[87] See the section entitled 'Financial support for resolution funds or financial arrangements and deposit insurance or investor compensation schemes' for some specific cases.

the establishment of a central register of bank account numbers;[88] (c) tasks of a credit mediator;[89] (d) tasks relating to the collection, maintenance and processing of data that supports the calculation of insurance premium transfers;[90] (e) tasks relating to the protection of competition in the mortgage loan market;[91] (f) tasks relating to the provision of resources to bodies that are independent of the NCBs and operate as an extension of the government;[92] (g) tasks of an information authority for the purposes of facilitating cross-border debt recovery in civil and commercial matters;[93] (h) tasks relating to the establishment of an insurance claims database;[94] (i) tasks related to carrying out scientific analyses on behalf and for the benefit of government entities;[95] and (j) tasks relating to national defence preparedness going beyond the internal contingency planning tasks of a central bank.[96] By contrast, central bank tasks may be, inter alia, supervisory tasks[97] or tasks relating to those supervisory tasks, such as those relating to consumer protection in the area of financial services[98] or compliance of credit institutions with loan restructuring requirements,[99] supervision over credit-acquiring companies[100] or financial leasing companies,[101] supervision of consumer credit providers and intermediaries,[102] licensing and supervision of microcredit providers,[103] supervision of credit reference agencies,[104] supervision of administrators of interest rate benchmarks,[105] supervisory tasks to ensure compliance with Union legislation in the field of investment services and products,[106] tasks relating to the oversight of payment schemes,[107] tasks relating to the supervision of rules related to the Single Euro Payments Area,[108] tasks relating to supervision of the issuance of covered bonds by credit institutions,[109] tasks relating to the application and enforcement of Union legislation concerning payment accounts,[110] administrative resolution tasks or certain tasks relating to the management of deposit guarantee or

[88] Opinions CON/2015/36, CON/2015/46, CON/2016/49, CON/2016/57 and CON/2018/57.

[89] Opinion CON/2015/12.

[90] Opinion CON/2016/45.

[91] Opinion CON/2016/54.

[92] Opinion CON/2017/19.

[93] Opinion CON/2017/32.

[94] Opinion CON/2018/43.

[95] Opinion CON/2021/29.

[96] Opinions CON/2020/2 and CON/2021/35.

[97] Opinion CON/2021/9.

[98] Opinions CON/2007/29, CON/2016/31, CON/2017/3 and CON/2017/12.

[99] Opinion CON/2019/27.

[100] Opinion CON/2015/45.

[101] Opinion CON/2016/31.

[102] Opinions CON/2015/54, CON/2016/34 and CON/2017/3.

[103] Opinion CON/2019/07.

[104] Opinion CON/2019/02.

[105] Opinion CON/2017/52.

[106] Opinions CON/2018/2 and CON/2018/5.

[107] Opinions CON/2016/38 and CON/2020/23.

[108] Opinion CON/2021/34.

[109] Opinion CON/2021/34.

[110] Opinion CON/2017/2.

investor protection schemes[111], or tasks relating to the operation and management of credit registers.[112]

In addition, no bridge financing may be provided by an NCB to enable a Member State to honour its obligations in respect of State guarantees of bank liabilities.[113] Also, the distribution of central bank profits which have not been fully realised, accounted for and audited does not comply with the monetary financing prohibition. To comply with the monetary financing prohibition, the amount distributed to the State budget pursuant to the applicable profit distribution rules cannot be paid, even partially, from the NCB's reserve capital. Therefore, profit distribution rules should leave unaffected the NCB's reserve capital. Moreover, when NCB assets are transferred to the State, they must be remunerated at market value and the transfer should take place at the same time as the remuneration.[114]

Similarly, intervention in the performance of other Eurosystem tasks, such as the management of foreign reserves, by introducing taxation of theoretical and unrealised capital gains is not permitted since this would result in a form of central bank credit to the public sector through the advanced distribution of future and uncertain profits.[115]

Assumption of public sector liabilities

National legislation which requires an NCB to take over the liabilities of a previously independent public body, as a result of a national reorganisation of certain tasks and duties (for example, in the context of a transfer to the NCB of certain supervisory tasks previously carried out by the state or independent public authorities or bodies), without fully insulating the NCB from all financial obligations resulting from the prior activities of such a body, would be incompatible with the monetary financing prohibition.[116] Along the same lines, national legislation that requires an NCB to obtain approval from the government prior to taking resolution actions under a broad range of circumstances, but which does not limit the NCB's liability to its own administrative acts, would be incompatible with the monetary financing prohibition.[117] In the same vein, national legislation that requires an NCB to pay compensation for damages, to the extent that it results in that NCB assuming the liability of the state, would not be in line with the monetary financing prohibition.[118]

Financial support for credit and/or financial institutions

National legislation which provides for financing by an NCB, granted independently and at their full discretion, of credit institutions other than in connection with central banking tasks (such as monetary policy, payment systems or temporary liquidity

[111] Opinion CON/2021/9. This is further qualified under the sub-section below on 'Financial support for resolution funds or financial arrangements and deposit insurance or investor compensation schemes'.

[112] Opinion CON/2016/42.

[113] Opinion CON/2012/4.

[114] Opinions CON/2011/91 and CON/2011/99.

[115] Opinions CON/2009/59 and CON/2009/63.

[116] Opinion CON/2013/56.

[117] Opinion CON/2015/22.

[118] Opinions CON/2019/20 and CON/2021/7.

support operations), in particular the support of insolvent credit and/or other financial institutions, would be incompatible with the monetary financing prohibition.

This applies, in particular, to the support of insolvent credit institutions. The rationale is that by financing an insolvent credit institution, an NCB would be assuming a government task.[119] The same concerns apply to the Eurosystem financing of a credit institution which has been recapitalised to restore its solvency by way of a direct placement of state-issued debt instruments where no alternative market-based funding sources exist (hereinafter “recapitalisation bonds”), and where such bonds are to be used as collateral. In such case of a state recapitalisation of a credit institution by way of direct placement of recapitalisation bonds, the subsequent use of the recapitalisation bonds as collateral in central bank liquidity operations raises monetary financing concerns.[120] Emergency liquidity assistance, granted by an NCB independently and at its full discretion to a solvent credit institution on the basis of collateral security in the form of a State guarantee, has to meet the following criteria: (i) it must be ensured that the credit provided by the NCB is as short term as possible; (ii) there must be systemic stability aspects at stake; (iii) there must be no doubts as to the legal validity and enforceability of the State guarantee under applicable national law; and (iv) there must be no doubts as to the economic adequacy of the State guarantee, which should cover both principal and interest on the loans.[121]

To this end, inserting references to Article 123 of the Treaty in national legislation should be considered.

Financial support for resolution funds or financial arrangements and deposit insurance or investor compensation schemes

The financing by an NCB of a resolution fund or a deposit guarantee fund that qualifies as a ‘body governed by public law’ within the meaning of Article 123(1) of the Treaty is not compatible with the monetary financing prohibition. A body is ‘governed by public law’ if it has all of the following characteristics: (a) it is established for the specific purpose of meeting needs in the general interest, not having an industrial or commercial character; (b) it has legal personality; and (c) it is closely dependent on the public sector entities referred to in Article 123(1) of the Treaty. A close dependence on those public sector entities is presumed when a body is financed, for the most part, by them; or is subject to management supervision by them; or has an administrative, managerial or supervisory board, more than half of whose members are appointed by them.[122]

While administrative resolution tasks are generally considered as related to those referred to in Article 127(5) of the Treaty, and even if the financing is not provided to a ‘body governed by public law’, the financing of any resolution fund or financial arrangement is not in line with the monetary financing prohibition.[123] Where an NCB

[119] Opinion CON/2013/5.

[120] Opinions CON/2012/50, CON/2012/64, and CON/2012/71.

[121] Opinion CON/2012/4, footnote 42 referring to further relevant Opinions in this field. See also Opinions CON/2016/55 and CON/2017/1.

[122] Opinions CON/2020/24 and CON/2021/17.

[123] Opinions CON/2015/22, CON/2016/28 and CON/2019/16.

acts as resolution authority, it should not, under any circumstances, assume or finance any obligation of either a bridge institution or an asset management vehicle.[124] To this end, national legislation should clarify that the NCB will not assume or finance any of these entities' obligations.[125]

The Deposit Guarantee Schemes Directive[126] and the Investor Compensation Schemes Directive[127] provide that the costs of financing deposit guarantee schemes and investor compensation schemes must be borne, respectively, by credit institutions and investment firms themselves. With the exception of financing a 'body governed by public law', national legislation which provides for the financing by an NCB of a national deposit insurance scheme for credit institutions or a national investor compensation scheme for investment firms would be compatible with the monetary financing prohibition only if it were short term, addressed urgent situations, systemic stability aspects were at stake, and decisions were at the NCB's discretion.[128] To this end, inserting references to Article 123 of the Treaty in national legislation should be considered. When exercising its discretion to grant a loan, the NCB must ensure that it is not de facto taking over a government task.[129] In particular, central bank support for deposit guarantee schemes should not amount to a systematic pre-funding operation.[130]

Fiscal agency function

Article 21.2 of the Statute establishes that the 'ECB and the national central banks may act as fiscal agents' for 'Union institutions, bodies, offices or agencies, central governments, regional local or other public authorities, other bodies governed by public law, or public undertakings of Member States.' The purpose of Article 21.2 of the Statute is, following transfer of the monetary policy competence to the Eurosystem, to clarify that NCBs may continue to provide the fiscal agent service traditionally provided to governments and other public entities without infringing the monetary financing prohibition. In addition, Regulation (EC) No 3603/93 establishes a number of explicit and narrowly drafted exemptions from the monetary financing prohibition relating to the fiscal agency function, as follows: (i) intra-day credits to the public sector are permitted provided that they remain limited to the day and that no extension is possible;[131] (ii) crediting the public sector's account with cheques issued by third parties before the drawee bank has been debited is permitted if a fixed period of time corresponding to the normal period for the collection of cheques by the NCB concerned has elapsed since receipt of the cheque, provided that any float which may arise is exceptional, is of a small amount and averages out in the short term;[132] and

[124] Opinions CON/2011/103, CON/2012/99, CON/2015/3 and CON/2015/22.

[125] Opinions CON/2015/33, CON/2015/35 and CON/2016/60.

[126] Recital 27 of Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes (OJ L 173, 12.6.2014, p. 149).

[127] Recital 23 of Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor-compensation schemes (OJ L 84, 26.3.1997, p. 22).

[128] Opinions CON/2020/24 and CON/2021/17.

[129] Opinions CON/2011/83 and CON/2015/52.

[130] Opinion CON/2011/84.

[131] Article 4 of Regulation (EC) No 3603/93 and Opinion CON/2013/2.

[132] Article 5 of Regulation (EC) No 3603/93.

(iii) the holding of coins issued by and credited to the public sector is permitted where the amount of such assets remains at less than 10 % of coins in circulation.[133]

National legislation on the fiscal agency function should be compatible with EU law in general, and with the monetary financing prohibition in particular.[134] Taking into account the express recognition in Article 21.2 of the Statute of the provision of fiscal agency services, which is a legitimate function traditionally performed by NCBs, the provision by central banks of fiscal agency services complies with the monetary financing prohibition, provided that such services remain within the field of the fiscal agency function and do not constitute central bank financing of public sector obligations vis-à-vis third parties or central bank crediting of the public sector outside the narrowly defined exceptions specified in Regulation (EC) No 3603/93.[135] National legislation that enables an NCB to hold government deposits and to service government accounts does not raise concerns about compliance with the monetary financing prohibition as long as such provisions do not enable the extension of credit, including overnight overdrafts. However, there would be a concern about compliance with the monetary financing prohibition if, for example, national legislation were to enable the remuneration of deposits or current account balances above, rather than at or below, market rates. Remuneration that is above market rates constitutes a de facto credit, contrary to the objective of the prohibition on monetary financing, and might therefore undermine the prohibition's objectives. It is essential for any remuneration of an account to reflect market parameters and it is particularly important to correlate the remuneration rate of the deposits with their maturity.[136] Moreover, the provision without remuneration by an NCB of fiscal agent services does not raise monetary financing concerns, provided they are core fiscal agent services.[137]

Prohibition on privileged access

Article 124 of the Treaty provides that '[a]ny measure, not based on prudential considerations, establishing privileged access by Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States to financial institutions, shall be prohibited.' As with the monetary financing prohibition, the prohibition of privileged access aims to encourage the Member States to follow a sound budgetary policy, not allowing monetary financing of public deficits or privileged access by public authorities to the financial markets to lead to excessively high levels of debt or excessive Member State deficits.[138]

[133] Article 6 of Regulation (EC) No 3603/93.

[134] Opinion CON/2013/3.

[135] Opinions CON/2009/23, CON/2009/67 and CON/2012/9.

[136] See, among others, Opinions CON/2010/54, CON/2010/55 and CON/2013/62.

[137] Opinion CON/2012/9.

[138] See, to that effect, *Smaranda Bara and Others* v *Casa Naţională de Asigurări de Sănătate and Others*, C-201/14, EU:C:2015:638, paragraph 22; and *Peter Gauweiler and Others* v *Deutscher Bundestag*, C-62/14, EU:C:2015:400, paragraph 100.

Under Article 1(1) of Council Regulation (EC) No 3604/93,[139] privileged access is understood as any law, regulation or other binding legal instrument adopted in the exercise of public authority which: (a) obliges financial institutions to acquire or to hold liabilities of EU institutions or bodies, central governments, regional, local or other public authorities, other bodies governed by public law or public undertakings of Member States, or (b) confers tax advantages that only benefit financial institutions or financial advantages that do not comply with the principles of a market economy, in order to encourage those institutions to acquire or hold such liabilities.

As public authorities, NCBs may not take measures granting privileged access to financial institutions by the public sector if such measures are not based on prudential considerations. Furthermore, the rules on the mobilisation or pledging of debt instruments enacted by the NCBs must not be used as a means of circumventing the prohibition on privileged access.[140] Member States' legislation in this area may not establish such privileged access.

Article 2 of Regulation (EC) No 3604/93 defines 'prudential considerations' as those which underlie national laws, regulations or administrative actions based on, or consistent with, EU law and designed to promote the soundness of financial institutions so as to strengthen the stability of the financial system as a whole and the protection of the customers of those institutions. Prudential considerations seek to ensure that banks remain solvent with regard to their depositors.[141] In the area of prudential supervision, EU secondary legislation has established a number of requirements to ensure the soundness of credit institutions.[142] A 'credit institution' has been defined as an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account.[143] Additionally, credit institutions, commonly referred to as 'banks', require an authorisation by a competent Member State authority to provide services.[144]

Although minimum reserves might be seen as a part of prudential requirements, they are part of an NCB's operational framework and used as a monetary policy tool in most economies, including in the euro area.[145] In this respect, paragraph 2 of Annex I to Guideline ECB/2014/60[146] states that the Eurosystem's minimum reserve system primarily pursues the aims of stabilising the money market interest rates and creating

[139] Council Regulation (EC) No 3604/93 of 13 December 1993 specifying definitions for the application of the prohibition of privileged access referred to in Article 104a of the Treaty [establishing the European Community] (OJ L 332, 31.12.1993, p. 4). Article 104a of the Treaty establishing the European Community is now Article 124 of the Treaty.

[140] Article 3(2) of and recital 10 of Regulation (EC) No 3604/93.

[141] Opinion of Advocate General Elmer in *Société civile immobilière Parodi* v *Banque H. Albert de Bary et Cie.,* C-222/95, EU:C:1997:345, paragraph 24.

[142] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.06.2013, p. 1) and Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.06.2013, p. 338).

[143] Article 4(1)(1) of Regulation (EU) No 575/2013.

[144] Article 8 of Directive 2013/36/EU.

[145] This is supported by Article 3(2) and recital 9 of Regulation (EC) No 3604/93.

[146] Guideline (EU) 2015/510 of the European Central Bank of 19 December 2014 on the implementation of the Eurosystem monetary policy framework (General Documentation Guideline) (ECB/2014/60) (OJ L 91, 2.4.2015, p. 3).

(or enlarging) a structural liquidity shortage.[147] The ECB requires credit institutions established in the euro area to hold the required minimum reserves (in the form of deposits) on account with their NCB.[148]

This report focuses on the compatibility both of national legislation or rules adopted by NCBs and of the NCBs' statutes with the Treaty prohibition on privileged access. However, this report is without prejudice to an assessment of whether laws, regulations, rules or administrative acts in Member States are used under the cover of prudential considerations as a means of circumventing the prohibition on privileged access. Such an assessment is beyond the scope of this report.

2.2.6 Single spelling of the euro

Article 3(4) of the Treaty on European Union lays down that the 'Union shall establish an economic and monetary union whose currency is the euro'. In the texts of the Treaties in all the authentic languages written using the Roman alphabet, the euro is consistently identified in the nominative singular case as 'euro'. In the Greek alphabet text, the euro is spelled 'ευρώ' and in the Cyrillic alphabet text the euro is spelled 'евро'.[149] Consistent with this, Council Regulation (EC) No 974/98 of 3 May 1998 on the introduction of the euro[150] makes it clear that the name of the single currency must be the same in all the official languages of the EU, taking into account the existence of different alphabets. The Treaties thus require a single spelling of the word 'euro' in the nominative singular case in all EU and national legislative provisions, taking into account the existence of different alphabets.

In view of the exclusive competence of the EU to determine the name of the single currency, any deviations from this rule are incompatible with the Treaties and should be eliminated.[151] While this principle applies to all national legislation, the assessment in the country chapters focuses on the NCBs' statutes and the euro changeover laws.

[147] The higher the reserve requirement is set, the fewer funds banks will have to loan out, leading to lower money creation.

[148] See: Article 19 of the Statute; Council Regulation (EC) No 2531/98 of 23 November 1998 concerning the application of minimum reserves by the European Central Bank (OJ L 318, 27.11.1998, p. 1); Regulation (EC) No 1745/2003 of the European Central Bank of 12 September 2003 on the application of minimum reserves (ECB/2003/9) (OJ L 250, 2.10.2003, p. 10); and Regulation (EU) No 1071/2013 of the European Central Bank of 24 September 2013 concerning the balance sheet of the monetary financial institutions sector (ECB/2013/33) (OJ L 297, 7.11.2013, p. 1).

[149] The 'Declaration by the Republic of Latvia, the Republic of Hungary and the Republic of Malta on the spelling of the name of the single currency in the Treaties', annexed to the Treaties, states that; 'Without prejudice to the unified spelling of the name of the single currency of the European Union referred to in the Treaties as displayed on banknotes and on coins, Latvia, Hungary and Malta declare that the spelling of the name of the single currency, including its derivatives as applied throughout the Latvian, Hungarian and Maltese text of the Treaties, has no effect on the existing rules of the Latvian, Hungarian or Maltese languages'.

[150] OJ L 139, 11.5.1998, p. 1.

[151] Opinion CON/2012/87.

2.2.7 Legal integration of NCBs into the Eurosystem

Provisions in national legislation (in particular an NCB's statutes, but also other legislation) which would prevent the performance of Eurosystem-related tasks or compliance with the ECB's decisions are incompatible with the effective operation of the Eurosystem once the Member State concerned has adopted the euro. National legislation therefore has to be adapted to ensure compatibility with the Treaty and the Statute in respect of Eurosystem-related tasks. To comply with Article 131 of the Treaty, national legislation had to be adjusted to ensure its compatibility by the date of establishment of the ESCB (as regards Sweden) and by 1 May 2004, 1 January 2007 and 1 July 2013 (as regards the Member States that joined the EU on these dates). Nevertheless, statutory requirements relating to the full legal integration of an NCB into the Eurosystem need only enter into force at the moment that full integration becomes effective, i.e. the date on which the Member State with a derogation adopts the euro.

The main areas examined in this report are those in which statutory provisions may hinder NCBs' compliance with the Eurosystem's requirements. These include provisions (a) that could prevent NCBs from taking part in implementing the single monetary policy, as defined by the ECB's decision-making bodies, or (b) that could hinder a Governor from fulfilling their duties as a member of the ECB's Governing Council, or (c) that do not respect the ECB's prerogatives, or (d) that do not recognise that the exclusive competence for ESCB-related tasks in Member States whose currency is the euro is irrevocably conferred on the Union,[152] or (e) pursuant to which NCBs in the performance of their ESCB-related tasks are bound by decisions of national authorities that conflict with legal acts of the ECB. Distinctions are made between economic policy objectives, tasks, financial provisions, exchange rate policy and international cooperation. Finally, other areas where NCBs' statutes may need to be adapted are mentioned.

Economic policy objectives

The full integration of an NCB into the Eurosystem requires its statutory objectives to be compatible with the ESCB's objectives, as laid down in Article 2 of the Statute. Among other things, this means that statutory objectives with a 'national flavour' – for example, where statutory provisions refer to an obligation to conduct monetary policy within the framework of the general economic policy of the Member State concerned – need to be adapted. Furthermore, an NCB's secondary objectives must be consistent and not interfere with its obligation to support the general economic policies in the EU with a view to contributing to the achievement of the objectives of the EU as laid down in Article 3 of the Treaty on European Union, which is itself an objective expressed to be without prejudice to maintaining price stability.[153]

[152] Opinion CON/2020/2.

[153] Opinions CON/2010/30 and CON/2010/48.

Tasks

The tasks of an NCB of a Member State whose currency is the euro are predominantly determined by the Treaty and the Statute, given that NCB's status as an integral part of the Eurosystem. In order to comply with Article 131 of the Treaty, provisions on tasks in an NCB's statutes therefore need to be compared with the relevant provisions of the Treaty and the Statute, and any incompatibility must be removed.[154] This applies to any provision that, after adoption of the euro and integration into the Eurosystem, constitutes an impediment to carrying out ESCB-related tasks and in particular to provisions which do not respect the ESCB's powers under Chapter IV of the Statute.

Any national legislative provisions relating to monetary policy must recognise that the EU's monetary policy is to be carried out through the Eurosystem.[155] An NCB's statutes may contain provisions on monetary policy instruments. Such provisions should be comparable to those in the Treaty and the Statute, and any incompatibility must be removed in order to comply with Article 131 of the Treaty.

Monitoring fiscal developments is a task that an NCB carries out on a regular basis to assess properly the stance to be taken in monetary policy. NCBs may also present their views on relevant fiscal developments on the basis of their monitoring activity and the independence of their advice, with a view to contributing to the proper functioning of the European Monetary Union. The monitoring of fiscal developments by an NCB for monetary policy purposes should be based on the full access to all relevant public finance data. Accordingly, the NCBs should be granted unconditional, timely and automatic access to all relevant public finance statistics. However, an NCB's role should not go beyond monitoring activities that result from or are linked – directly or indirectly – to the discharge of their monetary policy mandate.[156] A formal mandate for an NCB to assess forecasts and fiscal developments implies a function for the NCB in (and a corresponding responsibility for) fiscal policymaking which may risk undermining the discharge of the Eurosystem's monetary policy mandate and the NCB's independence.[157]

In the context of the national legislative initiatives to address the turmoil in the financial markets, the ECB has emphasised that any distortion in the national segments of the euro area money market should be avoided, as this may impair the implementation of the single monetary policy. In particular, this applies to the extension of State guarantees to cover interbank deposits.[158]

Member States must ensure that national legislative measures addressing liquidity problems of businesses or professionals, for example their debts to financial institutions, do not have a negative impact on market liquidity. In particular, such

[154] See, in particular, Articles 127 and 128 of the Treaty and Articles 3 to 6 and 16 of the Statute.

[155] First indent of Article 127(2) of the Treaty.

[156] Opinions CON/2012/105, CON/2013/90 and CON/2013/91.

[157] For example, national legislative provisions transposing Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States (OJ L 306, 23.11.2011, p. 41). See Opinions CON/2013/90 and CON/2013/91.

[158] Opinions CON/2009/99, CON/2011/79 and CON/2017/1.

measures may not be inconsistent with the principle of an open market economy, as reflected in Article 3 of the Treaty on European Union, as this could hinder the flow of credit, materially influence the stability of financial institutions and markets and therefore affect the performance of Eurosystem tasks.[159]

National legislative provisions assigning the exclusive right to issue banknotes to the NCB must recognise that, once the euro is adopted, the ECB's Governing Council has the exclusive right to authorise the issue of euro banknotes, pursuant to Article 128(1) of the Treaty and Article 16 of the Statute, while the right to issue euro banknotes belongs to the ECB and the NCBs. National legislative provisions enabling the government to influence issues such as the denominations, production, volume or withdrawal of euro banknotes must also either be repealed or recognition must be given to the ECB's powers with regard to euro banknotes, as set out in the provisions of the Treaty and the Statute. Irrespective of the division of responsibilities in relation to coins between governments and NCBs, the relevant provisions must recognise the ECB's power to approve the volume of issue of euro coins once the euro is adopted. A Member State may not consider currency in circulation as its NCB's debt to the government of that Member State, as this would defeat the concept of a single currency and be incompatible with the requirements of Eurosystem legal integration.[160]

With regard to foreign reserve management,[161] any Member State that has adopted the euro and which does not transfer its official foreign reserves[162] to its NCB is in breach of the Treaty. In addition, any right of a third party – for example, the government or parliament – to influence an NCB's decisions with regard to the management of the official foreign reserves would be inconsistent with the third indent of Article 127(2) of the Treaty. Furthermore, NCBs have to provide the ECB with foreign reserve assets in proportion to their shares in the ECB's subscribed capital. This means that there must be no legal obstacles to NCBs transferring foreign reserve assets to the ECB.

With regard to statistics, although regulations adopted under Article 34.1 of the Statute in the field of statistics do not confer any rights or impose any obligations on Member States that have not adopted the euro, Article 5 of the Statute, which concerns the collection of statistical information, applies to all Member States, regardless of whether they have adopted the euro. Accordingly, Member States whose currency is not the euro are under an obligation to design and implement, at national level, all measures they consider appropriate to collect the statistical information needed to fulfil the ECB's statistical reporting requirements[163] and to make timely preparations in the field of statistics in order for them to become Member States whose currency is the euro.[164] National legislation laying down the framework for cooperation between the

[159] Opinion CON/2010/8.

[160] Opinion CON/2008/34.

[161] Third indent of Article 127(2) of the Treaty.

[162] With the exception of foreign-exchange working balances, which Member State governments may retain pursuant to Article 127(3) of the Treaty.

[163] In this regard, national legislation should ensure consistency with the reporting requirements set out in Union legislation. See Opinion CON/2020/29.

[164] Opinion CON/2013/88.

NCBs and national statistical offices should guarantee the NCBs' independence in the performance of their tasks within the ESCB's statistical framework.[165]

Financial provisions

The financial provisions in the Statute comprise rules on financial accounts,[166] auditing,[167] capital subscription,[168] the transfer of foreign reserve assets[169] and the allocation of monetary income.[170] NCBs must be able to comply with their obligations under these provisions and therefore any incompatible national provisions must be repealed.

Exchange rate policy

A Member State with a derogation may retain national legislation which provides that the government is responsible for the exchange rate policy of that Member State, with a consultative and/or executive role being granted to the NCB. However, by the time that a Member State adopts the euro, such legislation must reflect the fact that responsibility for the euro area’s exchange rate policy has been transferred to the EU level in accordance with Articles 138 and 219 of the Treaty.

International cooperation

For the adoption of the euro, national legislation must be compatible with Article 6.1 of the Statute, which provides that in the field of international cooperation involving the tasks entrusted to the Eurosystem, the ECB decides how the ESCB is represented. National legislation allowing an NCB to participate in international monetary institutions must make such participation subject to the ECB’s approval (Article 6.2 of the Statute).

Miscellaneous

In addition to the above issues, for certain Member States there are other areas where national provisions need to be adapted (for example in the area of clearing and payment systems and the exchange of information).

[165] Opinions CON/2015/5 and CON/2015/24.

[166] Article 26 of the Statute.

[167] Article 27 of the Statute.

[168] Article 28 of the Statute.

[169] Article 30 of the Statute.

[170] Article 32 of the Statute.

3 The state of economic convergence

This chapter provides a horizontal overview. Some factors relevant for the overall assessment are not covered here, but in Chapters 4 and 5.

Mainly owing to challenging economic conditions, limited progress has been made as regards compliance with the convergence criteria since the ECB's 2020 Convergence Report (Table 3.1). In five of the seven countries examined in the report, HICP inflation is well above the reference value, as was the case in 2020. Since April 2020 the 12-month averages of long-term interest rate differentials versus the euro area has declined slightly in one country and remained virtually flat in three of the seven countries considered in the report, while it has increased – albeit to quite different extents – in the other three countries. The long-term interest rate was above the reference value in two countries and well above it in one country, compared with only one country above the reference value in 2020. Two countries (Bulgaria and Croatia) joined the exchange rate mechanism (ERM II) in July 2020. The currencies of some countries examined in this report have experienced sizeable fluctuations against the euro over the last few years and some currencies have recorded a significant depreciation since Russia's invasion of Ukraine on 24 February 2022. No progress has been made on reducing fiscal imbalances in most of the countries on account of the substantial deterioration in economic activity triggered by the COVID-19 pandemic and the fiscal measures adopted to mitigate its impact.

At the end of February 2022, the energy, commodity, foreign exchange and global capital markets experienced significant shocks originating from the Russia-Ukraine conflict. Such disturbances are likely to have had a particularly sizeable impact on central and eastern European countries. In particular, inflation has further increased owing to rising energy and commodity prices. As seen in recent inflation developments, price pressures are also increasingly broad-based and inflation could remain elevated and higher than previously expected in the coming months, driven by war-induced commodity price increases, broadening price pressures and further aggravated supply bottlenecks. The future magnitude of the impact of the Russia-Ukraine conflict on the countries under review and more generally on the EU economy is largely uncertain at this stage and will depend not least on the duration of the war and on the policy responses made. Global supply chains, in which the EU is highly integrated, were already under pandemic-induced stress and the war may result in permanent supply chain reconfiguration, affecting economic prospects and price levels in the medium term. The overall transmission of the war shock will vary across the countries under review, depending on trade and financial linkages, exposure to commodity price increases and the strength of the pre-existing inflation surge.

Table 3.1
Overview table of economic indicators of convergence

		Price stability	Government budgetary developments and projections			Exchange rate		Long-term interest rate [6]
		HICP inflation [1]	Country in excessive deficit [2], [3]	General government surplus (+)/ deficit (-) [4]	General government debt [4]	Currency participating in ERM II [3]	Exchange rate vis-à-vis the euro [5]	
Bulgaria	2020	1.2	No	-4.0	24.7	Yes	0.0	0.3
	2021	2.8	No	-4.1	25.1	Yes	0.0	0.2
	2022	5.9	No	-3.7	25.3	Yes	0.0	0.5
Czech Republic	2020	3.3	No	-5.8	37.7	No	-3.1	1.1
	2021	3.3	No	-5.9	41.9	No	3.1	1.9
	2022	6.2	No	-4.3	42.8	No	3.9	2.5
Croatia	2020	0.0	No	-7.3	87.3	Yes	-1.6	0.8
	2021	2.7	No	-2.9	79.8	Yes	0.1	0.4
	2022	4.7	No	-2.3	75.3	Yes	-0.2	0.8
Hungary	2020	3.4	No	-7.8	79.6	No	-8.0	2.2
	2021	5.2	No	-6.8	76.8	No	-2.1	3.1
	2022	6.8	No	-6.0	76.4	No	-3.1	4.1
Poland	2020	3.7	No	-6.9	57.1	No	-3.4	1.5
	2021	5.2	No	-1.9	53.8	No	-2.7	1.9
	2022	7.0	No	-4.0	50.8	No	-1.5	3.0
Romania	2020	2.3	Yes	-9.3	47.2	No	-2.0	3.9
	2021	4.1	Yes	-7.1	48.8	No	-1.7	3.6
	2022	6.4	Yes	-7.5	50.9	No	-0.5	4.7
Sweden	2020	0.7	No	-2.7	39.6	No	1.0	0.0
	2021	2.7	No	-0.2	36.7	No	3.2	0.3
	2022	3.7	No	-0.5	33.8	No	-3.0	0.4
Reference value [7]		4.9		-3.0	60.0			2.6

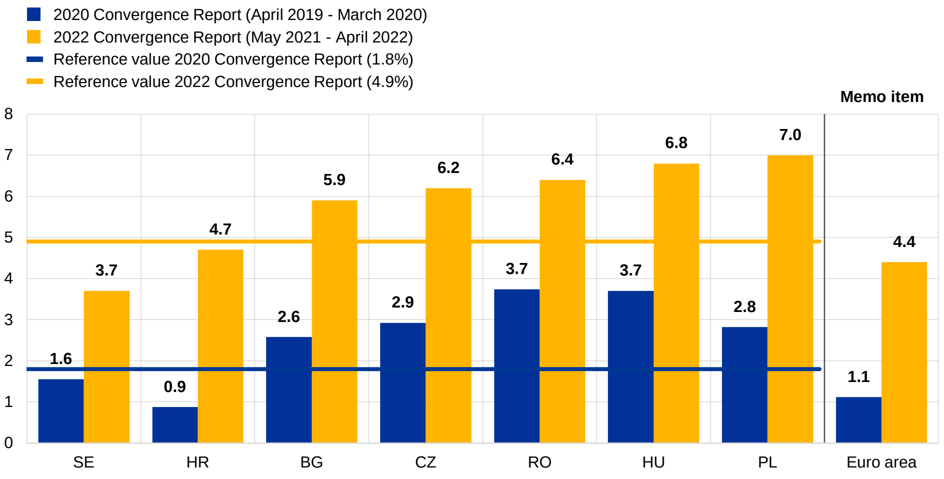
Sources: European Commission (Eurostat, Directorate-General for Economic and Financial Affairs) and European System of Central Banks.
1) Average annual percentage change. Data for 2022 refer to the period from May 2021 to April 2022.
2) Refers to whether a country was subject to an EU Council decision on the existence of an excessive deficit for at least part of the year.
3) The information for 2022 refers to the period up to the cut-off date for statistics (25 May 2022).
4) As a percentage of GDP. Data for 2022 are taken from the European Commission's Spring 2022 Economic Forecast.
5) Annual percentage change. A positive (negative) number denotes appreciation (depreciation) vis-à-vis the euro. Data for 2022 refer to the period from 1 January 2022 to 25 May 2022.
6) Average annual interest rate. Data for 2022 refer to the period from May 2021 to April 2022.
7) The reference values for HICP inflation and long-term interest rates refer to the period from May 2021 to April 2022; for the general government balance and debt, the reference values referred to in Article 126(2) of the Treaty are specified in the related Protocol (No 12) on the excessive deficit procedure.

After the publication of the previous Convergence Report in 2020, the EU experienced a longer than initially expected COVID-19 shock, which led to a significant drop-in economic activity in 2020, from which all the countries under review rebounded strongly. More recently, however, the outbreak of the Russia-Ukraine conflict in February 2022 has weighed on economic activity and is clouding economic prospects for at least 2022. The onset of the COVID-19 pandemic in March 2020 resulted in a large drop in economic activity in the second quarter of 2020 in all the countries under review. However, the phasing out of containment measures and the introduction of major fiscal, prudential and monetary policy measures to offset the economic damage from the pandemic bolstered the rebound in economic activity in subsequent quarters. Despite supply side bottlenecks, economic activity recovered strongly in the seven countries under review in 2021, mainly driven by robust domestic demand and dynamic labour market developments. In Croatia, a strong export performance was also a factor. The situation in the labour market rapidly improved when restrictions linked to the COVID-19 pandemic were eased, supported by the policy measures implemented by the authorities. As a result, labour market conditions have remained tight in most cases. In some countries, further progress has been made towards correcting external imbalances and reducing dependence on external funding. This has enhanced the resilience of those countries. However, significant macroeconomic and financial vulnerabilities persist, albeit to differing degrees depending on the country. If not adequately addressed in countries with lower GDP per capita, such vulnerabilities are likely to slow their convergence progress over the long term, including in response to adverse external shocks. Since early 2022 the Russia-Ukraine conflict has weighed on economic activity and prospects, while adding inflationary pressures through higher energy and commodity prices. Commodity prices have increased strongly and vulnerabilities stemming from a high dependence on imported energy and some other inputs from a single country (such as Russia) have come to the fore.

Regarding the price stability criterion, the 12-month average inflation rate was well above the reference value of 4.9% in five of the seven countries examined in the report (Chart 3.1). Bulgaria, the Czech Republic, Hungary, Poland and Romania recorded inflation rates well above the reference value, while rates were below the reference rate in Croatia and well below in Sweden. In the 2020 Convergence Report, Bulgaria, the Czech Republic, Hungary, Poland and Romania, recorded inflation rates well above the reference value applicable at that time, which was 1.8%.

Chart 3.1
HICP inflation

(average annual percentage changes)

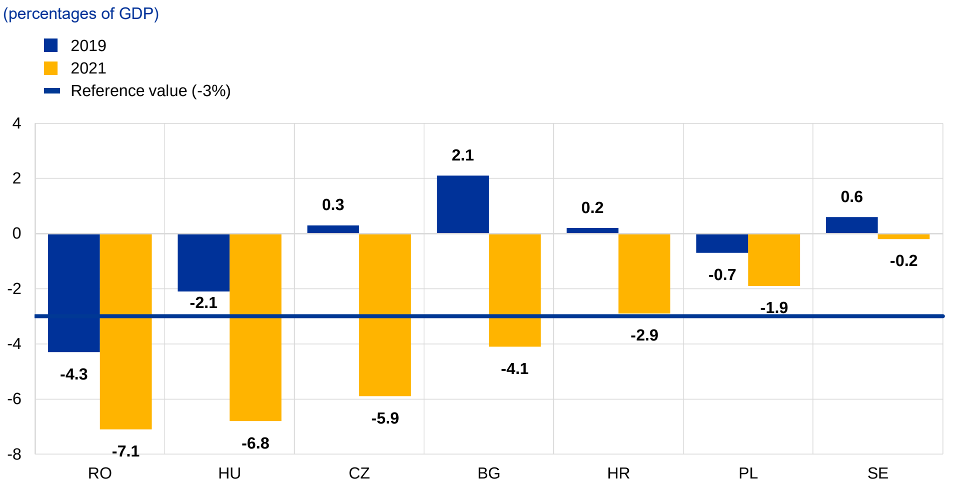


Source: Eurostat.

At the time of publication of this report, only Romania is subject to an excessive deficit procedure. Although four of the countries under review exceeded the

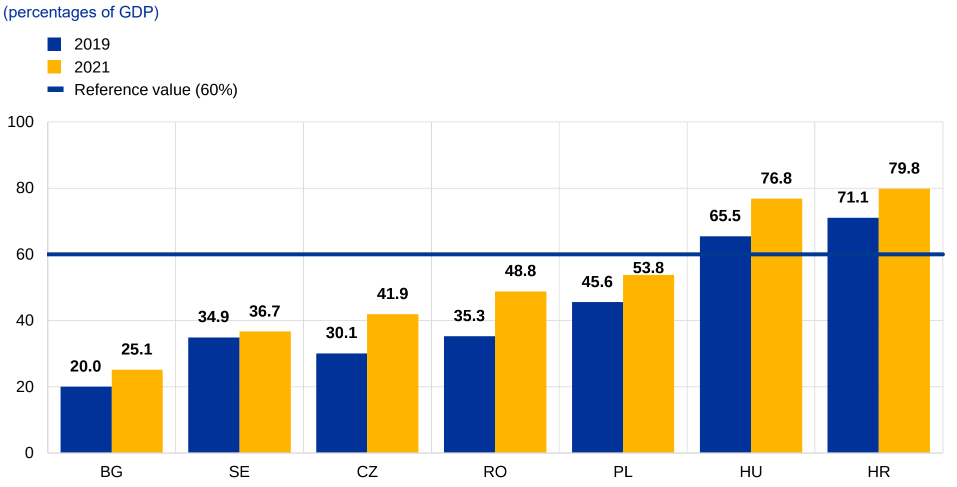
deficit reference value in 2021, no new excessive deficit procedures were opened. In the wake of the COVID-19 crisis, budget deficits increased sharply in all countries in 2020 and, except in Sweden, remained at elevated levels in 2021. Compared to the previous year, the budget balance improved in 2021 in all countries except Bulgaria and the Czech Republic. Nonetheless, four of the countries under review recorded budgets deficits above the 3% reference value in 2021, with the highest deficits being recorded in Hungary and Romania at 6.8% and 7.1% of GDP respectively (Chart 3.2). Moreover, the reference value was also exceeded by Bulgaria and the Czech Republic, which recorded deficits of 4.1% and 5.9% of GDP respectively. In 2022 the deficit-to-GDP ratio is expected to improve in four countries, according to the European Commission’s Spring 2022 Economic Forecast, and it is expected to remain above the 3% reference value in all countries except Croatia and Sweden. In 2023 a further improvement in the budget balance is expected in six countries, but it is expected to continue to exceed the reference value in the Czech Republic, Hungary, Poland and Romania. Regarding the debt criterion, in Bulgaria and Sweden, the debt ratio was 25.1% and 36.7% of GDP respectively in 2021 (Chart 3.3). In the Czech Republic, Poland and Romania, the debt ratio was between 40% and 60% of GDP. Croatia and Hungary were the only countries with a general government debt-to-GDP ratio above the 60% reference value in 2021, as was also the case in 2019. In both countries the debt ratios were on a diminishing trajectory from 2014 to 2019 and were approaching 60% of GDP at a satisfactory pace until the end of 2019. As a result of the COVID-19 pandemic, debt ratios in both countries rose by about 15 percentage points of GDP in 2020, before falling again in 2021. An assessment of government debt sustainability over the medium term is particularly important in a context in which the Stability and Growth Pact’s general escape clause has been applied over the past three consecutive years, i.e. 2020, 2021 and 2022. Moreover, it is also expected to remain in place in 2023. The European Commission concluded in May 2022 that the government deficit criterion had not been fulfilled in Bulgaria, the Czech Republic and Hungary based on their outcomes in 2021, as well as in Poland based on its planned deficit in 2022, and that the debt criterion had not been fulfilled in Hungary. However, taking into account the exceptional uncertainty created by the continued extraordinary macroeconomic and fiscal impact of the COVID-19 pandemic, together with the invasion of Ukraine by Russia, the Commission did not propose opening new excessive deficit procedures at that stage. Nevertheless, it stated that it would reassess the relevance of proposing to open excessive deficit procedures in autumn 2022. Romania is subject to an excessive deficit procedure, which was launched in April 2020 and was kept in abeyance on the basis of the achievement of the required headline deficit target and fiscal effort in 2021.

Chart 3.2
General government surplus (+) or deficit (-)



Source: Eurostat.
Note: Data for 2019 have been revised slightly since the 2020 Convergence Report.

Chart 3.3
General government gross debt



Source: Eurostat.
Note: Data for 2019 have been revised slightly since the 2020 Convergence Report.

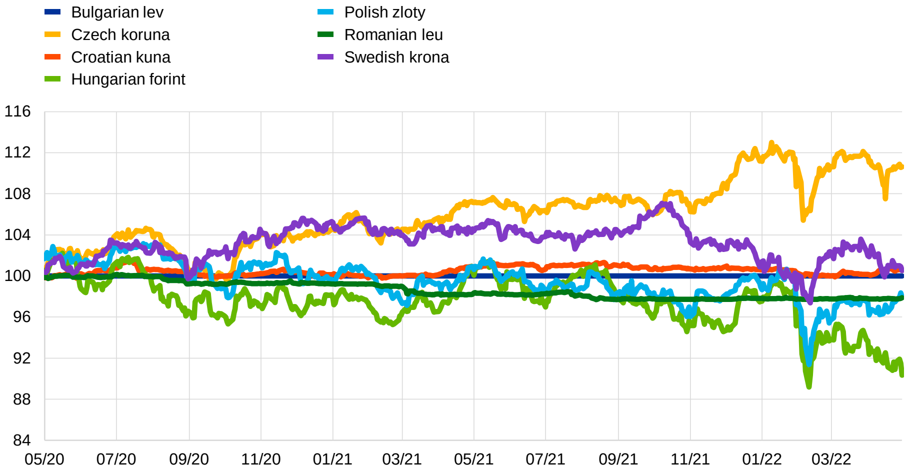
As regards the exchange rate criterion, on 10 July 2020 the ERM II parties decided, by mutual agreement, to include the Bulgarian lev and the Croatian kuna in ERM II, and the two currencies therefore participated in ERM II for most of the two-year reference period from 26 May 2020 to 25 May 2022. The Bulgarian lev was included in ERM II at a central rate of 1.95583 levs per euro, while the Croatian kuna was included at a central rate of 7.53450 kuna per euro.[171] Both currencies participate with the standard fluctuation band of ±15%. Bulgaria joined the

[171] For the purpose of this report exchange rates are quoted in units of national currency per euro. Thus a decrease in the exchange rate corresponds to an appreciation of the currency against the euro, whereas an increase in the exchange rate corresponds to a depreciation of the currency against the euro with the corresponding percentage changes indicating the degree of appreciation or depreciation of the currency.

exchange rate mechanism with its existing currency board in place as a unilateral commitment, thus placing no additional obligations on the ECB. The agreement on participation in ERM II was based on a number of policy commitments made by the Bulgarian and Croatian authorities (some of which were already fulfilled by the time of the inclusion of their currencies in ERM II – "prior commitments") with the aim of achieving a high degree of sustainable economic convergence by the time of euro adoption. The ECB and the European Commission have monitored the effective implementation of these commitments, acting within their respective areas of competence as provided for by the Treaties and secondary legislation. As regards Croatia, all deliverables envisaged in the ERM II "post-entry commitments" have been completed, while for Bulgaria they are broadly on track. However, further progress needs to be made to address outstanding shortcomings in the area of anti-money laundering (AML) in Croatia, as identified in the recent report by the Council of Europe's Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (MONEYVAL). Over the two-year reference period the Bulgarian lev did not exhibit any deviation from its central rate, while the Croatian kuna displayed a low degree of volatility and traded close to its central rate. Since the kuna's inclusion in ERM II in July 2020, and over the entire reference period, the maximum upward deviation from the central rate has been 1.0%, while the maximum downward deviation has amounted to 0.8%. These deviations are significantly smaller than the standard fluctuation band of ERM II. Among the currencies not participating in ERM II, the Romanian leu displayed very low volatility, while the remaining currencies were subject to relatively high volatility over most of the reference period.

Chart 3.4
Bilateral exchange rates vis-à-vis the euro

(index: average of May 2020 = 100; daily data; 26 May 2020 - 25 May 2022)



Source: ECB.
Note: An upward (downward) movement indicates appreciation (depreciation) of the currency.

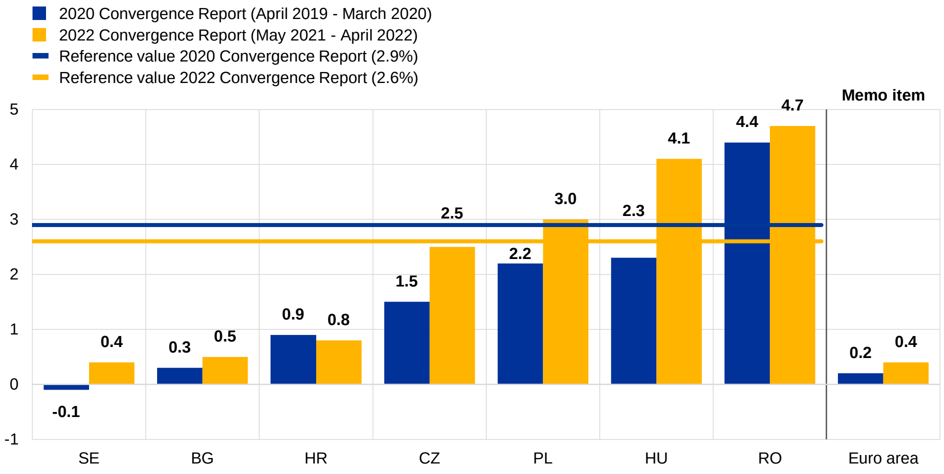
With regard to the convergence of long-term interest rates, two of the seven countries under review recorded long-term interest rates above the reference value, which was 2.6%. One country recorded a long-term interest rate well

above the reference value (Chart 3.5). Interest rates were above the reference value in Poland and Hungary, and well above it in Romania. The lowest values – all below 1% – were recorded in Bulgaria, Croatia and Sweden. By comparison, in the 2020 Convergence Report, only Romania had a long-term interest rate above the reference value, which at that time was 2.9%.

Chart 3.5

Long-term interest rates

(percentages, annual averages)



Sources: Eurostat and ECB.

When considering compliance with the convergence criteria, sustainability is essential. Convergence must be achieved on a lasting basis and not just at a given point in time. The first decade of Economic and Monetary Union (EMU) showed that weak fundamentals, an excessively loose macroeconomic stance and inadequate statistical capacity at the country level and overly optimistic expectations about convergence in real incomes pose risks not only for the countries concerned but also for the smooth functioning of the euro area as a whole. The second decade showed that economic convergence can be challenging and take a long time if initial macroeconomic imbalances are large, adjustment and reform processes are difficult and resilience to adverse shocks is weak. Compliance with the numerical convergence criteria at a single point in time is, by itself, not a guarantee of smooth membership of the euro area. Countries joining the euro area should therefore demonstrate the sustainability of their convergence processes and their capacity to live up to the ongoing commitments and challenges which euro adoption represents, taking into account that risk-sharing mechanisms within EMU are incomplete. This is in the country's own interest, as well as in the interest of the euro area.

To achieve sustainable convergence, lasting policy adjustments are required in many of the countries under review. A prerequisite for sustainable convergence is macroeconomic stability, a supportive business environment with efficient economic structures and public institutions and, in particular, a sound fiscal policy. A high degree of flexibility in product and labour markets is essential to cope with macroeconomic shocks. A stability culture needs to exist, with well-anchored inflation expectations helping to achieve an environment of price stability. Favourable conditions for the efficient use of capital and labour in the economy are needed to enhance total factor productivity and long-run economic growth. A high degree of economic integration with the euro area is needed to achieve the synchronisation of business cycles. Moreover, appropriate macroprudential policies need to be in place to prevent the build-up of macroeconomic and financial imbalances, such as excessive asset price increases and socially costly boom-bust credit cycles. An appropriate framework for the supervision of financial institutions also needs to be in place. For countries subject to in-depth reviews by the European Commission in the framework of the Macroeconomic Imbalance Procedure, it is essential that they address imbalances in their economies. Finally, the strength of the institutional environment, including a country's ability to implement economic adjustment and sound structural policies, is a major factor in economic integration and convergence. The Next Generation EU (NGEU) package represents a unique opportunity to accelerate the process of convergence with the euro area, with swift and effective implementation being crucial for its success.

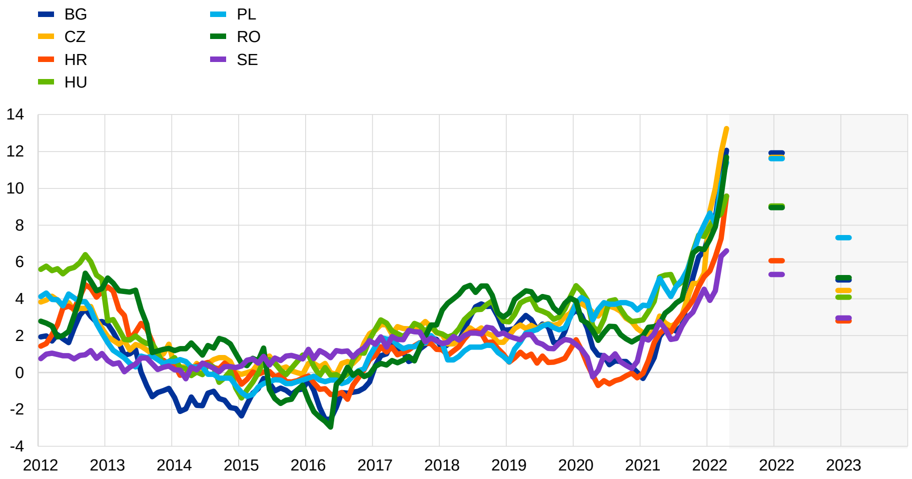
3.1 The price stability criterion

In April 2022 five of the seven countries under review recorded a 12-month average inflation rate well above the reference value of 4.9% for the price stability criterion. With the outbreak of the COVID-19 pandemic, inflation decelerated significantly in the euro area in 2020, before rising sharply in 2021, largely driven by base effects, strong increases in energy prices, particularly at the end of 2021, supply bottlenecks triggered by the pandemic and strong increases in global demand for goods. Since the previous Convergence Report, in most of the countries under review inflation has followed a similar pattern, but between May 2021 and April 2022 inflation was higher in Bulgaria, the Czech Republic, Hungary, Poland and Romania, reflecting higher food and energy prices as well as the tightness of the labour market. Against this background, these five countries recorded inflation rates well above the reference value, while inflation rates were below the reference value in Croatia and well below it in Sweden. Since early 2022 the conflict between Russia and Ukraine has added inflationary pressures through higher energy and commodity prices and by adding strains to already stretched supply chains. Consequently, inflation further increased in all countries under review at the beginning of 2022, albeit to different degrees.

Over the past ten years, both the average rate and the volatility of inflation have varied significantly across the countries examined (Chart 3.6). Over this period, Hungary and Romania recorded average HICP inflation rates above 2.0%. In the Czech Republic the average inflation rate was 2.0%, and in Poland it was slightly below that level. In Bulgaria, Croatia and Sweden inflation has averaged around 1.0%. Over the same period, inflation has fluctuated over a relatively wide range in all the countries under review, except Sweden. In countries with positive inflation differentials vis-à-vis the euro area, limited progress has been made towards convergence over the past decade. Meanwhile, the evolution of inflation differentials vis-à-vis the euro area over the reference period from May 2020 to April 2022 was heterogeneous across the countries under review.

Chart 3.6
Long-term HICP developments and outlook

(annual percentage changes)



Sources: Eurostat, European Commission (Directorate-General for Economic and Financial Affairs) and ECB.
Notes: Solid lines depict annual percentage changes in the monthly HICP. In the shaded area, projections of annual HICP inflation from the European Commission's Spring 2022 Economic Forecast are shown.

Longer-term price developments mirrored a more volatile macroeconomic environment in many countries. Looking at the past decade, heterogeneous price developments across the countries under review in 2012 partly reflected differences in the strength of the economic recovery and country-specific measures related to administered prices following the abrupt economic downturn in that year. However, in 2013 inflation embarked on a downward trend in all countries under review, reaching historical lows and often even negative rates. This broad-based movement mainly reflected developments in global commodity prices, low imported inflationary pressures and persistent spare capacity in some countries. The developments in global commodity prices have had a particularly pronounced impact on the central and eastern European economies, given the relatively large weights of energy and food in their HICP baskets. In some of the countries under review, reductions in administered prices and indirect taxes or a strengthening of the nominal effective exchange rate also exerted downward pressure on inflation. Against this backdrop, monetary policy conditions were loosened considerably. From 2017 inflation accelerated significantly, owing to the strengthening of economic activity, solid domestic demand and rising energy and commodity prices, prompting a tightening of the monetary policy stance in some of the countries under review. In 2019 and at the beginning of 2020, despite external headwinds and lower energy prices, inflation remained elevated in most countries considered in the report, driven by robust domestic demand, increasingly tight labour market conditions and food prices. The outbreak of the COVID-19 pandemic in March 2020 resulted in a large drop in economic activity in the second quarter of 2020 in all the countries under review. Inflation slowed significantly in some countries, while it remained particularly resilient in others, reflecting higher food and services prices as well as the tightness of the labour market. However, the relaxation of containment measures and the introduction of major fiscal, prudential and monetary policy measures by the national authorities to offset the economic damage wrought by the COVID-19 pandemic bolstered the subsequent rebound in economic activity. In this context, inflation increased significantly in all countries under review in 2021, largely driven by sharp increases in energy prices, particularly at the end of 2021, and by the supply-demand mismatches triggered by the pandemic and the macroeconomic policy responses. Since early 2022 the conflict between Russia and Ukraine has added to the inflationary pressures. A number of central banks strongly increased their main policy rates on several occasions in the course of 2021 and early 2022.

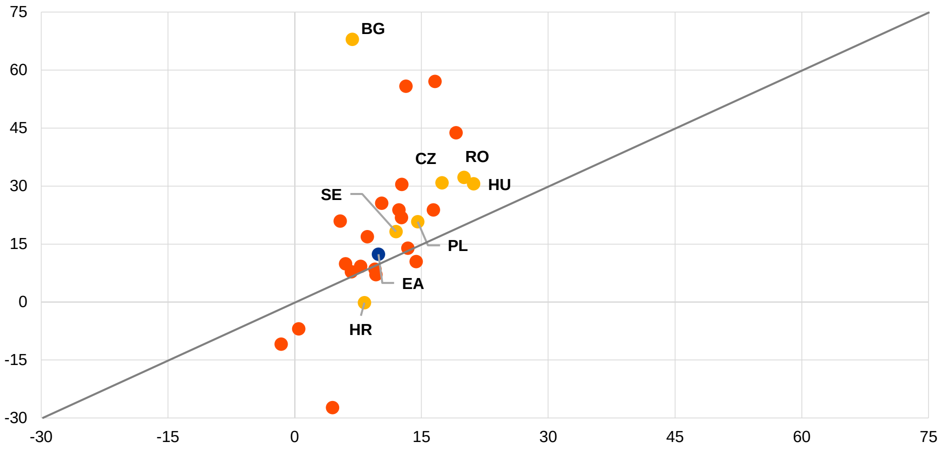
Inflation is expected to remain elevated in the coming quarters before gradually declining over the forecast horizon in all the countries under review. However, the forecasts are subject to considerable uncertainty given the current circumstances. Over the longer term there are concerns about the sustainability of inflation convergence in most of the countries examined. According to the European Commission’s Spring 2022 Economic Forecast, inflation is expected to significantly increase in all the countries under review in 2022, before declining in 2023 owing to lower energy and commodity prices and the easing of supply bottlenecks. However, inflation is expected to remain high in Bulgaria, the Czech Republic, Hungary, Poland and Romania over the forecast horizon and significantly above 2.0% in Croatia and Sweden. The risks to the inflation outlook are tilted to the upside in all the countries under review, as inflationary pressures stemming from the Russia-Ukraine conflict could last longer than previously expected and could also trigger an upward shift in wage growth and inflation expectations. Looking further ahead, since GDP per capita and price levels are still lower than in the euro area in all the central and eastern European countries under review, the catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area, unless counteracted by a rise in the nominal exchange rate.

An environment that is conducive to sustainable price stability in the countries covered in this report requires stability-oriented economic policies, structural reforms and measures to safeguard financial stability. Achieving or maintaining an environment supportive of price stability will crucially depend on the implementation of further structural reforms and the functioning of labour markets. Looking forward, an important factor will be how wages react to high realised inflation and how they reflect labour productivity growth and take into account labour market conditions and developments in competitor countries (Chart 3.7). Continued reform effort is needed to further improve the functioning of labour and product markets and to maintain favourable conditions for economic expansion and employment growth. To this end, measures to support stronger governance and further improvements in the quality of institutions are essential. Given the limited room for manoeuvre in monetary policy, especially for the two countries in ERM II, it is imperative that other policy areas support the capacity of these economies to maintain price stability, cope with country-specific shocks and avoid the build-up of macroeconomic imbalances. Financial sector and supervisory policies should be aimed at further safeguarding financial stability. In order to further bolster confidence in the financial system, the national competent authorities should continue to improve their supervisory practices by, among other things, following the applicable recommendations of the relevant international and European bodies and by collaborating closely with national supervisors of other EU Member States within the supervisory colleges.

Chart 3.7

Cumulative HICP and nominal unit labour cost (ULC) growth in 2012-21

(percentage points)



Source: Eurostat.
Notes: The chart shows cumulative ULC growth on the y-axis and cumulative HICP growth on the x-axis. The solid line represents the bisector. HICP growth is computed from monthly data aggregated to average annual data. The blue dot depicts the euro area aggregate, the yellow dots depict the seven countries under review (labelled) and the orange dots depict the remaining Member States (unlabelled).

3.2 The government budgetary position criterion

At the time of publication of this report, only Romania is subject to an excessive deficit procedure. The deficit in Romania exceeded the 3% of GDP reference value in 2019 and an excessive deficit procedure was opened in April 2020. The procedure is being kept in abeyance on the basis of the achievement of the required headline deficit target and fiscal effort in 2021. The deadline for correction of the excessive deficit is 2024. The fiscal deficit-to-GDP ratios of four countries exceeded the reference value in 2021. The deficits were well above the reference value in Bulgaria and the Czech Republic, amounting to 4.1% and 5.9% of GDP respectively, and significantly above the reference value in Hungary and Romania, amounting to 6.8% and 7.1% of GDP respectively. The deficit in Croatia remained just below the reference value at 2.9% of GDP and the deficit in Poland was well below it at 1.9% of GDP. Sweden remained close to a balanced budget, posting a deficit of 0.2% of GDP.

The fiscal balance in 2021 was below its 2019 level in all countries covered in this report on account of the economic impact of the COVID-19 pandemic and the fiscal policy measures taken in response to it. In 2020 the budget balance deteriorated in all countries as the COVID-19 crisis led to a substantial deterioration in economic activity and fiscal measures were adopted to mitigate its impact. While the deficit-to-GDP ratio only exceeded the 3% reference value in Romania in 2019, it rose above this level in six countries in 2020. In 2021 the budget balances improved in all countries except Bulgaria and the Czech Republic as the economies recovered and parts of the fiscal support measures were withdrawn. The further deterioration in Bulgaria is due to strong current expenditure growth, while the deterioration in the Czech Republic is related to a reform of personal income tax.

For 2022 the European Commission forecasts that the deficit-to-GDP ratio will remain below the 3% reference value only in Croatia and Sweden. Owing to a further improvement in economic activity and the withdrawal of most of the remaining fiscal support measures, the government balance is projected to increase in four countries. However, while it is expected to remain below the 3% reference value in Croatia and Sweden, it is projected to remain above it in Bulgaria and Poland, well above it in the Czech Republic and Hungary, and significantly above it in Romania.

In 2021 the debt ratio was above 60% of GDP in Croatia and Hungary, while in the other countries under review the debt levels were below or well below this threshold (Table 3.1 and Chart 3.3). The government debt-to-GDP ratio in 2021 was above its 2019 level in all countries under review, mostly on account of the COVID-19 crisis. The debt ratio increased by 13.5 percentage points of GDP in Romania, 11.8 in the Czech Republic, 11.3 in Hungary, 8.7 in Croatia, 8.2 in Poland, 5.1 in Bulgaria and 1.8 in Sweden. Taking a longer perspective, between 2012 and 2021 the government debt-to-GDP ratio increased strongly in Romania (by 11.7 percentage points) and Croatia (by 10.4 percentage points) and increased significantly in Bulgaria (by 8.5 percentage points), while it declined in the other countries.

For 2022 the European Commission projects an increase in debt-to-GDP ratios in three countries. While the debt ratio is expected to decline in four countries, it is projected to increase moderately in Bulgaria and the Czech Republic and notably in Romania. The Commission's projections indicate that the debt ratio will remain below or well below the 60% reference value in all countries in 2022, with the exception of Croatia and Hungary.

Even though the European Commission assessed that several countries had not fulfilled the deficit and debt criteria in 2021, it decided not to initiate new excessive deficit procedures. On 23 May 2022, the European Commission published a report prepared in accordance with Article 126(3) of the Treaty based on data validated by Eurostat on 22 April 2021.[172] It found that in 2021 the budget deficit was above and not close to the 3% of GDP reference value in Bulgaria, the Czech Republic and Hungary. Moreover, it found that Poland was planning a deficit above and not close to the reference value in 2022. The excess over the reference value was considered to be exceptional, as defined by the Treaty, in all countries under review, and was not expected to be temporary in the Czech Republic, Hungary or Poland. Overall, the analysis suggested that the deficit criterion was not fulfilled by Bulgaria, the Czech Republic, Hungary and Poland. Moreover, the European Commission found that the general government gross debt had exceeded the 60% of GDP reference value at the end of 2021 in Croatia and Hungary, and that of those two countries only Croatia had complied with the debt reduction benchmark. Consequently, the Commission's analysis suggested that the debt criterion had not

[172] Report prepared in accordance with Article 126(3) of the Treaty on the Functioning of the European Union (COM (2022) 630 final).

been fulfilled by Hungary. Nevertheless, in the Commission's view, the need to comply with the debt reduction benchmark was not warranted under the current exceptional economic conditions, as it would imply too demanding a frontloaded fiscal effort that risked jeopardising growth. Moreover, the Commission's report stressed that the COVID-19 pandemic had continued to have an extraordinary macroeconomic and fiscal impact that, together with the invasion of Ukraine by Russia, had created exceptional uncertainty, including for designing a detailed fiscal adjustment path. Beyond this, the pandemic and the related severe economic downturn had led to the general escape clause of the Stability and Growth Pact being activated and to the Council recommendations of 20 July 2020, in which the Council recommended that all Member States take all necessary measures to effectively address the COVID-19 pandemic, sustain the economy and support the ensuing recovery. Therefore, the European Commission stated in its Communication of 23 May 2022[173] that it did not propose opening new excessive deficit procedures at that stage, but would reassess the relevance of proposing to open excessive deficit procedures in autumn 2022.

Looking ahead, while fiscal policy should remain agile in its response to the evolving pandemic situation, and given the geopolitical situation, it is essential for the countries examined in this report to achieve and/or maintain sound and sustainable fiscal positions. Romania, which is subject to an excessive deficit procedure, should ensure compliance with the rules of the Stability and Growth Pact and correct its excessive deficit by 2024. The other countries should return their budget balances to below the 3% reference value as soon as the pandemic situation allows and build the buffers needed to allow automatic stabilisers to work. Moreover, Croatia and Hungary, whose debt-to-GDP ratios exceed the reference value, should ensure that their ratio is declining sufficiently to ensure that fiscal buffers are available for any future downturn. An assessment of government debt sustainability over the medium term is particularly important in a context in which the Stability and Growth Pact's general escape clause has been applied over the past three consecutive years, i.e. 2020, 2021 and 2022. Moreover, it is expected to remain in place in 2023. Moreover, for 2023 the Commission has provided guidance on fiscal policies in the EU that is largely qualitative and different from the numerical fiscal requirements that the Stability and Growth Pact would usually entail. This also reflects an ongoing review of the economic governance framework, which may lead to a reformed Stability and Growth Pact. In the absence of numerical fiscal adjustment requirements, an assessment of fiscal sustainability over the medium term should put particular emphasis on the ability of countries to correct fiscal imbalances. Generally, further consolidation would make it easier to deal with the budgetary challenges related to adverse demographic developments. Strong national fiscal frameworks that are fully in line with EU rules and implemented effectively should support fiscal consolidation and limit slippages in public expenditure, while helping to prevent a re-emergence of macroeconomic imbalances. Overall, fiscal strategies should be consistent with comprehensive structural reforms to increase potential growth and employment. The

[173] European Commission, 2022 European Semester - Spring Package (COM (2022) 600 final).

NGEU programme needs to be implemented effectively in order to support the recovery and to adjust to the structural changes that are under way.[174]

3.3 The exchange rate criterion

At the time of publication of this report, the Bulgarian lev and the Croatian kuna are participating in ERM II. The currencies of the other Member States under review operate under different exchange rate regimes.

On 10 July 2020 the ERM II parties decided, by mutual agreement, to include the Bulgarian lev in ERM II and it therefore participated in ERM II for most of the two-year reference period from 26 May 2020 to 25 May 2022. The Bulgarian lev was included in ERM II at a central rate of 1.95583 levs per euro with a standard fluctuation band of ±15%. Bulgaria joined the exchange rate mechanism with its existing currency board in place as a unilateral commitment, thus placing no additional obligations on the ECB. The agreement on participation in ERM II was based on a number of policy commitments made by the Bulgarian authorities (some of which were already fulfilled by the time of the inclusion of the lev in ERM II) with the aim of achieving a high degree of sustainable economic convergence by the time of euro adoption. The ECB and the European Commission have monitored the effective implementation of these commitments, acting within their respective areas of competence as provided for by the Treaties and secondary legislation. Over the reference period the lev did not exhibit any deviation from the central rate.

On 10 July 2020 the ERM II parties decided, by mutual agreement, to include the Croatian kuna in ERM II and it therefore participated in ERM II for most of the two-year reference period from 26 May 2020 to 25 May 2022. The Croatian kuna was included in ERM II at a central rate of 7.53450 kuna per euro with a standard fluctuation band of ±15%. The agreement on participation in ERM II was based on a number of policy commitments made by the Croatian authorities (some of which were already fulfilled by the time of the inclusion of the kuna in ERM II) with the aim of achieving a high degree of sustainable economic convergence by the time of euro adoption. The ECB and the European Commission have monitored the effective implementation of these commitments, acting within their respective areas of competence as provided for by the Treaties and secondary legislation. Notwithstanding that all deliverables envisaged in the ERM II post-entry commitments have been completed, further progress needs to be made to address the outstanding shortcomings in the area of AML identified in the recent report by the Council of Europe’s MONEYVAL Committee. Over the reference period, the exchange rate of the Croatian kuna displayed a low degree of volatility and traded close to its central rate. The deviations from the central rate were significantly smaller than the standard fluctuation band of ERM II.

The currencies not participating in ERM II traded under flexible or managed floating exchange rate regimes, most of them amid relatively high exchange

[174] The potential economic impact of NGEU is analysed in “The economic impact of Next Generation EU: a euro area perspective”, *Occasional Paper Series*, No 291, ECB, April 2022.

rate volatility. The Romanian leu, which traded under a managed floating exchange rate regime, exhibited a very low degree of volatility, while the other currencies not participating in ERM II traded under flexible exchange rate regimes and were subject to a relatively high degree of exchange rate volatility.

3.4 The long-term interest rate criterion

Over the reference period, two of the seven countries under review recorded average long-term interest rates that were above the 2.6% reference value and one country was just above. The countries with the lowest average long-term interest rates were Sweden, Bulgaria, and Croatia at 0.4%, 0.5% and 0.8% respectively. The Czech Republic recorded an average interest rate just below the reference value at 2.5%, while Poland and Hungary remained above at 3.0% and 4.1% respectively. In Romania the average interest rate was well above the 2.6% reference value at 4.7%. Starting in the final quarter of 2021, there was a non-negligible increase in the 12-month average of long-term interest rates in almost all the countries owing to increased inflationary pressures and the impact of the Russia-Ukraine conflict. The future dynamics of long-term interest rates are quite difficult to gauge, given the high level of uncertainty about the duration of the original shock and its impact on price developments and economic activity.

Since the 2020 Convergence Report, long-term interest rate spreads vis-à-vis the euro area average have widened in all of the countries under review. This is the result of the impact of the pandemic on fiscal and monetary policy, as well as the cyclical position of some countries compared to the euro area, a faster rebound in economic activity and stronger upward price pressures. Nonetheless, a significant degree of heterogeneity persists in long-term interest rate differentials across the countries under review, reflecting differences both in the countries' cyclical positions and in financial markets' assessments of their external and internal vulnerabilities, including developments in budgetary performance and the prospects for sustainable convergence. In April 2022, in Sweden and Bulgaria the long-term interest rate was above the level in the euro area, by 10 basis points and 20 basis points respectively. Sweden is a developed economy whose financial system is highly integrated with the euro area, while Bulgaria's banking system is predominantly owned by euro area-based banks and the central bank operates a currency board which de facto imports euro area monetary conditions. The Czech Republic, Hungary, Poland and Romania experienced the largest increases in the interest rate differential over the review period, ranging from 170 basis points to 350 basis points. Among the countries under review, Hungary and Romania were the countries with the largest interest rate differential, both at 520 basis points at the end of the reference period.

3.5 Other relevant factors

According to the European Commission, most of the countries under review had made progress in addressing imbalances in their economies until this

correction process was interrupted by the COVID-19 shock. In its Alert Mechanism Report 2022 the European Commission refers in particular to the reduction in debt-to-GDP ratios amid favourable macroeconomic conditions in 2021. The European Commission concluded that in-depth reviews were warranted in Croatia, Romania and Sweden. As regards Croatia, the Commission found that imbalances relating to high levels of external, private and government debt in the context of low potential growth continued to subside in 2021, returning to their favourable pre-pandemic trends. For Romania, the Commission found that the country entered the COVID-19 crisis with vulnerabilities linked to a widening current account deficit, a deteriorating external position and significant cost competitiveness losses. With the COVID-19 crisis, government debt has increased, albeit from low levels. In the case of Sweden, the Commission found that, the country entered the COVID-19 crisis with vulnerabilities linked to risks stemming from overvalued house price levels coupled with high and continuously rising household debt. With the COVID-19 crisis, private debt ratios, house prices and the unemployment rate have increased. Although the European Commission classified the other countries under review in this report as having no imbalances, those countries also face various challenges.

The external positions of most countries under review have stabilised in recent years. The macroeconomic imbalance procedure (MIP) scoreboard shows that three-year average current account balances remained in surplus in 2020 and 2021 in almost all the countries under review, with the exception of Hungary, which recorded a modest deficit, and Romania, where the deficit increased further (Table 3.2).

In almost all the countries under review, negative net international investment positions as a share of GDP have diminished but remain at high levels. The net foreign liabilities of the central and eastern European countries are mainly in foreign direct investment, which is assessed as constituting a more stable form of financing. In 2021 the net international investment position was beyond the indicative threshold of -35% of GDP in Hungary, Poland and Romania. Net foreign liabilities were smallest in the Czech Republic (15.6% of GDP) and Bulgaria (19.8%), while Sweden recorded a positive net international investment position (17.8% of GDP).

In terms of price and cost competitiveness, between 2019 and 2021 HICP-deflated real effective exchange rates appreciated to different degrees in most of the countries examined, with Sweden being the only exception. The three-year growth rate of unit labour costs, which in the years before the COVID-19 pandemic stood at very high levels in almost all of the countries under review, decreased but still exceeded the indicative threshold of 12% in Bulgaria, the Czech Republic and Hungary. Over the five-year period from 2016 to 2021, gains in export market shares were recorded in a majority of countries.

House prices continued to increase in all countries under review. Developments in EU housing markets, which were already buoyant before the COVID-19 pandemic, picked up pace in 2020 and 2021, with various countries displaying risks of overvaluation. This raises concerns, particularly where household debt is high or rising fast. In some countries under review, house prices accelerated further and reached their fastest growth rates since the global financial crisis. In the Czech Republic, Hungary and Sweden, house prices increased at a pace beyond the indicative threshold of 6% in 2021. The growth in house prices was driven by a variety of factors fuelling demand and constraining supply. Housing market prospects remain dependent on uncertainties related to the pandemic and the macroeconomic outlook.

Table 3.2

Scoreboard for the surveillance of macroeconomic imbalances

Table 3.2a – External imbalances and competitiveness indicators

		Current account balance [1]	Net international investment position [2]	Real effective exchange rate, HICP-deflated [3]	Export market share [4]	Nominal unit labour costs [5]
Bulgaria	2019	2.0	-30.2	4.7	15.1	20.4
	2020	0.9	-27.1	6.9	15.6	20.4
	2021	0.5	-19.8	3.8	12.1	18.9
Czech Republic	2019	0.8	-19.8	8.7	4.8	14.6
	2020	0.9	-16.3	5.6	8.2	19.3
	2021	0.5	-15.6	5.0	-1.1	15.0
Croatia	2019	2.8	-46.7	1.6	22.1	2.8
	2020	1.6	-47.8	0.4	-0.4	13.7
	2021	2.1	-33.9	-1.5	8.3	6.4
Hungary	2019	0.5	-49.1	0.4	5.0	11.8
	2020	-0.5	-48.9	-4.9	7.6	13.9
	2021	-1.5	-44.8	-4.1	0.0	14.7
Poland	2019	-0.4	-49.8	2.7	24.7	8.2
	2020	0.7	-44.3	1.0	36.2	14.0
	2021	0.9	-39.9	-0.4	26.1	11.2
Romania	2019	-4.2	-43.6	0.2	17.4	26.3
	2020	-4.8	-47.9	3.4	19.9	20.8
	2021	-5.6	-45.7	1.0	10.7	1.5
Sweden	2019	3.7	16.2	-8.3	-2.9	7.1
	2020	4.8	14.1	-4.8	4.0	9.6
	2021	5.7	17.8	2.1	-0.6	6.8
Threshold		-4.0/+6.0	-35.0	+/-11.0	-6.0	+12.0

Table 3.2b – Internal imbalances and unemployment indicators

		Internal imbalances						Unemployment indicators		
		House prices, consumption-deflated [6]	Private sector credit flow, consolidated [2]	Private sector debt, consolidated [2]	Financial sector liabilities [6]	General government debt [2]	Unemployment rate [7]	Activity rate [8]	Long-term unemployment [8]	Youth unemployment [8]
Bulgaria	2019	3.9	5.6	91.3	5.8	20.0	6.2	4.5	-2.1	-8.2
	2020	5.2	.	.	.	24.7	5.8	0.9	-1.1	1.3
	2021	4.9	.	.	.	25.1	5.5	0.6	-0.5	0.0
Czech Republic	2019	6.2	1.4	78.6	4.6	30.1	2.4	1.7	-1.1	-4.9
	2020	5.5	2.3	81.9	3.3	37.7	2.3	0.5	-0.4	0.0
	2021	16.1	.	.	.	41.9	2.5	0.0	0.1	1.4
Croatia	2019	7.8	1.1	88.3	6.7	71.1	8.8	0.9	-4.3	-14.9
	2020	7.3	1.3	98.0	7.3	87.3	7.5	0.7	-2.5	-6.5
	2021	4.5	.	.	.	79.8	7.3	2.4	-0.7	-1.9
Hungary	2019	11.8	3.9	67.1	36.7	65.5	3.6	2.6	-1.3	-1.5
	2020	1.6	7.7	76.1	55.6	79.6	3.7	1.9	-0.6	2.0
	2021	8.6	11.6	78.4	14.5	76.8	3.8	2.1	-0.2	3.6
Poland	2019	6.1	3.6	73.9	4.3	45.6	4.1	2.1	-1.5	-7.9
	2020	7.1	1.6	75.6	11.5	57.1	3.5	1.4	-0.9	-4.0
	2021	3.7	3.8	71.1	13.6	53.8	3.3	3.4	-0.1	0.1
Romania	2019	-1.9	2.0	46.7	10.2	35.3	5.4	3.2	-1.3	-4.9
	2020	2.2	1.3	48.4	13.3	47.2	5.4	2.3	-0.5	-1.6
	2021	-1.1	3.7	47.2	14.4	48.8	5.5	3.2	0.2	0.5
Sweden	2019	0.4	10.0	198.7	11.7	34.9	6.8	0.8	-0.3	1.2
	2020	3.0	12.6	212.5	10.7	39.6	7.3	0.0	-0.1	6.2
	2021	8.1	16.9	218.0	11.3	36.7	8.1	0.5	0.9	7.9
Threshold		+6.0	+14.0	+133.0	+16.5	+60.0	+10.0	-0.2	0.5	2.0

Sources: European Commission (Eurostat, Directorate-General for Economic and Financial Affairs) and European System of Central Banks.
Note: This table includes data available as at 25 May 2022, i.e. the cut-off date for this report, and therefore differs from the scoreboard published in the Alert Mechanism Report 2022, which was published in November 2021.
1) As a percentage of GDP, three-year average.
2) As a percentage of GDP.
3) Three-year percentage change relative to 41 other industrial countries. A positive value indicates a loss of competitiveness.
4) Five-year percentage change.
5) Three-year percentage change.
6) Year-on-year percentage change.
7) Three-year average.
8) Three-year percentage point change.

A relatively long period of credit expansion prior to the financial crisis left the private non-financial sector with high – though moderately declining – levels of accumulated debt in some of the countries under review. This continues to constitute a key vulnerability in those countries, although private credit growth has moderated and does not exceed the indicative threshold of 14% in any of the countries under review. Sweden, however, continued to record a particularly high stock of private sector debt, exceeding 200% of GDP in 2020.

Financial sector policies in the countries under review should be aimed at ensuring that the financial sector makes a sound contribution to sustainable economic growth and price stability, and supervisory policies should be geared towards ensuring a financially healthy and resilient banking system, which is a precondition for joining the Single Supervisory Mechanism (SSM). In order to further support confidence in the financial system, the national competent authorities should continue to improve their supervisory practices by, among other things, following the applicable recommendations of the relevant international and European bodies and by closely collaborating with national supervisors of other EU Member States within the supervisory colleges. With the entry into force of the close cooperation frameworks with Българска народна банка (Bulgarian National Bank) and Hrvatska narodna banka on 1 October 2020, the ECB assumed responsibility for (i) the direct supervision of the significant institutions in the two countries, (ii) the common procedures for all supervised entities, and (iii) the oversight of less significant institutions, which continue to be supervised by their national supervisors. Since establishing close cooperation with Българска народна банка (Bulgarian National Bank) and Hrvatska narodna banka, the ECB has worked closely with them to ensure their smooth integration into the SSM.

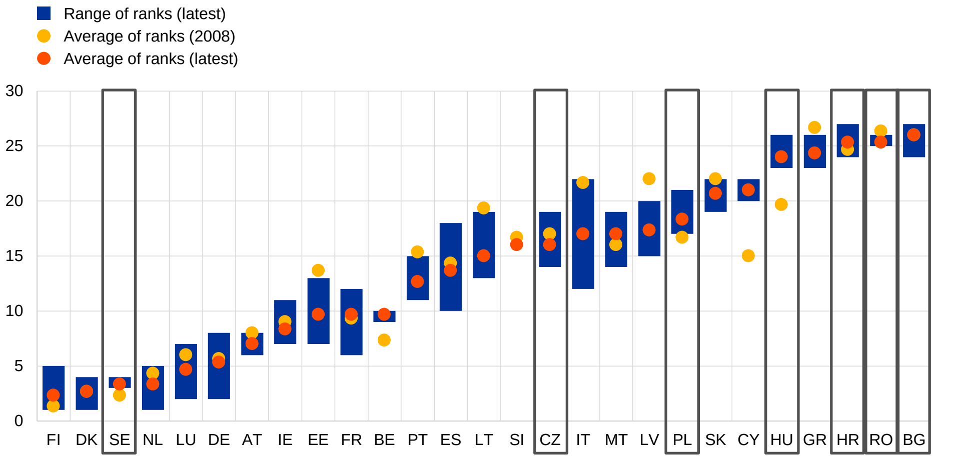
Unemployment rates continued on a declining path in almost all countries under review, supported by furlough schemes and other policy measures implemented by governments during the pandemic. Over the review period, the unemployment rate has declined further in most countries except Sweden and remains below the indicative threshold of 10% in all reviewed countries. The Czech Republic, Hungary and Poland have recorded historically low unemployment rates and some countries are increasingly facing labour shortages in certain segments of the labour market.

The strength of the institutional environment is another important factor in the analysis of the sustainability of economic integration and convergence. Low quality of institutions and weak governance may reflect, for example, weaknesses in the business environment, an inefficient public administration, tax evasion, corruption, a lack of social inclusion, a lack of transparency, a lack of judicial independence and/or poor access to online services. In several countries, enhancing institutional quality would contribute to removing the existing rigidities and impediments to the efficient use and allocation of production factors, thereby strengthening long-term growth capacity. By hampering potential output growth, a weak institutional environment may also undermine a country’s debt-servicing ability and make economic adjustment more difficult. It may also affect a country’s ability to implement necessary policy measures.

Except in Sweden, the quality of institutions and governance is relatively weak in all the countries under review – especially in Bulgaria, Romania, Croatia and Hungary. This can pose risks for economic resilience and the sustainability of convergence. Specific institutional indicators broadly confirm an overall picture of poor quality institutions and governance in most countries, although with some notable differences (Charts 3.8 and 3.9).[175] In this respect, Bulgaria, Romania, Croatia and Hungary are among the countries facing the greatest challenges within the EU.

Chart 3.8

Overview of EU country rankings in terms of institutional quality

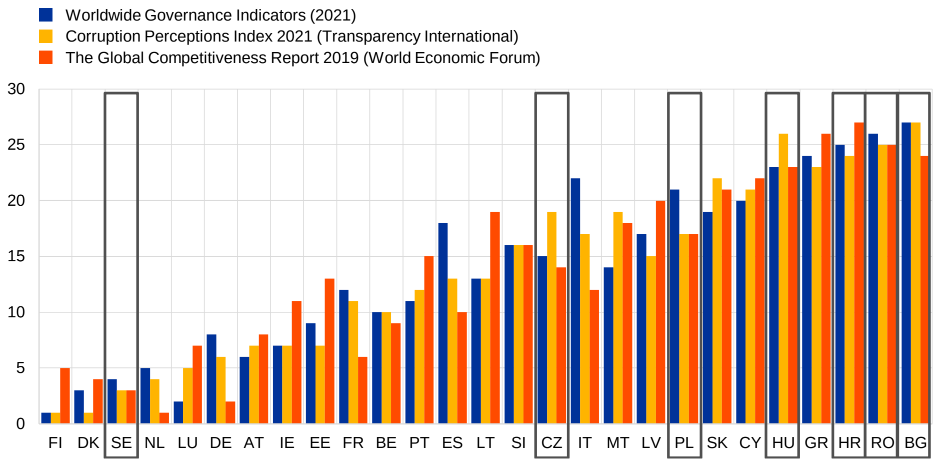


Sources: Worldwide Governance Indicators 2021 (World Bank), The Global Competitiveness Report 2019 (World Economic Forum) and Corruption Perceptions Index 2021 (Transparency International).
Notes: Countries are ranked from one (best performing in the EU) to 27 (worst performing in the EU) and ordered according to their average position in the latest rankings.

[175] Measuring institutional quality remains difficult and fraught with controversy.
On one hand, perception-based indicators can have some merit when compared with other indicators. One advantage of perception-based surveys resides in their catch-all nature, whereas more specific measures may provide highly distorted information. Also, while the absolute value of perception-based indicators may be questionable, they are useful for cross-country comparisons, unless it is clear that there is a systematic bias against one or more specific countries. Moreover, indicators that are based solely on the content of laws, but not on detailed knowledge of their actual implementation, can be misleading. Furthermore, as no institutional model may be presumed to be preferable ex ante, perception-based surveys may prevent the emergence of measurement biases when gauging the various dimensions of economic governance directly.
On the other hand, perception-based surveys also produce distortions. For instance, they may be heavily influenced by a recent episode or poorly designed questions.
Given the respective weaknesses and comparative advantages of perception-based (e.g. corruption) and more objective (e.g. competitiveness) institutional indicators, Charts 3.8 and 3.9 present both types of indicators.
Moreover, as regards EU countries, the institutional focus has only gained analytical and policy prominence in recent years. There is thus, generally speaking, still ample scope for measurement improvements. Finally, cross-country approaches to an issue as complex as institutional quality or good governance are necessarily somewhat insufficient and clearly need to be complemented with more country-specific and longer-term assessments. At the same time, measurement difficulties should not lead to a down-playing of these crucially important determinants of long-term prosperity, social fairness and well-being.

Chart 3.9

EU country rankings in terms of institutional quality by individual indicator



Sources: Worldwide Governance Indicators 2021 (World Bank), The Global Competitiveness Report 2019 (World Economic Forum) and Corruption Perceptions Index 2021 (Transparency International).
Note: Countries are ranked from one (best performing in the EU) to 27 (worst performing in the EU) and ordered according to their average position in the latest rankings.

Wide-ranging structural reforms are required in most of the countries under review to improve economic growth and competitiveness. Improving local institutions, governance and the business environment, along with further progress in the reform and privatisation of state-owned enterprises and the efficient absorption of EU funds, would help to speed up productivity growth. This would in turn contribute to increasing competition in key regulated sectors (e.g. energy and transport), lowering barriers to entry and encouraging much-needed private investment.

Finally, institutional features relating to the quality of statistics are also essential to support a smooth convergence process. This applies to, among other things, the legal independence of the national statistical authority, its administrative supervision and budget autonomy, its legal mandate for data collection and legal provisions governing statistical confidentiality, which are described in more detail in Chapter 6.

4 Country summaries

4.1 Bulgaria

In April 2022 the 12-month average rate of HICP inflation in Bulgaria was 5.9%, i.e. well above the reference value of 4.9% for the criterion on price stability. This rate is expected to increase gradually over the coming months, driven mainly by the higher commodity prices, broadening price pressures and further aggravation of supply bottlenecks resulting from the Russia-Ukraine war. Over the past ten years it has fluctuated within a relatively wide range, from -1.7% to 5.9%, and the average for that period was subdued, standing at 0.9%. Looking ahead, there are concerns about the sustainability of inflation convergence in Bulgaria over the longer term. The catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area, since GDP per capita and price levels are still significantly lower in Bulgaria than in the euro area. In order to prevent the build-up of excessive price pressures and macroeconomic imbalances, the catching-up process must be supported by appropriate policies.

Bulgaria’s general government budget deficit was well above the 3% reference value in 2021, while its debt-to-GDP ratio was well below the 60% reference value. Bulgaria has been subject to the preventive arm of the Stability and Growth Pact since 2012. In May 2022, the European Commission found that the general government deficit in 2021 was above and not close to the reference value of 3% of GDP. The excess over the reference value was considered to be exceptional and temporary. This notwithstanding, taking into account the exceptional uncertainty created by the continued extraordinary macroeconomic and fiscal impact of the COVID-19 pandemic, together with the invasion of Ukraine by Russia, the Commission did not propose opening new excessive deficit procedures at that stage. From 2012 to 2019, prior to the COVID-19 crisis, Bulgaria comfortably met both the deficit criterion (with one exception in 2014) and the debt criterion. The European Commission’s Spring 2022 Economic Forecast foresees an improvement in the fiscal position as of 2022 as a result of the combined effect of the gradual phasing-out of fiscal measures implemented during the crisis and an improvement in economic activity, with the budget balance still being expected to remain above 3% of GDP in 2022, before falling below it in 2023. The European Commission’s latest assessment of fiscal sustainability indicated that Bulgaria faced medium risks to fiscal sustainability over the medium and long term. While fiscal policy should remain agile in its response to the evolving pandemic situation and given the geopolitical situation, efficient and well-targeted measures, as well as prudent and growth-friendly fiscal policies, are essential for safeguarding sound public finances in the future.

On 10 July 2020 the ERM II parties decided, by mutual agreement, to include the Bulgarian lev in ERM II, and it therefore participated in ERM II for most of the two-year reference period from 26 May 2020 to 25 May 2022. The Bulgarian lev was included in ERM II at a central rate of 1.95583 levs per euro with a standard fluctuation band of ±15%. Bulgaria joined the exchange rate mechanism with its existing currency board in place, as a unilateral commitment, thus placing no additional obligations on the ECB. The agreement on participation in ERM II was based on a number of policy commitments by the Bulgarian authorities, some of which had already been met when the lev was included in ERM II, with the aim of achieving a high degree of sustainable economic convergence by the time of the adoption of the euro. The ECB and the European Commission have been monitoring the effective implementation of these commitments, acting within their respective areas of competence as provided for by the Treaties and secondary legislation. Over the reference period the lev did not exhibit any deviation from the central rate. In July 2020 Българска народна банка (Bulgarian National Bank) entered a precautionary swap line arrangement with the ECB, under which it could borrow up to €2 billion in exchange for Bulgarian levs in order to address possible euro liquidity needs of Bulgarian financial institutions owing to the pandemic. As this arrangement helped to reduce the potential risk of financial vulnerabilities, it may also have further supported the stability of the exchange rate over the reference period.

Over the reference period from May 2021 to April 2022, long-term interest rates in Bulgaria stood at 0.5% on average and were thus well below the 2.6% reference value for the interest rate convergence criterion. Long-term interest rates in Bulgaria have decreased since 2012, with 12-month average rates declining from 5.3% to 0.5%.

Achieving an environment that is conducive to sustainable convergence in Bulgaria requires stability-oriented economic policies and wide-ranging structural reforms. With regard to macroeconomic imbalances, the European Commission did not select Bulgaria for an in-depth review in its Alert Mechanism Report 2022. The sustainability of convergence and economic resilience would benefit from wide-ranging reforms to enhance structural resilience, the business environment, financial stability, institutional quality and governance. The convergence in banking supervision achieved under the close cooperation framework ensures the application of uniform supervisory standards and thus contributes to safeguarding financial stability. With the entry into force of that framework between the ECB and Българска народна банка (Bulgarian National Bank) on 1 October 2020, the ECB became responsible for the direct supervision of five significant institutions and for the oversight of 13 less significant institutions in Bulgaria.

Bulgarian law does not comply with all the requirements for central bank independence, the monetary financing prohibition and legal integration into the Eurosystem. Bulgaria is an EU Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.

4.2 Czech Republic

In April 2022 the 12-month average rate of HICP inflation in the Czech Republic was 6.2%, i.e. well above the reference value of 4.9% for the criterion on price stability. This rate is expected to increase gradually over the coming months, driven mainly by the higher commodity prices, broadening price pressures and further aggravation of supply bottlenecks resulting from the Russia-Ukraine war. Over the past ten years it has fluctuated within a relatively wide range, from 0.2% to 6.2%, and the average for the period was moderate, standing at 2.0%. Looking ahead, there are some concerns about the sustainability of inflation convergence in the Czech Republic over the longer term. The catching-up process may result in positive inflation differentials vis-à-vis the euro area, since GDP per capita and price levels are still relatively lower in Czech Republic than in the euro area, unless this is counteracted by an appreciation of the nominal exchange rate. In order to prevent the build-up of excessive price pressures and macroeconomic imbalances, the catching-up process must be supported by targeted economic policies.

The Czech Republic's general government budget deficit was well above the 3% reference value in 2021, while its debt-to-GDP ratio was below the 60% reference value. The Czech Republic has been subject to the preventive arm of the Stability and Growth Pact since 2014. In May 2022, the European Commission found that the general government deficit in 2021 was above and not close to the reference value of 3% of GDP. The excess over the reference value was considered to be exceptional but not temporary. This notwithstanding, taking into account the exceptional uncertainty created by the continued extraordinary macroeconomic and fiscal impact of the COVID-19 pandemic, together with the invasion of Ukraine by Russia, the Commission did not propose opening new excessive deficit procedures at that stage. In the period prior to the COVID-19 crisis, the deficit and debt criteria were comfortably met. While the European Commission's Spring 2022 Economic Forecast foresees an improvement in the fiscal position as of 2022 as a result of the combined effect of the improved economic activity and the partial phasing-out of fiscal measures implemented during the crisis, the budget deficit is still expected to remain above 3% of GDP until the end of the forecast horizon in 2023. The European Commission's latest assessment of fiscal sustainability found that the Czech Republic faced medium fiscal sustainability risks over the medium term. Over the long term, it was found to face high risks, primarily linked to budgetary pressures stemming from population ageing and the initial budgetary position. While fiscal policy should remain agile in its response to the evolving pandemic situation and given the geopolitical situation, efficient and well-targeted measures, as well as prudent and growth-friendly fiscal policies, are essential for safeguarding sound public finances in the future.

In the two-year reference period from 26 May 2020 to 25 May 2022, the Czech koruna did not participate in ERM II, but traded under a flexible exchange rate regime. The exchange rate of the Czech koruna exhibited, on average, a relatively high degree of volatility over the reference period. On 25 May 2022 the exchange rate stood at 24.6480 korunas per euro, i.e. 9.6% stronger than its average level in May 2020.

Over the reference period from May 2021 to April 2022, long-term interest rates in the Czech Republic stood at 2.5% on average and were thus just below the 2.6% reference value for the interest rate convergence criterion. Long-term interest rates in the Czech Republic have decreased since 2012, with 12-month average rates declining from 3.5% to 2.5%.

Maintaining sustainable convergence in the Czech Republic requires targeted economic policies, including structural reforms, that are geared towards fostering price and macroeconomic stability. With regard to macroeconomic imbalances, the European Commission did not select the Czech Republic for an in-depth review in its Alert Mechanism Report 2022. Medium to long-term vulnerabilities relate to the sustainability of the country's current growth model and to a disorderly reallocation of capital and capacity across the economy, which could suffocate growth in sectors that have been particularly hard hit by the pandemic. Economic and financial policies should aim to achieve broad efficiency gains and enhance productivity by appropriately reallocating capital. To this end, it will be important to strengthen administrative and institutional capacity (e.g. in areas such as governance and insolvency) and address inefficiencies in the business environment that weigh on potential growth by hindering innovation and the development of new business. Labour and skill shortages should also be addressed with targeted structural policies and investments, and small and medium-sized enterprises should have easier access to equity finance and venture capital in order to enhance the country's growth potential. In order to further bolster confidence in the financial system, the national competent authorities should continue to improve their supervisory practices, among other things, by following the applicable recommendations from the relevant international and European bodies, and by collaborating closely with other national supervisors of EU Member States within the respective supervisory colleges.

Czech law does not comply with all the requirements for central bank independence, the monetary financing prohibition and legal integration into the Eurosystem. The Czech Republic is an EU Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.

4.3 Croatia

In April 2022 the 12-month average rate of HICP inflation in Croatia was 4.7%, i.e. below the reference value of 4.9% for the criterion on price stability. This rate is expected to increase gradually over the coming months, driven mainly by the higher commodity prices, broadening price pressures and further aggravation of supply bottlenecks resulting from the Russia-Ukraine war. Over the past ten years it has fluctuated within a relatively wide range, from -0.8% to 4.7%, and the average for that period was subdued, standing at 1.1%. Looking ahead, there are concerns about the sustainability of inflation convergence in Croatia over the longer term. The catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area, since GDP per capita and price levels are still lower in Croatia than in the euro area. In order to prevent the build-up of excessive price pressures and macroeconomic imbalances, the catching-up process must be supported by appropriate policies.

Croatia's general government budget balance was just below the 3% deficit reference value in 2021, while its debt ratio was above the 60% reference value but on a downward trajectory. Croatia has been subject to the preventive arm of the Stability and Growth Pact since June 2017. Since the general government deficit-to-GDP ratio was below the reference value of 3% in 2021 and is projected to remain below it in 2022, the deficit criterion was fulfilled. The debt ratio was 79.8% of GDP in 2021, but that represented a decline of around 7.5 percentage points relative to the peak value of 87.3% of GDP that had been recorded in 2020 and respected the debt reduction benchmark, thus implying compliance with the debt criterion. The deficit criterion was met and the debt ratio declined in Croatia over the period 2017-19. For 2020, however, the European Commission found in June 2021 that the general government deficit was above and not close to the reference value of 3% of GDP. The excess over the reference value was considered to be exceptional, but not temporary. Moreover, Croatia's general government debt exceeded the 60% of GDP reference value and did not diminish at a satisfactory pace. This notwithstanding, taking into account the high uncertainty, the agreed fiscal policy response to the COVID-19 crisis and the Council recommendations of 20 July 2020, the Commission considered that at that juncture a decision on whether to place Member States under the excessive deficit procedure should not be taken. The European Commission's Spring 2022 Economic Forecast indicates continued compliance with the deficit and debt criteria of the Stability and Growth Pact. The European Commission's latest assessment of fiscal sustainability suggested that Croatia faced medium debt sustainability risks over the medium term, as well as over the long term. While fiscal policy should remain agile given the geopolitical situation, efficient and well-targeted measures, as well as prudent and growth-friendly fiscal policies, together with the implementation of the envisaged fiscal reforms under the Recovery and Resilience Plan, are essential for safeguarding sound public finances and putting the debt ratio on a long-lasting downward path.

On 10 July 2020 the ERM II parties decided, by mutual agreement, to include the Croatian kuna in ERM II, and it therefore participated in ERM II for most of the two-year reference period from 26 May 2020 to 25 May 2022. The Croatian kuna was included in ERM II at a central rate of 7.53450 kuna per euro with a standard fluctuation band of ±15%. The agreement on participation in ERM II was based on a number of policy commitments by the Croatian authorities, some of which had already been met when the kuna was included in ERM II, with the aim of achieving a high degree of sustainable economic convergence by the time of the adoption of the euro. The ECB and the European Commission have been monitoring the effective implementation of these commitments, acting within their respective areas of competence as provided for by the Treaties and secondary legislation. Over the reference period the exchange rate of the Croatian kuna against the euro displayed a low degree of volatility and traded close to its central rate. The deviations from the central rate were significantly smaller than the standard fluctuation band within ERM II. On 25 May 2022 the exchange rate stood at 7.5355 kuna per euro, i.e. virtually at the level of its central rate within ERM II. In April 2020 Hrvatska narodna banka entered a precautionary swap line arrangement with the ECB under which it could borrow up to €2 billion in exchange for Croatian kuna in order to address possible euro liquidity needs of Croatian financial institutions owing to the pandemic. As this arrangement helped to reduce the potential risk of financial vulnerabilities, it may also have further supported the stability of the exchange rate over the reference period.

Over the reference period from May 2021 to April 2022, long-term interest rates in Croatia stood at 0.8% on average and thus remained below the 2.6% reference value for the interest rate convergence criterion. Long-term interest rates in Croatia have decreased since 2012, with 12-month average rates declining from slightly below 7% to below 1.0%.

Achieving an environment that is conducive to sustainable convergence in Croatia requires stability-oriented economic policies and wide-ranging structural reforms. With regard to macroeconomic imbalances, the European Commission selected Croatia for an in-depth review in its Alert Mechanism Report 2022, which highlighted that imbalances relating to high levels of external, private and government debt in the context of low potential growth continued to subside in 2021. Croatia would benefit from structural reforms aimed at improving the institutional and business environment, boosting competition in product markets, reducing mismatches in the labour market and labour supply constraints, and enhancing the efficiency of the public administration and the judicial system. With the entry into force of the close cooperation framework between the ECB and Hrvatska narodna banka on 1 October 2020, the ECB became responsible for the direct supervision of eight significant institutions and for the oversight of 15 less significant institutions in Croatia.

Croatian law is compatible with the Treaties and the Statute as required under Article 131 of the Treaty.

4.4 Hungary

In April 2022 the 12-month average rate of HICP inflation in Hungary was 6.8%, i.e. well above the reference value of 4.9% for the criterion on price stability. This rate is expected to increase gradually over the coming months, driven mainly by the higher commodity prices, broadening price pressures and further aggravation of supply bottlenecks resulting from the Russia-Ukraine war. Over the past ten years it has fluctuated within a relatively wide range, from -0.3% to 6.8%, and the average for that period was elevated at 2.5%. Looking ahead, there are concerns about the sustainability of inflation convergence in Hungary over the longer term. The catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area, since GDP per capita and price levels are still lower in Hungary than in the euro area, unless this is counteracted by an appreciation in the nominal exchange rate. In order to prevent the build-up of excessive price pressures and macroeconomic imbalances, the catching-up process must be supported by appropriate policies.

Hungary’s general government budget deficit was well above the 3% reference value in 2021 and its debt was above the 60% reference value. Hungary has been subject to the preventive arm of the Stability and Growth Pact since 2013. For 2021, the European Commission found that the general government deficit was above and not close to the reference value of 3% of GDP. The excess over the reference value was considered to be exceptional, but not temporary. Moreover, Hungary’s general government debt exceeded the 60% of GDP reference value and did not diminish at a satisfactory pace. This notwithstanding, taking into account the exceptional uncertainty created by the continued extraordinary macroeconomic and fiscal impact of the COVID-19 pandemic, together with the invasion of Ukraine by Russia, the Commission did not propose opening new excessive deficit procedures at that stage. The European Commission's Spring 2022 Economic Forecast points to an improvement in Hungary's deficit after the sharp deterioration seen in 2020 and 2021, but the deficit is projected to remain well above 3% of GDP in 2023. The European Commission's latest assessment of fiscal sustainability indicated that Hungary was at medium risk of fiscal stress over the medium term and at high risk over the long term, with population ageing posing a challenge to the sustainability of public finances. While fiscal policy should remain agile in its response to the evolving pandemic situation and given the geopolitical situation, efficient and well-targeted measures, as well as prudent and growth-friendly fiscal policies, are essential for safeguarding sound public finances and putting the debt ratio on a long-lasting downward path.

In the two-year reference period from 26 May 2020 to 25 May 2022, the Hungarian forint did not participate in ERM II, but traded under a flexible exchange rate regime. The exchange rate of the Hungarian forint against the euro exhibited, on average, a high degree of volatility over the reference period. On 25 May 2022 the exchange rate stood at 388.25 forints per euro, i.e. 10.7% weaker than its average level in May 2020. In June 2020 the Magyar Nemzeti Bank entered a repo line arrangement with the ECB under which it could borrow up to €4 billion against adequate euro-denominated collateral to provide euro liquidity to Hungarian financial institutions in order to address possible needs owing to the pandemic. As this arrangement helped to reduce the potential risk of financial vulnerabilities, it may also have had an impact on exchange rate developments over the reference period.

Over the reference period from May 2021 to April 2022, long-term interest rates in Hungary stood at 4.1% on average and were thus above the 2.6% reference value for the interest rate convergence criterion. Long-term interest rates in Hungary have been on a downward path since 2012, with 12-month average rates declining from around 8% to around 4%.

Achieving an environment that is conducive to sustainable convergence in Hungary requires stability-oriented economic policies and wide-ranging structural reforms. With regard to macroeconomic imbalances, the European Commission did not select Hungary for an in-depth review in its Alert Mechanism Report 2022. However, on 27 April 2022 the European Commission, under the general regime of conditionality for the protection of the Union budget, sent a written notification to the Hungarian authorities about concerns over respect for the rule of law, which may result in a suspension of or reduction in the disbursement of EU funds. Hungary would benefit from structural reforms aimed at improving the quality of public institutions and administration, as well as from the implementation of adequate product market policies. In order to further bolster confidence in the financial system, the national competent authorities should continue to improve their supervisory practices, among other things, by following the applicable recommendations from the relevant international and European bodies, and by collaborating closely with other national supervisors of EU Member States within the supervisory colleges.

Hungarian law does not comply with all the requirements for central bank independence, the prohibition of monetary financing, the requirements for the single spelling of the euro and legal integration into the Eurosystem. Hungary is an EU Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.

4.5 Poland

In April 2022 the 12-month average rate of HICP inflation in Poland was 7.0%, i.e. well above the reference value of 4.9% for the criterion on price stability. This rate is expected to increase gradually over the coming months, driven mainly by the higher commodity prices, broadening price pressures and further aggravation of supply bottlenecks resulting from the Russia-Ukraine war. Over the past ten years it has fluctuated within a relatively wide range, from -0.7% to 7.0%, while the average for that period was moderate, standing at 1.7%. Looking ahead, there are concerns about the sustainability of inflation convergence in Poland over the longer term. The catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area, since GDP per capita and price levels are still lower in Poland than in the euro area, unless this is counteracted by an appreciation in the nominal exchange rate. In order to prevent the build-up of excessive price pressures and macroeconomic imbalances, the catching-up process must be supported by appropriate policies.

Poland's general government budget balance was well below the 3% deficit reference value in 2021, and the debt ratio was below the 60% reference value. Poland has been subject to the preventive arm of the Stability and Growth Pact since 2015. In the subsequent period to 2019, the deficit criterion was met and the debt ratio declined. In 2021, the general government budget balance recorded a deficit of 1.9% of GDP. However, the European Commission's Spring 2022 Economic Forecast foresees a notable deterioration in the budget balance in 2022, with the deficit standing above the 3% reference value on account of the costs to aid Ukrainian refugees, higher interest expenses, temporary relief measures against high energy and food inflation, and lower revenues from the income tax reform. In May 2022, the European Commission considered Poland's planned excess over the reference value to be exceptional but not temporary. However, taking into account the exceptional uncertainty created by the continued extraordinary macroeconomic and fiscal impact of the COVID-19 pandemic, together with the invasion of Ukraine by Russia, the Commission did not propose opening new excessive deficit procedures at that stage. In June 2021, the European Commission had found that the general government deficit in 2020 was above and not close to the reference value of 3% of GDP, while the debt-to-GDP ratio remained below the 60% threshold. This notwithstanding, the Commission did not open an excessive deficit procedure due to the exceptional situation determined by the COVID-19 pandemic. The deficit fell in 2021 as most emergency measures had expired, hence the government debt-to-GDP ratio declined to 53.8%. Meanwhile, the public debt ratio is projected to improve notably and remain below the 60% reference value. The European Commission's latest assessment of fiscal sustainability suggests that Poland faces medium risks to fiscal sustainability in the medium and long term owing to budgetary pressures stemming from population ageing and the unfavourable initial budgetary position. While fiscal policy should remain agile in its response to the evolving pandemic situation and given the geopolitical situation, efficient and well-targeted measures, as well as prudent and growth-friendly fiscal policies, are essential for safeguarding sound public finances in the future.

In the two-year reference period from 26 May 2020 to 25 May 2022, the Polish zloty did not participate in ERM II, but traded under a flexible exchange rate regime. The exchange rate of the Polish zloty against the euro exhibited, on average, a relatively high degree of volatility over the reference period. On 25 May 2022 the exchange rate stood at 4.6210 zlotys per euro, i.e. 2.1% weaker than its average level in May 2020. At the end of March 2022 Narodowy Bank Polski entered a swap line arrangement with the ECB under which it could borrow up to €10 billion against zlotys in order to address potential euro liquidity needs in the Polish financial system. As this arrangement helped to reduce the potential risk of financial vulnerabilities, it may also have had an impact on exchange rate developments over the end of the reference period.

Over the reference period from May 2021 to April 2022, long-term interest rates in Poland stood at3.0% on average and were thus above the reference value of 2.6% for the interest rate convergence criterion. Long-term interest rates in Poland have decreased since 2012, with 12-month average rates declining from approximately 6% to 3%.

Achieving an environment that is conducive to sustainable convergence in Poland requires stability-oriented economic policies, targeted structural reforms and policy measures that safeguard financial stability. With regard to macroeconomic imbalances, the European Commission did not select Poland for an in-depth review in its Alert Mechanism Report 2022. It is essential to preserve the currently strong financial position of the banking sector in order to maintain foreign investor confidence and to ensure its sound contribution to economic growth. This should be supported by well-targeted structural reforms aimed at reducing frictions in labour markets, boosting competition in product markets and speeding up innovation and infrastructure modernisation. In order to further bolster confidence in the financial system, the national competent authorities should continue to improve their supervisory practices, among other things, by following the applicable recommendations from the relevant international and European bodies, and by collaborating closely with other national supervisors of EU Member States within the supervisory colleges.

Polish law does not comply with all the requirements for central bank independence, confidentiality, the monetary financing prohibition and legal integration into the Eurosystem. Poland is an EU Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.

4.6 Romania

In April 2022 the 12-month average rate of HICP inflation in Romania was 6.4%, i.e. well above the reference value of 4.9% for the criterion on price stability. This rate is expected to increase gradually over the coming months, driven mainly by the higher commodity prices, broadening price pressures and further aggravation of supply bottlenecks resulting from the Russia-Ukraine war. Over the past ten years it has fluctuated within a relatively wide range, from -1.7% to 6.4%, and the average for that period was moderate, standing at 2.2%. Looking ahead, there are concerns about the sustainability of inflation convergence in Romania over the longer term. The catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area, since GDP per capita and price levels are still lower in Romania than in the euro area, unless this is counteracted by an appreciation of the nominal exchange rate. In order to prevent the build-up of excessive price pressures and reduce macroeconomic imbalances, the catching-up process must be supported by appropriate policies.

While Romania's deficit ratio was significantly above the 3% reference value in 2021, its excessive deficit procedure, which was launched in April 2020, is being kept in abeyance. Since April 2020, Romania has been subject to an excessive deficit procedure, as its fiscal position exceeded the 3% reference value in 2019. Its headline deficit stood at 7.1% of GDP in 2021, better than the recommended target, and the required fiscal effort was achieved. Therefore, the excessive deficit procedure is being kept in abeyance. According to the European Commission's Spring 2022 Economic Forecast, the targets for the period 2022-24 are not expected to be met unless policy changes are made, pointing to the need for a medium-term consolidation strategy and corresponding corrective measures. While the debt ratio is below the 60% of GDP threshold, it has been increasing since 2019. The European Commission's latest assessment of fiscal sustainability points to low sustainability risks in the short term, high sustainability risks in the medium term, and medium sustainability risks in the long term, with Romania needing to address the challenges of its ageing population. While fiscal policy should remain agile in its response to the evolving pandemic situation and given the geopolitical situation, efficient and well-targeted measures, as well as prudent and growth-friendly fiscal policies in line with the provisions of the Stability and Growth Pact, are essential to safeguard the sustainability of public finances over the medium term.

Over the reference period from 26 May 2020 to 25 May 2022, the Romanian leu did not participate in ERM II, but traded under a flexible exchange rate regime involving a managed floating of the currency's exchange rate. The exchange rate of the Romanian leu exhibited, on average, a very low degree of volatility over the reference period. On 25 May 2022 it stood at 4.9416 lei per euro, i.e. 2.2% weaker than its average level in May 2020. In June 2020 Banca Naţională a României entered a repo line arrangement with the ECB under which it could borrow up to €4.5 billion against high quality euro-denominated collateral to provide euro liquidity to Romanian financial institutions in order to address possible liquidity needs owing to the pandemic. As this arrangement helped to reduce the potential risk of financial vulnerabilities, it may also have had an impact on exchange rate developments over the reference period.

Over the reference period from May 2021 to April 2022, long-term interest rates in Romania stood at 4.7% on average and were thus well above the 2.6% reference value for the interest rate convergence criterion. Long-term interest rates in Romania have decreased since 2012, with 12-month average rates declining from slightly more than 7% to around 4.5%.

Achieving an environment that is conducive to sustainable convergence in Romania requires stability-oriented economic policies and wide-ranging structural reforms. With regard to macroeconomic imbalances, the European Commission selected Romania for an in-depth review in its Alert Mechanism Report 2022, highlighting issues related to its external position and cost competitiveness. Although Romania has made good progress on meeting the conditions for economic convergence since the early 2010s, there are still concerns about low productivity levels. The relatively weak quality of the country's institutions and governance, as well as its weak business environment, continue to hamper its growth potential. In addition, effective absorption of EU funds remains key to fostering economic growth in the medium term and to guiding the economy in the upcoming green and digital transition. Reform efforts aimed at fighting corruption, improving competition and enhancing the predictability of the country's tax, judicial, regulatory and administrative systems are also needed. In order to further bolster confidence in the financial system, the national competent authorities should continue to improve their supervisory practices, among other things, by following the applicable recommendations from the relevant international and European bodies, and by collaborating closely with other national supervisors of EU Member States within the supervisory colleges.

Romanian law does not comply with all the requirements for central bank independence, the monetary financing prohibition and legal integration into the Eurosystem. Romania is an EU Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.

4.7 Sweden

In April 2022 the 12-month average rate of HICP inflation in Sweden was 3.7%, i.e. well below the reference value of 4.9% for the criterion on price stability. This rate is expected to increase gradually over the coming months, driven mainly by the higher commodity prices, broadening price pressures and further aggravation of supply bottlenecks resulting from the Russia-Ukraine war. Over the past ten years it has fluctuated within a range from 0.2% to 3.7%, and the average for that period was subdued, standing at 1.2%. Sweden's GDP per capita is already above that of the euro area as a whole and so it is not faced with challenges related to the catching-up process. Looking ahead, monetary policy and the stability-oriented institutional framework should continue to support the achievement of price stability in Sweden.

Sweden's general government budget deficit was well below the 3% reference value in 2021 and its debt-to-GDP ratio was well below the 60% reference value. Sweden has never been subject to an excessive deficit procedure. The European Commission's Spring 2022 Economic Forecast indicates compliance with the requirements of the Stability and Growth Pact. The European Commission’s latest assessment of fiscal sustainability suggests that Sweden faces low risks over the medium and long term. While fiscal policy should remain agile in its response to the evolving pandemic situation and given the geopolitical situation, efficient and well-targeted measures, as well as continued compliance with the medium-term objective over the coming years, will ensure that Sweden’s track record of sound public finances is further enhanced.

In the two-year reference period from 26 May 2020 to 25 May 2022, the Swedish krona did not participate in ERM II, but traded under a flexible exchange rate regime. The exchange rate of the Swedish krona against the euro exhibited, on average, a relatively high degree of volatility over the two years. On 25 May 2022 it stood at 10.5419 kronor per euro, i.e. 0.5% stronger than its average level in May 2020. Over the reference period Sveriges Riksbank maintained a swap agreement with the ECB for borrowing up to €10 billion in exchange for Swedish kronor, which had been in place since 20 December 2007 with the aim of facilitating the functioning of financial markets and providing euro liquidity to them if needed. As this agreement helped to reduce the potential risk of financial vulnerabilities, it may also have had an impact on the exchange rate of the Swedish krona against the euro over the reference period.

Over the reference period from May 2021 to April 2022, long-term interest rates in Sweden stood at 0.4% on average and thus remained well below the 2.6% reference value for the interest rate convergence criterion. Long-term interest rates in Sweden have decreased since 2012, with 12-month average rates declining from around 2% to around 0.5%.

Maintaining an environment that is conducive to sustainable convergence in Sweden requires the continuation of stability-oriented economic policies, targeted structural reforms and measures to safeguard financial stability. Despite the significant impact of the pandemic on the real economy, residential property prices in Sweden have risen sharply since spring 2020, mainly on the back of increased demand. This price upturn seems to deviate significantly from historical fundamentals such as mortgage rates or household disposable income. The European Commission selected Sweden for an in-depth review in its Alert Mechanism Report 2022, in particular because of the macroeconomic imbalances stemming from the housing market. In order to further bolster confidence in the financial system, the national competent authorities should continue to improve their supervisory practices, among other things, by following the applicable recommendations from the relevant international and European bodies, and by collaborating closely with other national supervisors of EU Member States within the supervisory colleges.

Swedish law does not comply with all the requirements for central bank independence, the monetary financing prohibition and legal integration into the Eurosystem. Sweden is an EU Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty. Pursuant to the Treaty, Sweden has been under the obligation to adopt national legislation with a view to integration into the Eurosystem since 1 June 1998. As yet no legislative action has been taken by the Swedish authorities to remedy the incompatibilities described in this and previous reports.

5 Examination of economic convergence in individual countries

5.1 Bulgaria

5.1.1 Price developments

In April 2022 the 12-month average rate of HICP inflation in Bulgaria was 5.9%, i.e. well above the reference value of 4.9% for the criterion on price stability (Chart 5.1.1). This rate is expected to increase gradually over the coming months, driven mainly by the higher commodity prices, broadening price pressures and further aggravation of supply bottlenecks resulting from the Russia-Ukraine war.

Over the past ten years the 12-month average rate of HICP inflation has fluctuated within a relatively wide range, from -1.7% to 5.9%, and the average for that period was subdued, standing at 0.9%. From 2012 the average annual rate of inflation declined gradually, before bottoming out at -1.7% in 2015. This drop in inflation was driven by falling commodity prices, an appreciation in the effective exchange rate of the lev and domestic factors, such as cuts in administered prices. After a prolonged period in negative territory, inflation turned positive again in 2017. Robust economic growth and decreasing unemployment, together with a longer-term decline in the working age population, as well as administrative and policy factors, resulted in sharply rising nominal wages and unit labour costs, though at a slower rate than before the financial crisis. In 2018, 2019 and the first quarter of 2020 HICP inflation rose further, owing to upward pressure from both strong domestic demand on the back of robust wage growth and hikes in food and services prices. Thereafter, the contraction of the Bulgarian economy as a result of the coronavirus (COVID-19) pandemic and declines in oil and energy prices kept HICP inflation at low levels, averaging 1.2% in 2020. Rising international energy and food prices, changes in administered prices and the rebound in economic activity and private consumption then pushed up prices in the first half of 2021. From September of that year inflation accelerated sharply, owing to high electricity, fuel and gas prices and the associated direct and indirect effects (Table 5.1.1).

In the first four months of 2022 the average annual rate of HICP inflation stood at 9.7%. In April it reached 12.1%, its highest level in 13 years. This increase can be attributed to significant upward pressure from the surge in international prices for food and energy products (oil, natural gas and electricity) owing, in part, to Russia’s invasion of Ukraine. Other inflationary factors include the higher prices for imported non-energy industrial goods (in the context of global increases in transportation costs and supply bottlenecks) and strong domestic demand on the back of robust wage growth. To prevent further increases in electricity and heating prices for households, the Bulgarian Parliament imposed a moratorium on retail price changes on 15 December 2021 until the end of March 2022. Prior to that, the Government had implemented a compensation scheme for industrial end users by partially subsidising firms' electricity consumption. The lump sum payment per megawatt-hour was introduced in October 2021 and increased over time.

Inflation is expected to stay elevated in the coming months, before declining gradually. However, the forecasts are subject to considerable uncertainty in the light of the Russia-Ukraine war. Over the longer term there are concerns about the sustainability of inflation convergence in Bulgaria. According to the European Commission's Spring 2022 Economic Forecast, the average annual rate of inflation will rise to around 11.9% in 2022, before falling to 5.0% in 2023. This outlook is based on the expectation that double-digit energy inflation will persist over the forecast horizon and pass through to headline inflation. HICP inflation in 2022 and 2023 will be largely determined by developments in international food prices, by the magnitude of the direct and indirect effects of high energy prices and by how the national regulator decides to adjust retail prices based on the expected evolution of wholesale prices. Risks to the medium-term inflation outlook are tilted to the upside, as supply bottlenecks and higher energy prices could continue for longer than projected. Moreover, persistent labour shortages in some sectors may result in higher than expected wage growth, thus exerting upward pressure on inflation. Looking further ahead, there are concerns about the sustainability of inflation convergence in Bulgaria over the longer term, also taking into account the marked increase in unit labour costs and labour market tightness. Although the COVID-19 crisis has not hampered Bulgaria's reform momentum, also in the context of the post-entry commitments the country made upon joining ERM II, the catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area, since GDP per capita and price levels are still significantly lower in Bulgaria than in the euro area. In order to prevent the build-up of excessive price pressures and macroeconomic imbalances, the catching-up process must be supported by appropriate policies. In particular, while hourly labour costs in Bulgaria are still the lowest in the EU, growth in wages needs to be consistent with that in productivity, among other things, in order to safeguard price competitiveness and the country's attractiveness to foreign investors. Moreover, as Bulgaria has opted for a currency board and been participating in ERM II since July 2020, it is important to contain inflation with appropriate policies, not least to enhance productivity growth, especially in the non-traded goods sector.

Achieving an environment that is conducive to sustainable convergence in Bulgaria requires stability-oriented economic policies and wide-ranging structural reforms. Given monetary policy's limited room for manoeuvre under the currency board, it is imperative that other policy areas (fiscal, macroprudential) provide the economy with the wherewithal to cope with potential country-specific shocks and macroeconomic imbalances. This is also of utmost importance for a smooth participation in ERM II. Structural reforms to enhance the business and institutional environment are crucial in order to attract foreign direct investment and raise potential growth. These include significantly reducing corruption, ensuring an independent and effective judicial system, and enhancing the education system. A further reduction in the declining – but still elevated – corporate debt burden would support corporate profitability, credit growth and investment. It is also essential to strengthen national policies aimed at enhancing competition in product markets, to proceed with the liberalisation of regulated sectors and to manage a smooth transition to a digital and greener economy. In this context, additional efforts are needed to enhance administrative capacity and to further improve the absorption of EU funds. With long-term unemployment accounting for a large percentage of total unemployment, additional measures are required to improve the employability and strengthen the skill level of the workforce, and to promote the economic inclusion of the most vulnerable segments of the population. With regard to macroeconomic imbalances, the European Commission did not select Bulgaria for an in-depth review in its Alert Mechanism Report 2022.

The convergence in banking supervision achieved under the close cooperation framework ensures the application of uniform supervisory standards and thus contributes to safeguarding financial stability. With the entry into force of the close cooperation framework between the ECB and Българска народна банка (Bulgarian National Bank) on 1 October 2020, the ECB became responsible for the direct supervision of five significant institutions and for the oversight of 13 less significant institutions in Bulgaria. Българска народна банка (Bulgarian National Bank) has been integrated into the Single Supervisory Mechanism and is participating in its structures and networks. Bulgarian significant institutions are now supervised by Joint Supervisory Teams supported by experts in horizontal line supervision. With regard to the oversight of less significant institutions, which have a domestic market share of roughly 30%, the ECB is working closely with national supervisors to further harmonise implementation of the rules governing banking supervision, while also ensuring that joint supervisory standards are applied consistently across the system.

5.1.2 Fiscal developments

Bulgaria’s general government budget deficit was well above the 3% reference value in 2021, while its debt was well below the 60% reference value. In the reference year 2021, the general government budget recorded a deficit of 4.1% of GDP, thus standing well above the 3% deficit reference value. The general government gross debt-to-GDP ratio was 25.1%, well below the 60% reference value (Table 5.1.2). Compared with the previous year, the general government deficit increased by 0.1 percentage points and the debt ratio increased slightly by 0.4 percentage points. With regard to other fiscal factors, the deficit ratio exceeded the ratio of public investment to GDP in 2021. The budget deficits in 2020 and 2021 were substantially affected by the economic impact of the COVID-19 pandemic and the fiscal policy measures taken in response to it.

Bulgaria has been subject to the preventive arm of the Stability and Growth Pact since 2012. In May 2022, the European Commission found that the general government deficit-to-GDP ratio in 2021 was above and not close to the reference value of 3%. The excess over the reference value was considered to be exceptional and temporary, since the deficit was projected to fall below 3% of GDP in 2023. Overall, the Commission analysis suggested that the deficit criterion had not been fulfilled. However, taking into account the exceptional uncertainty created by the continued extraordinary macroeconomic and fiscal impact of the COVID-19 pandemic, together with the invasion of Ukraine by Russia, the Commission did not propose opening new excessive deficit procedures at that stage. In the preceding year, in June 2021, the European Commission had found that the general government deficit in 2020 was above but close to the reference value of 3% of GDP. The excess over the reference value was at the time considered to be exceptional and temporary, as defined by the Treaty. In sum, the analysis suggested that the deficit criterion had been fulfilled. Previously, Bulgaria had been subject to an excessive deficit procedure from 2010 to 2012. Owing to a rise in the budget deficit above the reference value in 2009, the ECOFIN Council decided in July 2010 that an excessive deficit situation existed in Bulgaria and set 2011 as the deadline for correcting it. Following the correction of the excessive deficit, the ECOFIN Council abrogated the excessive deficit procedure for Bulgaria in June 2012. In the subsequent period to 2019, general government debt was well below the 60% of GDP reference value and the general government balance breached the reference value only in 2014, reaching a deficit of 5.4% of GDP. Since the European Commission considered the excess over the reference value to be both exceptional and temporary, it concluded that opening an excessive deficit procedure was not warranted.

Both cyclical and non-cyclical factors relating to the COVID-19 pandemic contributed to the deterioration in the budget balance over the period 2019-21. Prior to the COVID-19 crisis, prudent fiscal policy had allowed Bulgaria to record structural surpluses, which reached 1.4% of GDP in 2019. As a consequence of the COVID-19 crisis, the structural balance deteriorated strongly in 2020 by 4.3 percentage points, mostly on account of higher current expenditure. This spending increase reflected, to a large extent, fiscal support measures which were taken in response to the pandemic. Moreover, cyclical factors contributed to the overall increase in the budget deficit by 6.1 percentage points in 2020, reflecting the deterioration in the economic situation. From 2020 to 2021, the structural deficit increased by another 0.9 percentage points on account of higher expenditure, whereas the cyclical component improved by 0.8 percentage points.

The government debt-to-GDP ratio has remained well below the 60% reference value over the past two decades but it increased during the COVID-19 crisis. Prior to the COVID-19 crisis, the debt ratio had declined between 2016 and 2019 by 9.1 percentage points to 20% of GDP, mostly owing to high primary surpluses and, to a lesser extent, favourable interest-growth differentials. Between 2019 and 2021, the debt ratio increased during the COVID-19 crisis by 5.1 percentage points, mainly on the back of primary deficits.

In the presence of a long-standing currency board, the level and structure of public debt allow Bulgaria to manage its debt effectively. The share of government debt with a short-term maturity has generally been negligible. Taking into account the low share of debt with a variable interest rate and the level of the debt ratio, fiscal balances are relatively insensitive to changes in interest rates. At the same time, the proportion of foreign currency-denominated government debt is high (74.6% in 2021), although almost entirely denominated in euro – the anchor currency of Bulgaria’s currency board framework. Fiscal balances are thus insensitive to changes in exchange rates other than the euro/lev exchange rate, which is fixed under the currency board.

The European Commission's Spring 2022 Economic Forecast predicts an improvement in the budget balance and a slight increase in the public debt ratio. According to the European Commission's Spring 2022 Economic Forecast, the headline balance is expected to improve to a deficit of 3.7% of GDP in 2022 and thus remain above the 3% deficit reference value. The foreseen improvement in the general government balance stems mainly from the partial phasing-out of pandemic support measures, which outweighs new measures in response to high energy prices and the Russia-Ukraine conflict. The budget balance is projected to improve further in 2023 and reach a deficit of 2.4% of GDP. Over the period 2022-23, the structural deficit is expected to stand well above the medium-term objective (a structural deficit of 1% of GDP). Nevertheless, in the context of the COVID-19 pandemic, the Stability and Growth Pact's general escape clause, which continues to be applied in 2022 and is expected to also remain in place in 2023, provides that "in periods of severe economic downturn for the euro area or the Union as a whole, Member States may be allowed temporarily to depart from the adjustment path towards the medium-term budgetary objective…, provided that this does not endanger fiscal sustainability in the medium term".[176] The debt ratio is projected to increase slightly to stand at 25.3% of GDP in 2022 and 25.6% of GDP in 2023. The 2022 headline deficit presented in the 2022 convergence programme is 5.3% of GDP and thus much higher than the European Commission's Spring 2022 Economic Forecast, while the projected debt ratio is slightly above the European Commission's figure.

Bulgaria's fiscal framework has helped it to maintain a low debt ratio, but there is still scope for further improvement. Bulgaria has a large number of fiscal rules at the general government and subnational levels, which comprise budget balance, debt and expenditure rules. While those rules mitigate the risk of increasing debt, in practice they are complex to implement and therefore need to be streamlined. As a response to the COVID-19 crisis, the Public Finance Act was amended in 2020. Two of the amendments are aimed at increasing the flexibility of the fiscal rules in the case of economic downturns. Those revisions allow deviations from the 3% general government deficit ceiling and the expenditure rule in the case of extraordinary circumstances outside the control of the government which seriously impact the fiscal position. Moreover, the ceiling for the cash-based budget deficit was increased from 2% to 3% and the maximum amount of expenditure under the consolidated fiscal programme was effectively increased, as EU funds and national co-financing were exempted from the scope of expenditure, while the maximum amount of 40% of GDP remained. Those revisions led to a lower stringency of the two rules. The Fiscal Council was introduced in 2016 in line with EU requirements, and its mandate and the quality of its work have been strengthened over time; further improvements in the areas of its technical and administrative capacities are nevertheless still needed. Progress made in tax collection and the reduction of the informal economy has contributed to significant growth in tax revenues and further progress should be pursued.

[176] For further details, see Box 2 in the Framework for analysis.

Bulgaria faces medium risks to fiscal sustainability over the medium and long term. The European Commission's 2021 Fiscal Sustainability Report found that Bulgaria faced medium fiscal sustainability risks over the medium term,[177] with the magnitude of the change in debt being subject to particularly large uncertainty. Over the long term, it was found to face medium risks, which were mainly driven by a projected increase in ageing-related costs.[178] According to the reference scenario from the 2021 Ageing Report prepared by the Ageing Working Group (AWG) of the EU's Economic Policy Committee,[179] age-related public expenditure is projected to increase notably by 2.1 percentage points of GDP over the period 2019-70, from a level of 16.2% of GDP in 2016. Under the AWG's risk scenario, the increase in costs was even higher and amounted to 4.1 percentage points of GDP, owing to a larger rise in healthcare and in long-term care spending (by respectively 0.9 and 1.2 percentage points of GDP in comparison with the baseline scenario). These projections signalled a need for further reforms in order to enhance the long-term sustainability of public finances.

Looking ahead, Bulgaria needs to gradually return to prudent fiscal policies despite the low level of public debt. While fiscal policy should remain agile in its response to the evolving pandemic situation and given the geopolitical situation, a consistent and prudent fiscal policy will ensure that Bulgaria will comply with the Stability and Growth Pact and maintains buffers to alleviate adverse shocks. Moreover, the Next Generation EU programme needs to be implemented effectively in order to support the recovery and to adjust to the structural changes that are under way. There is also scope for a more growth-friendly tax system and policies, as well as a more cost-effective provision of healthcare services. Safeguarding and extending the current reductions in tax collection gaps, further reducing the informal economy and increasing spending efficiency are all essential measures for preserving medium-term fiscal sustainability.

5.1.3 Exchange rate developments

On 10 July 2020 the ERM II parties decided, by mutual agreement, to include the Bulgarian lev in ERM II, and it therefore participated in ERM II for most of the two-year reference period from 26 May 2020 to 25 May 2022. The Bulgarian lev was included in ERM II at a central rate of 1.95583 levs per euro with a standard fluctuation band of ±15%. Bulgaria joined the exchange rate mechanism with its existing currency board in place, as a unilateral commitment, thus placing no additional obligations on the ECB. The agreement on participation in ERM II was based on a number of policy commitments by the Bulgarian authorities, some of which had already been met when the lev was included in ERM II, with the aim of achieving a high degree of sustainable economic convergence by the time of the adoption of the

[177] This assessment was confirmed by the updated debt sustainability analysis which was published as part of the European Commission's country report for Bulgaria on 23 May 2022.

[178] However, this assessment does not necessarily reflect the uncertainty surrounding the long-term assumptions and, for high-debt countries, it should be viewed with caution.

[179] European Commission and Economic Policy Committee, "The 2021 Ageing Report: Economic and Budgetary Projections for the EU Member States (2019-2070)", *European Economy Institutional Paper*, No 148, European Commission, 2021.

euro. These commitments relate to implementing specific policy measures pertaining to the non-banking financial sector, state-owned enterprises, the insolvency framework and the anti-money-laundering (AML) framework, as well as implementing the extensive reforms carried out in the judiciary and in the fight against corruption and organised crime in Bulgaria, in the light of the importance of these reforms for the stability and the integrity of the financial system. The ECB and the European Commission have been monitoring the effective implementation of these commitments, acting within their respective areas of competence as provided for by the Treaties and secondary legislation. In its role as the supervisory authority and given its shared responsibility for macroprudential policy, the ECB is closely monitoring the implementation of the commitments related to the financial sector, i.e. the insolvency framework and the AML framework, owing to their potential impact on prudential aspects. Notwithstanding the fact that all of the steps envisaged in the ERM II post-entry commitments are broadly on track, Bulgaria is encouraged to address in a timely manner any shortcomings that Council of Europe's Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (MONEYVAL) might possibly identify in its ongoing assessment. Over the reference period the lev did not exhibit any deviation from the central rate. As implied by the currency board framework, Българска народна банка (Bulgarian National Bank) has continued to exchange on demand domestic currency against the anchor currency (the euro) and vice versa at the fixed rate. Short-term interest rate differentials against the three-month EURIBOR stood at a low level throughout the reference period. In July 2020 Българска народна банка (Bulgarian National Bank) entered a precautionary swap line arrangement with the ECB under which it could borrow up to €2 billion in exchange for Bulgarian levs in order to address possible euro liquidity needs of Bulgarian financial institutions owing to the pandemic. As this arrangement helped to reduce the potential risk of financial vulnerabilities, it may also have further supported the stability of the exchange rate over the reference period.

The real effective exchange rate of the Bulgarian lev has appreciated slightly over the past ten years (Chart 5.1.4). However, this indicator should be interpreted with caution, as Bulgaria is subject to a process of economic convergence, which complicates any long-term assessment of real exchange rate developments.

Bulgaria's combined current and capital account balance has consistently remained in surplus over the past ten years and the country's net foreign liabilities have declined markedly (Table 5.1.3). From 2012 to 2019 the combined current and capital account improved, primarily reflecting a substantial reduction in the goods deficit on account of the export-led recovery and, in an initial phase, subdued domestic demand following a sharp contraction in activity. A surplus of 1.5% was recorded in 2020, which decreased further to 0.3% in 2021 reflecting a small current account deficit of 0.4% of GDP in that year. This deficit was mainly due to the contraction in exports of tourism services caused by the COVID-19 pandemic. Tourism revenues started to recover in 2021, although foreign tourist visits remained well below pre-crisis levels. While the substantial adjustment in the balance of payments was associated with a significant contraction in net direct investment inflows – which fell from double-digit levels before the global financial crisis to an average of 2.4% of GDP in the period 2017-21 – the balance on other investment recorded net outflows. Gross external debt decreased further, falling from 71.8% of GDP in 2017 to 61.8% in 2021. At the same time, the country's net international investment position, largely consisting of foreign direct investment, continued to improve and rose from -43.0% of GDP in 2017 to -19.8% of GDP in 2021 on account of a further accumulation of reserve assets. Nevertheless, fiscal and structural policies continue to be important for supporting external sustainability and the competitiveness of the economy.

The Bulgarian economy is well integrated with the euro area through trade and investment linkages. In 2021 exports of goods and services to the euro area constituted 45.2% of total exports, with the corresponding figure for imports standing at 41.1%. In the same year the share of the euro area in Bulgaria's stock of inward direct investment stood at 64.7% and its share in the country's stock of portfolio investment liabilities was 77.1%. The share of Bulgaria's stock of foreign assets invested in the euro area amounted to 49.9% in the case of direct investment and 47.2% for portfolio investment in 2021.

5.1.4 Long-term interest rate developments

Over the reference period from May 2021 to April 2022, long-term interest rates in Bulgaria increased slightly and stood at 0.5% on average, well below the 2.6% reference value for the interest rate convergence criterion (Chart 5.1.5).

Long-term interest rates in Bulgaria declined from 5.3% in January 2012 to 1.6% in April 2022. Over the last decade long-term interest rate developments in Bulgaria have been driven by the gradual compression in risk premia and by structural factors that helped to contain market expectations of future rates. The decline in risk premia is mainly attributable to the lower macro-financial risk perceived by financial markets and the significant improvement in the liquidity conditions of banks. This was due to the disappearance of uncertainty relating to the global financial crisis, which led to an improvement in the financial situation of the Bulgarian banking system and thus in the outlook for the public budget. Other factors have also contributed to the declining trend in long-term interest rates over the last ten years. These include the relatively weak private credit demand until 2015, spillovers from low interest rates in the euro area, Bulgarian banks' continued demand for government debt securities in the context of a limited supply of these securities and scarce opportunities for lending to the private sector, a high private savings rate, and the effect of global trade tensions on growth expectations and thus interest rates. From April 2020 the negative impact of the COVID-19 pandemic on global and domestic economic activity and inflation drove long-term interest rates in Bulgaria down to a historically low level of 0.1% in March 2021, where they remained until August 2021. Since then and until February 2022, in a context of increasing domestic inflation, long-term interest rates gradually increased in line with global financial market developments, also owing to the concentration of a large volume of government bond issues in the domestic market in the fourth quarter of 2021. In the last two months of the review period, the increase in long-term interest rates was steeper as a result of mounting global and domestic inflationary pressures. Hence, long-term interest rates in Bulgaria increased over the review period and stood at 1.6% in April 2022, up from 0.2% in April 2020 (Chart 5.1.5). The steady improvement in Bulgaria's macroeconomic performance and the stability of its fiscal outlook have also contributed to the decline in the default risk on long-term Bulgarian debt – as measured by ten-year credit default swap spreads – which fell from over 400 basis points in early 2012 to around 115 basis points in April 2022. Bulgaria's government debt is rated investment grade by all three main rating agencies (Moody's: Baa1; S&P: BBB; Fitch: BBB).

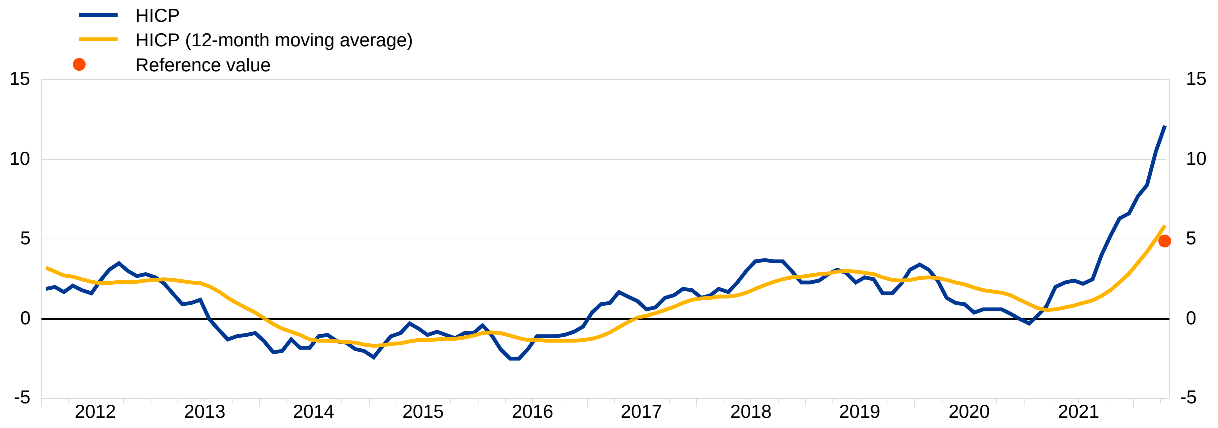
The long-term interest rate differential of Bulgarian government bonds vis-à-vis the euro area average stood at 0.2% in April 2022. Since 2012 Bulgarian long-term interest rates have gradually and continuously converged towards the euro area average rate of corresponding maturity (Chart 5.1.6). Initially, stable and relatively high rates in Bulgaria combined with a decline in the long-term average interest rate in the euro area led to some widening of the differential, which came close to, but never beyond, 2.0% for a few months in 2014 and in 2016. From late 2016 the differential declined steadily and, after remaining in negative territory for more than a year owing to heightened political and economic uncertainty in some euro area countries, it turned slightly positive in mid-2019. Since then it has fluctuated within a narrow range of between 0.0% and 0.5%. In April 2022 it stood at 0.2% (0.7% vis-à-vis the euro area AAA yield).

Capital markets in Bulgaria are smaller and less developed than in the euro area (Table 5.1.4). In the past few years only a few indications have emerged of any deepening of capital markets compared with early 2012. In recent years stock market capitalisation, as a percentage of GDP, has increased from an average of 10.7% over the period 2012-16 to 23.0% in 2021. Market-based debt financing of domestic monetary financial institutions (MFIs) has increased slightly since 2012 to stand at 1.6% of GDP. Over the same period, the access of non-financial corporations in Bulgaria to the corporate debt market seems to have remained broadly unchanged, as outstanding debt securities issued by this sector accounted for 2.5% of GDP in 2021, which is 0.4 percentage points of GDP lower than in the period 2012-16. In 2021 the reliance of the Bulgarian banking system on euro area banks for its funding needs remained very limited and much lower than the average over the period 2012-16. Euro area banks' claims on Bulgarian banks remained at historically low levels of 4.0% in 2021. The degree of financial intermediation remains quite low in Bulgaria compared with the euro area average, even if it is comparable to that of peer countries in the region. MFI credit to non-government residents stood at 54.6% of GDP in 2021, just over 6 percentage points below its average for the period 2012-16. At the end of 2020 foreign-owned banks continued to play a major role in the banking system in Bulgaria, accounting for more than 75% of total banking assets. The banking system is largely funded by resident private non-financial sector deposits (around 89% of total liabilities). The banking system's assets vis-à-vis the non-financial private sector were dominated by loans, 68% of which were denominated in local currency.

Bulgaria - Price developments

Chart 5.1.1 HICP inflation and reference value [1]

(annual percentage changes)



Sources: European Commission (Eurostat) and ECB calculations.

1) The basis of the calculation of the reference value for the period from May 2021 to April 2022 is the unweighted arithmetic average of the annual percentage changes in the HICP for France, Finland and Greece plus 1.5 percentage points. The reference value is 4.9%.

Table 5.1.1 Measures of inflation and related indicators

(annual percentage changes, unless otherwise indicated)

	2012-2021 [1]	2012-2016 [1]	2017-2021 [1]	2017	2018	2019	2020	2021	2022 [2]	2023 [2]
Measures of inflation										
HICP	0.9	-0.3	2.1	1.2	2.6	2.5	1.2	2.8	11.9	5.0
HICP excluding unprocessed food and energy	0.8	-0.1	1.8	0.3	2.1	2.5	2.0	1.9	9.5	6.1
HICP at constant tax rates [3]	0.9	-0.3	2.1	1.0	2.4	2.4	1.5	3.2	-	-
CPI	1.4	0.3	2.6	2.1	2.8	3.1	1.7	3.3	11.9	5.0
Private consumption deflator	1.9	1.4	2.4	4.6	2.4	2.0	-0.6	3.6	11.9	4.7
GDP deflator	3.3	1.8	4.9	4.8	4.2	5.2	4.2	6.2	9.5	3.9
Producer prices [4]	2.4	-0.3	5.2	4.2	4.1	3.8	-0.2	14.9	-	-
Related indicators										
Real GDP growth	1.7	1.5	1.8	2.8	2.7	4.0	-4.4	4.2	2.1	3.1
GDP per capita in PPS [5] (euro area = 100)	46.4	44.1	49.3	47.0	48.2	49.9	52.3	.	-	-
Comparative price levels (euro area = 100)	48.7	47.7	50.0	48.5	49.1	50.6	51.9	.	-	-
Output gap [6]	-0.4	-0.5	-0.2	0.2	0.6	2.5	-3.5	-1.0	-0.4	1.0
Unemployment rate (%) [7]	8.8	11.7	6.0	7.2	6.2	5.2	6.1	5.3	5.4	5.3
Unit labour costs, whole economy	5.8	4.7	6.8	9.5	6.7	3.1	9.5	5.4	7.7	4.8
Compensation per employee, whole economy	7.7	6.7	8.7	10.5	9.7	6.9	7.2	9.5	9.7	7.7
Labour productivity, whole economy	1.9	1.9	1.8	1.0	2.8	3.7	-2.1	4.0	1.9	2.7
Imports of goods and services deflator	0.7	-1.5	2.9	6.7	2.0	0.0	-6.6	13.5	11.2	4.2
Nominal effective exchange rate [8]	1.5	0.9	2.1	1.8	3.7	0.1	3.1	2.0	-	-
Money supply (M3) [9]	9.0	8.2	9.9	8.5	8.6	10.1	11.4	10.7	-	-
Lending from banks [10]	5.3	2.0	8.6	7.8	9.9	10.6	5.3	9.7	-	-
Stock prices (SOFIX) [11]	97.3	82.1	8.4	15.5	-12.3	-4.4	-21.2	42.0	-	-
Residential property prices	4.1	1.4	6.9	8.7	6.6	6.0	4.6	8.7	-	-

Sources: European Commission (Eurostat, Directorate-General for Economic and Financial Affairs), national data for CPI, money supply, lending from banks and ECB calculations based on Bloomberg Finance L.P. data for stock prices.

1) Multi-annual averages calculated using the geometric mean, except for GDP per capita in PPS, comparative price levels, output gap and unemployment rate, for which the arithmetic mean is used.

2) Data from the European Commission's Spring 2022 Economic Forecast.

3) The difference between the HICP and the HICP at constant tax rates shows the theoretical impact of changes in indirect taxes (e.g. VAT and excise duties) on the overall rate of inflation. This impact assumes a full and instantaneous pass-through of tax rate changes to the price paid by the consumer.

4) Domestic sales, total industry excluding construction.

5) PPS stands for purchasing power standards.

6) Percentage difference from potential GDP: a positive (negative) sign indicates that actual GDP is above (below) potential GDP.

7) Definition conforms to International Labor Organization guidelines.

8) EER-42 group of trading partners. A positive (negative) sign indicates an appreciation (depreciation).

9) The series includes repurchase agreements with central counterparties.

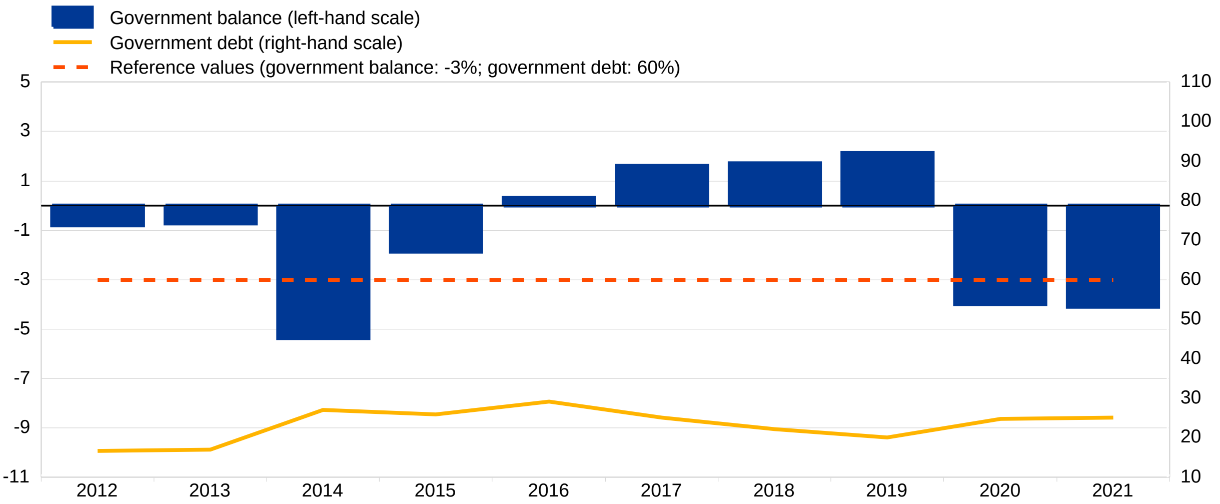
10) Adjusted for the derecognition of loans from the MFI statistical balance sheet due to their sale or securitisation.

11) Multi-annual and annual figures represent the percentage change between the end of the given period and the end of the previous period.

Bulgaria - Fiscal developments

Chart 5.1.2 General government balance and debt

(as a percentage of GDP)



Sources: European System of Central Banks and European Commission (Eurostat).

Table 5.1.2 Government budgetary developments and projections

(as a percentage of GDP, unless otherwise indicated)

	2012-2021 [1]	2012-2016 [1]	2017-2021 [1]	2017	2018	2019	2020	2021	2022 [2]	2023 [2]
Government balance	**-1.1**	**-1.7**	**-0.5**	**1.6**	**1.7**	**2.1**	**-4.0**	**-4.1**	-3.7	-2.4
Total revenue	37.3	36.4	38.2	37.1	38.7	38.4	38.1	39.0	40.2	40.7
Current revenue	35.7	34.2	37.2	36.0	37.9	37.5	36.7	37.8	37.8	38.1
Direct taxes	5.6	5.2	6.0	5.9	5.8	5.8	5.9	6.4	6.1	6.6
Indirect taxes	15.2	15.0	15.3	15.3	14.7	15.3	15.1	16.1	16.7	16.6
Net social contributions	8.2	7.5	8.8	8.2	8.7	8.8	9.2	9.3	9.2	9.3
Other current revenue [3]	6.8	6.5	7.1	6.6	8.7	7.6	6.6	6.0	5.8	5.6
Capital revenue	1.6	2.2	1.1	1.1	0.8	0.9	1.3	1.2	2.4	2.6
Total expenditure	38.4	38.1	38.8	35.4	37.0	36.3	42.0	43.1	43.9	43.1
Current expenditure	33.4	32.3	34.5	32.0	32.9	31.8	36.9	39.0	37.9	36.5
Compensation of employees	9.7	9.1	10.2	9.1	9.5	10.0	10.8	11.7	11.2	11.1
Social benefits	13.8	13.7	13.8	13.3	13.0	12.7	14.5	15.4	15.2	14.7
Interest payable	0.7	0.8	0.6	0.8	0.7	0.6	0.5	0.5	0.5	0.5
Other current expenditure [4]	9.2	8.6	9.9	8.8	9.8	8.5	11.0	11.4	11.0	10.2
Capital expenditure	5.0	5.8	4.2	3.4	4.1	4.5	5.2	4.1	5.9	6.6
of which: Investment	3.8	4.4	3.2	2.3	3.1	3.3	3.8	3.3	5.0	5.4
Cyclically adjusted balance	-1.0	-1.5	-0.4	1.6	1.5	1.4	-2.9	-3.8	-3.5	-2.7
One-off and temporary measures	-0.3	-0.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Structural balance [5]	-0.7	-0.9	-0.4	1.6	1.5	1.4	-2.9	-3.8	-3.5	-2.7
Government debt	**23.3**	**23.1**	**23.4**	**25.1**	**22.1**	**20.0**	**24.7**	**25.1**	25.3	25.6
Average residual maturity (in years)	7.3	7.0	7.7	7.6	7.1	6.9	8.8	8.1	.	.
In foreign currencies (% of total)	79.1	78.7	79.6	78.4	81.5	81.0	82.4	74.6	.	.
of which: Euro	74.5	70.2	78.7	77.3	80.4	80.1	81.8	74.0	.	.
Domestic ownership (% of total)	52.7	50.7	54.6	56.5	56.0	55.8	50.9	54.0	.	.
Medium and long-term maturity (% of total) [6]	97.3	94.7	99.9	99.9	99.9	100.0	100.0	99.9	.	.
of which: Variable interest rate (% of total)	9.3	13.6	4.9	8.4	5.2	4.7	3.3	3.0	.	.
Deficit-debt adjustment	**1.1**	**1.9**	**0.3**	**-0.3**	**0.4**	**1.9**	**0.6**	**-1.3**	.	.
Net acquisitions of main financial assets	0.8	1.6	0.0	-0.8	0.1	-0.7	0.6	0.9	.	.
Currency and deposits	0.7	1.3	0.1	-0.8	0.2	-0.4	0.7	0.9	.	.
Debt securities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	.	.
Loans	0.1	0.2	0.0	0.0	0.0	0.0	0.0	0.1	.	.
Equity and investment fund shares or units	0.0	0.1	-0.1	0.0	-0.1	-0.4	-0.1	-0.1	.	.
Revaluation effects on debt	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	.	.
of which: Foreign exchange holding gains/losses	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	.	.
Other [7]	0.3	0.3	0.2	0.6	0.2	2.6	0.0	-2.3	.	.
Convergence programme: government balance	-	-	-	-	-	-	-	-	-5.3	-2.9
Convergence programme: structural balance	-	-	-	-	-	-	-	-	-3.1	-2.7
Convergence programme: government debt	-	-	-	-	-	-	-	-	25.5	27.7

Sources: European System of Central Banks and European Commission (Eurostat, Directorate-General for Economic and Financial Affairs).

[1] Multi-annual averages calculated using the arithmetic mean.

[2] Data from the European Commission’s Spring 2022 Economic Forecast, except for convergence programme data.

[3] Sales and other current revenue.

[4] Intermediate consumption, subsidies payable and other current expenditure.

[5] Cyclically adjusted balance excluding one-off and other temporary measures.

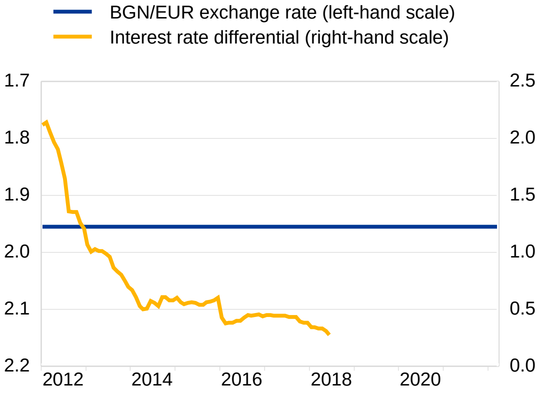
[6] Original maturity of more than one year.

[7] Time of recording differences and other factors (sector reclassifications and statistical discrepancies).

Bulgaria - Exchange rate and external developments

Chart 5.1.3 Bilateral exchange rate and short-term interest rate differential [1]

(BGN/EUR exchange rate: monthly averages; difference between three-month interbank interest rates and three-month EURIBOR: basis points, monthly values)

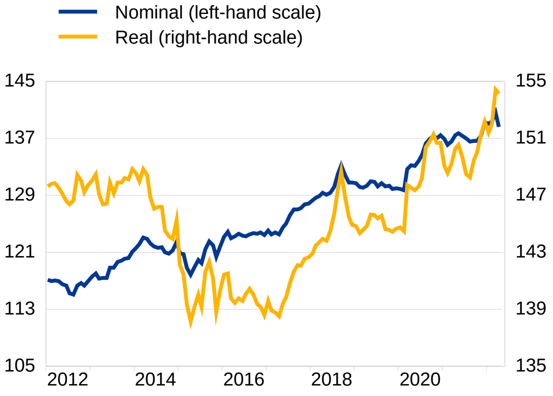


Sources: National data and ECB calculations.

1) The interest rate differential is calculated against SOFIBOR. Production of SOFIBOR reference rate was discontinued by the national central bank as of 1 July 2018; a comparable rate is not currently available.

Chart 5.1.4 Effective exchange rates [2]

(EER-42 group of trading partners; monthly averages; index: Q1 1999 = 100)



Source: ECB.

2) The real EER-42 is CPI-deflated. An increase (decrease) in the EER indicates an appreciation (depreciation).

Table 5.1.3 External developments

(as a percentage of GDP, unless otherwise indicated)

	2012-2021 [1]	2012-2016 [1]	2017-2021 [1]	2017	2018	2019	2020	2021	2022 [2]	2023 [2]
Balance of payments										
Current account and capital account balance [3]	2.6	2.9	2.3	4.3	2.0	3.3	1.5	0.3	0.7	0.5
Current account balance	1.0	0.9	1.1	3.3	0.9	1.9	-0.1	-0.4	-1.8	-1.8
Goods	-5.0	-6.1	-3.8	-1.5	-4.8	-4.7	-3.2	-4.9	.	.
Services	6.5	6.4	6.6	5.8	7.3	8.0	5.0	6.6	.	.
Primary income	-3.8	-3.5	-4.0	-4.3	-4.8	-4.2	-3.5	-3.3	.	.
Secondary income	3.3	4.2	2.4	3.3	3.2	2.9	1.5	1.1	.	.
Capital account balance	1.6	2.0	1.2	1.0	1.1	1.4	1.5	0.7	.	.
Combined direct and portfolio investment balance [3]	-1.1	-2.9	0.7	2.9	1.4	0.6	-3.3	1.7	.	.
Direct investment	-2.3	-2.2	-2.4	-2.5	-1.3	-2.0	-4.5	-1.7	.	.
Portfolio investment	1.2	-0.7	3.1	5.4	2.8	2.6	1.2	3.4	.	.
Other investment balance	1.6	2.6	0.6	1.2	1.7	4.3	-2.1	-1.9	.	.
Reserve assets	3.9	4.6	3.2	-0.2	2.4	-0.9	9.4	5.3	.	.
Exports of goods and services	63.4	63.4	63.4	67.0	65.7	63.9	56.3	64.2	.	.
Imports of goods and services	61.9	63.1	60.7	62.7	63.2	60.7	54.4	62.4	.	.
Net international investment position [4]	-48.9	-66.3	-31.4	-43.0	-37.0	-30.2	-27.1	-19.8	.	.
Gross external debt [4]	76.4	87.6	65.2	71.8	66.1	61.3	64.9	61.8	.	.
Trade with the euro area [5]										
Exports of goods and services	43.4	42.4	44.3	42.4	44.6	44.0	45.6	45.2	.	.
Imports of goods and services	42.2	42.6	41.8	42.8	42.6	41.6	40.8	41.1	.	.
Investment position with the euro area [5]										
Direct investment assets [4]	49.6	51.0	48.2	46.0	47.2	48.2	49.5	49.9	.	.
Direct investment liabilities [4]	65.4	65.7	65.1	66.1	65.8	65.2	63.8	64.7	.	.
Portfolio investment assets [4]	45.4	47.4	43.4	44.3	41.2	43.5	41.0	47.2	.	.
Portfolio investment liabilities [4]	74.7	72.2	77.2	79.9	83.5	71.8	73.6	77.1	.	.

Sources: European System of Central Banks and European Commission (Eurostat, Directorate-General for Economic and Financial Affairs).

1) Multi-annual averages calculated using the arithmetic mean.

2) Data from the European Commission's Spring 2022 Economic Forecast.

3) Differences between totals and the sum of their components are due to rounding.

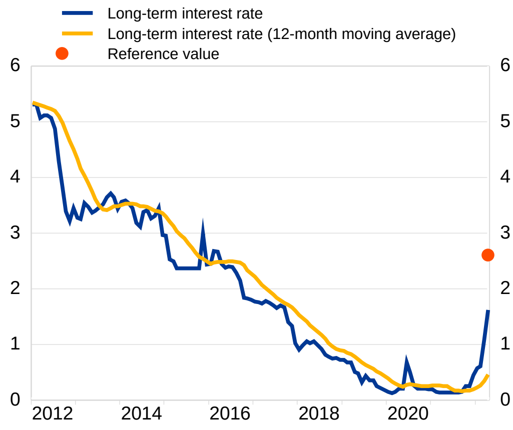
4) End-of-period outstanding amounts.

5) As a percentage of the total.

Bulgaria - Long-term interest rate developments

Chart 5.1.5 Long-term interest rate 1)

(monthly averages in percentages)

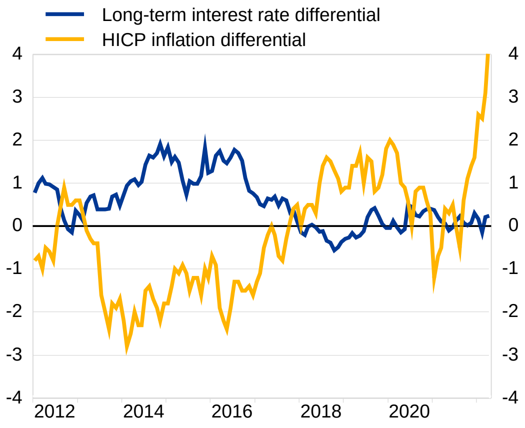


Sources: European System of Central Banks and ECB calculations.

1) The basis of the calculation of the reference value for the period from May 2021 to April 2022 is the unweighted arithmetic average of the interest rate levels in France, Finland and Greece plus 2 percentage points. The reference value is 2.6%.

Chart 5.1.6 Long-term interest rate and HICP inflation differentials vis-à-vis the euro area

(monthly averages in percentage points)



Sources: European System of Central Banks, ECB calculations and European Commission (Eurostat).

Table 5.1.4 Long-term interest rates and indicators of financial development and integration

(as a percentage of GDP, unless otherwise indicated)

	2012-2021 1)	2012-2016 1)	2017-2021 1)	2018	2019	2020	2021	May. 2021 to Apr. 2022	Memo item: euro area 2021
Long-term interest rates									
Bulgaria 2)	1.9	3.2	0.7	0.9	0.4	0.3	0.2	0.5	-
Euro area 3), 4)	1.4	2.2	0.6	1.1	0.4	0.1	0.1	0.4	-
Euro area AAA par curve, ten-year residual maturity 2), 4)	0.6	1.2	0.0	0.5	-0.2	-0.4	-0.3	-0.1	-
Indicators of financial development and integration									
Debt securities issued by financial corporations 5)	1.1	1.1	1.2	1.0	1.1	1.2	1.6	-	66.7
Debt securities issued by non-financial corporations 6)	2.8	2.9	2.8	2.8	2.6	2.7	2.5	-	13.4
Stock market capitalisation 7)	17.0	10.7	23.4	24.3	23.2	23.4	23.0	-	77.7
MFI credit to non-government residents 8)	57.2	60.9	53.6	52.9	53.0	55.5	54.6	-	111.1
Claims of euro area MFIs on resident MFIs 9)	5.4	7.5	3.3	3.2	3.3	2.9	4.0	-	29.5

Sources: European System of Central Banks and ECB calculations.

1) Multi-annual averages calculated using the arithmetic mean.

2) Average interest rate.

3) GDP-weighted average of the euro area long-term interest rates for the purpose of assessing convergence.

4) Included for information only.

5) Outstanding amount of debt securities issued by resident MFIs (excluding the national central bank) and other financial corporations.

6) Outstanding amount of debt securities issued by resident non-financial corporations.

7) Outstanding amount of listed shares issued by residents at market values.

8) MFI (excluding national central bank) credit to domestic non-MFI residents other than general government. Credit comprises outstanding amounts of loans and debt securities.

9) Outstanding amount of deposits and debt securities issued by domestic MFIs (excluding the national central bank) held by euro area MFIs as a percentage of total liabilities of domestic MFIs (excluding the national central bank). Total liabilities exclude capital and reserves and remaining liabilities.

5.2 Czech Republic

5.2.1 Price developments

In April 2022 the 12-month average rate of HICP inflation in the Czech Republic was 6.2%, i.e. well above the reference value of 4.9% for the criterion on price stability (Chart 5.2.1). This rate is expected to increase gradually over the coming months, driven mainly by the higher commodity prices, broadening price pressures and further aggravation of supply bottlenecks resulting from the Russia-Ukraine war.

Over the past ten years the 12-month average rate of HICP inflation has fluctuated within a relatively wide range, from 0.2% to 6.2%, and the average for that period was moderate, standing at 2.0%. Between 2012 and 2015 inflation fell significantly as a result of global commodity price developments and an economic recession during the period 2012-13. Import price growth accelerated in 2014, owing partly to the exchange rate floor of 27 korunas per euro set by Česká národní banka as a complementary and temporary instrument for lifting inflation towards its 2% inflation target. The Czech economy returned to a path of solid economic growth in the second half of the decade, which led to a notable appreciation in the koruna against the euro and in real effective terms. In addition, growth in compensation per employee exceeded labour productivity growth throughout the period under review (Table 5.2.1), which generated constant upward pressure on core inflation. Having grown by 3.0% in 2019, real GDP contracted markedly by 5.8% in 2020 on account of the coronavirus (COVID-19) pandemic. Following that sharp economic contraction, HICP inflation started to decline gradually towards the 2% target in the second half of the year, largely reflecting the stalling economy and developments in global markets. To counteract the economic effects of the pandemic, Česká národní banka cut its main policy rate by a cumulative 200 basis points over the period from March to May 2020, bringing it down to 0.25%, close to its all-time low of 0.05% (in November 2012). In the second half of 2021, large increases in the prices of energy and international commodities (including food), coupled with global supply bottlenecks, put significant upward pressure on HICP inflation and core inflation. Government support measures aimed at stabilising employment and providing emergency liquidity proved effective in supporting domestic consumption, generating sustained inflationary pressures during the economic recovery. To counter the acceleration in inflation, and with the economic recovery under way, Česká národní banka started a monetary policy tightening cycle in June 2021, which has thus far led to a cumulative 550 basis point hike in its main policy rate.

In the first four months of 2022 the average annual rate of HICP inflation stood at 11.0%. Inflationary pressures remained elevated and became more broad-based, spreading from the energy sector to other sectors of the economy such as food and services (particularly in relation to leisure and contact-intensive activities). On the domestic front, the main sources of the inflationary pressures were strong demand from households as a result of pandemic-related fiscal support measures, excess savings and positive wealth effects from robust financial and real estate markets, especially for wealthier households, as well as strong wage growth and rising owner-occupied housing costs. On the external front, increasing energy prices and the rise in producer prices owing to disruptions in global value chains and pandemic-related factory shutdowns also continued to put upward pressure on consumer price inflation. The growth in energy and food prices was notably amplified by developments in international commodity markets following Russia's invasion of Ukraine in late February 2022. Continuing its monetary policy tightening cycle, Česká národní banka raised its main policy rate by a cumulative 200 basis points at its Bank Board meetings in February, March and May 2022, up to 5.75% from 3.75% in December 2021.

The orientation of monetary policy towards price stability has played an important role in shaping inflation dynamics in the Czech Republic over the past decade. Since April 2001 the inflation target has been defined in terms of CPI inflation, originally as a continuously declining band and since 2006 as a flat point target. The CPI inflation target was set at 3% (±1 percentage point) in 2006 and reduced to 2% (±1 percentage point) on 1 January 2010. In November 2013, in order to fulfil its mandate to maintain price stability, Česká národní banka intervened to weaken the domestic currency and set the aforementioned exchange rate floor. When the bank abandoned its commitment to a minimum exchange rate vis-à-vis the euro in April 2017, the related policy shift was smooth, with the Czech koruna appreciating gradually. The exit from the exchange rate floor was the first step towards normalising domestic monetary conditions and was followed by a sequence of increases in Česká národní banka's interest rates from 2017 until early 2020.

Inflation in the Czech Republic is expected to continue its upward trend in the near term and remain above the upper bound of the target interval over the forecast horizon. However, the forecasts are subject to considerable uncertainty in the light of the Russia-Ukraine war. According to the European Commission's Spring 2022 Economic Forecast, HICP inflation is expected to rise significantly to 11.7% in 2022, owing to increasing levels of HICP inflation excluding food and energy, which is expected to reach 8.9%. It is then expected to decline to 4.5% in 2023. Particularly during the first half of 2022, factors such as high energy and administered prices, supply bottlenecks and elevated international commodity prices are expected to keep HICP inflation at a high level. If the effects of those factors subside, inflation is expected to fall gradually towards the upper bound of the target interval over the forecast horizon, supported also by tighter domestic monetary and macroprudential policies, an appreciation of the koruna and declining administered prices. Overall, risks to the inflation outlook are tilted to the upside in the near term, owing mostly to a higher pass-through of production costs to final consumer prices and higher than anticipated wage increases, in an environment of significantly lower real wages. Price growth could also continue to surprise on the upside beyond the near term if inflation expectations become unanchored from the 2% target, or if the koruna weakens as a result of geopolitical tensions or tighter global monetary conditions, which would reduce the current positive interest rate differential. Nevertheless, tighter domestic monetary and macroprudential policies alongside the unwinding of emergency fiscal support measures and fiscal consolidation could dampen household demand more strongly than expected and thus stall price growth. Looking further ahead, the catching-up process may result in positive inflation differentials vis-à-vis the euro area, since GDP per capita and price levels are still relatively lower in the Czech Republic than in the euro area, unless this is counteracted by an appreciation in the nominal exchange rate. In order to prevent the build-up of excessive price pressures and macroeconomic imbalances, the catching-up process must be supported by appropriate policies.

Maintaining sustainable convergence in the Czech Republic requires targeted economic policies, including structural reforms, that are geared towards fostering price and macroeconomic stability. With regard to macroeconomic imbalances, the European Commission did not select the Czech Republic for an in-depth review in its Alert Mechanism Report 2022. The Czech Republic is facing the challenge of boosting its economic growth potential by enhancing productivity. Economic and financial policies should aim to achieve broad efficiency gains by appropriately reallocating capital to bolster innovation and the knowledge-intensive sectors. To this end, it will be important to strengthen administrative and institutional capacity (e.g. in areas such as governance and insolvency) and address inefficiencies in the business environment that weigh on potential growth by hindering innovation and the development of new business. In addition, the lack of skilled labour should be addressed with targeted investments aimed at improving both the quality of higher education and the domestic business environment in high productivity sectors. Enhancing access to equity finance and venture capital for small and medium-sized enterprises, encouraging innovation (e.g. with tax incentives and grants for research and development) and improving insolvency frameworks will therefore be crucial to helping the economy operate at its full potential.

Financial sector policies should be aimed at safeguarding financial stability and ensuring that the financial sector can contribute to sustainable economic growth. Risks in the Czech Republic’s financial sector relate to the rapid growth in mortgage lending and the sustained acceleration in house prices, in an environment of increased risk-taking by households on the back of loose credit conditions. The current domestic macro-financial environment and its medium-term outlook have both been determined largely by the post-pandemic economic recovery and warranted a tightening of macroprudential policy. The stricter borrower-based limits (debt-to-income ratio, debt service-to-income ratio and loan-to-value ratio), which came into force in April 2022, are expected to reduce the risk of negative feedback loops between house price growth and banks’ mortgage lending. The recalibration of the countercyclical capital buffer to a level of 2.5%, which will have been fully phased in by April 2023, should also limit the build-up of risks in the housing and credit markets. In order to further bolster confidence in the financial system, the national competent authorities should continue to improve their supervisory practices, among other things, by following the applicable recommendations from the relevant international and European bodies, and by collaborating closely with other national supervisors of EU Member States within the supervisory colleges.

5.2.2 Fiscal developments

The Czech Republic's general government budget deficit was well above the 3% reference value in 2021, while its debt was below the 60% reference value. In the reference year 2021, the general government budget balance recorded a deficit of 5.9% of GDP, thus well above the 3% deficit reference value. The general government gross debt-to-GDP ratio was 41.9%, i.e. below the 60% reference value (Table 5.2.2). Compared with the previous year, the government deficit-to-GDP ratio increased by 0.1 percentage points, while the debt-to-GDP ratio increased notably by 4.2 percentage points. With regard to other fiscal factors, the deficit ratio exceeded the ratio of public investment to GDP in 2021. The budget deficits in 2020 and 2021 were substantially affected by the economic impact of the COVID-19 pandemic and the fiscal policy measures taken in response to it. However, some measures taken in 2021 are considered to have had a lasting negative effect on the budget balance. In particular, the 2021 income tax reform (which embeds a broad rate cut of around 5 percentage points) and the cancellation of the property sales tax are of a more permanent nature and have lowered revenue generation in the medium term significantly.

The Czech Republic has been subject to the preventive arm of the Stability and Growth Pact since 2014. In May 2022, the European Commission found that the general government deficit in 2021 was above and not close to the reference value of 3% of GDP. The excess over the reference value was considered to be exceptional but not temporary. Overall, the Commission's analysis suggested that the deficit criterion had not been fulfilled. However, taking into account the exceptional uncertainty created by the continued extraordinary macroeconomic and fiscal impact of the COVID-19 pandemic, together with the invasion of Ukraine by Russia, the Commission did not propose opening new excessive deficit procedures at that stage. In the preceding year, in June 2021, the European Commission had found that the general government deficit in 2020 was above and not close to the reference value of 3% of GDP, but it had argued against taking a decision to place Member States under the excessive deficit procedure in light of the exceptional uncertainty. Previously, the Czech Republic had been subject to an excessive deficit procedure between December 2009 and June 2014. In the subsequent period to 2019, the Czech Republic comfortably met its medium-term objective of a structural deficit of no more than 1% of GDP.

Both cyclical and non-cyclical factors relating to the COVID-19 pandemic contributed to the deterioration in the budget balance over the period 2019-21. Already prior to the COVID-19 crisis, the fiscal position had weakened significantly from a surplus of 1.5% of GDP in 2017 to 0.3% in 2019, driven by a deterioration in the structural balance. As a consequence of the COVID-19 crisis, this weakening accelerated in 2020 as the structural balance deteriorated strongly by 3.2 percentage points, mostly on account of higher expenditure. This spending increase reflected, to a large extent, fiscal support measures which were taken in response to the pandemic. Moreover, cyclical factors contributed to the overall increase in the budget deficit by 2.9 percentage points in 2020, reflecting the deterioration in the economic situation. From 2020 to 2021, the structural deficit increased by a further 0.8 percentage points, mainly on account of lower tax receipts due to the personal income tax reform, whereas the cyclical component improved by 0.7 percentage points.

The debt-to-GDP ratio has increased over the past two years after having been on a declining path in the period 2014-19, remaining well below the 60% reference value. Prior to the COVID-19 crisis, the debt ratio had decreased by 14.3 percentage points from its peak value of 44.4% of GDP in 2013, to 30.1% of GDP in 2019. The reduction was mostly driven by primary surpluses and favourable interest-growth differentials. Between 2019 and 2021, the debt ratio increased during the COVID-19 crisis by 11.8 percentage points, mainly on account of large primary deficits as expenditure increased strongly to support the economy during the pandemic. The increase in the debt-to-GDP ratio was also driven by a deficit-debt adjustment of 1.4 percentage points of GDP in 2020.

The level and structure of government debt protect the Czech Republic from any sudden changes in market conditions, with the bulk of debt at long-term maturities and most debt denominated in local currency. The share of government debt with a short-term maturity is low (2.5% in 2021 – Table 5.2.2). Taking into account also the share of debt with a variable interest rate and the overall level of the debt ratio, fiscal balances are relatively insensitive to changes in interest rates. The proportion of foreign currency-denominated government debt is low (7.7% in 2021); it is mostly denominated in euro (95% of foreign-denominated debt). Considering the size of the debt ratio, fiscal balances are also relatively insensitive to changes in exchange rates. The share of debt denominated in foreign currencies has been on a decreasing path and stands well below the 2010-14 average (21.8%), pointing to a decline in exchange rate-related vulnerabilities.

The European Commission’s Spring 2022 Economic Forecast predicts an improvement in the budget balance and a moderate increase in the public debt ratio. According to the European Commission’s Spring 2022 Economic Forecast, the headline balance is expected to improve to a deficit of 4.3% of GDP in 2022 and thus stay well above the 3% deficit reference value. The foreseen improvement in the general government balance stems from the improving macroeconomic outlook and the phasing-out of fiscal measures implemented to mitigate the adverse effects of the crisis. The budget balance is projected to improve slightly in 2023 and reach a deficit of 3.9% of GDP. Over the period 2022-23, the structural deficit is expected to stand well above the medium-term objective. Nevertheless, the Stability and Growth Pact’s general escape clause, which continues to be applied in 2022 and is also expected to remain in place in 2023, provides that “in periods of severe economic downturn for the euro area or the Union as a whole, Member States may be allowed temporarily to depart from the adjustment path towards the medium-term budgetary objective…, provided that this does not endanger fiscal sustainability in the medium term”. In 2022 the debt ratio is projected to increase to 42.8% of GDP, before rising further to stand at 44% in 2023. The Czech Republic’s medium-term fiscal policy strategy, as presented in the 2022 update of the convergence programme, forecasts a path for both the nominal and the structural deficit which is somewhat more optimistic than that shown in the European Commission’s Spring 2022 Economic Forecast.

The Czech Republic's fiscal governance framework is applied effectively but further progress remains warranted. The national legislation implementing the EU Directive on requirements for budgetary frameworks was adopted in 2017. Since then, the Fiscal Council has become operational and issued reports on long-term sustainability and on compliance with the budgetary rules. Nevertheless, coordination among the various levels of general government remains low and should be further enhanced. With regard to tax compliance, tax collection has benefited from the implementation of several measures, in particular the electronic registration of sales. Policies aimed at improving tax collection should be continued.

The Czech Republic faces medium risks to fiscal sustainability over the medium term and high risks over the long term. The European Commission's 2021 Fiscal Sustainability Report found that the Czech Republic faced medium fiscal sustainability risks over the medium term,[180] as government debt (which currently stands at 42% of GDP) is projected to rise to 67% of GDP in 2032. Moreover, a sensitivity to macro-fiscal shocks also contributed to this assessment. Over the long term, it was found to face high risks, which were primarily linked to budgetary pressures stemming from population ageing and the initial budgetary position but were also due to risks from a debt sustainability analysis perspective.[181] Indeed, according to the 2021 Ageing Report prepared by the Ageing Working Group (AWG) of the EU's Economic Policy Committee,[182] the Czech Republic would record a significant rise in age-related expenditure (6.1 percentage points of GDP by 2070) under the AWG's reference scenario, from a level of 18.6% of GDP in 2019. Under the AWG's risk scenario, the increase was projected to be 8.0 percentage points of GDP, which was significantly above the EU average. All these factors suggested that reforms of the pension, health and long-term care systems were necessary to improve the long-term sustainability of public finances.

Looking ahead, a prudent fiscal policy will be needed to safeguard the sustainability of public finances. While fiscal policy should remain agile in its response to the evolving pandemic situation and given the geopolitical situation, a consistent and prudent fiscal policy is required to ensure that the Czech Republic complies with the Stability and Growth Pact and maintains buffers to alleviate adverse shocks. This is particularly important given that current fiscal plans seem to entail a risk of entrenching higher structural deficits. These risks are largely associated with the 2021 income tax reform, which has likely lowered revenue generation in the medium term. Public sector indebtedness does, however, not represent a significant risk in the short run against the backdrop of an initial low level. Moreover, the Next Generation EU programme needs to be implemented effectively in order to support the recovery and to adjust to the structural changes that are under way.

[180] This assessment was confirmed by the updated debt sustainability analysis which was published as part of the European Commission's country report for the Czech Republic on 23 May 2022.

[181] However, this assessment does not necessarily reflect the uncertainty surrounding the long-term assumptions and, for high-debt countries, should be viewed with caution.

[182] European Commission and Economic Policy Committee, "The 2021 Ageing Report: Economic and Budgetary Projections for the EU Member States (2019-2070)", *European Economy Institutional Paper*, No 148, European Commission, 2021.

5.2.3 Exchange rate developments

In the two-year reference period from 26 May 2020 to 25 May 2022, the Czech koruna did not participate in ERM II, but traded under a flexible exchange rate regime. Over the reference period the Czech currency mostly traded significantly above its May 2020 average exchange rate against the euro of 27.2687 korunas per euro, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate (Chart 5.2.3). The maximum upward deviation from this benchmark was 11.5%, whereas the maximum downward deviation amounted to 0.6%. On 25 May 2022 the exchange rate stood at 24.6480 korunas per euro, i.e. 9.6% stronger than its average level in May 2020. Over the past ten years the Czech koruna has appreciated by 2.6% against the euro.

The Czech koruna exhibited, on average, a relatively high degree of volatility against the euro over the two-year reference period. Following a depreciation of the currency during the intensification of the COVID-19 pandemic, the Czech koruna broadly strengthened from the beginning of the reference period until late August 2020. It then started to weaken again in September and October as the country experienced a second wave of the pandemic. Thereafter the koruna reversed its depreciation and continued on the stable appreciating path which it had been following before the start of the pandemic, albeit with a higher degree of volatility. Volatility in foreign exchange markets significantly increased at the end of February 2022 following the Russian invasion of Ukraine. On average during the first quarter of 2022, the Czech koruna exhibited a high degree of volatility. At the same time, short-term interest rate differentials against the three-month EURIBOR were modest until the first half of 2021, before turning relatively wide in the second half of the year and further increasing substantially to a level of 5.1 percentage points 5.3 percentage points in the three-month period ending in March 2022.

Over the past ten years the Czech koruna has appreciated in real effective terms (Chart 5.2.4). Following a period of increased volatility at the height of the global financial crisis, the real effective exchange rate weakened until 2015 when it started to appreciate again. However, this indicator should be interpreted with caution, as the Czech Republic is subject to a process of economic convergence, which complicates any long-term assessment of real exchange rate developments.

The combined current and capital account balance has remained in surplus over the past ten years, while the country's net foreign liabilities have declined (Table 5.2.3). The combined current and capital account surplus rose from 0.8% of GDP in 2019 to 3.2% of GDP in 2020, reflecting an increase in the trade surplus owing to improved terms of trade, as well as a decline in the primary income deficit. In 2021 the current account balance narrowed notably. This was due to a decline in the trade surplus on the back of higher import prices and supply chain disruptions denting the recovery in exports, particularly in the automotive sector. At the same time, the primary income deficit decreased to 3.3% in 2021. On the financing side, the Czech Republic recorded fairly sizeable net inflows of other investment, amounting to 4.9% of GDP in 2021. However, these inflows were more than offset by net acquisitions of reserve assets and net inflows of portfolio investment. As a result, the country's gross external debt continued to decline, falling from 75.9% in 2020 to 73.1% in 2021. At the same time, the country's net international investment position continued to improve, from -19.8% of GDP in 2019 to -16.3% of GDP in 2020 and -15.6% in 2021.

The Czech economy is well integrated with the euro area through trade and investment linkages. In 2021 exports of goods and services to the euro area constituted 62.2% of total Czech exports, whereas imports of goods and services from the euro area amounted to 49.5% of the country's total imports. In the same year the share of the euro area in the Czech Republic's stock of inward direct investment stood at 79.4% and its share in the country's stock of portfolio investment liabilities was 75.7%. The share of the Czech Republic's stock of foreign assets invested in the euro area amounted to 69.6% in the case of direct investment and 69.7% for portfolio investment in 2021.

5.2.4 Long-term interest rate developments

Over the reference period from May 2021 to April 2022, long-term interest rates in the Czech Republic stood at 2.5% on average and were thus just below the 2.6% reference value for the interest rate convergence criterion (Chart 5.2.5).

Long-term interest rates in the Czech Republic stood at 4.0% at the end of the reference period, above the level seen at the start of 2012. In the period 2012-16 long-term interest rates in the Czech Republic declined, as the economic recovery did not push up inflation and thus allowed Česká národní banka to maintain a highly accommodative monetary policy. As inflation started to pick up in 2017 long-term interest rates followed suit and increased until 2018, reflecting global developments and an acceleration of economic growth that led to overheating in the domestic labour market and to rising inflationary pressures. In 2019 long-term interest rates changed course again and, despite the gradual tightening of monetary policy initiated by Česká národní banka in mid-2017, started to decline. This was due to signs of weakness in the global economic outlook combined with geopolitical tensions including, in particular, the US-China trade dispute and perceived risks of a disorderly Brexit. Following the outbreak of the COVID-19 pandemic, long-term interest rates reached their lowest point in the summer of 2020, in part reflecting the prompt and decisive interest rate cuts implemented by Česká národní banka over the period from March to May 2020. In this context, the two-week repo rate – the main policy rate – was lowered to 0.25% at the beginning of May 2020, down from 2.25% in February of that year. Since the final quarter of 2020 long-term interest rates have risen steadily owing to persistent inflationary pressures that led Česká národní banka to pursue a series of rate increases between June and December 2021, culminating in a rise in the two-week repo rate to 3.75%. The central bank increased the two-week repo rate three more times in 2022, with the rate standing at 5.75% at the end of the review period. This was in response to continuing upward pressures on inflation from both domestic and foreign sources and to the risk of the Russian invasion of Ukraine leading to higher, and more persistent, inflation than previously expected. The credit quality of Czech government debt remained rather benign. Credit default swap spreads for Czech government debt have been the lowest among the peer group of countries in recent months, stabilising at slightly below 50 basis points. The Czech Republic’s government debt is rated high investment grade by all three main rating agencies (Moody’s: Aa3; S&P: AA-; Fitch: AA-).

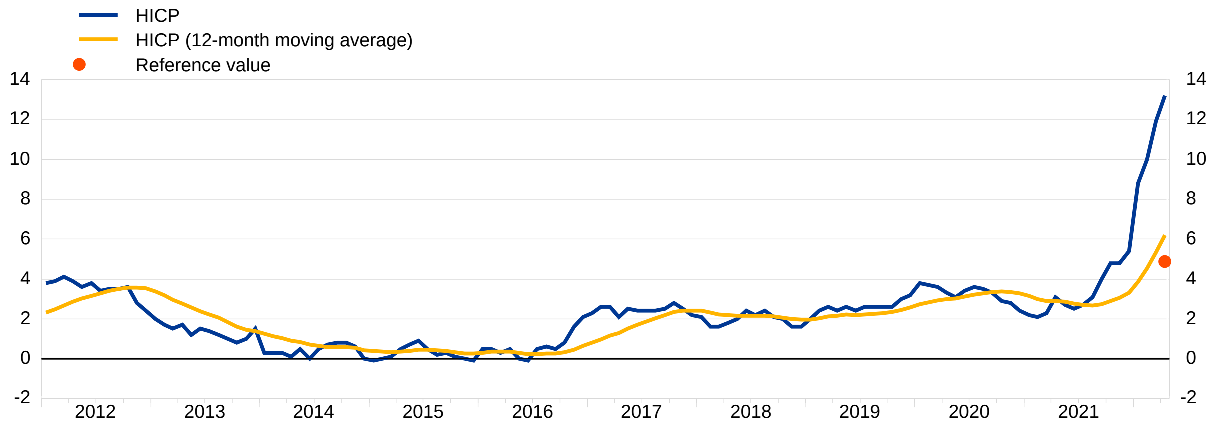
The Czech Republic’s long-term interest rate differential vis-à-vis the euro area average turned positive at the end of 2017 for the first time since 2012 and gradually increased further until April 2022. Over the period 2012-17 this differential remained negative but was increasing steadily, mainly because of the decline in risk premia on euro area sovereign debt that began in late 2012, when the reduction in uncertainty around the resolution of the euro area debt crisis contributed to driving down euro area yields. However, since the end of 2017 a positive – and increasing – long-term interest rate differential has opened, with Czech interest rates exceeding the euro area average, reflecting a persistent and rising inflation differential. In April 2022 the interest rate differential stood at 2.6% (3.1% vis-à-vis the euro area AAA yield), which is the second highest value since the start of the review period (April 2020).

Capital markets in the Czech Republic are smaller and less developed than those in the euro area (Table 5.2.4). Stock market capitalisation in the Czech Republic, as a percentage of GDP, stood at 13.3% in 2021, which is almost equal to the average value recorded over the period 2012-21. Outstanding debt securities issued by non-financial institutions (a measure of market-based indebtedness) have gradually decreased in recent years to stand at 5.2% of GDP in 2021, after averaging over 7% in the period 2012-16. Meanwhile, after having declined for five years, debt securities issued by financial institutions increased in 2021, returning to almost 13% of GDP, which is also in line with the average value observed during the period 2012-21. Financial intermediation, as measured by MFI credit to the non-government sector, increased in 2021 compared with the period 2012-16 and stood at 57.8% of GDP, around half of the euro area average. In recent years the ability of the Czech Republic’s banking sector to obtain funding from euro area banks has stabilised at high levels, as claims of euro area MFIs on resident MFIs stood at 22.4% of the total liabilities of domestic MFIs in 2021. The development of the Czech Republic’s capital markets in terms of size and intermediation capacity remains limited, but is in line with that of other non-euro area EU Member States in central and eastern Europe.

Czech Republic - Price developments

Chart 5.2.1 HICP inflation and reference value [1]

(annual percentage changes)



Sources: European Commission (Eurostat) and ECB calculations.

[1] The basis of the calculation of the reference value for the period from May 2021 to April 2022 is the unweighted arithmetic average of the annual percentage changes in the HICP for France, Finland and Greece plus 1.5 percentage points. The reference value is 4.9%.

Table 5.2.1 Measures of inflation and related indicators

(annual percentage changes, unless otherwise indicated)

	2012-2021 [1]	2012-2016 [1]	2017-2021 [1]	2017	2018	2019	2020	2021	2022 [2]	2023 [2]
Measures of inflation										
HICP	2.0	1.2	2.7	2.4	2.0	2.6	3.3	3.3	11.7	4.5
HICP excluding unprocessed food and energy	2.1	1.3	2.8	2.6	1.8	2.3	3.7	3.8	8.9	4.0
HICP at constant tax rates [3]	1.7	0.7	2.7	2.6	1.9	2.6	3.2	3.4	-	-
CPI	2.0	1.2	2.9	2.5	2.1	2.8	3.2	3.8	.	.
Private consumption deflator	1.8	0.8	2.7	2.3	2.5	2.8	2.8	3.1	11.7	5.4
GDP deflator	2.4	1.5	3.2	1.3	2.6	3.9	4.4	4.0	7.4	4.7
Producer prices [4]	0.9	-0.9	2.7	1.8	2.0	2.6	0.1	7.1	-	-
Related indicators										
Real GDP growth	1.8	1.8	1.7	5.2	3.2	3.0	-5.8	3.3	1.9	2.7
GDP per capita in PPS [5] (euro area = 100)	83.4	80.6	87.0	85.0	86.3	87.6	89.2	.	-	-
Comparative price levels (euro area = 100)	67.4	65.3	70.1	66.8	70.0	71.0	72.5	.	-	-
Output gap [6]	-0.7	-1.4	0.1	1.9	2.4	2.9	-4.3	-2.4	-2.2	-1.2
Unemployment rate (%) [7]	4.2	5.8	2.5	2.9	2.2	2.0	2.6	2.8	2.6	2.6
Unit labour costs, whole economy	3.0	1.3	4.8	3.5	6.1	4.3	7.7	2.3	2.8	2.8
Compensation per employee, whole economy	4.3	2.3	6.2	7.2	8.1	7.2	3.2	5.6	2.4	5.3
Labour productivity, whole economy	1.2	1.0	1.4	3.6	1.8	2.8	-4.2	3.2	-0.3	2.4
Imports of goods and services deflator	0.6	0.3	0.9	0.3	-0.6	0.8	-0.2	4.4	7.9	3.1
Nominal effective exchange rate [8]	0.0	-1.9	2.0	3.6	4.5	-0.6	-1.3	3.8	-	-
Money supply (M3) [9]	7.2	6.2	8.1	11.2	6.2	6.5	9.7	7.2	-	-
Lending from banks [10]	6.2	5.7	6.7	7.6	7.3	5.5	3.3	10.1	-	-
Stock prices (PX Index) [11]	56.5	1.2	54.7	17.0	-8.5	13.1	-7.9	38.8	-	-
Residential property prices	6.8	2.4	11.4	11.7	8.6	9.2	8.4	19.7	-	-

Sources: European Commission (Eurostat, Directorate-General for Economic and Financial Affairs), national data for CPI, money supply, lending from banks and ECB calculations based on Refinitiv data for stock prices.

[1] Multi-annual averages calculated using the geometric mean, except for GDP per capita in PPS, comparative price levels, output gap and unemployment rate, for which the arithmetic mean is used.

[2] Data from the European Commission’s Spring 2022 Economic Forecast.

[3] The difference between the HICP and the HICP at constant tax rates shows the theoretical impact of changes in indirect taxes (e.g. VAT and excise duties) on the overall rate of inflation. This impact assumes a full and instantaneous pass-through of tax rate changes to the price paid by the consumer.

[4] Domestic sales, total industry excluding construction.

[5] PPS stands for purchasing power standards.

[6] Percentage difference from potential GDP: a positive (negative) sign indicates that actual GDP is above (below) potential GDP.

[7] Definition conforms to International Labor Organization guidelines.

[8] EER-42 group of trading partners. A positive (negative) sign indicates an appreciation (depreciation).

[9] The series includes repurchase agreements with central counterparties.

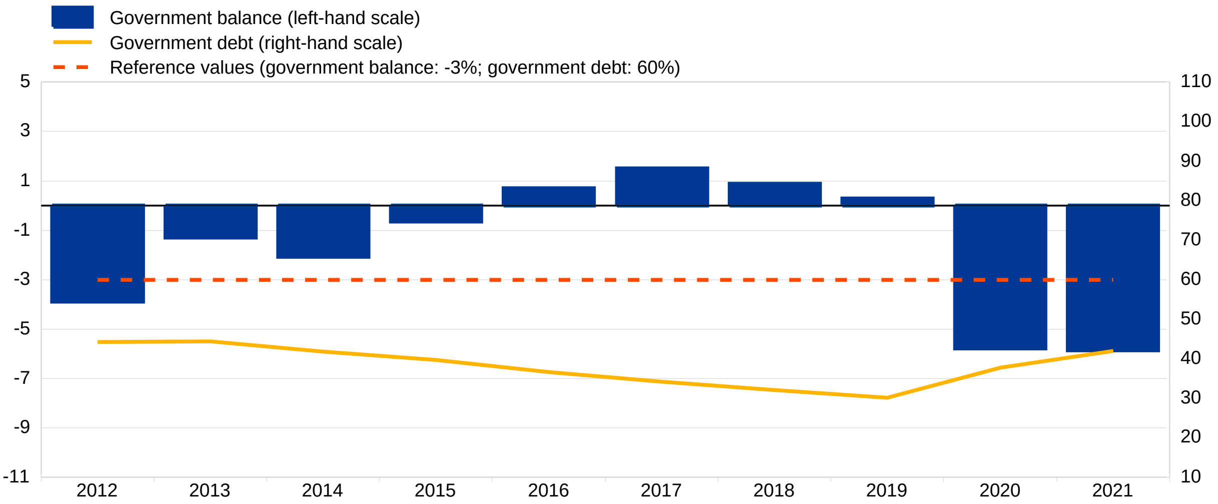
[10] Adjusted for the derecognition of loans from the MFI statistical balance sheet due to their sale or securitisation.

[11] Multi-annual and annual figures represent the percentage change between the end of the given period and the end of the previous period.

Czech Republic - Fiscal developments

Chart 5.2.2 General government balance and debt

(as a percentage of GDP)



Sources: European System of Central Banks and European Commission (Eurostat).

Table 5.2.2 Government budgetary developments and projections

(as a percentage of GDP, unless otherwise indicated)

	2012-2021 [1]	2012-2016 [1]	2017-2021 [1]	2017	2018	2019	2020	2021	2022 [2]	2023 [2]
Government balance	**-1.6**	**-1.4**	**-1.8**	**1.5**	**0.9**	**0.3**	**-5.8**	**-5.9**	-4.3	-3.9
Total revenue	41.0	40.9	41.1	40.5	41.5	41.4	41.6	40.5	40.2	39.8
Current revenue	40.0	39.7	40.3	39.8	40.7	40.5	40.6	39.6	38.6	38.1
Direct taxes	7.9	7.7	8.1	8.1	8.5	8.5	8.5	6.8	6.5	6.5
Indirect taxes	12.0	12.2	11.8	12.3	12.0	11.9	11.4	11.5	11.4	11.4
Net social contributions	15.1	14.6	15.7	14.9	15.4	15.5	16.0	16.6	15.8	15.5
Other current revenue [3]	5.0	5.3	4.7	4.6	4.8	4.7	4.7	4.8	4.9	4.8
Capital revenue	1.0	1.2	0.8	0.6	0.8	0.8	0.9	0.9	1.6	1.7
Total expenditure	42.6	42.3	42.9	39.0	40.6	41.1	47.3	46.4	44.5	43.7
Current expenditure	37.3	36.9	37.8	35.0	35.7	36.0	41.2	40.9	38.8	38.2
Compensation of employees	9.4	8.7	10.2	9.0	9.6	9.9	11.1	11.0	10.2	10.0
Social benefits	16.3	16.3	16.3	15.2	15.1	15.3	18.0	17.8	17.2	17.2
Interest payable	1.0	1.2	0.7	0.7	0.7	0.7	0.8	0.7	0.9	0.9
Other current expenditure [4]	10.6	10.7	10.6	10.0	10.3	10.0	11.3	11.4	10.5	10.1
Capital expenditure	5.3	5.4	5.1	4.0	4.9	5.1	6.1	5.5	5.8	5.5
of which: Investment	4.2	4.1	4.3	3.3	4.1	4.4	4.9	4.7	4.9	5.2
Cyclically adjusted balance	-1.4	-0.9	-1.8	0.7	-0.1	-0.9	-4.1	-4.9	-3.4	-3.5
One-off and temporary measures	-0.2	-0.4	0.0	0.0	0.0	0.0	0.0	0.0	-0.4	0.0
Structural balance [5]	-1.1	-0.4	-1.8	0.7	-0.1	-0.9	-4.1	-4.9	-3.1	-3.5
Government debt	**38.3**	**41.3**	**35.2**	**34.2**	**32.1**	**30.1**	**37.7**	**41.9**	42.8	44.0
Average residual maturity (in years)	-	-	-	-	-	-	-	-	.	.
In foreign currencies (% of total)	15.8	20.6	11.1	15.0	12.4	11.7	8.7	7.7	.	.
of which: Euro	14.9	19.2	10.5	14.2	11.7	11.1	8.1	7.4	.	.
Domestic ownership (% of total)	64.2	65.3	63.2	54.6	60.4	61.6	67.8	71.6	.	.
Medium and long-term maturity (% of total) [6]	96.0	94.1	97.8	97.1	97.0	98.7	98.7	97.5	.	.
of which: Variable interest rate (% of total)	13.8	15.8	11.8	11.8	12.5	12.4	10.2	11.9	.	.
Deficit-debt adjustment	**0.1**	**-0.7**	**1.0**	**1.4**	**0.6**	**0.4**	**1.4**	**0.9**	.	.
Net acquisitions of main financial assets	0.7	0.1	1.4	1.8	0.2	0.3	2.0	2.5	.	.
Currency and deposits	0.8	0.1	1.5	2.2	0.4	0.4	2.0	2.4	.	.
Debt securities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	.	.
Loans	-0.1	0.0	-0.1	-0.3	-0.2	-0.1	0.0	0.1	.	.
Equity and investment fund shares or units	0.0	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	.	.
Revaluation effects on debt	-0.1	-0.1	0.0	-0.2	0.1	0.0	0.1	-0.1	.	.
of which: Foreign exchange holding gains/losses	0.0	0.0	-0.1	-0.3	0.0	0.0	0.1	-0.1	.	.
Other [7]	-0.5	-0.6	-0.4	-0.2	0.3	0.0	-0.7	-1.5	.	.
Convergence programme: government balance	-	-	-	-	-	-	-	-	-3.6	-2.3
Convergence programme: structural balance	-	-	-	-	-	-	-	-	-3.1	-3.1
Convergence programme: government debt	-	-	-	-	-	-	-	-	42.7	43.4

Sources: European System of Central Banks and European Commission (Eurostat, Directorate-General for Economic and Financial Affairs).

[1] Multi-annual averages calculated using the arithmetic mean.

[2] Data from the European Commission’s Spring 2022 Economic Forecast, except for convergence programme data.

[3] Sales and other current revenue.

[4] Intermediate consumption, subsidies payable and other current expenditure.

[5] Cyclically adjusted balance excluding one-off and other temporary measures.

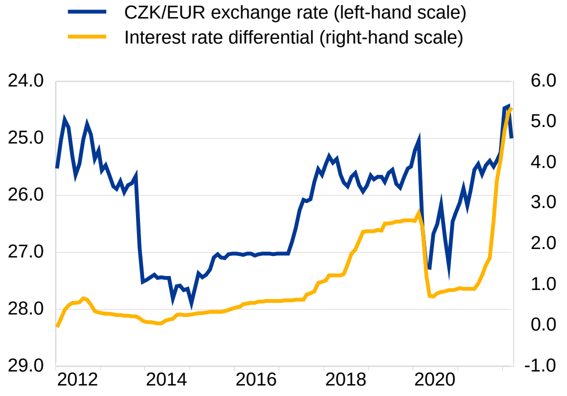
[6] Original maturity of more than one year.

[7] Time of recording differences and other factors (sector reclassifications and statistical discrepancies).

Czech Republic - Exchange rate and external developments

Chart 5.2.3 Bilateral exchange rate and short-term interest rate differential

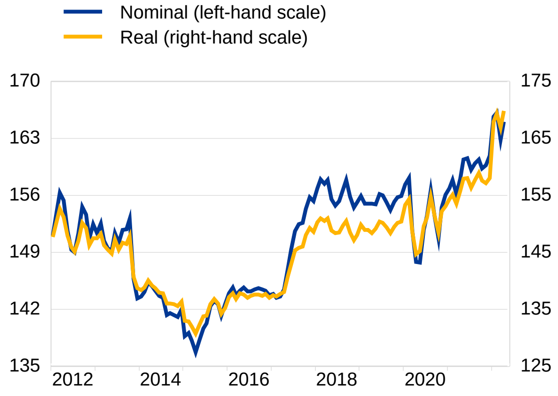
(CZK/EUR exchange rate: monthly averages; difference between three-month interbank interest rates and three-month EURIBOR: basis points, monthly values)



Sources: National data and ECB calculations.

Chart 5.2.4 Effective exchange rates [1]

(EER-42 group of trading partners; monthly averages; index: Q1 1999 = 100)



Source: ECB.

1) The real EER-42 is CPI-deflated. An increase (decrease) in the EER indicates an appreciation (depreciation).

Table 5.2.3 External developments

(as a percentage of GDP, unless otherwise indicated)

	2012-2021 [1]	2012-2016 [1]	2017-2021 [1]	2017	2018	2019	2020	2021	2022 [2]	2023 [2]
Balance of payments										
Current account and capital account balance [3]	1.5	1.5	1.5	2.4	0.7	0.8	3.2	0.7	-1.9	-1.8
Current account balance	0.4	0.1	0.7	1.5	0.5	0.3	2.0	-0.9	-3.7	-3.8
Goods	4.1	4.3	3.8	5.0	3.7	4.1	4.9	1.2	.	.
Services	1.9	1.8	2.0	2.4	2.2	1.8	1.8	1.8	.	.
Primary income	-5.1	-5.7	-4.5	-5.0	-4.8	-5.0	-4.2	-3.3	.	.
Secondary income	-0.5	-0.3	-0.6	-1.0	-0.7	-0.6	-0.5	-0.5	.	.
Capital account balance	1.2	1.4	0.9	0.9	0.2	0.4	1.2	1.6	.	.
Combined direct and portfolio investment balance [3]	-3.0	-3.2	-2.9	-5.9	-0.4	-4.2	-5.0	1.1	.	.
Direct investment	-1.4	-1.5	-1.4	-0.9	-0.9	-2.4	-2.6	-0.1	.	.
Portfolio investment	-1.6	-1.7	-1.5	-5.0	0.6	-1.8	-2.4	1.2	.	.
Other investment balance	-1.1	-0.3	-2.0	-15.4	0.9	2.4	6.9	-4.9	.	.
Reserve assets	6.0	5.5	6.4	23.8	0.9	1.9	0.8	4.9	.	.
Exports of goods and services	76.6	78.7	74.5	78.9	77.0	73.9	70.2	72.5	.	.
Imports of goods and services	70.6	72.6	68.7	71.5	71.0	67.9	63.4	69.5	.	.
Net international investment position [4]	-28.4	-36.6	-20.2	-24.9	-24.4	-19.8	-16.3	-15.6	.	.
Gross external debt [4]	72.5	66.7	78.3	85.5	81.6	75.7	75.9	73.1	.	.
Trade with the euro area [5]										
Exports of goods and services	62.3	62.3	62.2	62.6	61.9	61.9	62.2	62.2	.	.
Imports of goods and services	51.8	52.4	51.2	52.5	52.1	51.6	50.4	49.5	.	.
Investment position with the euro area [5]										
Direct investment assets [4]	76.3	78.8	73.8	80.4	73.7	73.2	72.3	69.6	.	.
Direct investment liabilities [4]	80.5	81.0	80.0	80.8	80.5	80.0	79.1	79.4	.	.
Portfolio investment assets [4]	71.4	73.2	69.7	70.2	69.2	69.8	69.6	69.7	.	.
Portfolio investment liabilities [4]	61.4	53.7	69.0	61.9	65.4	69.4	72.4	75.7	.	.

Sources: European System of Central Banks and European Commission (Eurostat, Directorate-General for Economic and Financial Affairs).

1) Multi-annual averages calculated using the arithmetic mean.

2) Data from the European Commission's Spring 2022 Economic Forecast.

3) Differences between totals and the sum of their components are due to rounding.

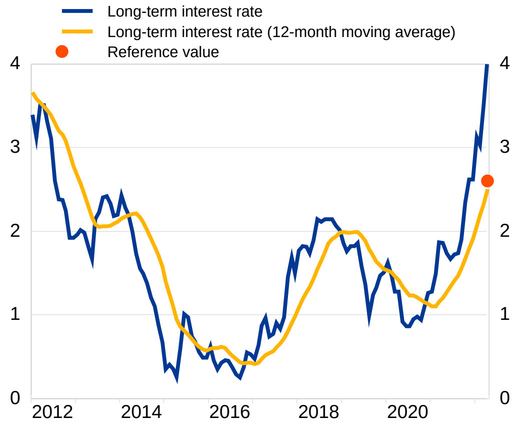
4) End-of-period outstanding amounts.

5) As a percentage of the total.

Czech Republic - Long-term interest rate developments

Chart 5.2.5 Long-term interest rate [1)]

(monthly averages in percentages)

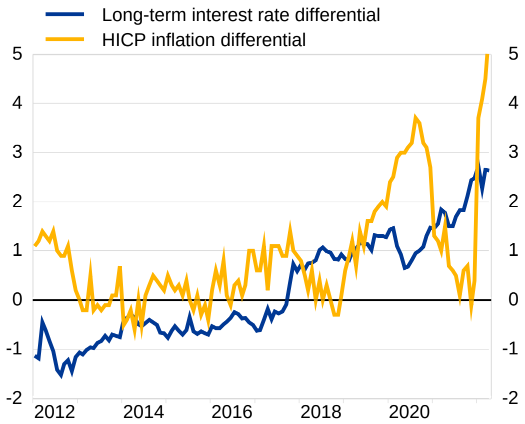


Sources: European System of Central Banks and ECB calculations.

1) The basis of the calculation of the reference value for the period from May 2021 to April 2022 is the unweighted arithmetic average of the interest rate levels in France, Finland and Greece plus 2 percentage points. The reference value is 2.6%.

Chart 5.2.6 Long-term interest rate and HICP inflation differentials vis-à-vis the euro area

(monthly averages in percentage points)



Sources: European System of Central Banks, ECB calculations and European Commission (Eurostat).

Table 5.2.4 Long-term interest rates and indicators of financial development and integration

(as a percentage of GDP, unless otherwise indicated)

	2012-2021 [1)]	2012-2016 [1)]	2017-2021 [1)]	2018	2019	2020	2021	May. 2021 to Apr. 2022	Memo item: euro area 2021
Long-term interest rates									
Czech Republic [2)]	1.5	1.5	1.5	2.0	1.5	1.1	1.9	2.5	-
Euro area [3), 4)]	1.4	2.2	0.6	1.1	0.4	0.1	0.1	0.4	-
Euro area AAA par curve, ten-year residual maturity [2), 4)]	0.6	1.2	0.0	0.5	-0.2	-0.4	-0.3	-0.1	-
Indicators of financial development and integration									
Debt securities issued by financial corporations [5)]	12.8	13.7	11.8	11.3	9.2	13.6	12.7	-	66.7
Debt securities issued by non-financial corporations [6)]	6.8	7.4	6.2	6.8	6.4	6.2	5.2	-	13.4
Stock market capitalisation [7)]	13.1	14.6	11.6	11.2	10.3	10.0	13.3	-	77.7
MFI credit to non-government residents [8)]	54.5	53.2	55.8	55.2	54.1	57.1	57.8	-	111.1
Claims of euro area MFIs on resident MFIs [9)]	17.1	9.9	24.3	26.0	25.0	22.8	22.4	-	29.5

Sources: European System of Central Banks and ECB calculations.

1) Multi-annual averages calculated using the arithmetic mean.

2) Average interest rate.

3) GDP-weighted average of the euro area long-term interest rates for the purpose of assessing convergence.

4) Included for information only.

5) Outstanding amount of debt securities issued by resident MFIs (excluding the national central bank) and other financial corporations.

6) Outstanding amount of debt securities issued by resident non-financial corporations.

7) Outstanding amount of listed shares issued by residents at market values.

8) MFI (excluding national central bank) credit to domestic non-MFI residents other than general government. Credit comprises outstanding amounts of loans and debt securities.

9) Outstanding amount of deposits and debt securities issued by domestic MFIs (excluding the national central bank) held by euro area MFIs as a percentage of total liabilities of domestic MFIs (excluding the national central bank). Total liabilities exclude capital and reserves and remaining liabilities.

5.3 Croatia

5.3.1 Price developments

In April 2022 the 12-month average rate of HICP inflation in Croatia was 4.7%, i.e. below the reference value of 4.9% for the criterion on price stability (Chart 5.3.1). This rate is expected to increase gradually over the coming months, driven mainly by the higher commodity prices, broadening price pressures and further aggravation of supply bottlenecks resulting from the Russia-Ukraine war.

Over the past ten years the 12-month average rate of HICP inflation has fluctuated within a relatively wide range, from -0.8% to 4.7%, and the average for that period was subdued, standing at 1.1%. Average inflation rose between 2012 and 2013 owing to increases in energy and food prices, before falling to a very low level in 2014 and entering negative territory in 2015 and 2016, largely on the back of lower commodity prices and subdued domestic price pressures. In 2017 inflation turned positive, driven mainly by food price developments and a recovery in domestic demand (Table 5.3.1). Headline inflation increased further in 2018 as growth in energy prices accelerated, but fell again in 2019 owing to a significant reduction in the value added tax (VAT) rate on selected unprocessed foods and a moderation in energy price inflation. The slowdown in inflation in 2020 was driven by the sharp drop in energy prices as a result of the fall in global oil prices during the first few months of the coronavirus (COVID-19) pandemic. To a lesser extent that slowdown also reflected a decline in demand for tourism-related services and durable consumer goods. In 2021 HICP inflation rose sharply again, owing mainly to higher energy costs, but also to the higher food prices resulting from the spillover of inflationary pressures on imported goods (e.g. raw materials, energy products and transportation costs) and from the adverse weather conditions that weighed on the supply of certain crops. Helped by ample policy support, the impact of the pandemic on labour markets was contained. Wage growth continued its pre-pandemic upward trend almost unabated, while the unemployment rate returned to close to its pre-crisis level in 2021, in the context of an exceptionally strong rebound in economic activity.

In the first four months of 2022 the average annual rate of HICP inflation stood at 7.2%. Continuing the upward trend it had started in 2021, HICP inflation increased further at the beginning of 2022, driven largely by sharp increases in energy and food prices. Those high inflationary pressures were then compounded by Russia’s invasion of Ukraine in late February. The rise in HICP inflation was mitigated by fiscal measures (some temporary), such as reduced VAT rates for gas, electricity and basic groceries, cuts in fuel excise duties and the freezing of margins on petroleum products.

Policy choices have played an important role in shaping inflation dynamics in Croatia over the past decade, most notably the orientation of monetary policy towards price stability. The primary objective of Hrvatska narodna banka is to maintain price stability. Since the introduction of the kuna in 1994, the central bank has pursued that objective by ensuring a stable exchange rate of the kuna against the euro. Prior to Croatia’s participation in ERM II, the local currency traded under a tightly managed floating exchange rate regime, with no pre-announced level, path or band, and its exchange rate against the euro fluctuated within a narrow range of -4.7% and +3.8% around its average level from 1999. Over the years Hrvatska narodna banka conducted foreign exchange interventions (one of the main monetary policy tools of the central bank) both to support and weaken the currency, although in the five years preceding the outbreak of the pandemic, most of those interventions were to counter appreciation pressures. In the early stages of the COVID-19 crisis, the central bank had to strongly intervene to support the kuna and maintain sufficient liquidity in the financial system (see Section 5.3.3 for more details). In July 2020 the kuna was included in ERM II with a central exchange rate of 7.53450 kuna per euro.

Inflation is expected to return to moderate levels in the coming years. However, the forecasts are subject to considerable uncertainty in the light of the Russia-Ukraine war. Over the longer term there are concerns about the sustainability of inflation convergence in Croatia. According to the European Commission’s Spring 2022 Economic Forecast, the average annual rate of HICP inflation is expected to reach 6.1% in 2022, before decelerating to 2.8% in 2023, owing mainly to a fall in energy prices and the easing of global supply bottlenecks. The risks to the short-term inflation outlook are tilted to the upside, as supply bottlenecks and the higher energy and food prices could continue for longer than projected. Moreover, although recent liberalisation measures in the labour market have helped to cushion wage pressures, persistent labour shortages in some sectors may still result in stronger than expected wage growth, thus exerting upward pressure on inflation. Looking further ahead, the catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area, since GDP per capita and price levels are still lower in Croatia than in the euro area. In order to prevent the build-up of excessive price pressures and macroeconomic imbalances, the catching-up process must be supported by appropriate policies.

Achieving an environment that is conducive to sustainable convergence in Croatia requires stability-oriented economic policies and wide-ranging structural reforms. Given monetary policy’s limited room for manoeuvre owing to the tightly managed floating exchange rate regime and the high level of euroisation, it is imperative that other policy areas provide the economy with the wherewithal to cope with country-specific shocks in order to ensure the correction of macroeconomic imbalances and prevent their recurrence in the future. Although the COVID-19 crisis has not hampered Croatia’s reform momentum, also in the context of the post-entry commitments the country made upon joining ERM II, its economic growth potential is still low for a catching-up economy, particularly in terms of the contribution from productivity. As this is standing in the way of economic convergence with the euro area average, Croatia needs to implement structural policies aimed at raising potential growth and enhancing the competitiveness of its economy. Priority should be given to improving the quality of the institutional and business environment, including boosting competition in product markets. In addition, it is essential to improve the efficiency of the public administration and the judicial system. Overall, policies should be geared towards supporting innovation and investment in new technologies, also with a view to reducing the country’s high dependence on tourism. Modernising its infrastructure (in particular the rail network) would boost potential output and promote a more efficient allocation of resources. Measures should also be implemented to reduce mismatches in the labour market, enhance the quantity and quality of the labour supply, push up the low participation rate (especially in the 50-64 age group) and align the education system with the needs of the market. Against this background, it will be of utmost importance to ensure an efficient absorption of the abundant EU funds allocated to the country. With regard to macroeconomic imbalances, the European Commission selected Croatia for an in-depth review in its Alert Mechanism Report 2022, which highlighted that imbalances relating to high levels of external, private and government debt in the context of low potential growth continued to subside in 2021, returning to their favourable pre-pandemic trends.

The convergence in banking supervision achieved under the close cooperation framework ensures the application of uniform supervisory standards and thus contributes to safeguarding financial stability. With the entry into force of the close cooperation framework between the ECB and Hrvatska narodna banka on 1 October 2020, the ECB became responsible for the direct supervision of eight significant institutions and for the oversight of 15 less significant institutions in Croatia. Hrvatska narodna banka has been integrated into the Single Supervisory Mechanism and is participating in its structures and networks. Croatian significant institutions are now supervised by Joint Supervisory Teams supported by experts in horizontal line supervision. With regard to the oversight of less significant institutions, which have a domestic market share of roughly 22%, the ECB is working closely with national supervisors to further harmonise implementation of the rules governing banking supervision, while also ensuring that joint supervisory standards are applied consistently across the system. As at the end of 2021, Croatia's banking sector had a sound capital position and sufficient liquidity. Following a sharp decline in 2020, bank profits recovered partially in 2021. The non-performing loan ratio stood at 4.6% in September 2021, but continued to decline despite the phasing-out of the pandemic-related policy support measures. After a setback in 2020, the corporate debt-to-GDP ratio started to fall again in 2021 but remains high. By contrast, household debt, although low relative to GDP, continued the upward trend it had initiated in 2017, underpinned by the Government's subsidisation programme for housing loans and buoyant house price dynamics. In this context, the build-up of risks in the residential real estate segment warrants close monitoring.

5.3.2 Fiscal developments

Croatia's general government budget balance was just below the 3% deficit reference value in 2021 and its debt was above the 60% reference value. In the reference year 2021, the general government budget balance recorded a deficit of 2.9% of GDP, thus just below the 3% deficit reference value. The general government gross debt-to-GDP ratio was 79.8%, above the 60% reference value (Table 5.3.2). Compared with the previous year, the general government deficit improved by 4.4 percentage points and the debt ratio decreased significantly by 7.5 percentage points. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2021. The budget deficits in 2020 and 2021 were substantially affected by the economic impact of the COVID-19 pandemic and the fiscal policy measures taken in response to it.

Croatia has been subject to the preventive arm of the Stability and Growth Pact since 2017. The general government deficit-to-GDP ratio in 2021 was below the reference value of 3% and is projected to remain below it in 2022. Therefore, Croatia fulfilled the deficit criterion as defined in the Treaty and in Regulation (EC) No 1467/1997. Even though Croatia's debt ratio was above the reference value of 60% of GDP, it complied with the debt criterion, as the debt reduction benchmark had been respected in 2021. In the preceding year, in June 2021, the European Commission had found that the general government deficit in 2020 was above and not close to the reference value of 3% of GDP. The excess over the reference value was considered to be exceptional, but not temporary, as defined by the Treaty. Moreover, Croatia's general government debt exceeded the 60% of GDP reference value and did not diminish at a satisfactory pace. However, taking into account the high uncertainty, the agreed fiscal policy response to the COVID-19 crisis and the Council recommendations of 20 July 2020, the Commission considered that at that juncture a decision on whether to place Member States under the excessive deficit procedure should not be taken. Previously, Croatia had been subject to an excessive deficit procedure as of January 2014, which was abrogated in June 2017.[183] In the subsequent period to 2019, the deficit and debt criteria were comfortably met and Croatia was found to be compliant with the provisions of the preventive arm of the Stability and Growth Pact.

Both cyclical and non-cyclical factors relating to the COVID-19 pandemic contributed to the deterioration in the budget balance over the period 2019-21. During the period 2015-19, the nominal budget deficit improved markedly to an average of 0.6% (from an average of 6.1% of GDP in the period 2010-14). This was driven by a large structural adjustment and the improvement in the macroeconomic conditions. In 2019 Croatia recorded a surplus of 0.2% of GDP. Owing to the COVID-19 pandemic, the budget balance deteriorated in 2020 by 7.5 percentage points (3 percentage points in structural terms), before recovering in 2021 by 4.4 percentage points (1.3 percentage points in structural terms). The sharp deterioration in the government balance in 2020 resulted from the marked deterioration in economic activity and the discretionary fiscal measures implemented to support companies and households, as well as the operation of automatic fiscal stabilisers. Croatia's deficit improved significantly over 2021 thanks to the strong growth in GDP and government tax revenue, coupled with the phasing-out of COVID-19-related expenditure measures.

The government debt-to-GDP ratio has remained well above the 60% reference value over the past decade, having followed a downward path from 2015 to 2019, before increasing again during the COVID-19 crisis. The debt ratio increased rapidly and continuously from 48.7% of GDP in 2009 to a peak of 84.7% of GDP in 2014. From 2015 to 2019, the debt ratio followed a downward path and

[183] The ECOFIN Council, following Croatia's accession to the EU in June 2013 and taking into account the level of the 2013 deficit, as well as the planned 2014 deficit – both of which breached the 3% deficit reference value – decided on January 2014 to open an excessive deficit procedure, with the deadline for correcting the excessive deficit being 2016.

reached a trough of 71.1% of GDP in 2019, mostly reflecting primary surpluses, as well as some favourable deficit-debt adjustments. However, the debt ratio increased by 16.2 percentage points of GDP in 2020, rising to a historical peak of 87.3% of GDP, notably on account of the impact of the COVID-19 crisis. The debt ratio decreased by around 7.5 percentage points in 2021 to reach 79.8% of GDP, i.e. below the peak value in 2014 prior to the pandemic.

While Croatia is protected, to some extent, from interest rate shocks, its fiscal balances would be highly sensitive to any exchange rate movements vis-à-vis the euro. The share of government debt with a short-term maturity is low (5.7% in 2021 – Table 5.3.2). Taking into account the fact that the medium and long-term debt is based entirely on fixed rates, fiscal balances are relatively insensitive to interest rate changes. However, a high share of public debt is denominated in foreign currency (70.7% in 2021), mainly euro (99.9% of foreign-denominated debt). Taking the government debt-to-GDP ratio into account, this implies that fiscal balances are highly sensitive to exchange rate changes. However, the high sensitivity of fiscal balances to euro/kuna exchange rate changes is mitigated by the tightly managed float operated by Hrvatska narodna banka (designed to reduce exchange rate volatility against the euro). In addition, the proportion of government debt issued in kuna has slightly increased (Table 5.3.2).

The European Commission's Spring 2022 Economic Forecast predicts an improvement in the budget balance (with the deficit remaining below the 3% reference value) and a marked decrease in the debt ratio. The European Commission's Spring 2022 Economic Forecast indicates continued compliance with the deficit and debt criteria of the Stability and Growth Pact. The nominal deficit is expected to remain below the 3% reference value and decline to 2.3% of GDP in 2022 and 1.8% of GDP in 2023. According to the European Commission's Spring 2022 Forecast, the structural deficit is expected to stand well above the medium-term objective (a structural deficit of 1% of GDP) over the period 2022-23.[184] Nevertheless, the Stability and Growth Pact's general escape clause, which continues to be applied in 2022 and is also expected to remain in place in 2023, provides that "in periods of severe economic downturn for the euro area or the Union as a whole, Member States may be allowed temporarily to depart from the adjustment path towards the medium-term budgetary objective…, provided that this does not endanger fiscal sustainability in the medium term". In 2022 the debt ratio is projected to further decrease to 75.3% of GDP, but remain above the 60% reference value. Croatia's medium-term fiscal policy strategy, as presented in the 2022 update of the convergence programme, forecasts a path for both the nominal and the structural deficit which is close to that shown in the European Commission's Spring 2022 Economic Forecast.

Croatia has improved its fiscal framework, but further progress remains warranted with a view to ensuring efficient absorption of the Next Generation EU funds. Since the last report, Croatia has made progress in the reduction of public sector inefficiencies, including the management of state-owned enterprises,

[184] In January 2020, Croatia's medium-term objective changed from a structural deficit of 1.75% of GDP to a structural deficit of 1% of GDP.

simplification and digitalisation of administrative procedures and the fight against corruption. Measures have also been taken to improve the public finance management framework and the efficiency and sustainability of the healthcare system, with a view to strengthening the structural position of Croatia’s public finances in the medium term. Croatia has the opportunity, as one of the main recipients of the Next Generation EU funds, to address these challenges further and, if funds are used efficiently, upgrade its infrastructure and improve its resilience to adverse shocks without weighing on its government debt.

Croatia faces medium debt sustainability risks over the medium and long run. While the 2021 Fiscal Sustainability Report concluded that risks to fiscal sustainability over the medium term are high, the updated assessment that was published as part of the European Commission’s country report for Croatia on 23 May 2022 points to medium risks. Over the long term, Croatia appeared to be at medium risk,[185] as the risks to age-related spending (particularly old age pension spending) were contained. Indeed, according to the 2021 Ageing Report prepared by the Ageing Working Group (AWG) of the EU’s Economic Policy Committee,[186] Croatia was likely to experience a slight decline in age-related public expenditure by 0.3 percentage points of GDP by 2070 under the AWG’s reference scenario, from a level of 21.5% of GDP in 2019, albeit this turns into an increase of 3.1 percentage points of GDP under the AWG’s risk scenario. The decline was mainly due to some savings in gross pensions, which were projected to fall from 10.2% of GDP to 9.5% in the period 2019-70, owing to a relative decline in the benefit ratio and the coverage ratios. A recent reform of the pension system over the period 2019-20 has nevertheless mitigated the decline in these ratios by increasing the retirement age and the minimum pension and penalising early retirement. In turn, the adequacy of the pension system has improved by comparison with the previous AWG report, with a limited burden on long-term fiscal sustainability.

Looking ahead, a prudent and credible fiscal policy, as well as further structural reforms, are needed for public finances to ensure a downward debt path. While fiscal policy should remain agile in its response to the evolving pandemic situation and given the geopolitical situation, a consistent and prudent fiscal policy will ensure that Croatia complies with the Stability and Growth Pact and maintains buffers to alleviate adverse shocks. A fiscal policy aimed at enhancing the efficiency of public spending should also create space for more growth-supporting policies. The Next Generation EU programme needs to be implemented effectively to support the recovery and adjust to the structural changes that are under way. Moreover, there is scope for more cost-effective provision of healthcare and social protection services, as rising arrears exert notable pressures on the fiscal budget. The health sector is specifically supported by a dedicated component of the Recovery and Resilience Facility, with a view to improving its efficiency and financial sustainability. Also, to ensure a downward government debt path, the fiscal responsibility legislation should be enforced. Continued efforts to improve the governance framework of state-owned enterprises

[185] However, this assessment does not necessarily reflect the uncertainty surrounding the long-term assumptions and, for high-debt countries, should be viewed with caution.

[186] European Commission and Economic Policy Committee, “The 2021 Ageing Report: Economic & Budgetary Projections for the 28 EU Member States (2019-2070)”, *European Economy Institutional Paper*, No 148, European Commission, 2021.

and further lower the stock of arrears in the health sector are warranted to further reduce the government’s contingent liabilities.

5.3.3 Exchange rate developments

On 10 July 2020 the ERM II parties decided, by mutual agreement, to include the Croatian kuna in ERM II, and it therefore participated in ERM II for most of the two-year reference period from 26 May 2020 to 25 May 2022. The Croatian kuna was included in ERM II at a central rate of 7.53450 kuna per euro with a standard fluctuation band of ±15%. The agreement on participation in ERM II was based on a number of policy commitments by the Croatian authorities, some of which had already been met when the kuna was included in ERM II, with the aim of achieving a high degree of sustainable economic convergence by the time of the adoption of the euro. These commitments relate to banking supervision, the country’s macroprudential framework, its anti-money-laundering (AML) framework, the collection, production and dissemination of statistics, the business environment, public sector governance and the insolvency framework. The ECB and the European Commission have been monitoring the effective implementation of these commitments, acting within their respective areas of competence as provided for by the Treaties and secondary legislation. In its role as the supervisory authority and given its shared responsibility for macroprudential policy, the ECB is closely monitoring the implementation of the commitments related to the financial sector, i.e. the insolvency framework and AML framework, owing to their potential impact on prudential aspects. Notwithstanding the fact that all of the measures envisaged in the ERM II post-entry commitments have been met, further progress needs to be made to address the outstanding shortcomings in the area of AML, as identified in the recent report by the Council of Europe’s Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (MONEYVAL). Based on the key findings of the Mutual Evaluation Report on Croatia, MONEYVAL decided at its plenary meeting on 15-17 December 2021 to place Croatia in “enhanced follow-up”.[187] Over the reference period the exchange rate of the Croatian kuna against the euro displayed a low degree of volatility and traded close to its central rate (Chart 5.3.3). Since the kuna’s inclusion in ERM II, as well as over the entire reference period, the maximum upward deviation from the central rate has been 1.0%, while the maximum downward deviation has amounted to 0.8%. These deviations are significantly smaller than the standard fluctuation band within ERM II. On 25 May 2022 the exchange rate stood at 7.5355 kuna per euro, i.e. virtually at the level of its central rate within ERM II. In April 2020 Hrvatska narodna banka entered a precautionary swap line arrangement with the ECB under which it could borrow up to €2 billion in exchange for Croatian kuna in order to address possible euro liquidity needs of Croatian financial institutions owing to

[187] See *Anti-money laundering and counter-terrorist financing measures: Croatia. Fifth Round Mutual Evaluation Report*, Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (MONEYVAL), 15 December 2021, available at: https://rm.coe.int/moneyval-2021-24-mer-hr-en/1680a56562. See also *Meeting Report of the 62nd Plenary Meeting of MONEYVAL*, Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (MONEYVAL), 17 December 2021, available at: https://rm.coe.int/moneyval-2021-40-plen62-meetingreport-en/1680a60d34.

the pandemic. As this arrangement helped to reduce the potential risk of financial vulnerabilities, it may also have further supported the stability of the exchange rate over the reference period. Over the past ten years the exchange rate of the Croatian kuna against the euro has remained virtually unchanged, reflecting Croatia's track record of maintaining exchange rate stability with the euro even prior to the inclusion of the kuna in ERM II.

The exchange rate of the Croatian kuna against the euro exhibited, on average, a low degree of volatility over the reference period. This reflected the commitment by Hrvatska narodna banka under ERM II to limit exchange rate fluctuations around the central rate. In March and April 2020 growing uncertainty about the effects of the pandemic spurred demand for foreign currency by the domestic sector. The central bank had to strongly intervene in support of the kuna (for the first time since 2015), leading to a considerable decline in its stock of foreign reserves which, however, quickly recovered thereafter. Besides the swap line agreement concluded with the ECB, sufficient liquidity was also maintained via structural and regular market operations and a reduction in banks' reserve requirements. Finally, with a view to preventing the freezing of the bond market and to securing favourable financing conditions for all sectors, the central bank implemented for the first time a programme of government bond purchases in March 2020. While the central bank had to strongly intervene in support of the kuna in the early stages of the COVID-19 crisis, over the reference period it only conducted four smaller foreign exchange interventions – two by selling euro in support of the kuna and two by selling domestic currency for euro. Overall, its sales and purchases of foreign currency over the two-year reference period resulted in a net sale.

The real effective exchange rate of the Croatian kuna has depreciated slightly over the past ten years (Chart 5.3.4). Looking forward, this indicator should be interpreted with caution, as Croatia is subject to a process of economic convergence, which complicates any long-term assessment of real exchange rate developments.

Croatia's combined current and capital account balance has improved over the past ten years, while the country's net foreign liabilities declined markedly (Table 5.3.3). The combined current and capital account balance turned positive in 2014 and has remained in surplus since then, reaching 4.6% of GDP in 2019. Developments between 2014 and 2019 primarily reflected buoyant tourism receipts, which more than offset the rising goods trade deficit. The combined current and capital account balance declined to 2.0% in 2020, on account of the slump in tourism engendered by restrictions and uncertainties related to people's movement across borders in the context of the COVID-19 pandemic. This balance improved significantly in 2021 (peaking at +5.8%) on the back of a strong recovery in tourism. Gross external debt, after having declined steadily from 2014 to 2019, increased to around 80% of GDP in 2020 before returning to a downward trend in 2021. The gradual narrowing of the net international investment position observed since 2011 came to a temporary halt in 2020. In 2021 the net international investment position improved again to reach a level of -33.9% of GDP, slightly above the MIP threshold of -35%. The country's net foreign liabilities are largely composed of foreign direct investment, which constitutes a more stable source of funding than portfolio and other investment. However, fiscal and structural policies continue to be important for supporting external sustainability and the competitiveness of the economy.

The Croatian economy is well integrated with the euro area through trade and financial linkages. In 2021 exports of goods and services to the euro area constituted 53.8% of total exports, while the corresponding figure for imports was higher, at 57.1%. In the same year the share of the euro area in Croatia’s stock of inward direct investment stood at 71.9% and its share in the country’s stock of portfolio investment liabilities was 58.1%. The share of Croatia’s stock of foreign portfolio investment assets invested in the euro area amounted to 35.7% in 2021. Croatia’s economy is also characterised by a high degree of euroisation, which goes beyond public and private debt and is also reflected in the currency composition of household savings and liquid assets of non-financial corporates.

5.3.4 Long-term interest rate developments

Over the reference period from May 2021 to April 2022, long-term interest rates in Croatia stood at 0.8% on average and thus remained below the 2.6% reference value for the interest rate convergence criterion (Chart 5.3.5).

Long-term interest rates in Croatia stood at 2.4% at the end of the reference period, after having declined continuously from 2012, when they averaged around 6%, to the beginning of 2022. Over the past ten years the declining trend in long-term interest rates in Croatia was interrupted by two short-lived episodes of sizeable increases in 2013 and mid-2015. In both cases, domestic factors played a major role in driving up long-term interest rates. In 2013 the increase in the long-term interest rate was accompanied by the downgrading of Croatian sovereign debt to below investment grade and by rising credit default swap spreads, which are a measure of investors’ perceptions of Croatian sovereign risk. In 2015 the upward movements in the risk premia on Croatian long-term bond yields were driven by the slowdown in the economy and the perceived political uncertainty. The expected deterioration in bank balance sheets following the conversion into euro of loans originally denominated in Swiss francs also raised sovereign yields via the sovereign-bank nexus. Since the second half of 2015 long-term interest rates in Croatia have been falling steadily. This can be attributed to the progress with fiscal consolidation that allowed a more accommodative monetary policy stance in a context of an improving economic outlook. Global developments also contributed to the trend decline in long-term interest rates. More recently, after falling further in 2019 in line with developments in global financial markets, long-term interest rates fluctuated around 1% between April and October 2020, with the dynamics influenced by the impact of the COVID-19 pandemic on financial market volatility. However, in the third quarter of 2020 long-term interest rates resumed their declining trend, also thanks to the government bond purchase programme initiated by Hrvatska narodna banka in March 2020 to maintain favourable financing conditions and support the stability of the government bond market. The declining trend of long-term interest rates continued until the beginning of 2022, when financial markets seemed to assess the resurgence of inflation in 2021 – which occurred in a context of robust economic growth – to be more persistent than previously expected. In April 2022 the long-term interest rate stood at 2.4%. Over the review period, credit default swap spreads have widened slightly by around 10 basis points. In the past two years two of the three main international rating agencies have upgraded the country's rating.

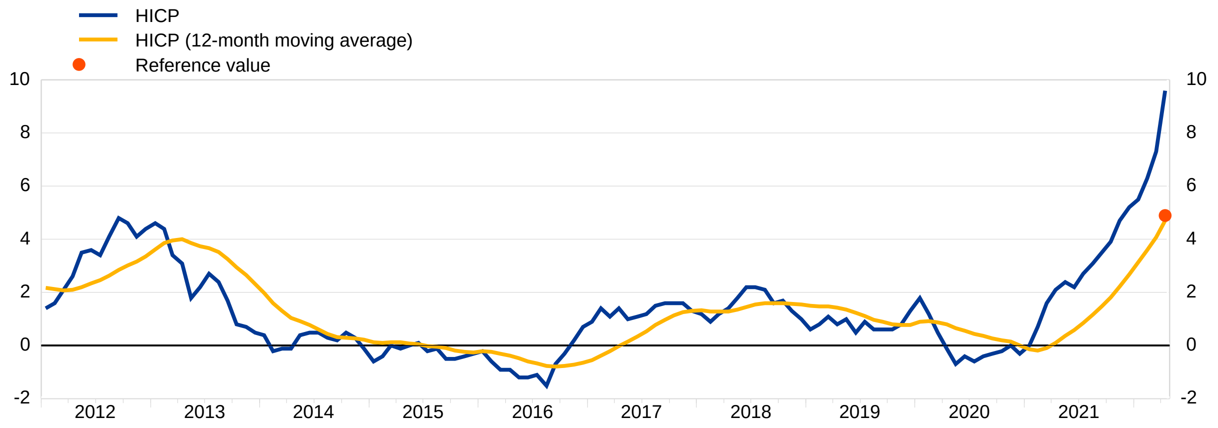
Croatia's long-term interest rate differential vis-à-vis the euro area has declined since 2012 and stood at 1.0% in April 2022. From 2012 to mid-2016 the long-term interest rate differential fluctuated between 2% and 3%, reflecting investors' perceptions of a more vulnerable sovereign outlook for Croatia than for the euro area as a whole, despite inflation being, at times, lower than in the euro area. Since the summer of 2016 the progress made on structural policy and the substantial alignment of the domestic business cycle with that of the euro area contributed to the gradual but continuous convergence of Croatian long-term interest rates towards euro area levels. Therefore, the differential has increased only slightly over the review period, from 0.9% in April 2020 to 1.0% in April 2022.

Capital markets in Croatia are smaller and less developed than those in the euro area (Table 5.3.4), but they are among the most developed in central and eastern Europe. The Croatian financial system is still dominated by foreign-owned banks (which account for around 90% of the total assets of the banking sector), but non-banking institutions are also playing an increasingly significant role in financial intermediation. In particular, insurance corporations and, since the start of the pension system reform in 2002, pension funds together account for around 18% of total financial sector assets. Stock market capitalisation as a percentage of GDP has historically been higher than in many peer countries in the region and stood at 32.7% in 2021. Overall, the degree of financial intermediation remains much lower than in the euro area, but it is in line with that of peer countries in the region. MFI credit to private residents as a percentage of GDP stabilised at 54.7% in 2021, which is in line with the average over the last five years. The corporate debt market remains underdeveloped. The share of debt securities issued by financial and non-financial institutions as a percentage of GDP stood at 1.4% and 4.4% respectively in 2021, thus remaining close to their very low historical levels. Recourse by Croatia's banking sector to funding from euro area banks has fallen dramatically over the past ten years. The claims of euro area MFIs on resident MFIs decreased from an annual average of more than 7% of GDP between 2012 and 2021 to 1.9% of GDP in 2021. Since 2012 the share of MFI loans denominated in domestic currency in total loans extended to the private sector has increased consistently, from about 27% at the end of 2012 to 48% in February 2022.

Croatia - Price developments

Chart 5.3.1 HICP inflation and reference value [1]

(annual percentage changes)



Sources: European Commission (Eurostat) and ECB calculations.

[1] The basis of the calculation of the reference value for the period from May 2021 to April 2022 is the unweighted arithmetic average of the annual percentage changes in the HICP for France, Finland and Greece plus 1.5 percentage points. The reference value is 4.9%.

Table 5.3.1 Measures of inflation and related indicators

(annual percentage changes, unless otherwise indicated)

	2012-2021 [1]	2012-2016 [1]	2017-2021 [1]	2017	2018	2019	2020	2021	2022 [2]	2023 [2]
Measures of inflation										
HICP	1.1	1.0	1.3	1.3	1.6	0.8	0.0	2.7	6.1	2.8
HICP excluding unprocessed food and energy	1.2	1.1	1.3	1.4	1.1	1.1	0.8	1.8	4.3	3.3
HICP at constant tax rates [3]	0.9	0.5	1.4	1.2	1.5	1.4	0.3	2.4	-	-
CPI	1.0	0.7	1.2	1.1	1.5	0.8	0.2	2.6	6.1	2.8
Private consumption deflator	1.0	0.7	1.3	0.9	1.4	1.1	0.3	2.7	6.0	2.5
GDP deflator	1.1	0.5	1.6	1.2	2.0	1.9	-0.1	3.2	3.8	2.4
Producer prices [4]	0.9	-0.7	2.5	2.1	2.4	0.8	-2.0	9.6	-	-
Related indicators										
Real GDP growth	1.4	0.6	2.2	3.4	2.9	3.5	-8.1	10.2	3.4	3.0
GDP per capita in PPS [5] (euro area = 100)	58.7	56.7	61.1	59.3	60.7	62.6	61.8	.	-	-
Comparative price levels (euro area = 100)	66.1	65.7	66.6	65.6	66.8	67.4	66.8	.	-	-
Output gap [6]	-1.3	-2.9	0.3	1.5	2.5	3.6	-6.5	0.3	0.8	1.1
Unemployment rate (%) [7]	12.1	16.0	8.3	11.2	8.4	6.6	7.5	7.6	6.3	6.0
Unit labour costs, whole economy	-0.2	-2.1	1.8	-0.7	3.6	0.0	9.8	-3.1	1.1	1.5
Compensation per employee, whole economy	0.7	-1.0	2.4	0.2	3.9	0.4	2.1	5.6	3.0	2.7
Labour productivity, whole economy	0.8	1.1	0.6	0.9	0.3	0.4	-7.0	8.9	1.8	1.1
Imports of goods and services deflator	1.0	-0.1	2.1	2.3	1.1	0.4	-0.1	6.7	7.6	3.7
Nominal effective exchange rate [8]	0.3	-0.3	0.9	1.6	2.4	-0.4	0.0	0.7	-	-
Money supply (M3) [9]	5.7	3.0	8.5	5.6	8.4	4.5	11.0	13.0	-	-
Lending from banks [10]	1.4	-1.6	4.4	4.5	4.4	5.8	3.6	3.7	-	-
Stock prices (CROBEX) [11]	19.5	14.6	4.2	-7.6	-5.1	15.4	-13.8	19.6	-	-
Residential property prices	2.4	-1.8	6.8	3.8	6.1	9.0	7.7	7.3	-	-

Sources: European Commission (Eurostat, Directorate-General for Economic and Financial Affairs), national data for CPI, money supply, lending from banks and ECB calculations based on Bloomberg Finance L.P. data for stock prices.

[1] Multi-annual averages calculated using the geometric mean, except for GDP per capita in PPS, comparative price levels, output gap and unemployment rate, for which the arithmetic mean is used.

[2] Data from the European Commission’s Spring 2022 Economic Forecast.

[3] The difference between the HICP and the HICP at constant tax rates shows the theoretical impact of changes in indirect taxes (e.g. VAT and excise duties) on the overall rate of inflation. This impact assumes a full and instantaneous pass-through of tax rate changes to the price paid by the consumer.

[4] Domestic sales, total industry excluding construction.

[5] PPS stands for purchasing power standards.

[6] Percentage difference from potential GDP: a positive (negative) sign indicates that actual GDP is above (below) potential GDP.

[7] Definition conforms to International Labor Organization guidelines.

[8] EER-42 group of trading partners. A positive (negative) sign indicates an appreciation (depreciation).

[9] The series includes repurchase agreements with central counterparties.

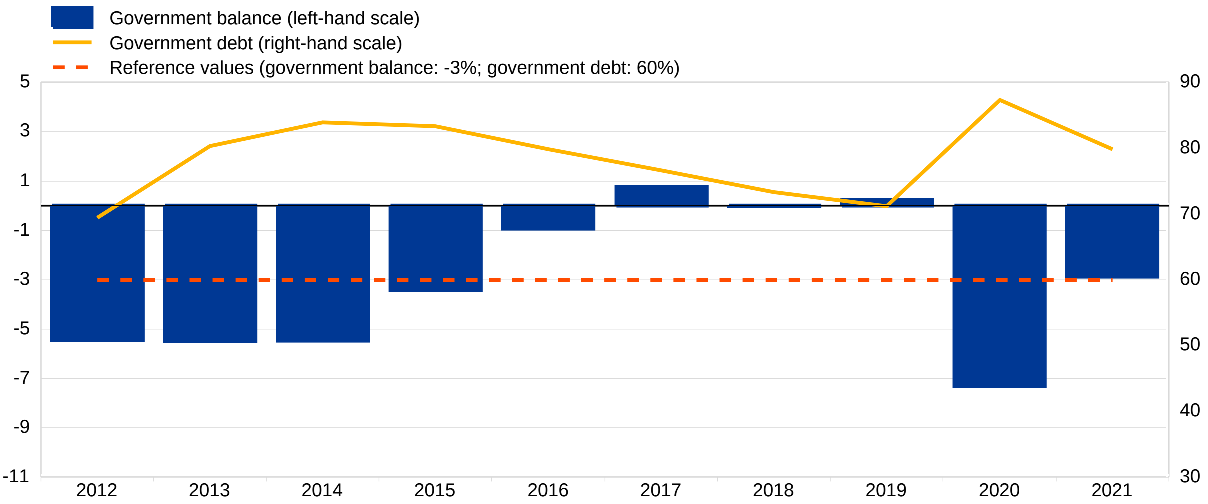
[10] Adjusted for the derecognition of loans from the MFI statistical balance sheet due to their sale or securitisation.

[11] Multi-annual and annual figures represent the percentage change between the end of the given period and the end of the previous period.

Croatia - Fiscal developments

Chart 5.3.2 General government balance and debt

(as a percentage of GDP)



Sources: European System of Central Banks and European Commission (Eurostat).

Table 5.3.2 Government budgetary developments and projections

(as a percentage of GDP, unless otherwise indicated)

	2012-2021 1)	2012-2016 1)	2017-2021 1)	2017	2018	2019	2020	2021	2022 2)	2023 2)
Government balance	**-3.0**	**-4.1**	**-1.9**	**0.8**	**0.0**	**0.2**	**-7.3**	**-2.9**	-2.3	-1.8
Total revenue	45.0	43.9	46.2	45.5	45.5	46.3	47.2	46.4	46.4	46.7
Current revenue	44.3	43.5	45.1	45.0	45.0	45.4	45.6	44.4	43.9	43.7
Direct taxes	6.2	6.3	6.2	6.2	6.3	6.5	6.5	5.4	5.3	5.3
Indirect taxes	18.9	18.5	19.3	19.2	19.6	19.7	18.7	19.3	19.3	19.5
Net social contributions	11.6	11.6	11.5	11.7	11.5	11.3	11.7	11.3	11.1	10.9
Other current revenue 3)	7.6	7.1	8.1	7.9	7.5	7.9	8.7	8.4	8.2	8.0
Capital revenue	0.7	0.4	1.1	0.4	0.5	0.9	1.6	1.9	2.4	3.0
Total expenditure	48.0	48.1	48.0	44.7	45.5	46.1	54.5	49.2	48.6	48.5
Current expenditure	42.4	42.7	42.0	40.7	40.1	39.7	46.7	42.8	41.5	40.8
Compensation of employees	11.8	11.5	12.1	11.2	11.6	11.6	13.3	12.5	12.4	12.5
Social benefits	16.0	16.3	15.7	15.4	15.2	15.1	17.1	15.5	15.2	15.0
Interest payable	2.7	3.2	2.1	2.6	2.3	2.2	2.0	1.6	1.4	1.3
Other current expenditure 4)	11.9	11.6	12.2	11.5	11.1	10.9	14.3	13.2	12.5	12.2
Capital expenditure	5.7	5.4	6.0	4.0	5.3	6.3	7.9	6.4	7.2	7.7
of which: Investment	3.9	3.7	4.2	2.7	3.5	4.3	5.6	4.8	5.3	5.7
Cyclically adjusted balance	-2.4	-2.9	-2.0	0.1	-1.2	-1.3	-4.4	-3.0	-2.6	-2.2
One-off and temporary measures	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Structural balance 5)	-2.4	-2.9	-2.0	0.1	-1.2	-1.4	-4.4	-3.1	-2.7	-2.3
Government debt	**78.5**	**79.4**	**77.6**	**76.7**	**73.3**	**71.1**	**87.3**	**79.8**	75.3	73.1
Average residual maturity (in years)	5.4	5.2	5.6	5.5	5.3	5.4	5.8	5.8	.	.
In foreign currencies (% of total)	75.8	78.8	72.8	76.3	74.7	71.3	70.9	70.7	.	.
of which: Euro	72.8	74.4	71.2	72.7	70.9	71.1	70.8	70.6	.	.
Domestic ownership (% of total)	61.6	58.1	65.1	60.8	63.5	67.5	67.9	66.0	.	.
Medium and long-term maturity (% of total) 6)	93.8	92.8	94.8	95.1	95.2	95.3	93.8	94.3	.	.
of which: Variable interest rate (% of total)	24.5	31.1	17.9	21.7	19.9	16.7	13.9	17.2	.	.
Deficit-debt adjustment	**0.6**	**0.0**	**1.2**	**1.1**	**0.3**	**1.8**	**2.5**	**0.2**	.	.
Net acquisitions of main financial assets	0.7	0.3	1.2	0.6	0.4	1.5	2.9	0.4	.	.
Currency and deposits	0.4	0.0	0.8	0.2	0.1	1.7	2.4	-0.3	.	.
Debt securities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	.	.
Loans	0.4	0.3	0.4	0.4	0.5	-0.1	0.5	0.7	.	.
Equity and investment fund shares or units	0.0	0.0	-0.1	0.0	-0.2	-0.1	0.0	0.0	.	.
Revaluation effects on debt	0.1	0.1	0.1	-0.3	-0.7	0.3	1.0	0.2	.	.
of which: Foreign exchange holding gains/losses	0.1	0.2	0.1	-0.4	-0.6	0.3	1.1	0.2	.	.
Other 7)	-0.3	-0.4	-0.1	0.8	0.5	0.0	-1.4	-0.4	.	.
Convergence programme: government balance	-	-	-	-	-	-	-	-	-2.8	-1.6
Convergence programme: structural balance	-	-	-	-	-	-	-	-	-2.9	-2.4
Convergence programme: government debt	-	-	-	-	-	-	-	-	76.2	71.7

Sources: European System of Central Banks and European Commission (Eurostat, Directorate-General for Economic and Financial Affairs).

1) Multi-annual averages calculated using the arithmetic mean.

2) Data from the European Commission’s Spring 2022 Economic Forecast, except for convergence programme data.

3) Sales and other current revenue.

4) Intermediate consumption, subsidies payable and other current expenditure.

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

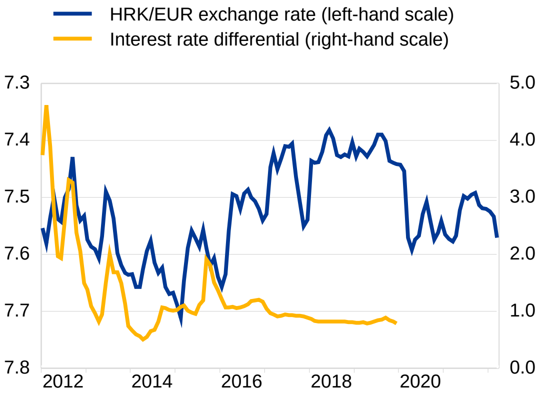
6) Original maturity of more than one year.

7) Time of recording differences and other factors (sector reclassifications and statistical discrepancies).

Croatia - Exchange rate and external developments

Chart 5.3.3 Bilateral exchange rate and short-term interest rate differential[1]

(HRK/EUR exchange rate: monthly averages; difference between three-month interbank interest rates and three-month EURIBOR: basis points, monthly values)

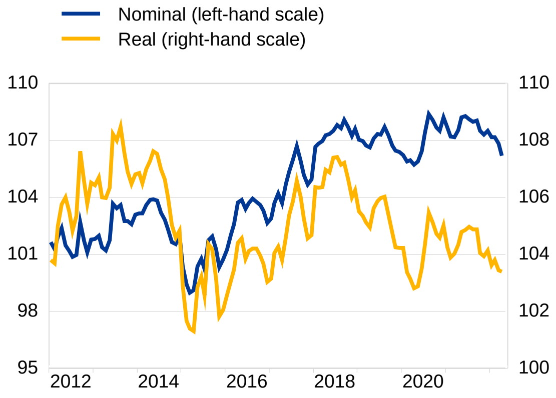


Sources: National data and ECB calculations.

[1] The interest rate differential is calculated against ZIBOR. Production of ZIBOR reference rate was discontinued as of 1 January 2020; a comparable rate is not currently available.

Chart 5.3.4 Effective exchange rates[2]

(EER-42 group of trading partners; monthly averages; index: Q1 1999 = 100)



Source: ECB.

[2] The real EER-42 is CPI-deflated. An increase (decrease) in the EER indicates an appreciation (depreciation).

Table 5.3.3 External developments

(as a percentage of GDP, unless otherwise indicated)

	2012-2021[1]	2012-2016[1]	2017-2021[1]	2017	2018	2019	2020	2021	2022[2]	2023[2]
Balance of payments										
Current account and capital account balance[3]	2.6	1.2	4.0	4.4	3.1	4.6	2.0	5.8	6.2	4.8
Current account balance	1.5	0.6	2.3	3.5	1.9	3.0	-0.1	3.4	1.7	0.3
Goods	-16.5	-15.2	-17.9	-16.9	-18.3	-18.8	-17.3	-18.1	.	.
Services	15.5	14.7	16.3	17.6	17.5	18.5	10.5	17.2	.	.
Primary income	-0.7	-1.7	0.3	-0.4	-0.5	-0.1	2.3	0.3	.	.
Secondary income	3.2	2.8	3.7	3.3	3.2	3.4	4.4	4.0	.	.
Capital account balance	1.1	0.6	1.7	0.9	1.3	1.6	2.1	2.4	.	.
Combined direct and portfolio investment balance[3]	-2.6	-2.9	-2.3	-1.5	0.3	-3.7	-1.5	-5.1	.	.
Direct investment	-2.7	-2.1	-3.3	-2.3	-1.6	-6.1	-1.3	-5.0	.	.
Portfolio investment	0.1	-0.8	1.0	0.8	1.9	2.4	-0.1	-0.1	.	.
Other investment balance	2.8	3.7	2.0	1.6	0.0	6.5	2.3	-0.5	.	.
Reserve assets	2.9	1.0	4.3	5.2	2.9	1.8	1.2	10.5	.	.
Exports of goods and services	45.9	42.9	48.8	49.3	49.5	50.8	42.0	52.5	.	.
Imports of goods and services	46.9	43.4	50.4	48.6	50.3	51.1	48.8	53.4	.	.
Net international investment position[4]	-66.6	-83.5	-49.7	-64.2	-55.7	-46.7	-47.8	-33.9	.	.
Gross external debt[4]	93.2	106.6	79.8	87.9	80.8	72.7	79.8	77.9	.	.
Trade with the euro area[5]										
Exports of goods and services	55.6	57.1	54.4	54.5	55.7	54.5	53.6	53.8	.	.
Imports of goods and services	58.6	59.3	58.0	58.5	57.1	58.3	58.9	57.1	.	.
Investment position with the euro area[5]										
Direct investment assets[4]	30.9	30.9	30.8	28.3	29.9	29.5	29.7	36.8	.	.
Direct investment liabilities[4]	70.1	68.9	71.2	68.4	69.1	73.1	73.3	71.9	.	.
Portfolio investment assets[4]	49.9	59.3	42.4	48.2	48.7	42.6	36.8	35.7	.	.
Portfolio investment liabilities[4]	56.6	53.4	59.9	58.7	59.4	61.7	61.8	58.1	.	.

Sources: European System of Central Banks and European Commission (Eurostat, Directorate-General for Economic and Financial Affairs).

[1] Multi-annual averages calculated using the arithmetic mean. Owing to the unavailability of data, the multi-annual averages for the "trade with the euro area" series and for the "direct investment assets", "portfolio investment assets" and "direct investment liabilities" components of the "investment position with the euro area" series are calculated for the period starting in 2013.

[2] Data from the European Commission’s Spring 2022 Economic Forecast.

[3] Differences between totals and the sum of their components are due to rounding.

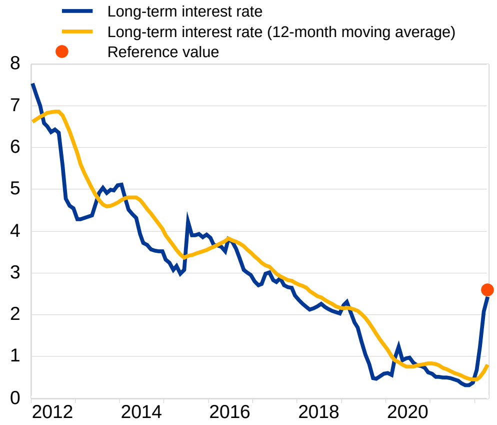
[4] End-of-period outstanding amounts.

[5] As a percentage of the total.

Croatia - Long-term interest rate developments

Chart 5.3.5 Long-term interest rate 1)

(monthly averages in percentages)

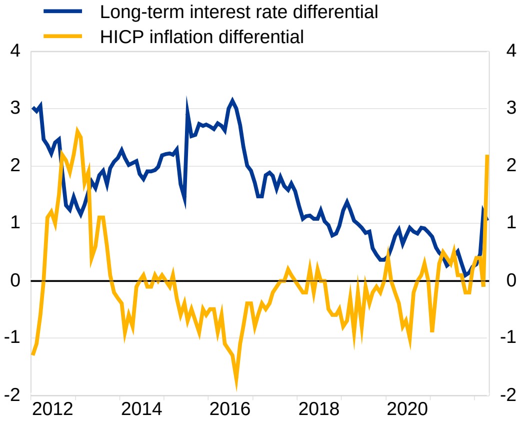


Sources: European System of Central Banks and ECB calculations.

1) The basis of the calculation of the reference value for the period from May 2021 to April 2022 is the unweighted arithmetic average of the interest rate levels in France, Finland and Greece plus 2 percentage points. The reference value is 2.6%.

Chart 5.3.6 Long-term interest rate and HICP inflation differentials vis-à-vis the euro area

(monthly averages in percentage points)



Sources: European System of Central Banks, ECB calculations and European Commission (Eurostat).

Table 5.3.4 Long-term interest rates and indicators of financial development and integration

(as a percentage of GDP, unless otherwise indicated)

	2012-2021 1)	2012-2016 1)	2017-2021 1)	2018	2019	2020	2021	May. 2021 to Apr. 2022	Memo item: euro area 2021
Long-term interest rates									
Croatia 2)	2.9	4.4	1.5	2.2	1.3	0.8	0.4	0.8	-
Euro area 3), 4)	1.4	2.2	0.6	1.1	0.4	0.1	0.1	0.4	-
Euro area AAA par curve, ten-year residual maturity 2), 4)	0.6	1.2	0.0	0.5	-0.2	-0.4	-0.3	-0.1	-
Indicators of financial development and integration									
Debt securities issued by financial corporations 5)	0.5	-	0.5	0.3	0.4	0.4	1.4	-	66.7
Debt securities issued by non-financial corporations 6)	4.6	-	4.1	3.7	4.0	4.3	4.4	-	13.4
Stock market capitalisation 7)	36.9	-	35.7	34.4	36.4	36.8	32.7	-	77.7
MFI credit to non-government residents 8)	61.6	66.8	56.3	55.4	53.8	60.6	54.7	-	111.1
Claims of euro area MFIs on resident MFIs 9)	7.3	11.4	3.1	4.1	3.1	3.1	1.9	-	29.5

Sources: European System of Central Banks and ECB calculations.

1) Multi-annual averages calculated using the arithmetic mean.

2) Average interest rate.

3) GDP-weighted average of the euro area long-term interest rates for the purpose of assessing convergence.

4) Included for information only.

5) Outstanding amount of debt securities issued by resident MFIs (excluding the national central bank) and other financial corporations. Data available since 2013.

6) Outstanding amount of debt securities issued by resident non-financial corporations. Data available since 2013.

7) Outstanding amount of listed shares issued by residents at market values. Data available since 2013.

8) MFI (excluding national central bank) credit to domestic non-MFI residents other than general government. Credit comprises outstanding amounts of loans and debt securities. Data available since 2010.

9) Outstanding amount of deposits and debt securities issued by domestic MFIs (excluding the national central bank) held by euro area MFIs as a percentage of total liabilities of domestic MFIs (excluding the national central bank). Total liabilities exclude capital and reserves and remaining liabilities. Data available since 2010.

5.4 Hungary

5.4.1 Price developments

In April 2022 the 12-month average rate of HICP inflation in Hungary was 6.8%, i.e. well above the reference value of 4.9% for the criterion on price stability (Chart 5.4.1). This rate is expected to increase gradually over the coming months, driven mainly by the higher commodity prices, broadening price pressures and further aggravation of supply bottlenecks resulting from the Russia-Ukraine war.

Over the past ten years the 12-month average rate of HICP inflation has fluctuated within a relatively wide range, from -0.3% to 6.8%, and the average for that period was elevated at 2.5%. In 2012, with economic activity slowing, inflation rose to 5.7% as a result of, among other things, a hike in the value added tax rate. The ensuing economic recovery was to a large extent supported by government and central bank policies in an environment of contracting bank lending to the private sector. As inflation receded, the Magyar Nemzeti Bank loosened its monetary policy stance. In 2014 and 2015 the average annual rate of HICP inflation was close to zero owing to a combination of factors, including global commodity price developments, utility price cuts, relatively muted wage growth and subdued external price pressures. However, from 2016 it accelerated again, reaching 2.4% in 2017 on account of the ongoing economic recovery, and rising further to 2.9% in 2018 and 3.4% in 2019. This increase reflected strong domestic demand and a tight labour market environment, as well as changes to indirect taxes, most notably excise duties on tobacco products, the impact of volatile items sensitive to global commodity price movements and strong wage growth, which were partially offset by a reduction in social security contributions and VAT rates on some food items and services. The outbreak of the coronavirus (COVID-19) pandemic in March 2020 resulted in a large drop in economic activity in the second quarter of that year, with annual real GDP falling by 4.5%. The authorities took unprecedented fiscal, macroprudential and monetary policy measures to mitigate the impact of the pandemic on the economy. In particular, the Magyar Nemzeti Bank made two key policy rate cuts of 15 basis points each in June and July 2020, bringing the rate down to a historical low of 0.6%. It also purchased government securities in the secondary market. At the same time, inflation remained rather resilient, standing at 3.4% in 2020. This was largely attributable to higher prices for food and services, the interplay of the effects of the overlapping demand and supply shocks triggered by the pandemic and the weakening exchange rate, together with the pre-pandemic very robust domestic demand and buoyant wage growth amid tight labour market conditions, which offset the negative contribution of fuel prices to inflation. In 2021 the economy rebounded strongly, with real GDP rising at an annual average rate of 7.1%. Inflation also picked up considerably, driven mainly by sharp increases in energy prices, particularly towards the end of the year, but also by the supply bottlenecks triggered by the pandemic. In this context, the Magyar Nemzeti Bank started a cycle of interest rate hikes, raising its key policy rate seven times from June 2021, which brought it up to 2.4% in December. Average HICP inflation stood at 5.2% in 2021 (Table 5.5.1).

In the first four months of 2022 the average annual rate of HICP inflation increased further to 8.6%. Continuing the upward trend it had initiated at the end 2021, HICP inflation rose further at the beginning of 2022. This was largely due to higher energy and commodity prices, while the inflationary effects of the robust wage growth stemming mainly from administrative wage increases were largely offset by the reduction in social security contributions paid by the employer. Against this background, the Magyar Nemzeti Bank raised its key policy rate four times in the first four months of 2022, bringing it up to 5.4% in April. Following Russia's invasion of Ukraine in late February, inflationary pressures intensified, notably on account of rapidly rising energy and commodity prices.

Policy choices have played an important role in shaping inflation dynamics in Hungary over the past decade, most notably the orientation of monetary policy towards price stability. The Magyar Nemzeti Bank defines its inflation target as an annual rate of consumer price inflation of 3% with an ex-ante tolerance band of ±1 percentage point that was adopted in March 2015. Successive cuts in administrative prices, which constitute a large share of Hungary's HICP basket of goods and services, have helped to contain consumer price inflation.

Inflation is expected to decline gradually in the coming years. However, the forecasts are subject to considerable uncertainty in the light of the Russia-Ukraine war. Over the longer term there are concerns about the sustainability of inflation convergence in Hungary. According to the European Commission's Spring 2022 Economic Forecast, the rate of HICP inflation is projected to accelerate significantly in 2022, up to a high level of 9.0%, before declining to 4.1% in 2023. This outlook is based on the expectation that economic growth will moderate, but nevertheless remain robust, with unemployment stabilising at historically low levels and private consumption continuing to be the main driver of growth. The risks to the inflation outlook are tilted to the upside, as labour market conditions remain tight, global supply bottlenecks could have a further impact on price developments in certain product and market segments, and tensions in energy markets may continue to exacerbate inflationary pressures. Looking further ahead, unless counteracted by an appreciation in the nominal exchange rate, the catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area, since GDP per capita and price levels are still lower in Hungary than in the euro area. In order to prevent the build-up of excessive price pressures and macroeconomic imbalances, the catching-up process must be supported by appropriate policies.

Achieving an environment that is conducive to sustainable convergence in Hungary requires stability-oriented economic policies and wide-ranging structural reforms. Further improving the quality of public institutions and ensuring that they are free from undue political intervention, as well as implementing adequate product market policies, are prerequisites for private sector-led economic growth. Enhanced governance, stronger institutions and a better functioning administration at the national level should, among other things, help to improve the absorption of EU funds. In this respect, however, on 27 April 2022 the European Commission, under the general regime of conditionality for the protection of the Union budget,[188] sent a written notification to the Hungarian authorities about concerns over respect for the rule of law, which may result in a suspension of or reduction in the disbursement of EU funds. With regard to macroeconomic imbalances, the European Commission did not select Hungary for an in-depth review in its Alert Mechanism Report 2022.

Financial sector policies should be aimed at safeguarding financial stability and ensuring that the financial sector makes a sound contribution to sustainable economic growth. Efforts to strengthen banks' balance sheets over the past years have borne fruit, and the banking sector overall has sound capital positions and sufficient liquidity buffers. Bank profitability has improved and the non-performing loan ratio has declined further. However, there is still the risk that borrowers will have difficulties servicing their debts once the debt servicing moratorium that was granted in response to the pandemic has been phased out. In turn, this could push up the number of non-performing loans. Moreover, a deterioration in the quality of loan portfolios could put additional pressure on banks' profitability. Strengthening the banking sector's long-term profitability will also require consolidation in the sector and further financial deepening. Financial policies should be geared towards achieving sustainable developments in loans to households and avoiding the build-up of macro-financial imbalances. Existing or planned economic policy measures to protect specific groups of society or the government budget should take into account any potentially adverse implications for financial stability. At the same time, there are still signs of overvaluation in at least some segments of the housing market, mainly in the capital city. Moreover, corporate real estate lending in foreign currency has been increasing steadily, which, going forward, may lead to significant currency mismatches and heighten credit institutions' foreign exchange risk. In order to further bolster confidence in the financial system, the national competent authorities should continue to improve their supervisory practices, among other things, by following the applicable recommendations from the relevant international and European bodies, and by collaborating closely with other national supervisors of EU Member States within the supervisory colleges.

5.4.2 Fiscal developments

Hungary's general government budget deficit was well above the 3% reference value in 2021 and its debt was above the 60% reference value. In the reference year 2021, the general government budget balance recorded a deficit of 6.8% of GDP, i.e. significantly above the 3% reference value. The general government gross debt-to-GDP ratio was 76.8%, i.e. above the 60% reference value (Table 5.4.2). Compared with the previous year, the deficit ratio decreased by 1 percentage point of GDP and the debt ratio declined notably by 2.8 percentage points. Regarding other fiscal factors, the deficit ratio exceeded the ratio of public investment to GDP in 2021. The budget deficits in 2020 and 2021, and therefore the debt ratio, were substantially

[188] Regulation (EU, Euratom) 2020/2092 of the European Parliament and of the Council of 16 December 2020 on a general regime of conditionality for the protection of the Union budget (OJ L 433I, 22.12.2020, p. 1).

affected by the economic impact of the COVID-19 pandemic and the fiscal policy measures taken in response to it.

Hungary has been subject to the preventive arm of the Stability and Growth Pact since 2013. In May 2022, the European Commission found that the general government deficit in 2021 was above and not close to the reference value of 3% of GDP. The excess over the reference value was considered to be exceptional but not temporary. Overall, the Commission's analysis suggested that the deficit criterion had not been fulfilled. Moreover, as Hungary's debt ratio in 2021 was higher than the 60% reference value and had not decreased in line with the debt reduction benchmark, it was found that the debt criterion had not been fulfilled. However, in the Commission's view, the need to comply with the debt reduction benchmark was not warranted under the current exceptional economic conditions as such compliance would imply too demanding a frontloaded fiscal effort that risked jeopardising growth. Moreover, taking into account the exceptional uncertainty created by the continued extraordinary macroeconomic and fiscal impact of the COVID-19 pandemic, together with the invasion of Ukraine by Russia, the Commission did not propose opening new excessive deficit procedures at that stage. In the preceding year, in June 2021, the European Commission had found that the general government deficit in 2020 was above and not close to the reference value of 3% of GDP and that the debt criterion had not been fulfilled, but it had argued against taking a decision to place Member States under the excessive deficit procedure in light of the exceptional uncertainty. During the pre-pandemic period, Hungary had been compliant with the corrective arm. Hungary was subject to a significant deviation procedure between 2018 and 2020 following a significant deviation from its medium-term budgetary objective in 2017.

Both cyclical and non-cyclical factors relating to the COVID-19 pandemic contributed to a deterioration in the budget balance over the period 2019-21. Prior to the COVID-19 crisis, the budget deficit had benefited from favourable macroeconomic conditions and had remained below the 3% reference value since 2012, reaching 2.1% of GDP in 2019. The structural position has since deteriorated and stood at a deficit of around 3.8% of GDP in 2019, without any notable improvement since 2017. On account of the COVID-19 pandemic, the budget balance declined in 2020 by 5.7 percentage points, before improving by 1 percentage point in 2021 to record a deficit of 6.8% of GDP. This deterioration was due to both (i) a significant decrease in government revenues (well above the one suggested by cyclical developments) and (ii) an increase in public expenditure, leading to a significant increase in the structural deficit (which rose from 3.8% of GDP in 2019 to 6.6% in 2021). Therefore, the sharp deterioration in the government balance reflected not only the marked worsening of the macroeconomic outlook but also the fiscal measures that were implemented to mitigate the crisis.

The government debt-to-GDP ratio has remained above the 60% reference value over the past decade, having followed a downward path from 2012 to 2019, before increasing again during the COVID-19 pandemic. In the run-up to the pandemic, the debt ratio followed a downward path, underpinned largely by a favourable interest-growth differential. Having declined by 15 percentage points since 2012, the debt ratio reached a trough of 65.5% of GDP in 2019. It then increased markedly on account of the impact of the COVID-19 crisis, rising by 11.3 percentage points to reach 76.8% in 2021, wiping out all of the reduction efforts made over the previous ten years. By reducing GDP and increasing public expenditure, coupled with unfavourable deficit-debt adjustments (due to the acquisition of financial assets and revaluation effects), the COVID-19 pandemic and the fiscal response to it explain a large part of the increase observed over the period 2020-21.

The level and structure of government debt indicate low roll-over risks and low sensitivity to exchange rate movements. The reliance on short-term funding has been reduced over time: the share of government debt with a short-term maturity significantly declined from 18.2% in 2017 to 5.9% in 2021, which helps to shield debt financing costs from roll-over risks in times of stress. It is worth noting that a substantial part of long-term government debt can be redeemed earlier upon request by the holder (MÁP+ bonds), although such early redemption has historically been low and investors who do so tend to reinvest in another long-term government bond. The risk of early redemption is mitigated by the structure of interest payments and the repurchase terms and conditions. Hungary has managed to considerably reduce the proportion of foreign currency-denominated government debt (which is almost exclusively denominated in euro); this declined from 39.3%, on average, over the period 2012-16 to 22.6% in 2021. At the same time, fiscal balances remain relatively sensitive to changes in the exchange rate vis-à-vis the euro.

The European Commission's Spring 2022 Economic Forecast foresees an improvement in the budget balance and a slight decrease in the debt ratio. According to the European Commission's latest forecast, the headline deficit is expected to significantly decrease from a record level of 7.8% of GDP in 2020 but stay above 3%, reaching 4.9% of GDP by 2023.[189] Over the period 2022-23, the structural deficit is expected to stand well above the medium-term objective (a structural deficit of 1.0% of GDP). Nevertheless, the Stability and Growth Pact's general escape clause, which continues to be applied in 2022 and is also expected to remain in place in 2023, provides that "in periods of severe economic downturn for the euro area or the Union as a whole, Member States may be allowed temporarily to depart from the adjustment path towards the medium-term budgetary objective…, provided that this does not endanger fiscal sustainability in the medium term". With regard to the debt ratio, the European Commission forecasts a slight decrease by 0.7 percentage point of GDP by 2023, to reach 76.1% of GDP, thus remaining above the 60% reference value. Hungary's medium-term fiscal policy strategy, as presented in the 2022 update of the convergence programme, forecasts a path for both the nominal and the structural deficit which is significantly (more than 1 percentage point of GDP) lower than the European Commission's Spring 2022 Economic Forecast.

Despite some progress in reforming the fiscal framework, there is scope for further improvement. In December 2019, the Hungarian Parliament adopted amendments to the national fiscal rules that should increase their transparency and enhance their implementation. However, the fiscal framework should put stronger emphasis on the multi-annual dimension of the budget process. In particular, the

[189] In January 2020, Hungary's medium-term objective changed from a structural deficit of 1.5% of GDP to a structural deficit of 1.0% of GDP.

incentives to systematically spend budget reserves before the end of the calendar year should be removed, as they lower the quality of public spending.

Hungary is at medium risk of fiscal stress over the medium term and at high risk over the long term, mostly on account of projected debt remaining above the 60% reference value and the ageing population. The European Commission's 2021 Fiscal Sustainability Report pointed to medium risks in the medium term[190] and high risks in the long term.[191] This higher medium-term risk compared with the 2019 assessment was driven by the notable COVID-19 pandemic-related increase in the debt-to-GDP ratio. Looking at the longer term, according to the 2021 Ageing Report prepared by the Ageing Working Group (AWG) of the EU's Economic Policy Committee,[192] Hungary would experience a significant rise in age-related expenditure of 5.5 percentage points by 2070 under the AWG's reference scenario, from a level of 17.1% of GDP in 2019. Under the AWG's risk scenario, the increase was projected to be 9.8 percentage points (arising mostly from increases of 3.1% and 1.2% of GDP in long-term care and healthcare respectively), which is significantly above the EU average. All these factors suggest that reforms are needed to improve the long-term sustainability of public finances.

Looking ahead, a prudent and credible fiscal policy, as well as further structural reforms, are needed for public finances to ensure a downward debt path. While fiscal policy should remain agile in its response to the evolving pandemic situation and given the geopolitical situation, a prudent fiscal policy is needed to safeguard the sustainability of public finances. A consistent and prudent fiscal policy will ensure that Hungary complies with the Stability and Growth Pact and maintains buffers to alleviate adverse shocks. The country has made some progress in reducing the complexity of its tax system. It has focused on decreasing the high tax-to-GDP ratio, especially the labour tax burden, and has improved the effectiveness of value added tax collection. Still, policies aimed at improvements in tax collection and reductions in the informal economy should continue to be pursued. Distortive tax measures should be avoided. Reinforcing multi-annual fiscal planning could mitigate the procyclicality of fiscal policy and increase the effectiveness of public spending. Structural reforms to the pension system, as well as the health and long-term care systems, are also necessary to address longer-term risks to fiscal sustainability.

5.4.3 Exchange rate developments

Over the reference period from 26 May 2020 to 25 May 2022, the Hungarian forint did not participate in ERM II, but traded under a flexible exchange rate regime. In the two-year reference period the Hungarian forint often traded significantly weaker than its May 2020 average exchange rate against the euro of 350.76 forints

[190] This assessment was confirmed by the updated debt sustainability analysis which was published as part of the European Commission's country report for Hungary on 23 May 2022.

[191] However, this assessment does not necessarily reflect the uncertainty surrounding the long-term assumptions and, for high-debt countries, should be viewed with caution.

[192] European Commission and Economic Policy Committee, "The 2021 Ageing Report: Economic & Budgetary Projections for the 28 EU Member States (2019-2070)", *European Economy Institutional Paper*, No 148, European Commission, 2021.

per euro, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate (Chart 5.4.3). The maximum upward deviation from this benchmark was 2.2%, while the maximum downward deviation amounted to 12.1%. On 25 May 2022 the exchange rate stood at 388.25 forints per euro, i.e. 10.7% weaker than its average level in May 2020. In June 2020 the Magyar Nemzeti Bank entered a repo line arrangement with the ECB under which it could borrow up to €4 billion against adequate euro-denominated collateral to provide euro liquidity to Hungarian financial institutions in order to address possible needs owing to the pandemic. As this arrangement helped to reduce the potential risk of financial vulnerabilities, it may also have had an impact on exchange rate developments over the reference period. Over the past ten years the exchange rate of the Hungarian forint against the euro has depreciated by 32.2%.

The exchange rate of the Hungarian forint against the euro exhibited, on average, a high degree of volatility over the reference period. Between late May and mid-August 2020 the Hungarian forint continued its recovery from the sharp depreciation recorded during the intensification of the COVID-19 pandemic in March 2020, against the background of a gradual reduction in volatility in global foreign exchange markets and the conclusion of the repo line arrangement between the Magyar Nemzeti Bank and the ECB in June. Thereafter the exchange rate of the forint continued to display a relatively high degree of volatility, reflecting the continued uncertainty in global financial markets regarding the evolution of the pandemic. At the same time, the Magyar Nemzeti Bank entered a rate hiking cycle in June 2021 and has raised its key policy rate on 11 occasions since then, by a total of 450 basis points. As a result, short-term interest rate differentials against the three-month EURIBOR, which were relatively wide over the entire reference period, increased substantially to 5.3 percentage points in the three-month period ending in March 2022.

The real effective exchange rate of the Hungarian forint has depreciated over the past ten years (Chart 5.4.4). Looking forward, this indicator should be interpreted with caution, as Hungary is subject to a process of economic convergence, which complicates any long-term assessment of real exchange rate developments.

Over the past ten years Hungary’s combined current and capital account balance remained in surplus until 2021 and contributed to a reduction in the country’s net foreign liabilities, which, however, remain high (Table 5.4.3). Between 2012 and 2016 Hungary’s combined current and capital account balance was in a range from around 4% to 7% of GDP, averaging 5.5% of GDP over the period. This reflected both a large trade surplus, averaging 7.3% – which more than offset the deficit on income payments – as well as a sizeable capital account surplus which was due to large transfers from the EU budget. In 2017 the trade balance started to narrow on account of very robust domestic demand. As a result, the current account balance turned negative as of 2019. As this was only partly offset by an increase in the capital account balance, the combined current and capital account surplus gradually narrowed from 2.8% in 2017 to 1.2% in 2019. In 2020 and 2021 the current account deficit widened further to 1.0% and 2.9% of GDP respectively, as exports declined more than imports during the pandemic, pushing the combined current and capital account into a deficit of 0.4% of GDP in 2021. Hungary’s combined current and capital account surplus has been mirrored in sizeable net financial outflows over the past decade. Since 2012, while being a net recipient of foreign direct investment flows, Hungary has been a net exporter of capital in the form of portfolio investment and other investment. Against this background, gross external debt gradually decreased from an average of 139.5% of GDP over the period 2012-16 to 98.4% of GDP in 2019. In 2020 gross external debt increased sharply to 155.5% of GDP largely on account of transactions of a large multinational enterprise – which, however, also led to a roughly equal increase in the country's gross external assets – and stood at 158.0% of GDP in 2021. As a result, Hungary's net international investment position improved from an average of -76.0% of GDP over the period 2012-16 to -49.1% in 2019, and then improved further to -48.9% of GDP in 2020 and -44.8% of GDP in 2021. However, the country's net foreign liabilities remain high. Fiscal and structural policies therefore continue to be important for supporting external sustainability and the competitiveness of the economy.

The Hungarian economy is well integrated with the euro area through trade and investment linkages. In 2021 exports of goods and services to the euro area constituted 56.5% of total exports, while the corresponding figure for imports was marginally lower, at 55.6%. In the same year the share of the euro area in Hungary's stock of inward direct investment stood at 42.4% and its share in the country's stock of portfolio investment liabilities was 45.7%. The share of Hungary's stock of foreign assets invested in the euro area amounted to 29.6% in the case of direct investment and 59.0% for portfolio investment in 2021.

5.4.4 Long-term interest rate developments

Over the reference period from May 2021 to April 2022, long-term interest rates in Hungary stood at 4.1% on average and thus above the 2.6% reference value for the interest rate convergence criterion (Chart 5.4.5).

Long-term interest rates in Hungary have been on a downward path since mid-2012. A combination of factors has contributed to this declining trend, including improving macroeconomic conditions and lower global risk aversion. Several monetary policy measures adopted by the Magyar Nemzeti Bank – such as reducing the availability of its short-term deposit facilities, introducing foreign exchange and long-term interest rate swaps, purchasing corporate, mortgage and government bonds, and providing cheap financing for SMEs through its various Funding for Growth schemes – also contributed to the decline in long-term rates. Overall, long-term interest rates in Hungary declined from 9.5% in January 2012 to around 2% in December 2017. They then temporarily increased in 2018 owing to the rebound in economic activity and the resurgence of inflationary pressures. However, long-term interest rates resumed their decline in 2019, reflecting developments in global yields, until reaching a historical low in the summer of 2021. This more recent decline was initially driven by the deterioration in the global economic outlook and higher levels of global risk aversion, which favoured global portfolio flows into low-risk, high-return assets, including Hungarian fixed income assets. Since spring 2020 long-term interest rates have also been affected by the measures taken by the Magyar Nemzeti Bank to dampen the high volatility in financial markets caused by the COVID-19 pandemic and ensure the proper functioning of the monetary policy transmission mechanism. Such measures consisted of changes to the operational framework; the introduction of a bond purchase programme including government, corporate and mortgage products; foreign exchange liquidity swaps; and an enhanced lending facility under the Funding for Growth Scheme. Furthermore, to counter the negative impact of the pandemic on the economic outlook, the central bank reduced its main policy rate from 0.9% – the level maintained since May 2016 – to 0.6% in July 2020. In 2021, following the robust recovery of the economy and, more notably, the acceleration in price dynamics, the Magyar Nemzeti Bank decided to increase the base rate, which stood at 2.9% in January 2022, close an emergency credit facility inaugurated during the pandemic, discontinue its forint liquidity-providing foreign exchange swaps, and phase out quantitative easing instruments. Since then the Magyar Nemzeti Bank has sharply increased its base rate on account of higher than expected inflation outcomes and distinct upside risks to future inflation arising from the consequences of the Russian invasion of Ukraine. As a result, the base rate stood at 5.4% at the end of April 2022. Mirroring these developments, long-term interest rates in Hungary stood at 6.6% in April 2022, 410 basis points higher than their April 2020 level. After declining for the last two years, credit default swap spreads for Hungarian government debt have recently increased to approximately their April 2020 level, standing at around 115 basis points in April 2022. Hungary’s government debt is rated investment grade by all three main rating agencies.

Hungary’s long-term interest rate differential vis-à-vis the euro area increased recently after a long period of stabilisation (Chart 5.4.6). Hungary’s long-term interest rate differential declined from around 5% in 2012 to around 2% in 2015, where it stayed for a long period. The decline in the interest rate differential coincided with the gradual but sustained tightening of Hungary’s fiscal stance, which allowed the central bank to bring down interest rates and adopt a monetary policy stance closer to that prevailing in the euro area. Over the period from April 2020 to April 2022 the long-term interest rate differential increased from a trough of 1.7% in May 2020 to 5.2% in April 2022, reflecting the positive and increasing inflation differential and the tightening of monetary policy in Hungary.

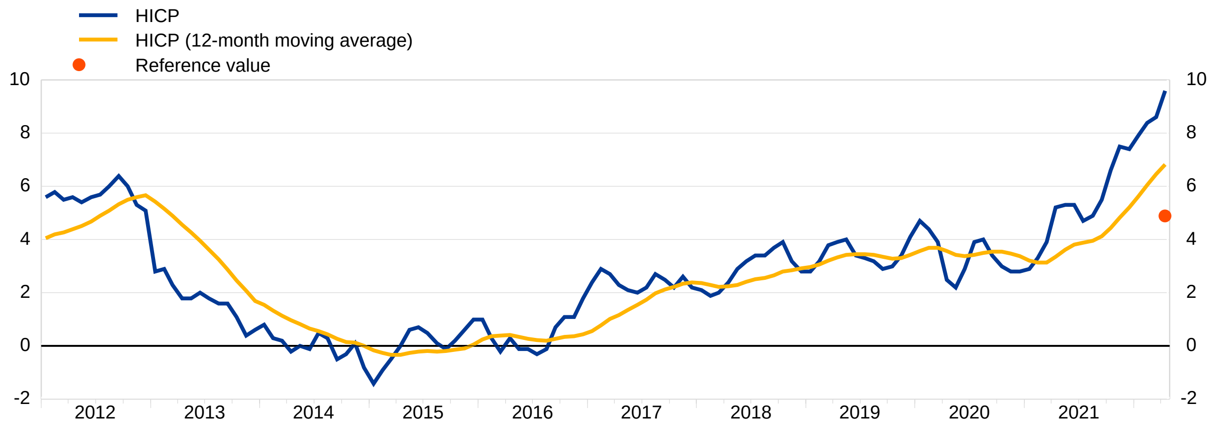
Capital markets in Hungary are smaller and much less developed than in the euro area (Table 5.4.4). Stock market capitalisation as a percentage of GDP remains rather low at just over 18.2% of GDP in 2021, which is slightly above the annual average during the period 2012-21. In 2021 outstanding debt securities issued by non-financial corporations remained at low levels, standing at 5.9% of GDP, but have increased compared with the ten-year average of 2.2% over the period 2012-21. Debt securities issued by financial institutions in 2021 amounted to 7.0% of GDP, which is slightly below the average value recorded over the period 2012-21. Hungarian banks’ borrowing from euro area banks – a measure of banking system integration – has continued to fall, with claims by euro area banks on Hungarian banks standing at 3.6% of GDP in 2021, well below the average of 6.1% over the period 2012-21. The degree of financial intermediation is low compared with the euro area average and is among the lowest in the region. MFI credit to non-government residents stood at 41.0% of

GDP in 2021, practically the same as the average level recorded in the period 2012-21.

Hungary - Price developments

Chart 5.4.1 HICP inflation and reference value 1)

(annual percentage changes)



Sources: European Commission (Eurostat) and ECB calculations.

1) The basis of the calculation of the reference value for the period from May 2021 to April 2022 is the unweighted arithmetic average of the annual percentage changes in the HICP for France, Finland and Greece plus 1.5 percentage points. The reference value is 4.9%.

Table 5.4.1 Measures of inflation and related indicators

(annual percentage changes, unless otherwise indicated)

	2012-2021 1)	2012-2016 1)	2017-2021 1)	2017	2018	2019	2020	2021	2022 2)	2023 2)
Measures of inflation										
HICP	2.5	1.6	3.5	2.4	2.9	3.4	3.4	5.2	9.0	4.1
HICP excluding unprocessed food and energy	2.9	2.5	3.3	2.1	2.3	3.7	3.7	4.5	8.4	4.0
HICP at constant tax rates 3)	2.3	1.0	3.5	2.9	3.4	3.2	3.3	4.7	-	-
CPI	2.4	1.5	3.4	2.3	2.8	3.3	3.3	5.1	9.0	4.1
Private consumption deflator	3.1	2.0	4.1	3.3	3.3	4.6	3.3	6.3	9.0	4.1
GDP deflator	4.0	2.7	5.4	4.0	4.8	4.8	6.3	6.9	5.6	4.6
Producer prices 4)	2.7	-0.8	6.3	4.6	6.2	3.9	0.8	16.9	-	-
Related indicators										
Real GDP growth	2.7	2.1	3.3	4.3	5.4	4.6	-4.5	7.1	3.6	2.6
GDP per capita in PPS 5) (euro area = 100)	65.4	63.6	67.8	64.5	66.9	68.6	71.0	.	-	-
Comparative price levels (euro area = 100)	60.4	58.4	62.8	62.5	62.4	63.7	62.5	.	-	-
Output gap 6)	-0.1	-1.5	1.3	2.2	3.8	4.1	-3.7	-0.2	-0.5	-1.1
Unemployment rate (%) 7)	5.9	7.9	3.8	4.0	3.6	3.3	4.1	4.1	3.8	4.0
Unit labour costs, whole economy	3.2	2.1	4.4	4.6	3.3	3.4	6.6	4.0	6.7	4.5
Compensation per employee, whole economy	4.1	1.7	6.5	7.0	6.4	6.9	3.0	9.2	8.7	6.5
Labour productivity, whole economy	0.8	-0.4	2.0	2.3	3.0	3.4	-3.4	5.0	1.9	1.9
Imports of goods and services deflator	1.9	0.1	3.8	1.8	3.5	1.2	2.4	10.3	9.6	-1.0
Nominal effective exchange rate 8)	-2.1	-2.2	-1.9	1.7	-1.2	-2.6	-5.9	-1.5	-	-
Money supply (M3) 9)	8.3	4.3	12.3	8.5	10.7	8.4	18.9	15.5	-	-
Lending from banks 10)	3.5	-3.6	11.2	6.4	11.0	15.1	11.4	12.3	-	-
Stock prices (BUX) 11)	198.8	88.5	58.5	23.0	-0.6	17.7	-8.6	20.5	-	-
Residential property prices	8.6	4.6	12.7	12.2	14.3	17.0	4.9	15.4	-	-

Sources: European Commission (Eurostat, Directorate-General for Economic and Financial Affairs), national data for CPI, money supply, lending from banks and ECB calculations based on Refinitiv data for stock prices.

1) Multi-annual averages calculated using the geometric mean, except for GDP per capita in PPS, comparative price levels, output gap and unemployment rate, for which the arithmetic mean is used.

2) Data from the European Commission's Spring 2022 Economic Forecast.

3) The difference between the HICP and the HICP at constant tax rates shows the theoretical impact of changes in indirect taxes (e.g. VAT and excise duties) on the overall rate of inflation. This impact assumes a full and instantaneous pass-through of tax rate changes to the price paid by the consumer.

4) Domestic sales, total industry excluding construction.

5) PPS stands for purchasing power standards.

6) Percentage difference from potential GDP: a positive (negative) sign indicates that actual GDP is above (below) potential GDP.

7) Definition conforms to International Labor Organization guidelines.

8) EER-42 group of trading partners. A positive (negative) sign indicates an appreciation (depreciation).

9) The series includes repurchase agreements with central counterparties.

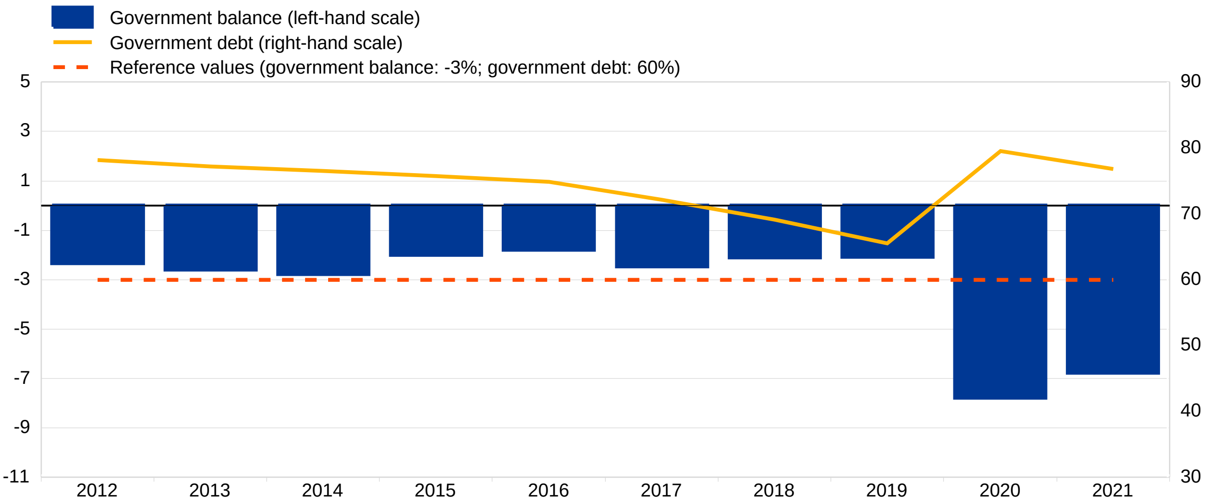
10) Adjusted for the derecognition of loans from the MFI statistical balance sheet due to their sale or securitisation.

11) Multi-annual and annual figures represent the percentage change between the end of the given period and the end of the previous period.

Hungary - Fiscal developments

Chart 5.4.2 General government balance and debt

(as a percentage of GDP)



Sources: European System of Central Banks and European Commission (Eurostat).

Table 5.4.2 Government budgetary developments and projections

(as a percentage of GDP, unless otherwise indicated)

	2012-2021 1)	2012-2016 1)	2017-2021 1)	2017	2018	2019	2020	2021	2022 2)	2023 2)
Government balance	**-3.3**	**-2.3**	**-4.2**	**-2.5**	**-2.1**	**-2.1**	**-7.8**	**-6.8**	-6.0	-4.9
Total revenue	45.2	47.0	43.3	44.3	44.0	43.9	43.4	41.1	41.3	41.4
Current revenue	43.2	44.6	41.8	43.3	42.7	42.1	41.8	39.2	39.9	40.0
Direct taxes	6.7	6.8	6.5	7.1	6.6	6.6	6.7	5.6	6.8	6.7
Indirect taxes	18.1	18.4	17.9	17.8	18.0	17.9	18.1	17.5	18.0	18.1
Net social contributions	12.6	13.4	11.7	12.8	12.1	11.7	11.2	10.5	10.0	9.8
Other current revenue 3)	5.8	5.9	5.8	5.5	6.0	5.8	5.9	5.6	5.2	5.3
Capital revenue	2.0	2.4	1.5	1.0	1.3	1.8	1.6	1.9	1.4	1.4
Total expenditure	48.4	49.3	47.6	46.7	46.1	46.0	51.2	47.9	47.3	46.4
Current expenditure	40.8	42.6	39.0	40.0	38.5	37.8	40.1	38.4	37.9	37.1
Compensation of employees	10.4	10.3	10.5	10.8	10.5	10.3	10.8	10.2	10.9	10.3
Social benefits	14.2	15.7	12.7	13.6	12.8	12.1	12.5	12.3	12.3	12.0
Interest payable	3.1	3.9	2.4	2.6	2.3	2.2	2.3	2.3	2.7	3.0
Other current expenditure 4)	13.1	12.7	13.4	13.1	13.0	13.2	14.4	13.6	12.0	11.7
Capital expenditure	7.6	6.6	8.6	6.7	7.6	8.2	11.1	9.6	9.4	9.3
of which: Investment	5.2	4.6	5.7	4.5	5.8	6.2	6.4	5.8	5.4	5.9
Cyclically adjusted balance	-3.2	-1.6	-4.8	-3.5	-3.8	-4.0	-6.1	-6.7	-5.8	-4.4
One-off and temporary measures	0.1	0.1	0.0	0.4	0.0	-0.2	0.1	-0.1	0.0	0.0
Structural balance 5)	-3.3	-1.7	-4.9	-3.8	-3.8	-3.8	-6.2	-6.6	-5.8	-4.4
Government debt	**74.5**	**76.5**	**72.6**	**72.1**	**69.1**	**65.5**	**79.6**	**76.8**	76.4	76.1
Average residual maturity (in years)	4.5	4.4	4.6	3.9	3.8	4.1	5.1	5.9	.	.
In foreign currencies (% of total)	31.1	39.3	22.9	26.2	23.2	20.5	22.0	22.6	.	.
of which: Euro	30.9	38.8	22.9	26.2	23.2	20.5	22.0	22.6	.	.
Domestic ownership (% of total)	56.4	47.4	65.5	62.7	63.7	66.1	66.7	68.3	.	.
Medium and long-term maturity (% of total) 6)	86.3	84.9	87.7	81.8	82.1	88.6	91.9	94.1	.	.
of which: Variable interest rate (% of total)	10.8	9.0	12.5	13.7	14.4	13.1	10.8	10.5	.	.
Deficit-debt adjustment	**1.1**	**0.2**	**2.1**	**0.7**	**1.7**	**0.4**	**7.3**	**0.5**	.	.
Net acquisitions of main financial assets	0.8	0.4	1.2	-0.1	0.9	0.0	5.7	-0.5	.	.
Currency and deposits	0.4	0.1	0.6	-0.5	1.0	-0.5	4.6	-1.7	.	.
Debt securities	0.0	0.0	0.0	0.0	0.0	-0.1	0.0	0.0	.	.
Loans	0.4	0.4	0.5	0.3	0.1	0.2	0.6	1.1	.	.
Equity and investment fund shares or units	0.1	-0.1	0.2	0.1	-0.1	0.4	0.5	0.1	.	.
Revaluation effects on debt	0.4	0.0	0.8	0.3	0.8	0.4	1.7	0.7	.	.
of which: Foreign exchange holding gains/losses	0.3	0.0	0.6	-0.1	0.6	0.6	1.7	0.4	.	.
Other 7)	-0.1	-0.2	0.1	0.5	-0.1	-0.1	-0.1	0.2	.	.
Convergence programme: government balance	-	-	-	-	-	-	-	-	-4.9	-3.5
Convergence programme: structural balance	-	-	-	-	-	-	-	-	-3.6	-3.0
Convergence programme: government debt	-	-	-	-	-	-	-	-	76.1	73.8

Sources: European System of Central Banks and European Commission (Eurostat, Directorate-General for Economic and Financial Affairs).

1) Multi-annual averages calculated using the arithmetic mean.

2) Data from the European Commission's Spring 2022 Economic Forecast, except for convergence programme data.

3) Sales and other current revenue.

4) Intermediate consumption, subsidies payable and other current expenditure.

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

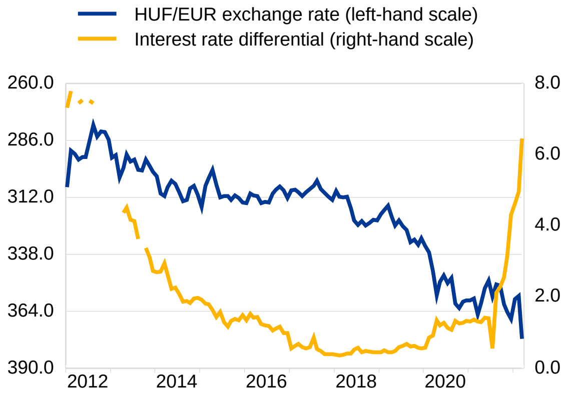
6) Original maturity of more than one year.

7) Time of recording differences and other factors (sector reclassifications and statistical discrepancies).

Hungary - Exchange rate and external developments

Chart 5.4.3 Bilateral exchange rate and short-term interest rate differential

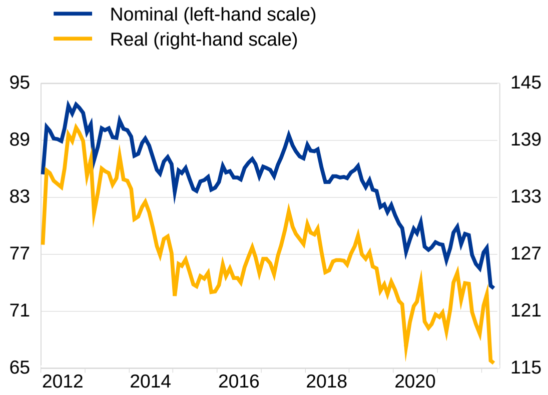
(HUF/EUR exchange rate: monthly averages; difference between three-month interbank interest rates and three-month EURIBOR: basis points, monthly values)



Sources: National data and ECB calculations.

Chart 5.4.4 Effective exchange rates [1]

(EER-42 group of trading partners; monthly averages; index: Q1 1999 = 100)



Source: ECB.

[1] The real EER-42 is CPI-deflated. An increase (decrease) in the EER indicates an appreciation (depreciation).

Table 5.4.3 External developments

(as a percentage of GDP, unless otherwise indicated)

	2012-2021 [1]	2012-2016 [1]	2017-2021 [1]	2017	2018	2019	2020	2021	2022 [2]	2023 [2]
Balance of payments										
Current account and capital account balance [3]	3.5	5.5	1.4	2.8	2.5	1.2	1.0	-0.4	-3.4	-0.8
Current account balance	1.1	2.6	-0.5	2.0	0.2	-0.7	-1.0	-2.9	-5.5	-3.5
Goods	0.9	3.0	-1.2	1.3	-1.7	-2.5	-0.9	-2.5	.	.
Services	4.4	4.3	4.5	5.5	5.9	4.9	3.0	3.2	.	.
Primary income	-3.4	-3.7	-3.1	-3.9	-3.6	-2.5	-2.5	-3.0	.	.
Secondary income	-0.8	-1.0	-0.6	-0.9	-0.4	-0.5	-0.6	-0.7	.	.
Capital account balance	2.4	2.9	1.9	0.8	2.3	1.9	2.0	2.5	.	.
Combined direct and portfolio investment balance [3]	-0.7	-0.4	-1.0	1.4	-2.3	0.8	-3.7	-1.1	.	.
Direct investment	-1.7	-2.0	-1.4	-1.6	-2.2	-0.2	-1.9	-1.3	.	.
Portfolio investment	1.0	1.6	0.5	3.0	-0.1	1.1	-1.8	0.2	.	.
Other investment balance	3.4	7.6	-0.9	0.8	1.2	-0.8	-2.1	-3.5	.	.
Reserve assets	-0.1	-2.2	1.9	0.0	2.7	0.2	4.3	2.4	.	.
Exports of goods and services	84.4	86.4	82.4	85.9	83.8	81.9	79.1	81.3	.	.
Imports of goods and services	79.1	79.1	79.1	79.1	79.6	79.5	77.0	80.6	.	.
Net international investment position [4]	-62.8	-76.0	-49.6	-54.4	-50.7	-49.1	-48.9	-44.8	.	.
Gross external debt [4]	131.1	139.5	122.7	101.5	100.4	98.4	155.5	158.0	.	.
Trade with the euro area [5]										
Exports of goods and services	56.8	56.2	57.4	57.4	57.3	57.6	58.2	56.5	.	.
Imports of goods and services	57.2	57.6	56.8	58.8	57.6	56.7	55.5	55.6	.	.
Investment position with the euro area [5]										
Direct investment assets [4]	29.8	32.6	26.9	19.7	30.1	24.5	30.6	29.6	.	.
Direct investment liabilities [4]	53.5	59.2	47.8	64.5	49.8	36.2	46.1	42.4	.	.
Portfolio investment assets [4]	62.6	65.6	59.6	60.3	60.6	59.4	58.6	59.0	.	.
Portfolio investment liabilities [4]	42.4	44.2	40.7	38.2	38.3	37.6	43.5	45.7	.	.

Sources: European System of Central Banks and European Commission (Eurostat, Directorate-General for Economic and Financial Affairs).

[1] Multi-annual averages calculated using the arithmetic mean.

[2] Data from the European Commission's Spring 2022 Economic Forecast.

[3] Differences between totals and the sum of their components are due to rounding.

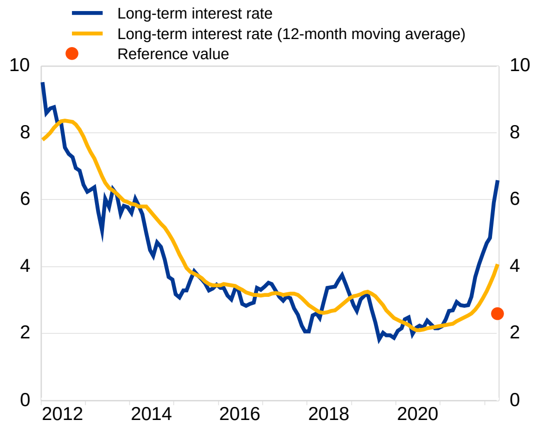
[4] End-of-period outstanding amounts.

[5] As a percentage of the total.

Hungary - Long-term interest rate developments

Chart 5.4.5 Long-term interest rate [1]

(monthly averages in percentages)

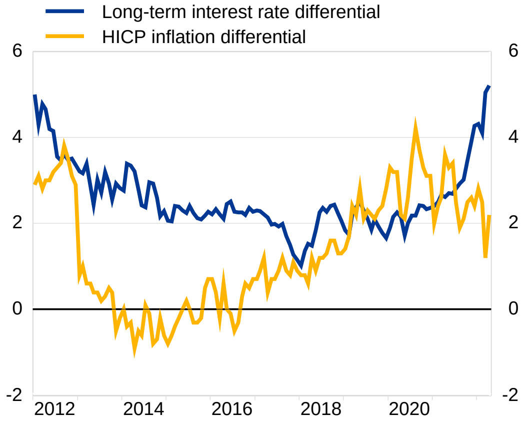


Sources: European System of Central Banks and ECB calculations.

[1] The basis of the calculation of the reference value for the period from May 2021 to April 2022 is the unweighted arithmetic average of the interest rate levels in France, Finland and Greece plus 2 percentage points. The reference value is 2.6%.

Chart 5.4.6 Long-term interest rate and HICP inflation differentials vis-à-vis the euro area

(monthly averages in percentage points)



Sources: European System of Central Banks, ECB calculations and European Commission (Eurostat).

Table 5.4.4 Long-term interest rates and indicators of financial development and integration

(as a percentage of GDP, unless otherwise indicated)

	2012-2021 [1]	2012-2016 [1]	2017-2021 [1]	2018	2019	2020	2021	May. 2021 to Apr. 2022	Memo item: euro area 2021
Long-term interest rates									
Hungary [2]	3.9	5.0	2.8	3.1	2.5	2.2	3.1	4.1	-
Euro area [3, 4]	1.4	2.2	0.6	1.1	0.4	0.1	0.1	0.4	-
Euro area AAA par curve, ten-year residual maturity [2, 4]	0.6	1.2	0.0	0.5	-0.2	-0.4	-0.3	-0.1	-
Indicators of financial development and integration									
Debt securities issued by financial corporations [5]	7.7	9.3	6.1	5.5	5.7	6.6	7.0	-	66.7
Debt securities issued by non-financial corporations [6]	2.2	1.8	2.7	1.4	1.6	3.2	5.9	-	13.4
Stock market capitalisation [7]	16.9	14.8	19.0	18.7	20.4	17.2	18.2	-	77.7
MFI credit to non-government residents [8]	40.6	44.0	37.1	34.4	35.7	40.5	40.9	-	111.1
Claims of euro area MFIs on resident MFIs [9]	6.1	8.5	3.7	3.7	4.3	3.4	3.6	-	29.5

Sources: European System of Central Banks and ECB calculations.

[1] Multi-annual averages calculated using the arithmetic mean.

[2] Average interest rate.

[3] GDP-weighted average of the euro area long-term interest rates for the purpose of assessing convergence.

[4] Included for information only.

[5] Outstanding amount of debt securities issued by resident MFIs (excluding the national central bank) and other financial corporations.

[6] Outstanding amount of debt securities issued by resident non-financial corporations.

[7] Outstanding amount of listed shares issued by residents at market values.

[8] MFI (excluding national central bank) credit to domestic non-MFI residents other than general government. Credit comprises outstanding amounts of loans and debt securities.

[9] Outstanding amount of deposits and debt securities issued by domestic MFIs (excluding the national central bank) held by euro area MFIs as a percentage of total liabilities of domestic MFIs (excluding the national central bank). Total liabilities exclude capital and reserves and remaining liabilities.

5.5 Poland

5.5.1 Price developments

In April 2022 the 12-month average rate of HICP inflation in Poland was 7.0%, i.e. well above the reference value of 4.9% for the criterion on price stability (Chart 5.5.1). This rate is expected to increase gradually over the coming months, driven mainly by the higher commodity prices, broadening price pressures and further aggravation of supply bottlenecks resulting from the Russia-Ukraine war.

Over the past ten years the 12-month average rate of HICP inflation has fluctuated within a relatively wide range, from -0.7% to 7.0%, while the average for that period was moderate, standing at 1.7%. In 2012 the Polish economy slowed on account of weak domestic demand and unfavourable external conditions. The weakening of domestic economic activity during the period 2012-13, together with the significant fall in global commodity prices, contributed to a sharp decline in inflation from 2013 to 2015. The average annual rate of HICP inflation stood at -0.7% in 2015, despite the stronger rate of real GDP growth from 2014 and the fact that Narodowy Bank Polski had cut its main policy rate to 1.5% in March 2015. From mid-2016 HICP inflation rose gradually on the back of relatively strong economic activity. Although real GDP growth moderated somewhat from mid-2018, it rose over the period 2017-19 at an annual average rate of close to 5%. From 2019 HICP inflation started to rise more markedly, to stand at 3% at the end of the year. This increase was driven largely by hikes in food and services prices. The outbreak of the coronavirus (COVID-19) pandemic in March 2020 resulted in a significant decline in real GDP growth in the second quarter of that year. Over 2020 as a whole, real GDP fell by 2.2%, which was less of a marked decline than in most EU Member States. The national authorities took major fiscal, macroprudential and monetary policy measures to offset the economic damage caused by the pandemic. In particular, Narodowy Bank Polski cut its main policy rate on several occasions from mid-March 2020, bringing it down to a historical low of 0.1% in May 2020. Inflation was more resilient, largely reflecting higher prices for food and services, and stood on average at 3.7% that year. In 2021 the economy rebounded strongly, with real GDP rising at an annual average rate of 5.9%. Against this background, inflation rose sharply in the same year, driven mainly by surging energy prices, particularly at the end of the year. To counteract the risk of inflation expectations becoming unanchored from the target, Narodowy Bank Polski raised its main policy rate to 1.75% during the fourth quarter of 2021. On average, HICP inflation stood at 5.2% in 2021 (Table 5.5.1).

In the first four months of 2022 the average annual rate of HICP inflation stood at a high level of 9.6%. Continuing the marked upward trend it had initiated at the end of 2021, HICP inflation rose further at the beginning of 2022, owing largely to sharp increases in energy and food prices on the back of rising global commodity prices and supply bottlenecks that were exacerbated by Russia’s invasion of Ukraine in late February. The hikes in energy prices were nevertheless contained somewhat by the temporary fiscal measures taken by the authorities at the end of 2021 and start of 2022. Rising services prices also contributed to the overall increase in consumer price inflation, in the context of a strong rebound in domestic economic activity from early 2021 and robust wage growth as a result of unemployment rates remaining at historically low levels. Against this background, Narodowy Bank Polski raised its main policy rate further from the start of 2022, bringing it up to 5.25% in early May.

Policy choices have played an important role in anchoring inflation expectations in Poland over the past decade, most notably the orientation of monetary policy towards price stability. Narodowy Bank Polski operates a floating exchange rate system and has had an inflation-targeting monetary policy framework in place since 1998. The medium-term CPI inflation target has been 2.5% (±1 percentage point) since 2004. Despite the developments in 2021, inflation expectations have generally remained well anchored, broadly supported by a number of reforms designed to strengthen financial stability, increase labour market flexibility and enhance product market competition.

Inflation is projected to decline from mid-2023. However, the forecasts are subject to considerable uncertainty in the light of the Russia-Ukraine war. Over the longer term there are concerns about the sustainability of inflation convergence in Poland. According to the European Commission’s Spring 2022 Economic Forecast, average annual HICP inflation is projected to increase from 5.2% in 2021 to 11.6% in 2022, before moderating to 7.3% in 2023. The risks to the inflation outlook are tilted to the upside, as domestic labour market shortages look set to continue in the short term, global supply bottlenecks could have a further impact on price developments in certain product segments, and, in particular, tensions in energy markets may continue to exacerbate inflationary pressures. Looking further ahead, the catching-up process is likely to result in positive inflation differentials vis-à-vis the euro area, given that GDP per capita and price levels are still lower in Poland than in the euro area, unless this is counteracted by an appreciation in the nominal exchange rate. In order to prevent the build-up of excessive price pressures and macroeconomic imbalances, the catching-up process must be supported by appropriate policies.

Achieving an environment that is conducive to sustainable convergence in Poland requires stability-oriented economic policies and targeted structural reforms. Although the Polish economy managed to weather both the global financial crisis and the pandemic comparatively well, a number of structural issues still need to be addressed. It is still important that fiscal and structural policies continue to support external sustainability, enhance competitiveness and ensure investor confidence. In order to enhance potential growth and resource allocation, efforts are required to boost competition in product markets, and to speed up innovation and infrastructure modernisation. In the labour market, a number of structural weaknesses need to be dealt with, for example, by strengthening vocational education and reducing labour market mismatches, as well as by boosting the labour force participation rate. It is also essential that structural reforms are carried out to tackle disincentives to work. In the long term, there is a pressing need for Poland to reduce both its reliance on fossil fuel energy production and its greenhouse gas emissions. Otherwise, that dependency may continue to exert pressure on energy prices in the years to come. With regard to macroeconomic imbalances, the European Commission did not select Poland for an in-depth review in its Alert Mechanism Report 2022.

Financial sector policies should be aimed at safeguarding financial stability and ensuring that the financial sector makes a sound contribution to economic growth. The consequences of the pandemic have proved to be less severe for the economy and the banking sector than initially anticipated. In 2021 the burden of credit losses on banks' balance sheets decreased markedly, and the concerns about a credit crunch that were being voiced at the beginning of the pandemic did not materialise, with lending to the non-financial sector having started to pick up again. Legal risks associated with the conversion of foreign exchange-denominated mortgage loans into domestic currency remain the main source of risk and uncertainty for the banking sector, especially given the recent increase in market volatility. In addition, the relatively high level of growth in house prices and the rebound in mortgage lending recorded in 2021 require close monitoring. In order to further strengthen the financial system, the national competent authority should continue to improve its supervisory practices, among other things, by following the applicable recommendations from the relevant international and European bodies, and by collaborating closely with other national supervisors of EU Member States within the supervisory colleges.

5.5.2 Fiscal developments

Poland's general government budget balance was well below the 3% deficit reference value in 2021, and its debt was below the 60% reference value. In the reference year 2021, the general government budget balance recorded a deficit of 1.9% of GDP, i.e. well below the 3% reference value. The general government gross debt-to-GDP ratio was 53.8%, i.e. below the 60% reference value (Table 5.5.2). Compared with the previous year, the deficit declined by 5 percentage points of GDP and the debt ratio fell notably by 3.3 percentage points. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2021. The budget deficits in 2020 and 2021 were substantially affected by the economic impact of the COVID-19 pandemic and the fiscal policy measures taken in response to it.

Poland has been subject to the preventive arm of the Stability and Growth Pact since 2015. In May 2022, the European Commission found that while the 2021 general government deficit was well below the reference value of 3% of GDP, Poland is planning a deficit above and not close to 3% of GDP in 2022. The planned excess over the reference value was considered to be exceptional but not temporary. Overall, the Commission's analysis suggested that the deficit criterion had not been fulfilled. However, taking into account the exceptional uncertainty created by the continued extraordinary macroeconomic and fiscal impact of the COVID-19 pandemic, together with the invasion of Ukraine by Russia, the Commission did not propose opening new excessive deficit procedures at that stage. In the preceding year, in June 2021, the European Commission had found that the general government deficit in 2020 was above and not close to the reference value of 3% of GDP, while the debt-to-GDP ratio remained below the 60% threshold, but it had argued against taking a decision to place Member States under the excessive deficit procedure in light of the exceptional uncertainty. Previously, Poland had been in an excessive deficit procedure as of 2009, which was subsequently abrogated by the ECOFIN Council in June 2015, one year earlier than the extended deadline, on account of a systemic pension reform. In the subsequent period to 2019, some deviations from the requirements of the preventive arm of the Stability and Growth Pact were observed, in particular vis-à-vis the recommended adjustment path towards the country's medium-term objective.

Both cyclical and non-cyclical factors relating to the COVID-19 pandemic contributed to the deterioration in the budget balance over the period 2019-21. Poland entered the pandemic with a low budget deficit of 0.7% of GDP in 2019, and this was also the case in the previous years (0.2% of GDP in 2018 and 1.5% of GDP in 2017). This allowed for a forceful policy response in 2020, increasing the budget deficit by 6.2 percentage points. The deterioration in the fiscal position resulted in a structural deficit of 5.9% of GDP (from 2.3% in 2019), driven mostly by higher expenditure. Cyclical factors contributed to the increase in the deficit by 2.6 percentage points, reflecting the economic downturn. In 2021 fiscal support was gradually scaled down, as many of the initial measures were extended with greater targeting to assist those households and businesses that were most affected by the virus. As a result, the structural deficit fell to 1.8% of GDP, with revenues recovering by 1 percentage point and expenses falling by 4 percentage points, while the cyclical component improved by 0.9 percentage points from 2020 to 2021.

Following a strong increase in 2020, the debt-to-GDP ratio declined in 2021, remaining below the 60% reference value. The debt-to-GDP ratio had been on a declining path prior to the pandemic, falling from 50.6% of GDP in 2017 to 45.6% of GDP in 2019 on account of primary balances and a favourable interest-growth differential. Driven by the pandemic-induced higher primary deficit and negative growth, as well as a large deficit-debt adjustment (5.5% of GDP), the debt ratio increased by 11.5 percentage points to 57.1% of GDP in 2020, above its historical average. The debt-to-GDP ratio declined by 3.3% of GDP in 2021 as the primary deficit moderated and economic activity rebounded.

The structure of government debt makes Poland relatively sensitive to interest rate and exchange rate developments. In 2021, 20.1% of government debt was subject to variable interest rates (Table 5.5.2). Short-term debt stood at only 1.2% of total debt. Taking both factors into account, together with the level of the debt-to-GDP ratio, the budget balance is relatively sensitive to changes in interest rates. The share of foreign currency-denominated debt, most of which is denominated in euro, was relatively high at 22.7%, and the share of debt held domestically stood at 66.9%. Overall, and taking the debt-to-GDP ratio into account, the fiscal balance is relatively sensitive to exchange rate fluctuations.

The European Commission's Spring 2022 Economic Forecast foresees a notable deterioration in the budget balance and a notable improvement in the public debt ratio. According to the European Commission's latest forecasts, the general government deficit is projected to notably deteriorate to 4% and 4.4% of GDP in 2022 and 2023 respectively, thus standing well above the 3% reference value. The deterioration in the budget balance reflects the cost of aid to people fleeing from Ukraine, higher interest expenses, temporary measures in response to high energy and food prices, and lower revenues from the income tax reform. Over the period 2022-23, the structural deficit is projected to remain above the medium-term objective of 1% of GDP. Nevertheless, the Stability and Growth Pact's general escape clause, which continues to be applied in 2022 and is also expected to remain in place in 2023, provides that "in periods of severe economic downturn for the euro area or the Union as a whole, Member States may be allowed temporarily to depart from the adjustment path towards the medium-term budgetary objective…, provided that this does not endanger fiscal sustainability in the medium term". The public debt ratio is projected to decline over the projection horizon and remain below the 60% reference value, decreasing to 49.8% of GDP by 2023. The 2022 (2023) budget balance development presented in Poland's 2022 convergence programme is slightly below (slightly above) the European Commission's Spring 2022 Economic Forecast, while the projected debt ratio is above the European Commission's figure.

The Polish fiscal framework is strong overall, but its effectiveness should be improved. The constitutional debt rule provides a safeguard against exceeding the 60% reference value. The medium-term budgetary planning is based on the Multiannual State Financial Plan, and furthermore a permanent expenditure rule limiting spending growth depending on pre-specified debt thresholds has also been in place since 2015. However, recently several new expenditure items have been channelled through extra-budgetary funds which do not fall under this rule. Currently, Poland is the only EU country that does not have an independent fiscal council. In line with the provisions of the fiscal compact, independent institutions responsible for monitoring compliance with EU fiscal rules should be set up before joining the euro area.

Poland faces medium risks to fiscal sustainability in the medium and long run, as the adequacy of the pension system needs to be ensured. While the 2021 Fiscal Sustainability Report concluded that risks to fiscal sustainability over the medium term were low, the updated assessment that was published as part of the European Commission's country report for Poland on 23 May 2022 points to medium risks. Long-term risks were revised upwards compared with the Debt Sustainability Monitor 2019, i.e. from low to medium due to the budgetary pressures stemming from a projected notable increase in age-related costs and the unfavourable initial budgetary position. The 2021 Ageing Report prepared by the Ageing Working Group of the EU's Economic Policy Committee[193] shows a 4 percentage point rise in age-related expenditure by 2070 under the reference scenario, from 20.1% of GDP in 2019. The expected increase is driven by healthcare and long-term care spending, while pension spending is projected to remain stable. However, amid a marked increase in population ageing and the old age dependency ratio, only a substantial decline in the benefit ratio can stabilise the pension bill.[194] This poses risks of old age poverty and could trigger additional social payments to support the elderly, thereby weighing on long-term fiscal sustainability.

[193] European Commission and Economic Policy Committee, "The 2021 Ageing Report: Economic & Budgetary Projections for the EU Member States (2019-2070)", *European Economy Institutional Paper*, No 148, European Commission, 2021.

[194] The benefit ratio is defined as average pensions in relation to average wages. The old age dependency ratio is defined as the ratio between the number of persons aged 65 and over (age when they are generally economically inactive) and the number of persons aged between 15 and 64.

Looking ahead, fiscal policy should rebuild buffers and advance structural reforms to safeguard the long-term sustainability of public finances. While fiscal policy should remain agile in its response to the evolving pandemic situation and the geopolitical situation, a consistent and prudent fiscal policy will ensure that Poland continues to comply with the Stability and Growth Pact and maintains buffers to alleviate adverse shocks. Moreover, the Next Generation EU programme needs to be implemented effectively in order to support the recovery and to adjust to the structural changes that are under way. The role and independence of national institutions monitoring compliance with the EU fiscal rules should be strengthened. Efforts to simplify labour taxation, reduce the tax wedge, and enhance progressivity and social benefits schemes should continue, but their budgetary implications need to be carefully assessed. Preserving the long-term sustainability of public finances, while also ensuring adequate pension payments and services in the health and long-term care sectors, remains a priority.

5.5.3 Exchange rate developments

In the two-year reference period from 26 May 2020 to 25 May 2022, the Polish zloty did not participate in ERM II, but traded under a flexible exchange rate regime. Over the reference period the Polish zloty mostly traded close to its May 2020 average exchange rate against the euro of 4.5251 zlotys per euro, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate (Chart 5.5.3). The maximum upward deviation from this benchmark was 3.1%, while the maximum downward deviation amounted to 9.4%. On 25 May 2022 the exchange rate stood at 4.6210 zlotys per euro, i.e. 2.1% weaker than its average level in May 2020. At the end of March 2022 Narodowy Bank Polski entered a swap line arrangement with the ECB under which it could borrow up to €10 billion against zlotys in order to address potential euro liquidity needs in the Polish financial system. As this arrangement helped to reduce the potential risk of financial vulnerabilities, it may also have had an impact on exchange rate developments over the end of the reference period. Over the past ten years the exchange rate of the Polish zloty against the euro has depreciated by 7.6%.

The exchange rate of the Polish zloty against the euro exhibited, on average, a relatively high degree of volatility over the reference period. Overall, exchange rate volatility tended to increase somewhat from the end of 2021, likely reflecting significant changes in the country’s main policy rates during the last quarter of the year. Following a pronounced depreciation in mid-March 2020 in the wake of the initial economic impact of the pandemic, the exchange rate of the Polish zloty mostly fluctuated in a range of between 4.4 zlotys and 4.6 zlotys per euro over the reference period. However, the outbreak of the war in Ukraine at the end of February 2022 resulted in increased volatility in foreign exchange markets. From mid-2020 to the third quarter of 2021 short-term interest rate differentials against the three-month EURIBOR remained largely stable and modest, at around 0.8 percentage points, on account of the substantial cuts in the policy rates by Narodowy Bank Polski after the outbreak of the pandemic. Since the fourth quarter of 2021 decisive increases in the policy rates in Poland have resulted in a sizeable increase in short-term interest rate differentials against the three-month EURIBOR to 4.0 percentage points in the three-month period ending in March 2022.

The real effective exchange rate of the Polish zloty has depreciated somewhat over the past ten years (Chart 5.5.4). The real effective exchange rate weakened until 2016, when it began to appreciate. This appreciation continued until 2018 and since then it has remained broadly stable. Looking forward, this indicator should be interpreted with caution, as Poland is subject to a process of economic convergence, which complicates any long-term assessment of real exchange rate developments.

Poland's combined current and capital account balance has improved over the past ten years, while the country's net foreign liabilities remain high, although they have been declining since 2017 and consist mostly of net direct investment liabilities (Table 5.5.3). After standing virtually in balance on average over the period 2012-16, the current and capital account subsequently recorded an increasing surplus. It reached a relatively large surplus in 2020 of slightly above 5% of GDP, which moderated in 2021 to 1.0% of GDP largely due to a reduction in the goods trade balance. On the financing side, Poland has received net inflows in combined direct and portfolio investment over the past ten years, however, these inflows tended to diminish somewhat over the period 2018-20 while increasing again in 2021. Gross external debt increased up to 2016 and declined in 2017-21, reaching 56.6% of GDP in 2021. Over this period Poland's net international investment position deteriorated up to 2017, reaching -61.2% of GDP in that year, but subsequently it improved notably and reached -40.2% of GDP in 2021. However, the country's net foreign liabilities remain high. Fiscal and structural policies continue to be important for supporting external sustainability and maintaining Poland's attractiveness as a target for foreign direct investment, to enhance the competitiveness of the economy.

The Polish economy is well integrated with the euro area through trade and investment linkages. In 2021 exports of goods and services to the euro area constituted 58.4% of total exports, while the corresponding figure for imports was slightly lower at 56.9%. In the same year the share of the euro area in Poland's stock of inward direct investment stood at 77.3%, and its share in the country's stock of portfolio investment liabilities was 45.5%. The share of Poland's stock of foreign assets invested in the euro area amounted to 57.3% in the case of direct investment and 45.4% for portfolio investment in 2021.

5.5.4 Long-term interest rate developments

Over the reference period from May 2021 to April 2022, long-term interest rates in Poland stood at 3.0% on average and were thus above the reference value of 2.6% for the interest rate convergence criterion (Chart 5.5.5).

Overall, long-term interest rates in Poland have declined since 2012, when they averaged around 5% (Chart 5.5.5). Over the period 2012-14 the Polish Government was able to gradually tighten its fiscal stance amid the impact of the global and euro area financial crises pushing up the risk premia incorporated in the long-term interest rates on sovereign bonds. After bottoming out at around 2% at the end of 2014, long-term interest rates in Poland increased for two years on the back of strong economic activity and gradually increasing price dynamics, which resulted in inflation turning positive by the end of 2016 after a period of declining prices. During the period 2017-18 long-term interest rates declined only very gradually as, after peaking at levels slightly below 4% at the start of 2017, the upward pressure exerted by buoyant economic activity offset the dampening effect of lower inflation, thus bringing the long-term interest rate at the end of 2018 to around 3%. In 2019 long-term interest rates were mostly influenced by global trends and declined until the beginning of 2020, although domestic growth remained quite robust and inflation was increasing. In the second quarter of 2020 long-term interest rates declined to their historical lows at slightly above 1%, also because the reference monetary policy rate was swiftly cut from 1.5% to 0.1% in response to the outbreak of the COVID-19 pandemic. In addition, Narodowy Bank Polski launched purchases of government and government-guaranteed securities on the secondary market as part of structural open market operations. It also offered bill discount credit aimed at refinancing loans granted to enterprises by banks and lowered the reserve requirements to prevent the pandemic having a negative impact on credit supply. Since 2021 long-term interest rates have been gradually increasing owing to the economic recovery and the rise in inflation, which also contributed to bringing forward expectations of tighter monetary policy. Since October 2021 Narodowy Bank Polski has responded to higher than expected inflation outcomes and, more recently, the higher upside risks arising from the possible consequences of the Russian invasion of Ukraine by raising policy rates, including the reference interest rate, which stood at 5.25% (from 0.1% in September 2021) at the end of the review period. As a result, long-term interest rates also increased significantly, reaching 6.0%. During the review period credit default swap spreads remained well below 100 basis points, which is low by historical standards and one of the lowest among the group of peer countries in the region, suggesting a benign market perception of sovereign credit risk. Currently, Poland’s government debt is rated high quality investment grade by all three main rating agencies.

Poland’s long-term interest rate differential vis-à-vis the euro area has increased recently, reaching 4.6% (Chart 5.5.6). Over the period 2012-13 the faster decline in Poland’s long-term interest rates compared with the euro area took the differential vis-à-vis the euro area to its lowest level of around 1%. The differential then gradually increased again, as a result of the higher dynamism of the Polish economy and the associated higher inflation rate, before stabilising at around 200 basis points over the period 2016-19. Owing to the clear acceleration in inflation since the summer of 2021, the differential reached its historical peak of 4.6% at the end of the review period – up from 1.1% in April 2020. At the end of the review period the interest rate differential vis-à-vis the euro area AAA yield stood at 5.0%.

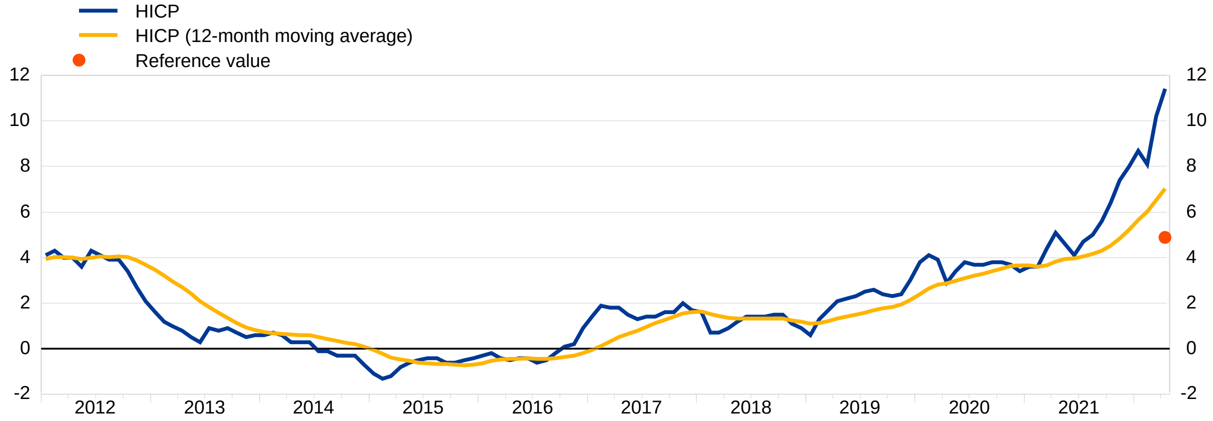
Capital markets in Poland are smaller and much less developed than in the euro area (Table 5.5.4). The market for both financial and non-financial corporate debt was still much smaller than the respective markets in the euro area at the end of 2021. Debt securities issued by financial and non-financial corporations stood at 12.3% and 2.1% of GDP respectively. In 2021 stock market capitalisation was around 27% of GDP, slightly lower than the annual average over the period 2012-21 but still one of the highest levels among peer countries. Euro area banks’ provision of funds to the

Polish banking system is quite limited. The claims of euro area MFIs on Polish banks accounted for 3.5% of Polish banks’ liabilities at the end of 2021. The degree of financial intermediation in Poland is in line with that of peer countries in the region and, as measured by the credit extended by MFIs to the private sector, amounted to slightly less than 52% of GDP in 2021 (compared with around 111% in the euro area). Foreign ownership of banks in Poland, while remaining elevated, has declined markedly in recent years on the back of government initiatives. At the end of 2020 the share of foreign banks in total Polish banking sector assets stood at around 44%.

Poland - Price developments

Chart 5.5.1 HICP inflation and reference value [1]

(annual percentage changes)



Sources: European Commission (Eurostat) and ECB calculations.

[1] The basis of the calculation of the reference value for the period from May 2021 to April 2022 is the unweighted arithmetic average of the annual percentage changes in the HICP for France, Finland and Greece plus 1.5 percentage points. The reference value is 4.9%.

Table 5.5.1 Measures of inflation and related indicators

(annual percentage changes, unless otherwise indicated)

	2012-2021 [1]	2012-2016 [1]	2017-2021 [1]	2017	2018	2019	2020	2021	2022 [2]	2023 [2]
Measures of inflation										
HICP	1.7	0.7	2.8	1.6	1.2	2.1	3.7	5.2	11.6	7.3
HICP excluding unprocessed food and energy	1.7	1.0	2.5	1.2	0.6	2.3	4.2	4.2	8.3	4.9
HICP at constant tax rates [3]	1.6	0.5	2.7	1.6	1.2	2.1	3.5	5.1	-	-
CPI	0.1	-0.9	1.1	2.0	1.7	2.3	3.4	5.1	.	.
Private consumption deflator	1.7	0.4	3.0	2.0	1.7	2.4	3.4	5.4	11.8	7.3
GDP deflator	2.1	0.9	3.2	1.9	1.2	3.2	4.2	5.8	10.0	7.8
Producer prices [4]	1.6	-0.3	3.6	4.8	2.8	1.6	-0.9	9.8	-	-
Related indicators										
Real GDP growth	3.2	2.6	3.7	4.8	5.4	4.7	-2.2	5.9	3.7	3.0
GDP per capita in PPS [5] (euro area = 100)	65.4	63.2	68.1	65.0	66.3	68.4	72.6	.	-	-
Comparative price levels (euro area = 100)	55.3	54.4	56.4	55.7	56.4	56.9	56.4	.	-	-
Output gap [6]	-0.2	-1.1	0.7	0.9	2.5	3.2	-2.5	-0.6	-0.5	-0.9
Unemployment rate (%) [7]	6.3	8.8	3.7	5.0	3.9	3.3	3.2	3.4	4.1	3.9
Unit labour costs, whole economy	2.1	1.0	3.2	2.3	3.2	2.4	7.9	0.6	6.0	5.1
Compensation per employee, whole economy	4.6	2.9	6.4	5.8	8.1	7.3	5.6	5.0	9.5	8.0
Labour productivity, whole economy	2.4	1.8	3.0	3.4	4.8	4.8	-2.1	4.4	3.3	2.7
Imports of goods and services deflator	1.7	0.1	3.3	1.4	2.7	1.8	0.1	10.7	14.4	5.1
Nominal effective exchange rate [8]	-0.5	-1.0	0.0	3.5	1.9	-1.4	-1.7	-2.4	-	-
Money supply (M3) [9]	8.4	7.5	9.4	5.9	8.7	8.7	15.3	8.5	-	-
Lending from banks [10]	5.1	5.5	4.8	7.4	6.3	5.8	-1.2	5.7	-	-
Stock prices (Warsaw General Index) [11]	84.3	37.7	33.9	23.2	-9.5	0.2	-1.4	21.5	-	-
Residential property prices	3.4	-0.7	7.7	3.9	6.6	8.7	10.5	9.2	-	-

Sources: European Commission (Eurostat, Directorate-General for Economic and Financial Affairs), national data for CPI, money supply, lending from banks and ECB calculations based on Refinitiv data for stock prices.

[1] Multi-annual averages calculated using the geometric mean, except for GDP per capita in PPS, comparative price levels, output gap and unemployment rate, for which the arithmetic mean is used.

[2] Data from the European Commission’s Spring 2022 Economic Forecast.

[3] The difference between the HICP and the HICP at constant tax rates shows the theoretical impact of changes in indirect taxes (e.g. VAT and excise duties) on the overall rate of inflation. This impact assumes a full and instantaneous pass-through of tax rate changes to the price paid by the consumer.

[4] Domestic sales, total industry excluding construction.

[5] PPS stands for purchasing power standards.

[6] Percentage difference from potential GDP: a positive (negative) sign indicates that actual GDP is above (below) potential GDP.

[7] Definition conforms to International Labor Organization guidelines.

[8] EER-42 group of trading partners. A positive (negative) sign indicates an appreciation (depreciation).

[9] The series includes repurchase agreements with central counterparties.

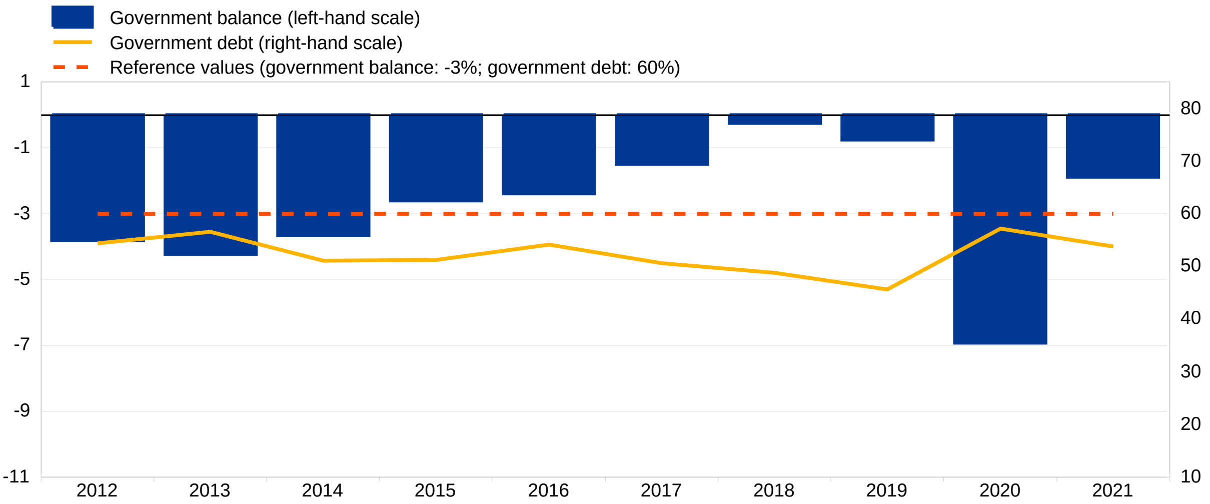
[10] Adjusted for the derecognition of loans from the MFI statistical balance sheet due to their sale or securitisation.

[11] Multi-annual and annual figures represent the percentage change between the end of the given period and the end of the previous period.

Poland - Fiscal developments

Chart 5.5.2 General government balance and debt

(as a percentage of GDP)



Sources: European System of Central Banks and European Commission (Eurostat).

Table 5.5.2 Government budgetary developments and projections

(as a percentage of GDP, unless otherwise indicated)

	2012-2021 [1]	2012-2016 [1]	2017-2021 [1]	2017	2018	2019	2020	2021	2022 [2]	2023 [2]
Government balance	**-2.8**	**-3.3**	**-2.3**	**-1.5**	**-0.2**	**-0.7**	**-6.9**	**-1.9**	-4.0	-4.4
Total revenue	40.1	39.0	41.1	39.8	41.3	41.0	41.3	42.3	39.9	38.6
Current revenue	39.0	38.0	40.1	39.0	40.1	39.9	40.1	41.4	39.1	37.7
Direct taxes	7.4	6.9	7.9	7.3	7.8	7.9	7.9	8.4	7.3	6.1
Indirect taxes	13.6	13.0	14.2	13.8	14.0	13.8	13.9	15.2	14.7	15.0
Net social contributions	13.8	13.4	14.1	13.9	14.1	14.2	14.5	14.0	13.6	13.2
Other current revenue [3]	4.3	4.6	4.0	4.1	4.2	4.0	3.8	3.8	3.6	3.4
Capital revenue	1.0	1.0	1.0	0.8	1.2	1.1	1.2	1.0	0.8	0.9
Total expenditure	42.9	42.3	43.4	41.3	41.5	41.8	48.2	44.2	43.9	43.0
Current expenditure	37.9	37.5	38.3	36.6	36.4	37.1	42.5	39.0	38.2	37.6
Compensation of employees	10.5	10.5	10.4	10.2	10.1	10.3	10.9	10.5	10.2	10.0
Social benefits	17.0	16.4	17.5	17.0	16.7	17.2	18.6	17.9	17.5	17.1
Interest payable	1.7	2.1	1.4	1.6	1.4	1.4	1.3	1.1	1.5	1.8
Other current expenditure [4]	8.8	8.5	9.1	7.9	8.2	8.2	11.7	9.4	9.1	8.8
Capital expenditure	4.9	4.8	5.1	4.6	5.1	4.7	5.7	5.2	5.7	5.4
of which: Investment	4.3	4.3	4.3	3.8	4.7	4.3	4.5	4.1	4.2	3.9
Cyclically adjusted balance	-2.7	-2.8	-2.6	-1.9	-1.5	-2.3	-5.7	-1.6	-3.7	-4.0
One-off and temporary measures	0.0	0.0	0.1	0.0	0.0	0.0	0.3	0.2	0.3	0.0
Structural balance [5]	-2.7	-2.7	-2.7	-1.9	-1.5	-2.3	-5.9	-1.8	-4.0	-4.0
Government debt	**52.3**	**53.5**	**51.2**	**50.6**	**48.8**	**45.6**	**57.1**	**53.8**	50.8	49.8
Average residual maturity (in years)	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	.	.
In foreign currencies (% of total)	30.4	33.3	27.4	31.7	30.9	28.4	23.4	22.7	.	.
of which: Euro	23.7	24.5	22.9	25.6	25.1	23.8	20.0	19.9	.	.
Domestic ownership (% of total)	51.2	45.2	57.2	47.6	49.9	55.9	65.5	66.9	.	.
Medium and long-term maturity (% of total) [6]	99.1	99.4	98.8	99.2	99.0	98.9	98.2	98.8	.	.
of which: Variable interest rate (% of total)	20.0	18.7	21.3	21.3	21.8	23.9	19.2	20.1	.	.
Deficit-debt adjustment	**-0.2**	**-1.6**	**1.1**	**-1.6**	**1.1**	**-0.3**	**5.5**	**1.0**	.	.
Net acquisitions of main financial assets	0.8	-0.1	1.8	0.0	1.1	0.8	5.4	1.5	.	.
Currency and deposits	0.6	0.1	1.1	-0.1	0.8	0.4	3.2	1.1	.	.
Debt securities	0.2	0.0	0.3	0.2	0.0	0.3	0.5	0.4	.	.
Loans	0.3	0.1	0.5	0.1	0.4	0.1	1.6	0.1	.	.
Equity and investment fund shares or units	-0.2	-0.3	-0.1	-0.2	0.0	0.0	0.1	-0.1	.	.
Revaluation effects on debt	0.1	0.2	0.0	-1.2	0.6	-0.1	0.7	0.0	.	.
of which: Foreign exchange holding gains/losses	0.1	0.1	0.0	-1.4	0.6	-0.1	1.0	0.1	.	.
Other [7]	-1.2	-1.7	-0.6	-0.4	-0.6	-0.9	-0.5	-0.6	.	.
Convergence programme: government balance	-	-	-	-	-	-	-	-	-4.3	-3.7
Convergence programme: structural balance	-	-	-	-	-	-	-	-	-4.2	-3.7
Convergence programme: government debt	-	-	-	-	-	-	-	-	52.1	51.5

Sources: European System of Central Banks and European Commission (Eurostat, Directorate-General for Economic and Financial Affairs).

[1] Multi-annual averages calculated using the arithmetic mean.

[2] Data from the European Commission’s Spring 2022 Economic Forecast, except for convergence programme data.

[3] Sales and other current revenue.

[4] Intermediate consumption, subsidies payable and other current expenditure.

[5] Cyclically adjusted balance excluding one-off and other temporary measures.

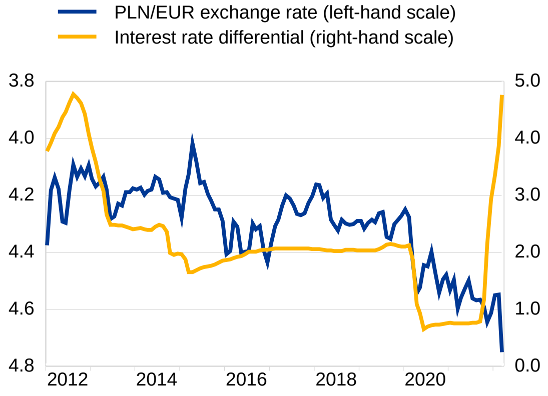
[6] Original maturity of more than one year.

[7] Time of recording differences and other factors (sector reclassifications and statistical discrepancies).

Poland - Exchange rate and external developments

Chart 5.5.3 Bilateral exchange rate and short-term interest rate differential

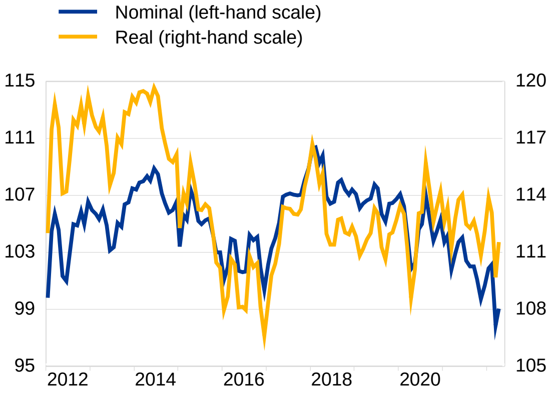
(PLN/EUR exchange rate: monthly averages; difference between three-month interbank interest rates and three-month EURIBOR: basis points, monthly values)



Sources: National data and ECB calculations.

Chart 5.5.4 Effective exchange rates [1)]

(EER-42 group of trading partners; monthly averages; index: Q1 1999 = 100)



Source: ECB.

1) The real EER-42 is CPI-deflated. An increase (decrease) in the EER indicates an appreciation (depreciation).

Table 5.5.3 External developments

(as a percentage of GDP, unless otherwise indicated)

	2012-2021 [1)]	2012-2016 [1)]	2017-2021 [1)]	2017	2018	2019	2020	2021	2022 [2)]	2023 [2)]
Balance of payments										
Current account and capital account balance [3)]	1.1	0.0	2.1	0.9	0.8	2.4	5.2	1.0	1.0	1.3
Current account balance	-0.9	-2.0	0.2	-0.4	-1.3	0.5	2.9	-0.6	-0.5	-0.2
Goods	-0.3	-0.8	0.2	-0.1	-1.2	0.3	2.4	-0.1	.	.
Services	3.3	2.3	4.3	3.8	4.3	4.5	4.3	4.6	.	.
Primary income	-3.7	-3.4	-4.0	-4.1	-4.0	-4.0	-3.5	-4.4	.	.
Secondary income	-0.2	-0.2	-0.3	0.0	-0.3	-0.3	-0.3	-0.7	.	.
Capital account balance	2.0	2.1	1.8	1.3	2.1	2.0	2.3	1.6	.	.
Combined direct and portfolio investment balance [3)]	-1.8	-2.2	-1.4	-2.3	-1.8	0.0	-0.9	-2.0	.	.
Direct investment	-1.9	-1.5	-2.3	-1.4	-2.6	-1.9	-2.1	-3.6	.	.
Portfolio investment	0.1	-0.7	1.0	-0.9	0.8	2.0	1.2	1.7	.	.
Other investment balance	0.6	0.0	1.2	3.6	1.0	-0.5	1.9	-0.1	.	.
Reserve assets	1.5	1.5	1.5	-1.5	1.3	1.7	3.1	2.8	.	.
Exports of goods and services	52.0	47.7	56.3	54.1	55.2	55.4	55.9	60.7	.	.
Imports of goods and services	48.9	46.1	51.7	50.4	52.2	50.6	49.2	56.2	.	.
Net international investment position [4)]	-57.9	-65.6	-50.2	-61.2	-55.9	-49.8	-44.3	-39.9	.	.
Gross external debt [4)]	66.8	72.4	61.3	67.0	64.2	58.8	60.3	56.2	.	.
Trade with the euro area [5)]										
Exports of goods and services	56.1	55.1	57.0	56.1	56.7	56.5	57.4	58.4	.	.
Imports of goods and services	57.8	57.8	57.7	58.7	57.7	57.1	58.2	56.9	.	.
Investment position with the euro area [5)]										
Direct investment assets [4)]	61.0	63.9	58.0	55.6	60.1	58.7	58.4	57.3	.	.
Direct investment liabilities [4)]	78.0	77.5	78.4	78.4	79.0	78.8	78.7	77.3	.	.
Portfolio investment assets [4)]	47.0	54.4	39.5	42.8	33.7	34.3	41.4	45.4	.	.
Portfolio investment liabilities [4)]	45.8	45.4	46.1	42.1	44.2	47.5	51.2	45.5	.	.

Sources: European System of Central Banks and European Commission (Eurostat, Directorate-General for Economic and Financial Affairs).

1) Multi-annual averages calculated using the arithmetic mean.

2) Data from the European Commission's Spring 2022 Economic Forecast.

3) Differences between totals and the sum of their components are due to rounding.

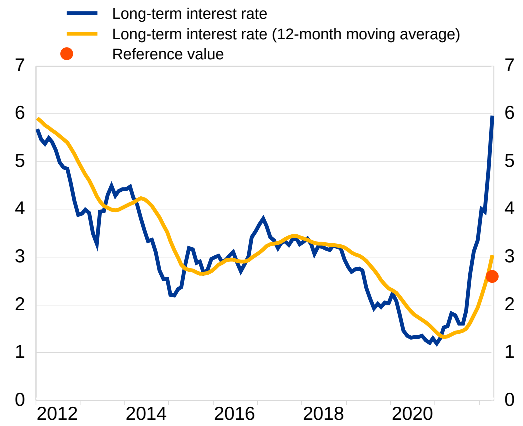
4) End-of-period outstanding amounts.

5) As a percentage of the total.

Poland - Long-term interest rate developments

Chart 5.5.5 Long-term interest rate [1]

(monthly averages in percentages)

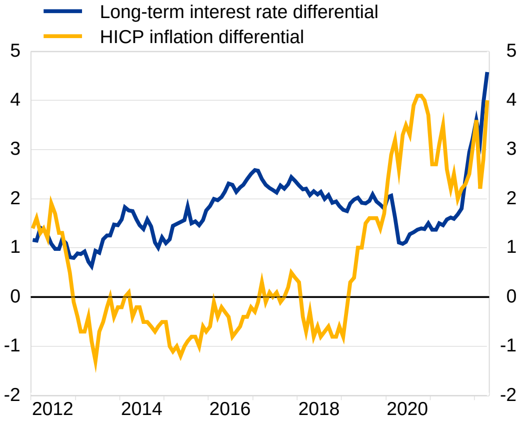


Sources: European System of Central Banks and ECB calculations.

1) The basis of the calculation of the reference value for the period from May 2021 to April 2022 is the unweighted arithmetic average of the interest rate levels in France, Finland and Greece plus 2 percentage points. The reference value is 2.6%.

Chart 5.5.6 Long-term interest rate and HICP inflation differentials vis-à-vis the euro area

(monthly averages in percentage points)



Sources: European System of Central Banks, ECB calculations and European Commission (Eurostat).

Table 5.5.4 Long-term interest rates and indicators of financial development and integration

(as a percentage of GDP, unless otherwise indicated)

	2012-2021 [1]	2012-2016 [1]	2017-2021 [1]	2018	2019	2020	2021	May. 2021 to Apr. 2022	Memo item: euro area 2021
Long-term interest rates									
Poland [2]	3.1	3.7	2.5	3.2	2.3	1.5	1.9	3.0	-
Euro area [3], [4]	1.4	2.2	0.6	1.1	0.4	0.1	0.1	0.4	-
Euro area AAA par curve, ten-year residual maturity [2], [4]	0.6	1.2	0.0	0.5	-0.2	-0.4	-0.3	-0.1	-
Indicators of financial development and integration									
Debt securities issued by financial corporations [5]	5.8	3.7	7.9	5.1	5.0	12.0	12.3	-	66.7
Debt securities issued by non-financial corporations [6]	4.3	4.8	3.7	4.9	3.3	3.0	2.1	-	13.4
Stock market capitalisation [7]	29.2	31.5	26.9	27.5	24.4	24.2	26.7	-	77.7
MFI credit to non-government residents [8]	54.9	55.2	54.6	56.1	54.4	55.0	51.8	-	111.1
Claims of euro area MFIs on resident MFIs [9]	5.2	6.6	3.8	4.1	3.6	3.6	3.5	-	29.5

Sources: European System of Central Banks and ECB calculations.

1) Multi-annual averages calculated using the arithmetic mean.

2) Average interest rate.

3) GDP-weighted average of the euro area long-term interest rates for the purpose of assessing convergence.

4) Included for information only.

5) Outstanding amount of debt securities issued by resident MFIs (excluding the national central bank) and other financial corporations.

6) Outstanding amount of debt securities issued by resident non-financial corporations.

7) Outstanding amount of listed shares issued by residents at market values.

8) MFI (excluding national central bank) credit to domestic non-MFI residents other than general government. Credit comprises outstanding amounts of loans and debt securities.

9) Outstanding amount of deposits and debt securities issued by domestic MFIs (excluding the national central bank) held by euro area MFIs as a percentage of total liabilities of domestic MFIs (excluding the national central bank). Total liabilities exclude capital and reserves and remaining liabilities.

5.6 Romania

5.6.1 Price developments

In April 2022 the 12-month average rate of HICP inflation in Romania was 6.4%, i.e. well above the reference value of 4.9% for the criterion on price stability (Chart 5.6.1). This rate is expected to increase gradually over the coming months, driven mainly by the higher commodity prices, broadening price pressures and further aggravation of supply bottlenecks resulting from the Russia-Ukraine war.

Over the past ten years the 12-month average rate of HICP inflation has fluctuated within a relatively wide range, from -1.7% to 6.4%, and the average for that period was moderate, standing at 2.2%. Over the years up to 2015, inflation was driven by rising compensation per employee. It then declined to historically low levels on account of a series of tax cuts, in particular the reduction in the value added tax rate on food items, non-alcoholic beverages and food services, which took it into negative territory in June 2015. Further tax cuts and a reduction in excise duties meant that HICP inflation remained negative throughout 2016, before turning positive again at the beginning of 2017, partly owing to favourable base effects. In 2018 inflation continued its accelerating trend on the back of strong fiscal stimulus and increases in minimum wages, and averaged 4.1% over the year. In response to that acceleration in inflation, Banca Naţională a României raised its monetary policy rate by 25 basis points three times over the months from January to May 2018, up from 1.75% to 2.5%. HICP inflation then fell slightly to 3.9% in 2019, but remained elevated as a result of developments in prices for food, tobacco and fuel, as well as strong wage growth. It continued its downward trend into 2020, also reflecting the coronavirus (COVID-19) pandemic, which dampened economic activity. Having expanded by 4.2% in 2019, real GDP contracted by 3.7% in 2020. To support the economy, in March 2020 Banca Naţională a României cut its monetary policy rate by 50 basis points to 2% and narrowed the interest rate corridor to a width of 1 percentage point. This was the start of a series of reductions in the monetary policy rate up to January 2021, bringing it down to 1.25% to support the nascent economic recovery. Government support measures mitigated the economic effects of the pandemic, preventing a sharp increase in unemployment and sustaining both household income and business activity. Inflation rose above the upper limit of the target interval, reaching an average level of 4.1% in 2021 (Table 5.6.1). Supply-side shocks, particularly in relation to prices for electricity, natural gas and fuel, were the main contributing factor to the considerable rise in inflation, especially during the second half of the year, followed by prices for processed and unprocessed food. With inflationary pressures mounting in the second half of 2021, Banca Naţională a României initiated a monetary policy tightening cycle by first ending government bond purchases in May and then introducing strict market liquidity controls and intervening in the money market through deposit-taking operations. Thereafter, it raised its monetary policy rate by 25 basis points in both October and November 2021, bringing it up to 1.75%. The monetary policy decision in November was complemented by a widening of the symmetric corridor of interest rates around on standing facilities around the policy rate to ±0.75 percentage points.

In the first four months of 2022 the average annual rate of HICP inflation stood at 9.1%. The continued increase in the rate of inflation over those months reflected mainly external supply-side shocks. Energy prices were the major inflationary factor, but were partly contained by the mitigating impact of temporary government measures adopted in November 2021. In April 2022 the government introduced a revised cap on natural gas and electricity prices for households and firms, which is expected to remain in place for a year. Prices for fuel and food, both locally produced and imported, strengthened their upward momentum as a result of surging crude oil prices, higher energy costs feeding into production, higher prices for international commodities owing to bad weather events and disruptions to global trade and value chains. Inflationary pressures were also exacerbated by developments in international energy and commodities markets linked to Russia’s invasion of Ukraine in late February. Given the increasing risks to medium-term inflation expectations triggered by supply-side shocks and in the context of declining labour market slack, Banca Naţională a României raised its key monetary policy rate further in January, February, April and May 2022, by a total of 200 basis points, bringing it up to 3.75%. In addition, the interest rate corridor was widened to ±1 percentage point.

The orientation of monetary policy towards price stability has played an important role in shaping inflation dynamics in Romania over the past decade. In 2005 Banca Naţională a României shifted to an inflation-targeting framework combined with a managed floating exchange rate regime. The annual CPI inflation target was initially set at 7.5% and from 2013 was reduced gradually to 2.5%, with a 1 percentage point variation band around the central target.

Inflation is expected to continue its upward trend in the near term and remain above the upper bound of the target interval over the forecast horizon. However, the forecasts are subject to considerable uncertainty in the light of the Russia-Ukraine war. Over the longer term there are concerns about the sustainability of inflation convergence in Romania. According to the European Commission’s Spring 2022 Economic Forecast, average annual inflation is expected to increase to 8.9% in 2022, before declining to 5.1% in 2023. The European Commission’s inflation outlook points to a gradual acceleration in inflation until the second quarter of 2022, owing to high food prices and a greater pass-through of energy price increases to other components of the inflation basket. Overall, risks to the medium-term inflation outlook are tilted to the upside, owing mostly to international factors related to lingering supply chain disruptions and high energy prices. However, a weaker than expected cyclical position of the economy at the end of 2021 poses downside risks to economic growth and could partly counterbalance some of the upward pressure on prices. Looking further ahead, there are concerns about the sustainability of inflation convergence in Romania over the longer term, also taking into account the marked increase in unit labour costs. The catching-up process is also likely to result in positive inflation differentials vis-à-vis the euro area, given that GDP per capita and price levels are still lower in Romania than in the euro area, unless this is counteracted by an appreciation of the nominal exchange rate. In order to prevent the build-up of excessive price pressures and reduce macroeconomic imbalances, the catching-up process must be supported by appropriate policies. In particular, wage growth needs to be consistent with productivity growth, among other things, in order to safeguard price competitiveness and the attractiveness of Romania to foreign investors.

Achieving an environment that is conducive to sustainable convergence in Romania requires stability-oriented economic policies and wide-ranging structural reforms. With regard to macroeconomic imbalances, the European Commission selected Romania for an in-depth review in its Alert Mechanism Report 2022, highlighting issues related to its external position and cost competitiveness. The relatively weak quality of the country's institutions and governance, as well as its weak business environment, continue to hamper its growth potential, in an environment of low productivity. As headwinds related to Romania's demographic profile and labour market (i.e. its ageing population coupled with high migration outflows) are likely to persist, Romania's current growth strategy, based on extensive labour utilisation, should be complemented by a growth model that is more focused on fostering innovation, as well as knowledge-based and high-value-added industries (e.g. ICT). Continued reform efforts aimed at fighting corruption, improving competition and enhancing the predictability of the country's tax, judicial, regulatory and administrative systems are needed, as they would also boost the country's attractiveness to foreign creditors by enhancing trust in domestic institutions. Measures should include upgrading skill levels by improving access to education for the minorities and the under-represented, strengthening the insolvency regime and combating regional disparities in living standards to spur a more inclusive growth. Finally, effective absorption of EU funds remains key to fostering economic convergence in the medium term and to guiding the economy in the upcoming green and digital transition.

Financial sector policies should be aimed at safeguarding financial stability and ensuring that the financial sector makes a sound contribution to economic growth. After several profitable years, the performance of the banking sector is strong, with banks showing solid capital and liquidity positions, and non-performing loans having come closer to EU levels. In the light of improved profitability in the domestic banking sector and the consolidation of ample voluntary capital and liquidity reserves, the Romanian authorities recalibrated the countercyclical capital buffer from 0% to 0.5% in 2021 and decided not to extend the restrictions on dividend distributions. In order to further bolster confidence in the financial system, the national competent authorities should continue to improve their supervisory practices, among other things, by following the applicable recommendations from the relevant international and European bodies, and by collaborating closely with other national supervisors of EU Member States within the supervisory colleges.

5.6.2 Fiscal developments

Romania's general government budget deficit was significantly above the 3% reference value in 2021, while its debt was below the 60% reference value. In the reference year 2021, the general government budget balance recorded a deficit of

7.1% of GDP, i.e. significantly above the 3% reference value. The general government debt ratio was 48.8% of GDP, i.e. below the 60% reference value (Table 5.6.2). Compared with the previous year, the general government deficit decreased by 2.2 percentage points and the debt ratio increased moderately by 1.6 percentage points of GDP. With regard to other fiscal factors, the deficit ratio exceeded the ratio of public investment to GDP in 2021. The budget deficits in 2020 and 2021 were substantially affected by the economic impact of the COVID-19 pandemic and the fiscal policy measures taken in response to it.

Romania is subject to an excessive deficit procedure, which was launched in April 2020 and kept in abeyance on the basis of the achievement of the required targets in 2021. Following a recommendation from the European Commission of 4 March 2020 on the basis of a planned excessive deficit in 2019, the Council decided on 3 April 2020, in accordance with Article 126(6) of the Treaty, that an excessive deficit existed in Romania and issued a recommendation to correct the excessive deficit by 2022 at the latest. On 20 March 2020, the Commission adopted a Communication on the activation of the general escape clause of the Stability and Growth Pact. On 18 November 2020, the Commission announced that in the light of the continued exceptional uncertainty created by the COVID-19 pandemic and its extraordinary macroeconomic and fiscal impact, it considered that no decision on further steps in the excessive deficit procedure initiated for Romania could be taken at that juncture. On 18 June 2021, the ECOFIN Council adopted a recommendation under the excessive deficit procedure for Romania, which involved revising the date for correcting the excessive deficit from 2022 to 2024, with the argument being that this extension was important so as not to compromise its economic recovery following the COVID-19 pandemic. The recommendation indicates that, in order to meet this new deadline, Romania would need to achieve general government deficit targets of 8.0% of GDP in 2021, 6.2% of GDP in 2022, 4.4% of GDP in 2023, and 2.9% of GDP in 2024. On the basis of the achievement of the required headline deficit target and the required fiscal effort in 2021, the excessive deficit procedure is being kept in abeyance.

Both cyclical and non-cyclical factors contributed to the deterioration in the budget balance over the period 2019-21. Romania’s fiscal position appeared highly vulnerable even before the COVID-19 pandemic, with the deficit having reached 4.3% of GDP in 2019. In 2020 the deficit ratio deteriorated by 5 percentage points and the structural balance deteriorated by 2.9 percentage points. This was mainly the result of pre-existing expansionary policies (including significant increases in pensions), as well as temporary measures taken in the face of the COVID-19 pandemic (albeit these were smaller in size than those implemented in other countries) and cyclical factors. In 2021 the deficit improved by 2.2 percentage points and the structural balance improved by 1.5 percentage points. While the strong economic recovery supported government revenues throughout the year, these gains were offset by expenditure slippages, mainly relating to the COVID-19 crisis measures and measures adopted to dampen spiking energy prices.

The debt-to-GDP ratio, while remaining below the 60% reference value, has been increasing since 2019. The debt ratio decreased from 39.2% of GDP in 2014 to

34.7% of GDP in 2018 owing to a favourable interest-growth differential and, to a lesser extent, some favourable deficit-debt adjustments. In 2019, by contrast, the debt ratio increased slightly for the first time since 2014. The debt ratio subsequently increased strongly in 2020, before a further moderate increase in 2021, when it reached 48.8% of GDP. The increases over the period 2019-21 were largely the result of primary deficits, with the favourable interest-growth differential helping to contain the debt increase in 2021 (Table 5.6.2).

The level and structure of government debt indicate that Romania's fiscal balances are protected from sudden changes in interest rates; however, those balances are sensitive to exchange rate fluctuations. The share of government debt with a short-term maturity is low (5.1% of overall debt in 2021 – Table 5.6.2). After decreasing during the global financial crisis, the share of debt with a medium or long-term maturity reached a peak of 96.9% in 2019. Taking into account medium and long-term debt with a variable interest rate as a percentage of GDP, fiscal balances appear relatively insensitive to interest rate changes. The proportion of foreign currency-denominated government debt is high (53.3% in 2021). Taking the size of the debt in relation to GDP into consideration, it can therefore be concluded that the fiscal balances are sensitive to exchange rate movements, mainly the euro/leu exchange rate, as a large part of the debt is denominated in euro (85.2% of foreign-denominated debt in 2021).

The European Commission's Spring 2022 Economic Forecast foresees a moderate improvement in the budget balance by 2023 and a notable increase in the debt ratio, with significant further consolidation required for Romania to correct its excessive deficit situation. According to the European Commission's Spring 2022 Economic Forecast, the deficit is projected to deteriorate to 7.5% of GDP in 2022 before improving to 6.3% of GDP in 2023. These fall short of the excessive deficit procedure's intermediate budget deficit targets of 6.2% and 4.4% of GDP respectively. Over the period 2022-23, the structural deficit is projected to stand at 6.5% and 5.4% of GDP in 2022 and 2023 respectively, thus pointing to the need for comprehensive further consolidation in order for Romania to return to its medium-term objective (a structural deficit of 1% of GDP). Nevertheless, the Stability and Growth Pact's general escape clause, which continues to be applied in 2022 and is also expected to remain in place in 2023, provides that "in periods of severe economic downturn for the euro area or the Union as a whole, Member States may be allowed temporarily to depart from the adjustment path towards the medium-term budgetary objective…, provided that this does not endanger fiscal sustainability in the medium term". With regard to the debt ratio, the European Commission forecasts a notable increase of 2.1 percentage points of GDP in 2022, followed by a further moderate increase of 1.7 percentage points in 2023. The debt ratio is projected to remain below the 60% reference value, reaching 52.6% of GDP in 2023, but this would be its highest level since 1995. Romania's April 2022 convergence programme update forecasts a deficit of 6.2% of GDP and a debt ratio of 49.4% of GDP for 2022, both of which are lower than the European Commission's forecasts. On the basis of the European Commission's Spring 2022 Economic Forecast, significant further consolidation will be required to correct the excessive deficit situation.

Romania has strengthened its national fiscal governance framework significantly, but the framework has not been respected or applied effectively, particularly in the context of policy decisions taken from 2015 onwards. Romania's fiscal governance framework was strengthened following the adoption of the fiscal compact (through the implementation of a structural budget balance rule, a debt rule and a correction mechanism), the creation of an independent Fiscal Council in 2010, and a reform of the tax collection agency. However, Romania has systematically and repeatedly derogated from its national fiscal rules and the timeline for the adoption of the medium-term fiscal strategy as enshrined in the national fiscal framework, thereby rendering these rules largely ineffective. In particular, the Romanian authorities should fully support the Fiscal Council by submitting the budget on a timely basis and by increasing the transparency of the macroeconomic and fiscal forecasts and the budget documentation. The Government should also increase efforts to improve its public finance management, reform the public administration and make tax policy and administration more efficient. Limited progress has been made in public investment project preparation and prioritisation. Moreover, the corporate governance of state-owned enterprises has been weakened. Romania's budgetary adjustment would be supported by the full application of the national fiscal framework.

Romania faces low sustainability risks in the short term, high sustainability risks in the medium term and medium sustainability risks in the long term, and it needs to address the challenges of its ageing population. The European Commission's 2021 Fiscal Sustainability Report points to low risks over the short term, with the assessment of short-term risks improving from high to low compared with the European Commission's 2020 Debt Sustainability Monitor, notably supported by the economic recovery in 2021. For the medium term, the high risk classification, unchanged compared with the 2020 Debt Sustainability Monitor, reflects the currently large deficit, rising debt, and sensitivity to adverse shocks.[195] For the long term, the assessment of risks has improved from high to medium compared with the 2020 Debt Sustainability Monitor due to lower ageing-related costs (which are, however, still expected to increase significantly). Indeed, the European Commission's 2021 Ageing Report[196] points to a significant increase of 5.1 percentage points of GDP in age-related public expenditure over the period 2019-70 under its reference scenario, from a level of 14.9% of GDP in 2019. Under the AWG's risk scenario, the increase in the cost of ageing amounted to 9.9 percentage points of GDP. All these developments suggest that further reforms are needed to improve the long-term sustainability of public finances.

Looking ahead, additional reforms and a sound fiscal position in line with the provisions of the Stability and Growth Pact are needed to safeguard the sustainability of public finances over the medium term. Fiscal policy should remain agile in its response to the evolving pandemic and given the geopolitical situation. At the same time, Romania must ensure compliance with the requirements of the excessive deficit procedure through comprehensive further consolidation, while

[195] This assessment was confirmed by the updated debt sustainability analysis which was published as part of the European Commission's country report for Romania on 23 May 2022.

[196] European Commission and Economic Policy Committee, "The 2021 Ageing Report: Economic & Budgetary Projections for the EU Member States (2019-2070)", *European Economy Institutional Paper*, No 148, European Commission, 2021.

being geared towards enhancing the quality of public finances and reinforcing the growth potential of the economy. Moreover, the Next Generation EU programme needs to be implemented effectively in order to support the recovery and adjust to the structural changes that are under way. The Romanian Government should make further efforts to improve the tax collection system, fight tax evasion, increase spending efficiency, advance structural fiscal reforms (including in the corporate governance of state-owned enterprises), and tackle the projected increase in age-related costs.

5.6.3 Exchange rate developments

Over the reference period from 26 May 2020 to 25 May 2022, the Romanian leu did not participate in ERM II, but traded under a flexible exchange rate regime involving a managed floating of the currency's exchange rate. Over the two-year reference period the Romanian leu mostly traded close to its May 2020 average exchange rate against the euro of 4.8371 lei per euro, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate (Chart 5.6.3). The maximum upward deviation from this benchmark was 0.1%, while the maximum downward deviation amounted to 2.4%. On 25 May 2022 the exchange rate stood at 4.9416 lei per euro, i.e. 2.2% weaker than its average level in May 2020. Furthermore, in June 2020 Banca Naţională a României entered a repo line arrangement with the ECB under which it could borrow up to €4.5 billion against high quality euro-denominated collateral to provide euro liquidity to Romanian financial institutions in order to address possible liquidity needs owing to the pandemic. As this arrangement helped to reduce the potential risk of financial vulnerabilities, it may also have had an impact on exchange rate developments over the reference period. Over the past ten years the Romanian leu has depreciated against the euro by 11.3%.

The exchange rate of the Romanian leu against the euro exhibited, on average, a very low degree of volatility over the reference period. In the immediate aftermath of the pandemic-related market turmoil, exchange rate volatility increased somewhat in the second quarter of 2020. However, it declined to stand at very low levels in the third quarter and throughout the remainder of the reference period, with only a moderate pick-up in the second quarter of 2021, mostly on account of developments related to the emergence of the Delta variant of the coronavirus. Although the performance of the Romanian economy has been relatively strong, throughout the reference period the leu continued its steady depreciating trend which started in late 2016. This mainly reflects risks to the country's fiscal sustainability, weaknesses in its external position and political tensions. The depreciating trend gained momentum in mid-March 2020 following the intensification of the COVID-19 pandemic in Europe, although there have been signs of a stabilisation since the end of the third quarter of 2021. Over the reference period short-term interest rate differentials against the three-month EURIBOR were relatively wide. After declining moderately from the end of 2020, spreads started to follow a notable upward trajectory from October 2021 and reached a peak of 4.0 percentage points in the three-month period ending in March 2022. This reflected the tighter domestic monetary policy stance in view of a widening of inflation differentials vis-à-vis the euro area. Indeed, Banca Naţională a României hiked its monetary policy rate on six occasions between October 2021 and May 2022.

The Romanian leu has depreciated slightly over the past ten years in real effective terms (Chart 5.6.4). Looking forward, this indicator should be interpreted with caution, as Romania is subject to a process of economic convergence, which complicates any long-term assessment of real exchange rate developments.

Romania's current and capital account balance has weakened over the past ten years, while the country's net foreign liabilities have declined gradually but remain high (Table 5.6.3). Following three consecutive EU and IMF financial assistance programmes ending in 2015, the combined current and capital account balance strengthened in the period to 2016, before deteriorating notably in the following four years. This reflected a growing trade deficit on the back of a worsening merchandise goods balance in conjunction with a flattening services surplus, in the light of a moderation in Romania's export performance and strong domestic demand, in particular household consumption. This trend continued after the outbreak of the COVID-19 pandemic, which further worsened the trade balance owing to the emergence of global supply chain disruptions. On the financing side, from 2012 to 2015 net inflows in direct and portfolio investment were more than offset by net outflows in other investment, and gross external debt declined simultaneously. Portfolio investment inflows in the form of debt securities subsequently gained in importance. Together with other debt-creating inflows, this led to an increase in gross external debt in nominal euro terms from 2015. However, as a result of nominal GDP growth, the gross external debt ratio decreased from 59.1% in 2015 to 49.5% in 2019. Subsequently, given the Romanian Government's extraordinary emergency fiscal spending (financed in part by the issuance of international bonds) and the economic contraction witnessed in the country, the gross external debt ratio increased notably to stand at 58.3% in 2020, before edging down to 56.4% in 2021. The country's net international investment position improved from -53.7% of GDP in 2015 to -43.6% of GDP in 2019, before worsening substantially again to -47.9% of GDP in 2020. It then improved again in 2021 to a level of -45.7% of GDP. While improving somewhat over the last ten years, the country's net foreign liabilities remain high. Fiscal and structural policies therefore continue to be important to promote external sustainability and to boost domestic economic competitiveness.

The Romanian economy is well integrated with the euro area through trade and investment linkages. In 2021 exports of goods and services to the euro area constituted 55.7% of total exports, while the corresponding figure for imports amounted to 52.4%. In the same year the share of the euro area in Romania's stock of inward direct investment stood at 79.2% and its share in the country's stock of portfolio investment liabilities was 58.7%. The share of Romania's stock of foreign assets invested in the euro area amounted to 67.2% in the case of direct investment and 58.5% for portfolio investment in 2021.

5.6.4 Long-term interest rate developments

Over the reference period from May 2021 to April 2022, long-term interest rates in Romania stood at 4.7% on average and were thus well above the 2.6% reference value for the interest rate convergence criterion (Chart 5.6.5).

Long-term interest rates in Romania stood at 6.6% in April 2022, an increase of 390 basis points compared with January and February 2021, which were the months when the lowest level was reached during the review period. Between 2012 and early 2015 long-term interest rates in Romania declined steadily from around 7% to a historical low of 2.7% in February 2015. During this period long-term interest rates were driven by developments in the euro area, where financial markets lowered their assessment of sovereign risk, and by the decrease in inflation expectations in Romania amid the steady decline in actual inflation, which then turned negative in 2015. The long-term interest rate in Romania then fluctuated between 3% and 4% over the period 2015-17 and between 4% and 5% thereafter, until the outbreak of the COVID-19 pandemic in spring 2020. During that period, the economy was characterised by sustained positive inflation dynamics, sizeable current account deficits and uncertainty regarding the sustainability of the Government’s fiscal policy. In March 2020 Banca Naţională a României started to purchase government bonds on the secondary market as part of a package of measures aimed at mitigating the economic impact of the pandemic and consolidating liquidity in the banking system. This was to ensure the good functioning of the money market and of other financial market segments, as well as the smooth financing of the real economy and the public sector. Furthermore, between March 2020 and January 2021 Banca Naţională a României cut its policy rate by a cumulative 125 basis points to counter the negative impact of the pandemic on economic growth and inflation. After touching their historical minimum of 2.7% again in February 2021, long-term interest rates embarked on a steep upward path owing to the quick recovery of economic growth as well as higher than expected inflation, among other factors. In a context of rising inflation and supply-side shocks posing risks to medium-term inflation expectations, Banca Naţională a României reversed the course of monetary policy and, in the fourth quarter of 2021, began to increase the policy rate, which currently stands at 3.75%, 250 basis points higher than its minimum in January 2021. Persistent market concerns about the sustainability of domestic government finances is one of the main factors behind the high credit default swap spreads for Romanian government bonds, which stood at 200 basis points in April 2022, one of the highest levels among the group of peer countries in the region. Romania’s government debt is rated at the lowest investment-grade notch by all three main rating agencies.

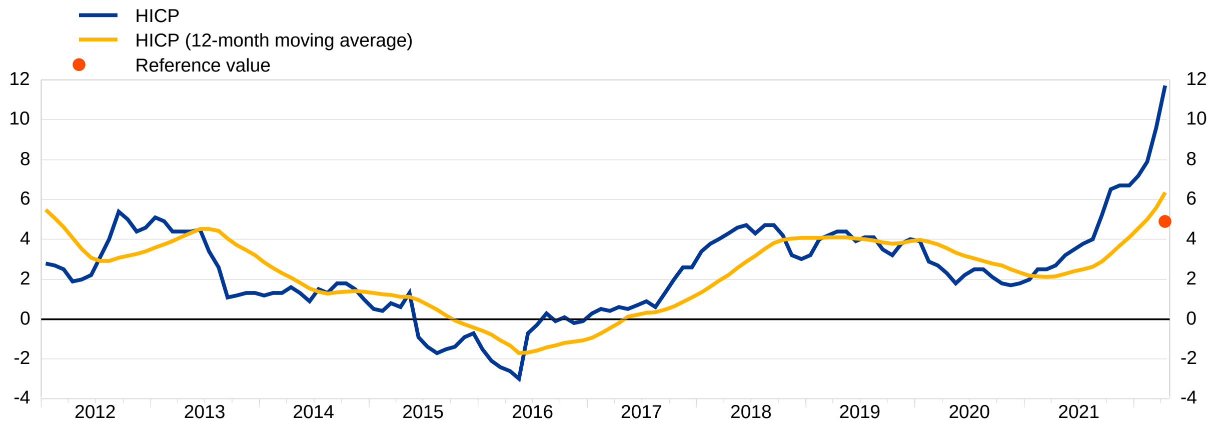
The long-term interest rate differential of Romanian bonds vis-à-vis the euro area has steadily increased since the end of 2016. After a period of relatively high volatility, the long-term interest rate differential of Romanian sovereign bonds vis-à-vis the euro area average stabilised between the end of 2014 and the end of 2016. Since then the interest rate differential has increased continuously, excluding a short-lived episode from May 2020 to February 2021, to reach levels of more than 5% at the end of the review period.

Capital markets in Romania are much smaller than in the euro area and are still underdeveloped (Table 5.6.4). At the end of 2021 the Romanian corporate debt market barely existed, as the outstanding amount of debt securities issued by financial and non-financial corporations amounted to only 0.8% and 0.4% of GDP respectively. Romania's equity market is also still quite small, as its stock market capitalisation, at 11.5% of GDP in 2021, ranks among the lowest in the region. Foreign-owned banks play a major role in Romania and accounted for around 71% of total banking assets in 2020. The degree of financial intermediation is quite small and is the lowest in the region, as measured by the credit extended by MFIs to the private sector, which stood at 27.4% of GDP in 2021. Over the past decade Romanian banks have gradually relied less on euro area banks for their funding needs. The claims of euro area banks on Romanian banks have declined from an annual average of around 11% of total liabilities of domestic MFIs over the period 2012-21 to 2.2% in 2021. Since 2012 the share of MFI loans denominated in domestic currency in total loans extended to the private sector has increased consistently, from about 38% at the end of 2012 to 72% in February 2022.

Romania - Price developments

Chart 5.6.1 HICP inflation and reference value [1]

(annual percentage changes)



Sources: European Commission (Eurostat) and ECB calculations.

[1] The basis of the calculation of the reference value for the period from May 2021 to April 2022 is the unweighted arithmetic average of the annual percentage changes in the HICP for France, Finland and Greece plus 1.5 percentage points. The reference value is 4.9%.

Table 5.6.1 Measures of inflation and related indicators

(annual percentage changes, unless otherwise indicated)

	2012-2021 [1]	2012-2016 [1]	2017-2021 [1]	2017	2018	2019	2020	2021	2022 [2]	2023 [2]
Measures of inflation										
HICP	2.2	1.3	3.1	1.1	4.1	3.9	2.3	4.1	8.9	5.1
HICP excluding unprocessed food and energy	2.1	1.5	2.7	0.9	2.7	3.8	3.3	3.1	7.1	4.8
HICP at constant tax rates [3]	2.6	2.1	3.1	2.0	3.8	3.7	2.3	3.9	-	-
CPI	2.4	1.2	3.5	1.4	4.6	3.8	2.6	5.1	8.9	5.1
Private consumption deflator	3.0	2.0	4.0	2.7	3.8	5.4	2.4	5.5	9.1	5.3
GDP deflator	4.2	2.9	5.4	4.7	6.2	6.8	3.9	5.4	9.5	4.9
Producer prices [4]	3.4	0.8	6.0	3.1	5.2	5.1	0.2	17.4	-	-
Related indicators										
Real GDP growth	3.5	3.4	3.5	7.3	4.5	4.2	-3.7	5.9	2.6	3.6
GDP per capita in PPS [5] (euro area = 100)	57.2	52.1	63.5	59.4	61.4	65.3	68.1	.	-	-
Comparative price levels (euro area = 100)	51.9	51.6	52.4	51.9	52.7	52.6	52.4	.	-	-
Output gap [6]	-1.2	-2.0	-0.4	1.4	1.9	2.0	-4.8	-2.5	-3.0	-2.7
Unemployment rate (%) [7]	7.0	8.4	5.6	6.1	5.3	4.9	6.1	5.6	5.5	5.3
Unit labour costs, whole economy	3.1	2.5	3.8	9.5	8.2	6.6	4.7	-9.1	6.4	4.1
Compensation per employee, whole economy	7.7	6.2	9.3	14.8	12.9	10.9	2.6	5.7	8.3	7.0
Labour productivity, whole economy	4.5	3.6	5.4	4.8	4.4	4.0	-2.0	16.3	1.7	2.8
Imports of goods and services deflator	0.8	-1.6	3.3	4.7	3.9	0.8	-1.7	9.2	10.9	3.8
Nominal effective exchange rate [8]	-0.8	-1.0	-0.6	-0.6	0.4	-2.1	0.1	-0.7	-	-
Money supply (M3) [9]	9.9	7.6	12.3	11.1	10.6	9.9	15.1	14.9	-	-
Lending from banks [10]	5.7	2.2	9.3	7.9	10.2	6.7	6.5	15.4	-	-
Stock prices (BET) [11]	201.3	63.4	84.4	9.4	-4.8	35.1	-2.4	34.2	-	-
Residential property prices	2.5	0.2	4.8	6.0	5.6	3.4	4.7	4.4	-	-

Sources: European Commission (Eurostat, Directorate-General for Economic and Financial Affairs), national data for CPI, money supply, lending from banks and ECB calculations based on Refinitiv data for stock prices.

[1] Multi-annual averages calculated using the geometric mean, except for GDP per capita in PPS, comparative price levels, output gap and unemployment rate, for which the arithmetic mean is used.

[2] Data from the European Commission’s Spring 2022 Economic Forecast.

[3] The difference between the HICP and the HICP at constant tax rates shows the theoretical impact of changes in indirect taxes (e.g. VAT and excise duties) on the overall rate of inflation. This impact assumes a full and instantaneous pass-through of tax rate changes to the price paid by the consumer.

[4] Domestic sales, total industry excluding construction.

[5] PPS stands for purchasing power standards.

[6] Percentage difference from potential GDP: a positive (negative) sign indicates that actual GDP is above (below) potential GDP.

[7] Definition conforms to International Labor Organization guidelines.

[8] EER-42 group of trading partners. A positive (negative) sign indicates an appreciation (depreciation).

[9] The series includes repurchase agreements with central counterparties.

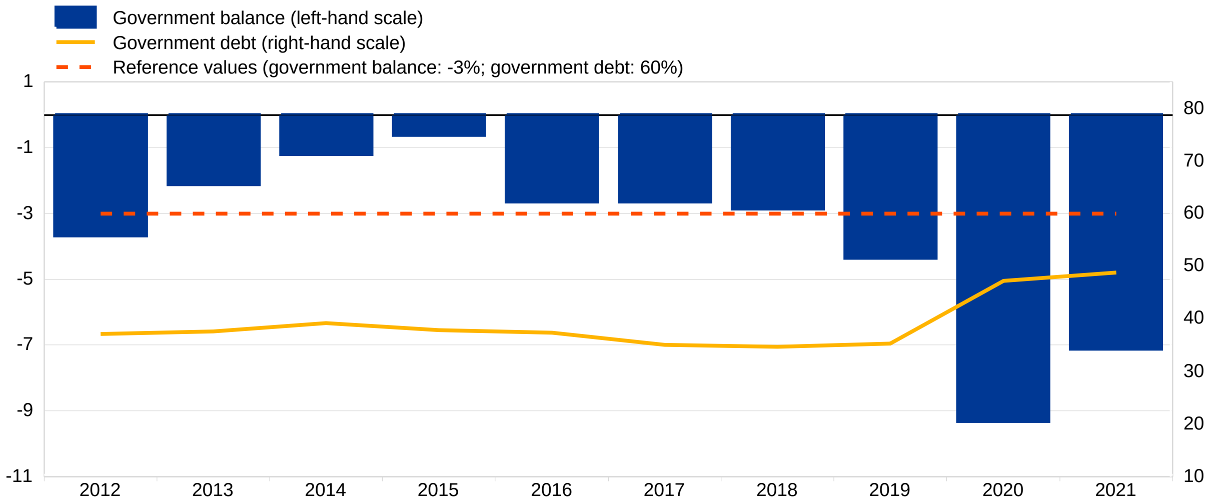
[10] Adjusted for the derecognition of loans from the MFI statistical balance sheet due to their sale or securitisation.

[11] Multi-annual and annual figures represent the percentage change between the end of the given period and the end of the previous period.

Romania - Fiscal developments

Chart 5.6.2 General government balance and debt

(as a percentage of GDP)



Sources: European System of Central Banks and European Commission (Eurostat).

Table 5.6.2 Government budgetary developments and projections

(as a percentage of GDP, unless otherwise indicated)

	2012-2021 [1]	2012-2016 [1]	2017-2021 [1]	2017	2018	2019	2020	2021	2022 [2]	2023 [2]
Government balance	**-3.6**	**-2.0**	**-5.2**	**-2.6**	**-2.8**	**-4.3**	**-9.3**	**-7.1**	-7.5	-6.3
Total revenue	32.9	33.8	32.0	30.8	32.0	31.9	32.7	32.8	33.6	33.3
Current revenue	31.3	31.9	30.6	29.4	31.0	30.7	31.0	30.9	31.5	31.3
Direct taxes	5.7	6.2	5.1	6.1	4.9	4.9	4.7	5.1	5.8	5.6
Indirect taxes	11.6	12.7	10.5	10.3	10.4	10.6	10.4	10.7	10.7	10.6
Net social contributions	9.8	8.6	11.1	9.4	11.4	11.3	11.9	11.4	11.3	11.4
Other current revenue [3]	4.2	4.5	3.9	3.7	4.2	4.0	4.0	3.6	3.7	3.7
Capital revenue	1.7	1.9	1.4	1.4	1.0	1.1	1.7	2.0	2.1	2.0
Total expenditure	36.6	35.9	37.3	33.5	34.8	36.2	42.0	39.9	41.1	39.6
Current expenditure	31.3	30.0	32.5	29.9	30.7	31.6	36.0	34.4	33.9	32.5
Compensation of employees	9.6	8.1	11.1	9.8	11.0	11.3	12.1	11.1	10.2	9.8
Social benefits	12.0	11.7	12.3	11.6	11.6	11.8	13.4	13.2	12.9	12.5
Interest payable	1.5	1.7	1.2	1.3	1.0	1.1	1.4	1.4	1.5	1.6
Other current expenditure [4]	8.2	8.4	7.9	7.2	7.1	7.4	9.1	8.7	9.2	8.7
Capital expenditure	5.3	5.9	4.8	3.6	4.1	4.6	6.0	5.6	7.2	7.0
of which: Investment	4.0	4.5	3.5	2.6	2.7	3.5	4.6	4.2	5.9	6.0
Cyclically adjusted balance	-3.3	-1.4	-5.1	-3.1	-3.5	-5.0	-7.8	-6.3	-6.5	-5.4
One-off and temporary measures	0.0	0.1	-0.1	0.0	-0.3	-0.1	0.0	0.0	0.0	0.0
Structural balance [5]	-3.3	-1.5	-5.0	-3.1	-3.1	-4.9	-7.8	-6.3	-6.5	-5.4
Government debt	**39.0**	**37.8**	**40.2**	**35.1**	**34.7**	**35.3**	**47.2**	**48.8**	50.9	52.6
Average residual maturity (in years)	6.0	5.0	7.0	6.2	6.6	6.9	7.7	7.4	.	.
In foreign currencies (% of total)	53.6	55.8	51.3	51.9	50.3	48.7	52.3	53.3	.	.
of which: Euro	44.1	45.4	42.9	43.4	41.2	40.4	43.9	45.4	.	.
Domestic ownership (% of total)	50.2	49.0	51.5	51.4	52.2	53.7	49.2	50.8	.	.
Medium and long-term maturity (% of total) [6]	93.9	91.7	96.0	95.0	96.8	96.9	96.5	94.9	.	.
of which: Variable interest rate (% of total)	9.6	12.6	6.5	11.4	6.3	5.5	5.0	4.5	.	.
Deficit-debt adjustment	**0.6**	**0.9**	**0.3**	**-0.8**	**0.3**	**-0.3**	**2.6**	**-0.6**	.	.
Net acquisitions of main financial assets	0.5	1.0	-0.1	-0.6	0.0	-1.3	2.1	-0.5	.	.
Currency and deposits	0.5	1.2	-0.2	-0.4	-0.3	-1.5	2.0	-0.6	.	.
Debt securities	0.0	0.0	0.1	0.0	0.1	0.0	0.1	0.1	.	.
Loans	0.2	0.0	0.3	0.4	0.4	0.3	0.2	0.1	.	.
Equity and investment fund shares or units	-0.2	-0.2	-0.3	-0.6	-0.3	-0.2	-0.2	-0.2	.	.
Revaluation effects on debt	0.1	-0.1	0.3	0.3	0.2	0.3	0.2	0.3	.	.
of which: Foreign exchange holding gains/losses	0.3	0.2	0.3	0.5	0.0	0.5	0.4	0.4	.	.
Other [7]	0.0	-0.1	0.1	-0.5	0.2	0.7	0.3	-0.4	.	.
Convergence programme: government balance	-	-	-	-	-	-	-	-	-6.2	-4.4
Convergence programme: structural balance	-	-	-	-	-	-	-	-	-5.4	-3.8
Convergence programme: government debt	-	-	-	-	-	-	-	-	49.4	49.7

Sources: European System of Central Banks and European Commission (Eurostat, Directorate-General for Economic and Financial Affairs).

[1] Multi-annual averages calculated using the arithmetic mean.

[2] Data from the European Commission’s Spring 2022 Economic Forecast, except for convergence programme data.

[3] Sales and other current revenue.

[4] Intermediate consumption, subsidies payable and other current expenditure.

[5] Cyclically adjusted balance excluding one-off and other temporary measures.

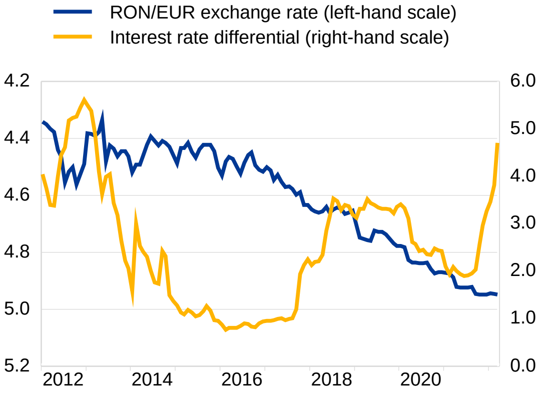
[6] Original maturity of more than one year.

[7] Time of recording differences and other factors (sector reclassifications and statistical discrepancies).

Romania - Exchange rate and external developments

Chart 5.6.3 Bilateral exchange rate and short-term interest rate differential

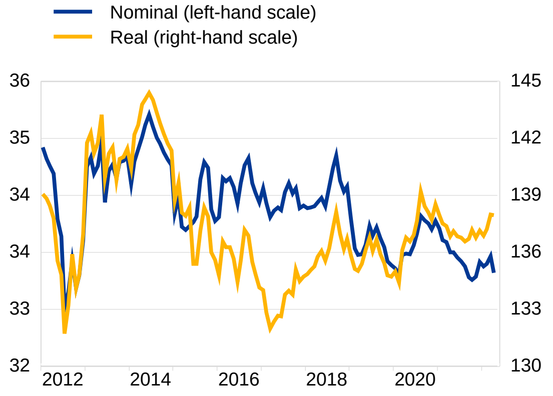
(RON/EUR exchange rate: monthly averages;
difference between three-month interbank interest rates
and three-month EURIBOR: basis points, monthly values)



Sources: National data and ECB calculations.

Chart 5.6.4 Effective exchange rates [1)]

(EER-42 group of trading partners; monthly averages; index: Q1 1999 = 100)



Source: ECB.

1) The real EER-42 is CPI-deflated. An increase (decrease) in the EER indicates an appreciation (depreciation).

Table 5.6.3 External developments

(as a percentage of GDP, unless otherwise indicated)

	2012-2021 [1)]	2012-2016 [1)]	2017-2021 [1)]	2017	2018	2019	2020	2021	2022 [2)]	2023 [2)]
Balance of payments										
Current account and capital account balance [3)]	-1.4	0.5	-3.4	-1.9	-3.4	-3.6	-3.1	-4.8	-5.9	-5.7
Current account balance	-3.3	-1.7	-4.9	-3.1	-4.6	-4.9	-5.0	-7.0	-7.5	-7.3
Goods	-6.7	-5.3	-8.1	-6.8	-7.5	-8.0	-8.7	-9.6	.	.
Services	3.9	3.6	4.1	4.4	4.1	3.9	4.3	4.0	.	.
Primary income	-1.4	-1.2	-1.6	-1.4	-1.8	-1.4	-1.5	-1.7	.	.
Secondary income	0.9	1.2	0.7	0.8	0.6	0.7	0.9	0.4	.	.
Capital account balance	1.9	2.2	1.6	1.2	1.2	1.3	1.9	2.2	.	.
Combined direct and portfolio investment balance [3)]	-4.2	-3.8	-4.6	-4.2	-3.8	-3.3	-7.5	-4.3	.	.
Direct investment	-2.2	-2.1	-2.3	-2.6	-2.4	-2.2	-1.3	-3.0	.	.
Portfolio investment	-2.0	-1.8	-2.3	-1.6	-1.4	-1.1	-6.1	-1.3	.	.
Other investment balance	2.7	4.4	0.9	2.3	1.7	1.1	1.4	-2.1	.	.
Reserve assets	0.4	0.1	0.6	0.2	-0.4	-0.1	2.6	0.9	.	.
Exports of goods and services	40.5	40.4	40.5	42.1	41.9	40.4	37.2	40.9	.	.
Imports of goods and services	43.3	42.1	44.5	44.5	45.3	44.5	41.5	46.5	.	.
Net international investment position [4)]	-52.0	-58.4	-45.7	-47.4	-43.8	-43.6	-47.9	-45.7	.	.
Gross external debt [4)]	59.4	65.6	53.2	52.9	48.9	49.5	58.3	56.4	.	.
Trade with the euro area [5)]										
Exports of goods and services	55.7	54.0	57.0	57.0	57.6	57.2	57.7	55.7	.	.
Imports of goods and services	53.8	54.3	53.5	54.5	54.2	52.9	53.3	52.4	.	.
Investment position with the euro area [5)]										
Direct investment assets [4)]	75.6	81.6	70.7	72.7	72.0	70.4	71.3	67.2	.	.
Direct investment liabilities [4)]	81.2	82.6	80.1	81.7	81.9	79.9	78.1	79.2	.	.
Portfolio investment assets [4)]	61.4	59.7	62.8	65.1	60.4	64.6	65.5	58.5	.	.
Portfolio investment liabilities [4)]	56.1	51.7	60.5	58.9	59.6	64.7	60.8	58.7	.	.

Sources: European System of Central Banks and European Commission (Eurostat, Directorate-General for Economic and Financial Affairs).

1) Multi-annual averages calculated using the arithmetic mean. Owing to the unavailability of data, the multi-annual averages for the "trade with the euro area" series and for the "direct investment assets", "portfolio investment assets" and "direct investment liabilities" components of the "investment position with the euro area" series are calculated for the period starting in 2013.

2) Data from the European Commission’s Spring 2022 Economic Forecast.

3) Differences between totals and the sum of their components are due to rounding.

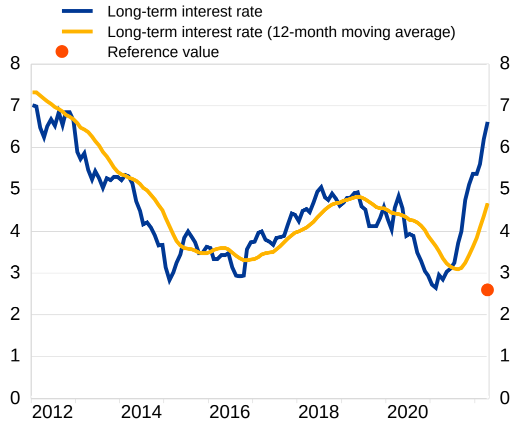
4) End-of-period outstanding amounts.

5) As a percentage of the total.

Romania - Long-term interest rate developments

Chart 5.6.5 Long-term interest rate 1)

(monthly averages in percentages)

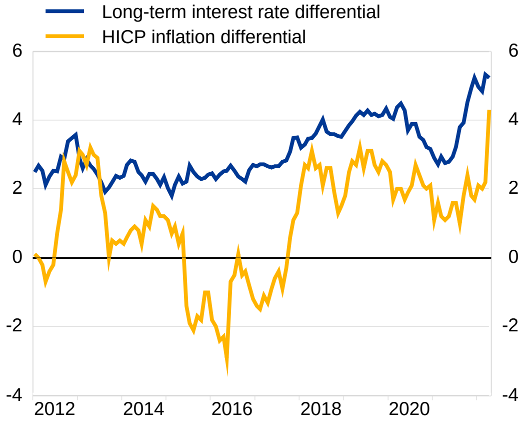


Sources: European System of Central Banks and ECB calculations.

1) The basis of the calculation of the reference value for the period from May 2021 to April 2022 is the unweighted arithmetic average of the interest rate levels in France, Finland and Greece plus 2 percentage points. The reference value is 2.6%.

Chart 5.6.6 Long-term interest rate and HICP inflation differentials vis-à-vis the euro area

(monthly averages in percentage points)



Sources: European System of Central Banks, ECB calculations and European Commission (Eurostat).

Table 5.6.4 Long-term interest rates and indicators of financial development and integration

(as a percentage of GDP, unless otherwise indicated)

	2012-2021 1)	2012-2016 1)	2017-2021 1)	2018	2019	2020	2021	May. 2021 to Apr. 2022	Memo item: euro area 2021
Long-term interest rates									
Romania 2)	4.4	4.7	4.1	4.7	4.5	3.9	3.6	4.7	-
Euro area 3), 4)	1.4	2.2	0.6	1.1	0.4	0.1	0.1	0.4	-
Euro area AAA par curve, ten-year residual maturity 2), 4)	0.6	1.2	0.0	0.5	-0.2	-0.4	-0.3	-0.1	-
Indicators of financial development and integration									
Debt securities issued by financial corporations 5)	0.3	0.3	0.4	0.2	0.4	0.4	0.8	-	66.7
Debt securities issued by non-financial corporations 6)	0.1	0.1	0.2	0.0	0.0	0.4	0.4	-	13.4
Stock market capitalisation 7)	9.7	10.0	9.4	8.0	9.5	8.5	11.5	-	77.7
MFI credit to non-government residents 8)	29.6	32.7	26.6	26.4	25.3	26.7	27.4	-	111.1
Claims of euro area MFIs on resident MFIs 9)	10.5	16.6	4.4	5.8	4.0	2.6	2.2	-	29.5

Sources: European System of Central Banks and ECB calculations.

1) Multi-annual averages calculated using the arithmetic mean.

2) Average interest rate.

3) GDP-weighted average of the euro area long-term interest rates for the purpose of assessing convergence.

4) Included for information only.

5) Outstanding amount of debt securities issued by resident MFIs (excluding the national central bank) and other financial corporations.

6) Outstanding amount of debt securities issued by resident non-financial corporations.

7) Outstanding amount of listed shares issued by residents at market values.

8) MFI (excluding national central bank) credit to domestic non-MFI residents other than general government. Credit comprises outstanding amounts of loans and debt securities.

9) Outstanding amount of deposits and debt securities issued by domestic MFIs (excluding the national central bank) held by euro area MFIs as a percentage of total liabilities of domestic MFIs (excluding the national central bank). Total liabilities exclude capital and reserves and remaining liabilities.

5.7 Sweden

5.7.1 Price developments

In April 2022 the 12-month average rate of HICP inflation in Sweden was 3.7%, i.e. well below the reference value of 4.9% for the criterion on price stability (Chart 5.7.1). This rate is expected to increase gradually over the coming months, driven mainly by the higher commodity prices, broadening price pressures and further aggravation of supply bottlenecks resulting from the Russia-Ukraine war.

Over the past ten years the 12-month average rate of HICP inflation has fluctuated within a range from 0.2% to 3.7%, and the average for that period was subdued, standing at 1.2%. Between 2012 and 2014 consumer price inflation was contained, owing to the steady appreciation of the krona in nominal effective terms and low external price pressures. In 2015 it picked up from very low levels, driven by the lagged effects of the krona’s depreciation in 2014 and strong economic growth (Chart 5.7.1). This upward trend was also underpinned by an accommodative monetary policy stance, as Sveriges Riksbank reduced its main policy rate, taking it into negative territory, and launched a programme of government bond purchases in February 2015. Between early 2017 and early 2019, HICP inflation hovered between 1.4% and 2.5%, as volatile energy prices contributed to fitful inflation growth. In December 2018 Sveriges Riksbank raised its repo rate from -0.50% to -0.25%, in the light of robust economic growth and accelerating core inflation. Despite a marked slowdown in economic activity and a drop in inflation to below the 2% target, owing to lower energy prices, the central bank lifted its main policy rate again at the end of December 2019, up from -0.25% to 0%. At the same time, core inflation continued to accelerate and stood at 1.8% in the fourth quarter of 2019. With the contraction of the Swedish economy in the first half of 2020 as a result of the coronavirus (COVID-19) pandemic, HICP inflation fell significantly, averaging 0.7% over the whole year. Weak cost pressures reflected, among other things, low resource utilisation, the strengthening of the real exchange rate, muted import prices and moderate wage gains. Social partners delayed negotiations on a multi-annual wage agreement, which led to a marked decline in overall compensation growth in the second half of 2020. Nevertheless, the major fiscal, macroprudential and monetary policy measures taken by the national authorities to offset the economic damage wrought by the pandemic, as well as the phasing-out of the pandemic-related restrictions, bolstered a rebound in economic activity. Against this background, in 2021 economic activity grew by 4.8% and HICP inflation rose by 2.7% – its highest increase since 2008 – owing mainly to rising energy prices (Table 5.7.1).

In the first four months of 2022 the average annual rate of HICP inflation increased further and stood at 5.3%. Both core and energy inflation rose significantly. Russia’s invasion of Ukraine in late February 2022 drove up energy and commodity prices, generating additional inflationary pressures. Against this background, the Executive Board of Sveriges Riksbank decided on 28 April 2022 to raise its policy rate to 0.25%, up from 0%, to prevent the high inflation from becoming entrenched in price and wage-setting. It also decided to reduce the pace of the central bank’s asset purchases during the second half of 2022.

Policy choices have played an important role in shaping inflation dynamics in Sweden over the past decade, most notably the orientation of monetary policy towards price stability. Since 1995 Sveriges Riksbank has had an inflation target that is quantified as an annual rise of 2.0% in the CPI. In June 2010 the tolerance margin of ±1 percentage point was removed from the policy objective. Sweden’s institutional framework, which fosters prudent fiscal policy and wage formation, has generally lent support to the achievement of price stability. However, in September 2017 Sveriges Riksbank decided to use inflation measured in terms of the CPIF (the CPI with a fixed interest rate) as a formal target variable for monetary policy, while keeping the target for monetary policy at 2.0%. It also decided to use a variation band of ±1 percentage point to illustrate uncertainty surrounding the development of inflation.

Inflation in Sweden is set to decline over the forecast horizon, but to remain above 2.0%. However, the forecasts are subject to considerable uncertainty given the current circumstances. According to the European Commission’s Spring 2022 Economic Forecast, average annual HICP inflation is expected to reach 5.3% in 2022, before falling to 3.0% in 2023, owing mainly to the easing of global supply bottlenecks and a fall in energy and commodity prices in early 2023. However, the risks to the inflation outlook are tilted to the upside, as inflationary pressures stemming from the Russia-Ukraine war could last longer than previously expected and also trigger an upward shift in wage growth and inflation expectations. Looking further ahead, monetary policy and the stability-oriented institutional framework should continue to support the achievement of price stability in Sweden.

Maintaining an environment that is conducive to sustainable convergence in Sweden requires the continuation of stability-oriented economic policies and targeted structural reforms. Despite the significant negative impact of the pandemic on the real economy, residential property prices in Sweden have risen sharply since spring 2020, mainly on the back of increased demand. This price upturn seems to deviate significantly from historical fundamentals such as mortgage rates or household disposable income. The European Commission selected Sweden for an in-depth review in its Alert Mechanism Report 2022, in particular because of the macroeconomic imbalances stemming from the housing market.

Financial sector policies should be aimed at continuing to safeguard financial stability and ensuring that the financial sector makes a sound contribution to economic growth. Macro-financial risks have been high in recent years, owing primarily to high residential property prices, elevated levels of household indebtedness and the large exposure of the banking sector to the housing market. Although the resilience of the banking sector has improved in recent years, as banks have built up liquidity buffers and increased their capital ratios, the Swedish authorities need to tackle the structural factors behind the residential property price dynamics to ease macro-financial risks. Against this background, the Swedish Financial Supervisory Authority (*Finansinspektionen*) decided at the end of 2021 to no longer offer the option of an exemption from the amortisation requirement and to raise the countercyclical buffer rate. In order to further bolster confidence in the financial system, the national competent authorities should continue to improve their supervisory practices, among other things, by following the applicable recommendations from the relevant international and European bodies, and by collaborating closely with other national supervisors of EU Member States within the supervisory colleges.

5.7.2 Fiscal developments

Sweden's general government budget deficit was well below the 3% reference value in 2021 and its debt ratio was well below the 60% reference value. In the reference year 2021, the general government budget recorded a deficit of 0.2% of GDP, i.e. well below the 3% deficit reference value and close to a balanced budget. The general government debt ratio was 36.7% of GDP, i.e. well below the 60% reference value (Table 5.7.2). Compared with the previous year, the deficit decreased by 2.5 percentage points of GDP and the debt ratio declined notably by 2.9 percentage points. With regard to other fiscal factors, the deficit ratio did not exceed the ratio of public investment to GDP in 2021. The budget entered into deficit territory in 2020 and 2021 due to the economic impact of the COVID-19 pandemic and the fiscal policy measures taken in response to it.

Sweden is currently subject to the preventive arm of the Stability and Growth Pact. Sweden has never been subject to an ECOFIN Council decision on the existence of an excessive deficit. The European Commission's Spring 2022 Economic Forecast assessed that the structural balance remained within the medium-term objective in 2021.

Both cyclical and non-cyclical factors relating to the COVID-19 pandemic contributed to the deterioration in the budget balance over the period 2019-21. After structural surpluses were recorded from 2016 until 2019, the European Commission's estimates (Table 5.7.2) indicate that the structural balance deteriorated by 0.8 percentage points in 2020, mostly on account of higher expenditure due to the policy response to the COVID-19 crisis. Cyclical factors also contributed to the overall increase in the budget deficit by 3.3 percentage points in 2020. From 2020 to 2021, the structural balance returned to surplus territory, reaching 0.5% of GDP, and the cyclical component improved by 1.6 percentage points.

Despite the COVID-19 crisis, the government debt-to-GDP ratio has remained well below the 60% reference value over the past few years. From 2017 to 2019, the debt ratio in Sweden had decreased steadily, moving from 40.7% to 34.9% of GDP, mostly owing to primary surpluses and favourable interest-growth differentials. However, the response to the pandemic pushed this ratio up again to 39.6% in 2020, on the back of a primary deficit and an unfavourable interest-growth differential. This course was already reversed in 2021, with the government debt ratio decreasing to 36.7% of GDP (Table 5.7.2).

Sweden's government debt structure shows that fiscal balances are relatively sensitive to interest rate fluctuations, but relatively insensitive to exchange rate

fluctuations. The share of government debt with a short-term maturity is relatively high (24.9% in 2021 – Table 5.7.2). Taking into account the share of debt with a variable interest rate and the level of the debt ratio, fiscal balances are relatively sensitive to changes in interest rates. Moreover, the proportion of government debt denominated in foreign currency is noticeable (17.3% in 2021). However, taking the small size of foreign currency-denominated debt as a percentage of GDP into consideration, this leaves fiscal balances relatively insensitive to exchange rate movements.

The European Commission's Spring 2022 Economic Forecast predicts a slight deterioration in the budget balance for 2022, followed by an improvement in 2023, and a notable decrease in the public debt ratio. According to the Commission's latest forecast, the budget balance is expected to slightly deteriorate to a deficit of 0.5% of GDP in 2022, before improving to a surplus of 0.5% of GDP in 2023, thus remaining well below the reference value of a deficit of 3% in 2022 and being in surplus in 2023. The expected moderate deterioration in the general government balance in 2022 stems from the fiscal measures implemented to mitigate the effects of the pandemic, the surge in inflation, and the consequences of the Russian invasion of Ukraine. In 2022 and 2023, the structural deficit is expected to remain within the medium-term objective (a structural deficit of 1% of GDP). The government debt ratio is projected to decrease notably in the coming years to 33.8% of GDP in 2022 and 30.5% of GDP in 2023, thus remaining well below the 60% reference value. The projected budget balance developments and debt ratios for 2022 and 2023 presented in Sweden's 2022 convergence programme are close to those shown in the European Commission's Spring 2022 Economic Forecast.

Sweden has a strong fiscal governance framework. Following the last revision of the fiscal framework, which entered into force in 2019, the general government surplus target is now ⅓% of GDP over the business cycle. This target is much more ambitious than the structural balance targets of the EU fiscal framework. In addition, a debt anchor was introduced into the fiscal framework in 2019, targeting a debt ratio of 35% (Maastricht definition). A deviation from the debt anchor by 5 percentage points or more in either direction requires the government to submit a report to Parliament explaining the causes of the deviation and presenting an action plan to address it. The debt level of 35% leaves a significant safety margin to the Maastricht reference value of 60% of GDP. The Swedish fiscal framework also includes a three-year rolling nominal expenditure ceiling for central government and the pension system, and a balanced budget requirement for local governments. Overall, the national fiscal framework is strong and compliance with the revised surplus target would support the medium-term sustainability of public finances in line with the requirements of the Stability and Growth Pact.

Sweden faces low risks to the sustainability of public finances over the medium and long term. The analysis laid out in the European Commission's 2021 Fiscal Sustainability Report points to low risks over the medium[197] and long term.[198] This

[197] This assessment was confirmed by the updated debt sustainability analysis which was published as part of the European Commission's country report for Sweden on 23 May 2022.

[198] However, this assessment does not necessarily reflect the uncertainty surrounding the long-term assumptions.

positive assessment stemmed largely from a favourable initial budgetary position that partly mitigates the projected increase in ageing-related costs, as well as low government debt. A notable increase in age-related public expenditure by 2.3 percentage points of GDP is expected over the period 2019-70 according to the reference scenario from the 2021 Ageing Report prepared by the Ageing Working Group (AWG) of the EU's Economic Policy Committee,[199] from a level of 24.1% of GDP in 2019. This rise is mainly driven by long-term care costs. Under the AWG's risk scenario, the increase in the cost of ageing amounted to 7.2 percentage points of GDP, which is above the EU average.

Looking ahead, Sweden should build on its strong track record and comply with the requirements of the preventive arm of the Stability and Growth Pact. While fiscal policy should remain agile in its response to the evolving pandemic situation and given the geopolitical situation, Sweden should continue to anchor sound public finances in its rule-based fiscal framework, which would be supported by compliance with its target of a budget surplus, on average, over the business cycle, thus ensuring compliance with its medium-term objective in the years to come.

5.7.3 Exchange rate developments

In the two-year reference period from 26 May 2020 to 25 May 2022, the Swedish krona did not participate in ERM II, but traded under a flexible exchange rate regime. Over the reference period the Swedish currency mostly traded significantly above its May 2020 average exchange rate against the euro of 10.5970 kronor per euro, which is used as a benchmark for illustrative purposes in the absence of an ERM II central rate (Chart 5.7.3). The maximum upward deviation from this benchmark was 6.6%, while the maximum downward deviation amounted to 2.7%. On 25 May 2022 the exchange rate stood at 10.5419 kronor per euro, i.e. 0.5% stronger than its average level in May 2020. Over the reference period Sveriges Riksbank maintained a swap agreement with the ECB for borrowing up to €10 billion in exchange for Swedish kronor, which had been in place since 20 December 2007 with the aim of facilitating the functioning of financial markets and providing euro liquidity to them if needed. As this agreement helped to reduce the potential risk of financial vulnerabilities, it might also have had an impact on the exchange rate of the Swedish krona against the euro over the reference period. Over the past ten years the exchange rate of the Swedish krona against the euro has depreciated by 17.2%.

The exchange rate of the Swedish krona against the euro exhibited, on average, a relatively high degree of volatility over the two-year reference period. Overall, the krona steadily strengthened against the euro in 2020, supported by the relative resilience of the Swedish economy in the context of the COVID-19 pandemic. During 2021 the exchange rate of the krona remained broadly stable, fluctuating around a level of about 10.2 kronor per euro. Towards the end of the year it appreciated temporarily, then weakened again and in early 2022 it stood at a level of 10.3 kronor

[199] European Commission and Economic Policy Committee, "The 2021 Ageing Report: Economic & Budgetary Projections for the EU Member States (2019-2070)", *European Economy Institutional Paper*, No 148, European Commission, 2021.

per euro. The exchange rate of the krona further depreciated following the disturbances in foreign exchange markets after Russia's invasion of Ukraine, before appreciating again from early March 2022 to reach a level of around 10.3 kronor per euro at the end of the reference period. During the reference period short-term interest rate differentials against the three-month EURIBOR were overall modest and stood at 0.5 percentage points in the three-month period ending in March 2022.

The real effective exchange rate of the Swedish krona has depreciated over the past ten years (Chart 5.7.4).

Over the past ten years Sweden has recorded relatively large current account surpluses and since 2018 its net international investment position has been significantly positive (Table 5.7.3). In 2021 the surplus in the combined current and capital account of the balance of payments stood at 5.7% of GDP, reflecting surpluses in the goods and primary income balances. The corresponding net capital outflows in the financial account were mainly in direct investment and other investment. Gross external debt, which is concentrated in monetary and financial institutions, stood at 173.3% of GDP in 2021. Over the past ten years Sweden has recorded a slightly positive net international investment position on average. Indeed, since 2018 its net international investment position has turned positive, reaching 17.8% of GDP in 2021.

The Swedish economy is well integrated with the euro area through trade and investment linkages. In 2021 exports of goods and services to the euro area constituted 46.6% of total exports, while the corresponding figure for imports was lower, at 42.2%. In the same year the share of the euro area in Sweden's stock of inward direct investment stood at 56.2% and its share in the country's stock of portfolio investment liabilities was 43.7%. The share of Sweden's stock of foreign assets invested in the euro area amounted to 38.7% in the case of direct investment and 33.9% for portfolio investment in 2021.

5.7.4 Long-term interest rate developments

Over the reference period from May 2021 to April 2022, long-term interest rates in Sweden stood at a slightly positive level of 0.4% on average and thus remained well below the 2.6% reference value for the interest rate convergence criterion (Chart 5.7.5).

Long-term interest rates in Sweden have been on a downward path since 2012, falling from around 2% to 1.5% at the end of the reference period. After a period of gradual but moderate increases in 2012-13, owing to high levels of risk appetite and a gradual shift from safe to risky assets, long-term interest rates declined by more than 200 basis points until March 2015. Since then long-term interest rates in Sweden have moved broadly in line with the domestic economic cycle and global developments. After increasing moderately over the period 2016-18 owing to the recovery of economic growth and inflation, long-term interest rates in Sweden followed the global downward trend in 2019 and fluctuated around 0% until the end of 2020, with temporary periods in which they turned slightly negative. In response to the COVID-19 pandemic, in 2020 Sveriges Riksbank announced, among other measures, an increase in the envelope of its quantitative easing programme until the end of 2021. The programme includes government and corporate bonds as well as commercial paper purchases and aims to counteract the negative economic effects of the pandemic, ensure loose financing conditions and foster market functionality. The repo rate was set to 0% in August 2020, 50 basis points above its lowest level, which was set in February 2016. Sveriges Riksbank's monetary policy stance remained accommodative from August 2020 to April 2022, thus helping to dampen the upward pressure on Swedish long-term interest rates stemming from the recovery of the global economy and the upturn in inflation and inflation expectations. At the end of April 2022 the central bank announced an increase in its repo rate to 0.25% and the inauguration of a tightening cycle amid rising and persistent inflation and with the objective of preventing the high inflation from becoming entrenched in price and wage-setting. As a result, the long-term interest rate stood at 1.5% in April 2022. Sweden's government debt is rated at the top investment-grade notch by all three main rating agencies.

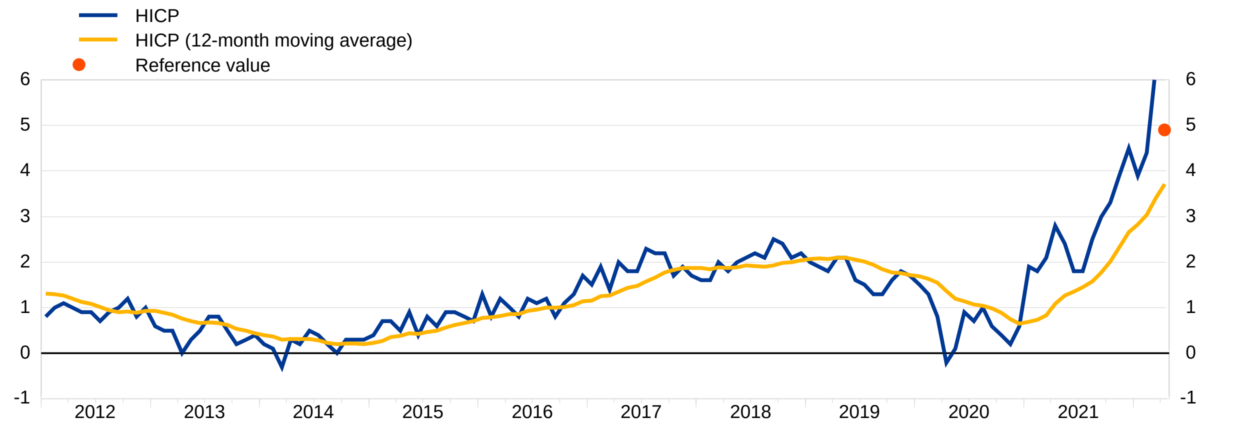
Sweden's long-term interest rate differential vis-à-vis the highest-rated euro area countries is very small. As a result of its sound fiscal policy and its balanced and healthy economy, Sweden enjoys the same credibility as the highest rated euro area countries. Historically, the interest rate differential vis-à-vis the euro area average was negative, albeit quite small. However, in the last quarter of 2020 it turned slightly positive and remained so until April 2022, when it stood at 10 basis points. The differential vis-à-vis the best-rated euro area government bonds was 50 basis points.

Capital markets in Sweden are highly developed, with corporate bond issuance and stock market capitalisation accounting for a higher percentage of GDP than in the euro area (Table 5.7.4). Relative to GDP, outstanding amounts of debt securities issued by non-financial corporations in Sweden are over twice those in the euro area. The size of the Swedish stock market, as a percentage of GDP, is also more than twice that of the euro area. Sweden's banks tend to fund their activities by borrowing from euro area banks only to a limited extent. Claims of euro area MFIs accounted for 8.7% of Swedish banks' total liabilities in 2021. The degree of financial intermediation in Sweden is high. At the end of 2021 bank credit to the private sector amounted to 140.3% of GDP, much higher than the corresponding figure in the euro area of 111.1%.

Sweden - Price developments

Chart 5.7.1 HICP inflation and reference value [1]

(annual percentage changes)



Sources: European Commission (Eurostat) and ECB calculations.

[1] The basis of the calculation of the reference value for the period from May 2021 to April 2022 is the unweighted arithmetic average of the annual percentage changes in the HICP for France, Finland and Greece plus 1.5 percentage points. The reference value is 4.9%.

Table 5.7.1 Measures of inflation and related indicators

(annual percentage changes, unless otherwise indicated)

	2012-2021 [1]	2012-2016 [1]	2017-2021 [1]	2017	2018	2019	2020	2021	2022 [2]	2023 [2]
Measures of inflation										
HICP	1.2	0.7	1.8	1.9	2.0	1.7	0.7	2.7	5.3	3.0
HICP excluding unprocessed food and energy	1.2	0.8	1.5	1.5	1.2	1.6	1.5	1.6	4.1	3.0
HICP at constant tax rates [3]	1.2	0.7	1.7	1.7	1.8	1.6	0.6	2.6	-	-
CPI	1.0	0.3	1.6	1.8	2.0	1.8	0.5	2.2	5.7	4.0
Private consumption deflator	1.3	0.8	1.9	1.8	2.5	2.1	1.1	1.9	5.7	4.0
GDP deflator	1.9	1.5	2.4	2.1	2.4	2.5	1.8	3.0	4.3	3.9
Producer prices [4]	1.8	-0.4	4.1	4.1	5.5	2.7	-2.2	11.0	-	-
Related indicators										
Real GDP growth	1.8	1.9	1.6	2.6	2.0	2.0	-2.9	4.8	2.3	1.4
GDP per capita in PPS [5] (euro area = 100)	116.3	118.4	113.6	113.7	112.4	111.9	116.6	.	-	-
Comparative price levels (euro area = 100)	121.7	123.9	119.0	124.5	118.4	116.7	116.3	.	-	-
Output gap [6]	-0.9	-1.0	-0.8	0.7	0.5	0.4	-4.2	-1.4	-0.8	-1.2
Unemployment rate (%) [7]	7.7	7.8	7.5	6.8	6.5	7.0	8.5	8.8	7.8	7.0
Unit labour costs, whole economy	2.1	1.9	2.4	1.9	3.5	1.5	4.3	0.8	2.6	3.2
Compensation per employee, whole economy	2.8	2.5	3.1	2.1	3.8	3.0	2.5	4.3	2.7	3.7
Labour productivity, whole economy	0.7	0.7	0.7	0.1	0.3	1.4	-1.7	3.5	0.1	0.5
Imports of goods and services deflator	0.9	-0.5	2.3	4.0	6.0	2.8	-4.2	3.4	12.2	5.1
Nominal effective exchange rate [8]	-0.8	-1.1	-0.5	-0.8	-4.2	-3.7	3.1	3.5	-	-
Money supply (M3) [9]	7.2	5.1	9.3	8.5	3.0	7.5	19.2	8.9	-	-
Lending from banks [10]	5.2	4.9	5.6	6.9	4.7	5.2	4.5	6.5	-	-
Stock prices (OMXS30) [11]	144.9	53.6	59.5	3.9	-10.7	25.8	5.8	29.1	-	-
Residential property prices	5.9	7.4	4.4	6.6	-0.9	2.5	4.2	10.2	-	-

Sources: European Commission (Eurostat, Directorate-General for Economic and Financial Affairs), national data for CPI, money supply, lending from banks and ECB calculations based on Refinitiv data for stock prices.

[1] Multi-annual averages calculated using the geometric mean, except for GDP per capita in PPS, comparative price levels, output gap and unemployment rate, for which the arithmetic mean is used.

[2] Data from the European Commission’s Spring 2022 Economic Forecast.

[3] The difference between the HICP and the HICP at constant tax rates shows the theoretical impact of changes in indirect taxes (e.g. VAT and excise duties) on the overall rate of inflation. This impact assumes a full and instantaneous pass-through of tax rate changes to the price paid by the consumer.

[4] Domestic sales, total industry excluding construction.

[5] PPS stands for purchasing power standards.

[6] Percentage difference from potential GDP: a positive (negative) sign indicates that actual GDP is above (below) potential GDP.

[7] Definition conforms to International Labor Organization guidelines.

[8] EER-42 group of trading partners. A positive (negative) sign indicates an appreciation (depreciation).

[9] The series includes repurchase agreements with central counterparties.

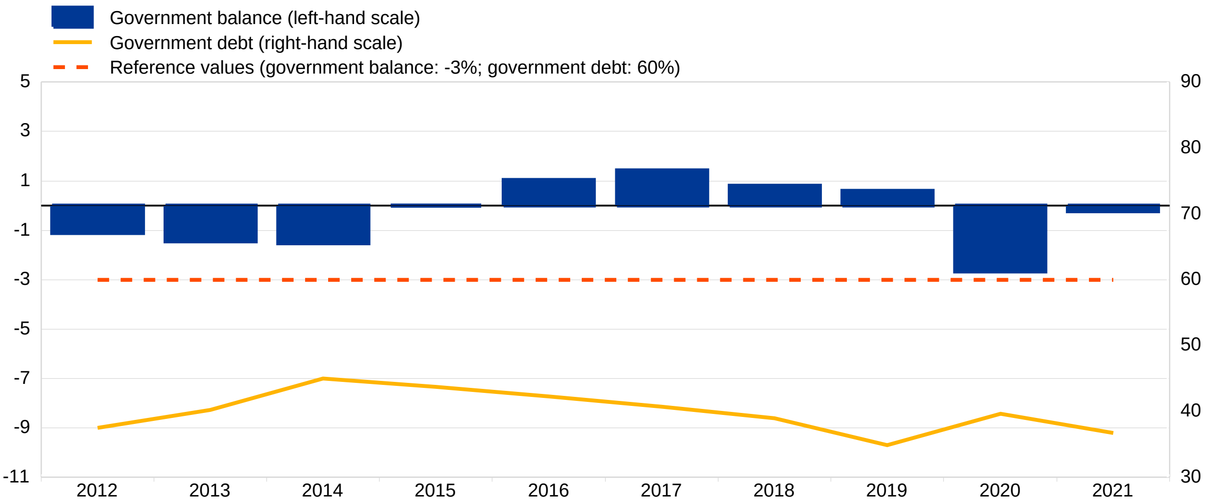
[10] Adjusted for the derecognition of loans from the MFI statistical balance sheet due to their sale or securitisation.

[11] Multi-annual and annual figures represent the percentage change between the end of the given period and the end of the previous period.

Sweden - Fiscal developments

Chart 5.7.2 General government balance and debt

(as a percentage of GDP)



Sources: European System of Central Banks and European Commission (Eurostat).

Table 5.7.2 Government budgetary developments and projections

(as a percentage of GDP, unless otherwise indicated)

	2012-2021 1)	2012-2016 1)	2017-2021 1)	2017	2018	2019	2020	2021	2022 2)	2023 2)
Government balance	**-0.3**	**-0.6**	**0.0**	**1.4**	**0.8**	**0.6**	**-2.7**	**-0.2**	-0.5	0.5
Total revenue	50.0	49.9	50.2	50.6	50.7	49.7	49.9	50.0	48.7	47.7
Current revenue	49.7	49.5	49.9	50.4	50.4	49.5	49.6	49.6	48.3	47.3
Direct taxes	18.2	18.0	18.5	19.0	18.6	18.1	18.4	18.4	17.9	17.7
Indirect taxes	21.9	21.8	22.0	22.3	22.3	21.9	21.7	21.9	21.8	21.7
Net social contributions	3.3	3.3	3.4	3.3	3.4	3.4	3.4	3.4	3.0	2.9
Other current revenue 3)	6.2	6.4	6.0	5.9	6.1	6.1	6.1	5.9	5.6	5.1
Capital revenue	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.4
Total expenditure	50.3	50.5	50.2	49.2	49.8	49.1	52.6	50.2	49.1	47.2
Current expenditure	45.5	45.9	45.1	44.5	44.7	44.0	47.2	45.1	44.0	42.2
Compensation of employees	12.7	12.6	12.7	12.6	12.7	12.6	13.1	12.7	12.0	11.8
Social benefits	16.6	17.1	16.1	16.5	16.2	15.8	16.5	15.8	15.5	15.3
Interest payable	0.5	0.7	0.4	0.4	0.5	0.4	0.3	0.2	0.1	0.2
Other current expenditure 4)	15.7	15.5	15.8	14.9	15.4	15.2	17.3	16.4	16.4	14.8
Capital expenditure	4.8	4.6	5.1	4.7	5.1	5.1	5.4	5.1	5.1	5.0
of which: Investment	4.6	4.4	4.8	4.6	4.9	4.9	5.0	4.8	4.8	4.8
Cyclically adjusted balance	0.2	-0.1	0.4	1.0	0.6	0.4	-0.4	0.5	0.0	1.2
One-off and temporary measures	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Structural balance 5)	0.2	-0.1	0.4	1.0	0.6	0.4	-0.4	0.5	0.0	1.2
Government debt	**40.0**	**41.8**	**38.2**	**40.7**	**38.9**	**34.9**	**39.6**	**36.7**	33.8	30.5
Average residual maturity (in years)	-	-	-	-	-	-	-	-	.	.
In foreign currencies (% of total)	22.8	24.4	21.2	23.4	24.6	21.8	18.6	17.3	.	.
of which: Euro	9.1	8.9	9.3	8.8	9.7	10.0	9.1	8.7	.	.
Domestic ownership (% of total)	70.4	64.0	76.8	76.9	76.1	73.6	76.5	80.9	.	.
Medium and long-term maturity (% of total) 6)	74.5	73.4	75.6	74.7	79.3	79.4	69.4	75.1	.	.
of which: Variable interest rate (% of total)	11.1	11.7	10.5	10.6	11.3	10.9	9.0	10.5	.	.
Deficit-debt adjustment	**1.1**	**1.8**	**0.4**	**1.8**	**0.7**	**-1.7**	**1.6**	**-0.3**	.	.
Net acquisitions of main financial assets	1.0	1.5	0.5	2.9	-1.3	-2.0	3.2	-0.3	.	.
Currency and deposits	0.2	0.3	0.1	0.5	-0.2	-0.3	1.1	-0.4	.	.
Debt securities	0.3	0.4	0.2	2.7	-1.1	-0.7	-0.6	0.7	.	.
Loans	0.6	1.2	0.1	0.3	0.6	-0.9	1.0	-0.5	.	.
Equity and investment fund shares or units	-0.2	-0.5	0.1	-0.6	-0.6	-0.1	1.7	-0.1	.	.
Revaluation effects on debt	0.3	0.5	0.1	-0.2	0.8	0.3	-0.4	0.2	.	.
of which: Foreign exchange holding gains/losses	0.2	0.4	0.0	-0.4	0.6	0.2	-0.5	0.2	.	.
Other 7)	-0.2	-0.1	-0.2	-0.9	1.2	-0.1	-1.1	-0.2	.	.
Convergence programme: government balance	-	-	-	-	-	-	-	-	-0.5	0.7
Convergence programme: structural balance	-	-	-	-	-	-	-	-	-0.4	0.5
Convergence programme: government debt	-	-	-	-	-	-	-	-	33.5	30.7

Sources: European System of Central Banks and European Commission (Eurostat, Directorate-General for Economic and Financial Affairs).

1) Multi-annual averages calculated using the arithmetic mean.

2) Data from the European Commission's Spring 2022 Economic Forecast, except for convergence programme data.

3) Sales and other current revenue.

4) Intermediate consumption, subsidies payable and other current expenditure.

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

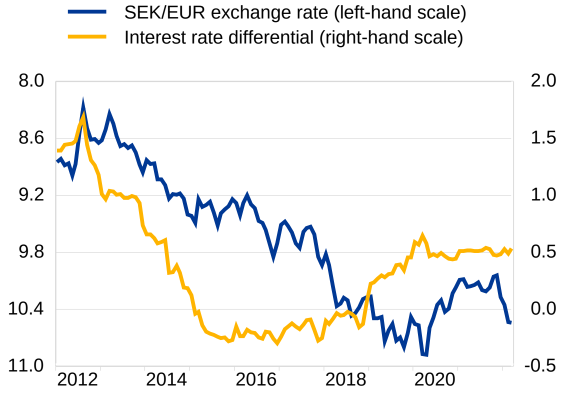
6) Original maturity of more than one year.

7) Time of recording differences and other factors (sector reclassifications and statistical discrepancies).

Sweden - Exchange rate and external developments

Chart 5.7.3 Bilateral exchange rate and short-term interest rate differential

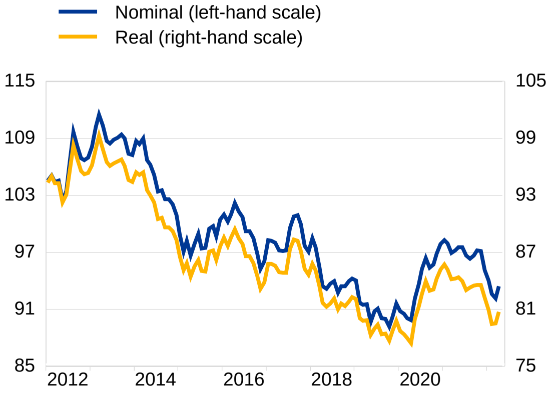
(SEK/EUR exchange rate: monthly averages; difference between three-month interbank interest rates and three-month EURIBOR: basis points, monthly values)



Sources: National data and ECB calculations.

Chart 5.7.4 Effective exchange rates [1]

(EER-42 group of trading partners; monthly averages; index: Q1 1999 = 100)



Source: ECB.

[1] The real EER-42 is CPI-deflated. An increase (decrease) in the EER indicates an appreciation (depreciation).

Table 5.7.3 External developments

(as a percentage of GDP, unless otherwise indicated)

	2012-2021 [1]	2012-2016 [1]	2017-2021 [1]	2017	2018	2019	2020	2021	2022 [2]	2023 [2]
Balance of payments										
Current account and capital account balance [3]	4.3	4.0	4.6	2.9	2.8	5.5	6.1	5.7	5.0	5.9
Current account balance	4.3	4.1	4.5	3.0	2.7	5.5	6.1	5.5	4.8	5.8
Goods	3.1	2.8	3.4	2.1	2.0	3.9	4.6	4.5	.	.
Services	0.9	1.5	0.3	0.6	0.3	0.6	0.0	-0.1	.	.
Primary income	2.1	1.5	2.6	1.7	2.0	2.9	3.5	3.0	.	.
Secondary income	-1.7	-1.6	-1.8	-1.5	-1.6	-1.9	-2.1	-1.9	.	.
Capital account balance	0.0	-0.1	0.1	0.0	0.0	0.0	0.1	0.2	.	.
Combined direct and portfolio investment balance [3]	1.4	-0.6	3.3	3.2	0.7	3.5	3.2	6.0	.	.
Direct investment	1.2	1.2	1.3	2.7	2.6	1.3	0.9	-1.1	.	.
Portfolio investment	0.1	-1.8	2.0	0.5	-1.8	2.2	2.3	7.1	.	.
Other investment balance	0.9	1.5	0.4	2.2	-0.1	1.4	2.2	-3.7	.	.
Reserve assets	0.4	0.7	0.0	0.1	-0.1	-1.2	0.1	1.0	.	.
Exports of goods and services	44.8	43.8	45.8	43.8	45.8	48.2	44.8	46.6	.	.
Imports of goods and services	40.8	39.6	42.1	41.1	43.5	43.8	40.2	42.2	.	.
Net international investment position [4]	0.9	-9.3	11.1	-0.9	8.1	16.2	14.1	17.8	.	.
Gross external debt [4]	178.2	184.3	172.1	181.8	172.9	167.0	165.6	173.3	.	.
Trade with the euro area [5]										
Exports of goods and services	39.5	39.8	39.2	40.7	40.4	38.5	38.1	38.4	.	.
Imports of goods and services	48.9	48.4	49.4	49.5	48.9	49.1	49.8	49.9	.	.
Investment position with the euro area [5]										
Direct investment assets [4]	47.3	48.9	45.8	47.8	46.4	46.2	44.8	43.7	.	.
Direct investment liabilities [4]	56.9	57.6	56.1	57.6	56.8	55.4	54.7	56.2	.	.
Portfolio investment assets [4]	36.1	37.1	35.2	36.4	36.1	34.7	34.8	33.9	.	.
Portfolio investment liabilities [4]	40.2	38.0	42.5	41.2	44.2	43.9	44.3	38.7	.	.

Sources: European System of Central Banks and European Commission (Eurostat, Directorate-General for Economic and Financial Affairs).

[1] Multi-annual averages calculated using the arithmetic mean.

[2] Data from the European Commission’s Spring 2022 Economic Forecast.

[3] Differences between totals and the sum of their components are due to rounding.

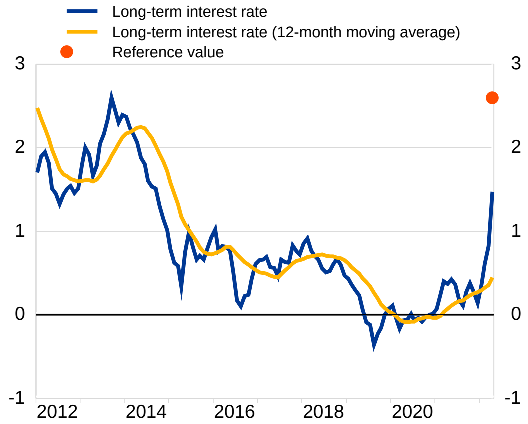
[4] End-of-period outstanding amounts.

[5] As a percentage of the total.

Sweden - Long-term interest rate developments

Chart 5.7.5 Long-term interest rate [1)]

(monthly averages in percentages)

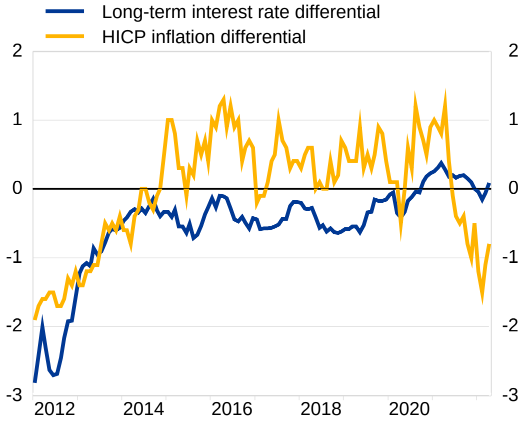


Sources: European System of Central Banks and ECB calculations.

1) The basis of the calculation of the reference value for the period from May 2021 to April 2022 is the unweighted arithmetic average of the interest rate levels in France, Finland and Greece plus 2 percentage points. The reference value is 2.6%.

Chart 5.7.6 Long-term interest rate and HICP inflation differentials vis-à-vis the euro area

(monthly averages in percentage points)



Sources: European System of Central Banks, ECB calculations and European Commission (Eurostat).

Table 5.7.4 Long-term interest rates and indicators of financial development and integration

(as a percentage of GDP, unless otherwise indicated)

	2012-2021 [1)]	2012-2016 [1)]	2017-2021 [1)]	2018	2019	2020	2021	May. 2021 to Apr. 2022	Memo item: euro area 2021
Long-term interest rates									
Sweden [2)]	0.8	1.3	0.3	0.7	0.0	0.0	0.3	0.4	-
Euro area [3), 4)]	1.4	2.2	0.6	1.1	0.4	0.1	0.1	0.4	-
Euro area AAA par curve, ten-year residual maturity [2), 4)]	0.6	1.2	0.0	0.5	-0.2	-0.4	-0.3	-0.1	-
Indicators of financial development and integration									
Debt securities issued by financial corporations [5)]	103.5	109.6	97.5	93.3	95.0	99.9	94.8	-	66.7
Debt securities issued by non-financial corporations [6)]	23.2	19.6	26.8	24.8	27.3	28.7	29.5	-	13.4
Stock market capitalisation [7)]	141.4	121.9	160.9	115.5	146.7	175.2	229.2	-	77.7
MFI credit to non-government residents [8)]	133.4	129.5	137.4	134.9	134.8	142.2	140.3	-	111.1
Claims of euro area MFIs on resident MFIs [9)]	8.7	8.5	8.9	9.5	9.3	8.9	8.7	-	29.5

Sources: European System of Central Banks and ECB calculations.

1) Multi-annual averages calculated using the arithmetic mean.

2) Average interest rate.

3) GDP-weighted average of the euro area long-term interest rates for the purpose of assessing convergence.

4) Included for information only.

5) Outstanding amount of debt securities issued by resident MFIs (excluding the national central bank) and other financial corporations.

6) Outstanding amount of debt securities issued by resident non-financial corporations.

7) Outstanding amount of listed shares issued by residents at market values.

8) MFI (excluding national central bank) credit to domestic non-MFI residents other than general government. Credit comprises outstanding amounts of loans and debt securities.

9) Outstanding amount of deposits and debt securities issued by domestic MFIs (excluding the national central bank) held by euro area MFIs as a percentage of total liabilities of domestic MFIs (excluding the national central bank). Total liabilities exclude capital and reserves and remaining liabilities.

6 Statistical methodology of convergence indicators

The examination of the convergence process is highly dependent on the quality and integrity of the underlying statistics; the compilation and reporting of statistics, particularly government finance statistics (GFS), must not be subject to any political or other external interference. Member States are invited to consider the quality and integrity of their statistics as a matter of priority, to ensure that a proper system of checks and balances is in place when compiling these statistics and to apply high standards with respect to governance and quality in the domain of statistics.

National statistical authorities in each Member State and the EU statistical authority within the European Commission (Eurostat) should enjoy professional independence and ensure that European statistics are impartial and of a high quality. This is in line with the principles laid down in Article 338(2) of the Treaty, the Regulation on European statistics[200] and the European Statistics Code of Practice[201]. Article 2(1) of the Regulation on European statistics states that the development, production and dissemination of European statistics shall be governed by the following statistical principles: a) professional independence, b) impartiality, c) objectivity, d) reliability, e) statistical confidentiality, and f) cost effectiveness. Pursuant to Article 11 of the Regulation, these statistical principles are elaborated further in the European Statistics Code of Practice.

Against this background, this chapter reviews the quality and integrity of the convergence indicators in terms of the underlying statistics. It provides information on the statistical methodology of the convergence indicators, as well as on the compliance of the underlying statistics with the standards necessary for an appropriate assessment of the convergence process.

6.1 Institutional features relating to the quality of statistics for the assessment of the convergence process

The governance of the European Statistical System (ESS) has been progressively improved, in particular with the adoption of the European

[200] Regulation (EC) No 223/2009 of the European Parliament and of the Council of 11 March 2009 on European statistics and repealing Regulation (EC, Euratom) No 1101/2008 of the European Parliament and of the Council on the transmission of data subject to statistical confidentiality to the Statistical Office of the European Communities, Council Regulation (EC) No 322/97 on Community Statistics, and Council Decision 89/382/EEC, Euratom establishing a Committee on the Statistical Programmes of the European Communities (OJ L 87, 31.3.2009, p. 164), as amended by Regulation (EU) 2015/759 of the European Parliament and of the Council of 29 April 2015 (OJ L 123, 19.5.2015, p.90).

[201] The European Statistics Code of Practice was endorsed by the European Commission in its Recommendation of 25 May 2005 on the independence, integrity and accountability of the national and Community statistical authorities (COM(2005) 217 final), and revised by the European Statistical System Committee in September 2011 and November 2017.

Statistics Code of Practice in 2005. In the specific context of the EU fiscal surveillance system and of the excessive deficit procedure (EDP), Council Regulation (EU) No 679/2010[202] granted Eurostat new competences for the regular monitoring and verification of public finance data, which it exercises by conducting more in-depth dialogue visits to Member States and by extending such visits to public entities supplying upstream public finance data to the national statistical institutes (NSIs).

Furthermore, the legislative package of six legal texts adopted in 2011 to strengthen the economic governance structure of the euro area and the EU as a whole requires the compilation of high-quality statistical information, which needs to be produced under robust quality management.[203] In this context, the European Statistics Code of Practice was revised in September 2011 in order to distinguish between the principles to be implemented by ESS members and the principles relating to the institutional environment that are to be implemented by Member State governments. In 2017 it was revised again in order to emphasise that the NSIs and Eurostat coordinate all activities involved in the development, production and dissemination of European statistics (produced in accordance with the Regulation on European statistics[204]) at the level of their national statistical systems and the ESS respectively.

In 2015 the Regulation on European statistics was amended[205] **in order to, among other things, clarify that the principle of professional independence of NSIs applies unconditionally.** Statistics must indeed be developed, produced and disseminated in an independent manner, free of any pressures from political or interest groups or from EU or national authorities, and existing institutional frameworks must not be allowed to restrict this principle.

The independence of other statistical authorities responsible for the compilation of European statistics (e.g. ministries of finance) also needs to be assured. Other statistical authorities' responsibility for the publication of statistics needs to be clearly identified in order to distinguish statistical releases from political statements. In Poland and Romania, the Ministries of Finance compile EDP debt data. In Bulgaria, the Ministry of Finance compiles quarterly government debt data, while the NSI compiles annual government debt. The institutional responsibilities for the

[202] Council Regulation (EU) No 679/2010 of 26 July 2010 amending Regulation (EC) No 479/2009 as regards the quality of statistical data in the context of the excessive deficit procedure (OJ L 198, 30.7.2010, p. 1).

[203] On 13 December 2011 the reinforced Stability and Growth Pact (SGP) entered into force with a new set of rules for economic and fiscal surveillance. These measures, known as the "six-pack", consist of five regulations and one directive proposed by the European Commission and approved in October 2010 by all 27 Member States at the time and the European Parliament.

[204] European statistics are developed, produced and disseminated by both the ESS and the ESCB but under separate legal frameworks reflecting their respective governance structures. The members of the ESCB are not involved in the production of European statistics pursuant to the Regulation on European statistics. However, with a view to minimising the reporting burden and guaranteeing the coherence necessary to produce European statistics, the ESS and the ESCB cooperate closely, while complying with the statistical principles set out in Article 2(1) of the Regulation on European statistics. Given that some European statistics may be compiled by NCBs in their capacity as members of the ESCB, the NSIs and the NCBs also cooperate closely under national arrangements with a view to ensuring the necessary cooperation between the ESS and the ESCB and to guaranteeing the production of complete and coherent European statistics.

[205] Regulation (EU) 2015/759 of the European Parliament and of the Council of 29 April 2015 amending Regulation (EC) No 223/2009 on European statistics (OJ L 123, 19.5.2015, p. 90).

compilation of EDP data and GFS in the countries are shown in Table 6.1. In Romania, the Law on the organisation and functioning of official statistics includes the principle of professional independence and applies to all statistical processes and products. In Bulgaria and Poland, although the independence of the compilers at the Ministries of Finance is not guaranteed by law, the monitoring and quality assurance of the EDP data and GFS compiled by the Ministries of Finance form part of the coordination role of the NSI.

In their letter on ERM II participation dated 4 July 2019, the Croatian authorities committed to improving the collection, production and dissemination of statistics by strengthening the institutional and methodological capacities in relation to the quality of national accounts and GFS/EDP reporting. This included specific deliverables, such as the adoption of a new Official Statistics Act to strengthen the professional independence of the Head of the NSI and free access to all administrative data sources, a new Memorandum of Understanding (signed in February 2020) between the compilers of statistics and data providers (the NSI, Ministry of Finance and NCB) to improve procedures and the timeliness of data exchange, and the adoption of a revision policy for national accounts statistics. In July 2020 it was confirmed that the Croatian authorities had fulfilled these statistical commitments.[206]

Table 6.1
Quality and integrity of convergence statistics

Bulgaria

Institutional features relating to the quality and integrity of the statistics used in assessing the convergence process	
Legal independence of the national statistical institute	Under the Law on Statistics, statistics are based on the principles of professional independence, impartiality, objectivity, reliability, statistical confidentiality and cost effectiveness. Under Article 8 of the Law on Statistics, the President of the NSI is appointed by the Prime Minister. The term of office is fixed (seven years; reappointment is possible, only once).
Administrative supervision and budget autonomy	The NSI has the status of a state agency and is directly subordinated to the Council of Ministers. It has budget autonomy on the basis of an annual amount assigned from the state budget.
Legal mandate for data collection	The Law on Statistics determines the main principles of data collection.
Legal provisions regarding statistical confidentiality	Under Articles 25 to 27a of the Law on Statistics, the confidentiality of the statistical data is assured.
HICP inflation [1)]	
Compliance with legal minimum standards	Eurostat made a compliance monitoring visit in 2013 and published a report in 2015 confirming that the methods used for producing the HICP are satisfactory. A follow-up report outlining the issues that had been addressed by Bulgaria was published in 2018. There were no apparent instances of non-compliance with the HICP methodology.
Other issues	Eurostat considered the representativeness of the HICP to be generally appropriate.
Government finance statistics	
Data coverage	Revenue, expenditure, deficit and debt data are provided for the period 2012-21.
Outstanding statistical issues	No major outstanding statistical issues identified. Eurostat made an EDP visit in 2021 and published the final findings on its website.
Institution responsible for the compilation of statistics	The NSI compiles the non-financial and annual financial accounts of government, as well as annual government debt. The Ministry of Finance compiles quarterly government debt and the NCB compiles the quarterly financial accounts of government.

[206] See *Letter from Executive Vice-President of the European Commission Valdis Dombrovskis and Commissioner for the Economy Paolo Gentiloni to ERM II parties*, on the assessment of Croatia’s implementation of the commitments it undertook before joining ERM II, European Commission, 8 July 2020, available at: https://ec.europa.eu/info/sites/default/files/economy-finance/com_opinion_on_hr_erm-ii.pdf.

Czech Republic

Institutional features relating to the quality and integrity of the statistics used in assessing the convergence process	
Legal independence of the national statistical institute	Under Article 5 of the State Statistical Service Act, statistics are based on objectivity, impartiality and independence. Under Article 3, the Head of the NSI is appointed by the President of the Republic.
Administrative supervision and budget autonomy	The NSI is a central statistical agency within the public administration. It has budget autonomy on the basis of an annual amount assigned from the state budget.
Legal mandate for data collection	The State Statistical Service Act determines the main principles of data collection.
Legal provisions regarding statistical confidentiality	Under Articles 16, 17 and 18 of the State Statistical Service Act, the confidentiality of the statistical data is assured.
HICP inflation [1]	
Compliance with legal minimum standards	Eurostat made a compliance monitoring visit in 2019 and published a report in January 2020 confirming that, in general, the methods used for producing the HICP are satisfactory. There were no apparent instances of non-compliance with the HICP methodology.
Other issues	Eurostat considered the representativeness of the HICP in terms of accuracy and reliability to be generally adequate.
Government finance statistics	
Data coverage	Revenue, expenditure, deficit and debt data are provided for the period 2012-21.
Outstanding statistical issues	The sector classification of a new unit (the National Development Fund), which was established in 2021, is still under discussion. Eurostat made an EDP visit in 2021 and will publish the final findings on its website.
Institution responsible for the compilation of statistics	The NSI compiles the non-financial and financial accounts of government, as well as government debt.

Croatia

Institutional features relating to the quality and integrity of the statistics used in assessing the convergence process	
Legal independence of the national statistical institute	Under Article 5 of the Official Statistics Act, statistics are based on the principles of relevance, impartiality, reliability, transparency, timeliness, professional independence, cost effectiveness, consistency, publicity, statistical confidentiality, the use of individual data for exclusively statistical purposes, and public accountability. The Head of the NSI is appointed by the Government and is accountable to the Government.
Administrative supervision and budget autonomy	The NSI is a state administration organisation which performs its tasks autonomously in conformity with the law. It has budget autonomy on the basis of an annual amount assigned from the state budget.
Legal mandate for data collection	The Official Statistics Act determines the main principles of data collection.
Legal provisions regarding statistical confidentiality	Under Article 59 of the Official Statistics Act, the confidentiality of the statistical data is assured.
HICP inflation [1]	
Compliance with legal minimum standards	Eurostat made a compliance monitoring visit in 2015 and published a report in that year confirming that, in general, the methods used for producing the HICP are in line with requirements. A follow-up report outlining the issues that had been addressed by Croatia was published in 2018.
Other issues	Eurostat considered that comparability with the HICP of other countries can be regarded as assured. A follow-up report published in 2018 showed that good progress had been made regarding the recommendations for further improvements to the Croatian HICP as set out in the compliance monitoring report.
Government finance statistics	
Data coverage	Revenue, expenditure, deficit and debt data are provided for the period 2012-21.
Outstanding statistical issues	No major outstanding statistical issues identified. Eurostat made an EDP visit in 2021 and will publish the final findings on its website.
Institution responsible for the compilation of statistics	The NSI compiles the non-financial accounts of government. The NCB compiles government debt and the financial accounts of government.

Hungary

Institutional features relating to the quality and integrity of the statistics used in assessing the convergence process	
Legal independence of the national statistical institute	Under Act CLV of 2016 on Official Statistics, statistics are compiled following the principles of objectivity, independence and confidentiality. The Head of the NSI is appointed by the Prime Minister. The term of office is fixed (six years; reappointment is possible, only twice).
Administrative supervision and budget autonomy	The NSI is a public administration under the immediate supervision of the Government. It has budget autonomy on the basis of an annual amount assigned from the state budget.
Legal mandate for data collection	Act XLVI on Statistics determines the main principles of data collection.
Legal provisions regarding statistical confidentiality	Under Article 17 of Act XLVI on Statistics, the confidentiality of the statistical data is assured.
HICP inflation [1]	
Compliance with legal minimum standards	Eurostat made a compliance monitoring visit in 2019 and published a report in March 2020 confirming that, in general, the methods used for producing the HICP are satisfactory. Some instances of non-compliance with the HICP methodology were identified, but those were considered by Eurostat to be limited and unlikely to have a major impact in practice on the annual average rates of change in the HICP.
Other issues	Eurostat considered the representativeness of the HICP in terms of accuracy and reliability to be generally adequate.
Government finance statistics	
Data coverage	Revenue, expenditure, deficit and debt data are provided for the period 2012-21.
Outstanding statistical issues	No major outstanding statistical issues identified. Eurostat made an EDP visit in 2021 and published the final findings on its website.
Institution responsible for the compilation of statistics	The NSI compiles the non-financial accounts of government. The NCB compiles government debt and the financial accounts of government.

Poland

Institutional features relating to the quality and integrity of the statistics used in assessing the convergence process	
Legal independence of the national statistical institute	Under Article 1 of the Law on Public Statistics, statistics are based on reliability, objectivity and transparency. The Head of the NSI is selected by open competition and appointed by the President of the Council of Ministers. The term of office is fixed (five years).
Administrative supervision and budget autonomy	The NSI is a central agency within the public administration under supervision of the President of the Council of Ministers. It has budget autonomy on the basis of an annual amount assigned from the state budget.
Legal mandate for data collection	The Law on Official Statistics determines the main principles of data collection.
Legal provisions regarding statistical confidentiality	Under Articles 10, 11, 12, 38, 39 and 54 of the Law on Official Statistics, the confidentiality of the statistical data is assured.
HICP inflation [1]	
Compliance with legal minimum standards	Eurostat made a compliance monitoring visit in 2015 and published a report in 2016 confirming that the methods used for producing the HICP are of a good standard and in line with legal requirements.
Other issues	In the 2016 report, Eurostat made further recommendations for increasing the accuracy and reliability of the Polish HICP. A follow-up report issued in 2018 showed that most recommendations had been implemented or were in the process of being implemented.
Government finance statistics	
Data coverage	Revenue, expenditure, deficit and debt data are provided for the period 2012-21.
Outstanding statistical issues	No major outstanding statistical issues identified. Eurostat made an EDP visit in 2020 and published the final findings on its website.
Institution responsible for the compilation of statistics	The NSI compiles the non-financial and financial accounts of government. The Ministry of Finance compiles government debt.

Romania

Institutional features relating to the quality and integrity of the statistics used in assessing the convergence process	
Legal independence of the national statistical institute	The autonomy of official statistics is stated in the Statistical Law, together with the principles of confidentiality, transparency, reliability, proportionality, statistical deontology and cost/efficiency ratio. The Head of the NSI is appointed by the Prime Minister. The term of office is fixed (six years; reappointment is possible, only once).
Administrative supervision and budget autonomy	Under the Statistical Law, the NSI is a specialised institution, subordinated to the Government. It is financed via the state budget.
Legal mandate for data collection	Under the Statistical Law, "the official statistics in Romania are implemented and coordinated by the NSI".
Legal provisions regarding statistical confidentiality	The Statistical Law states that "during statistical research, from collection to dissemination, the official statistics services and statisticians have the obligation to adopt and implement all the necessary measures for protecting the data referring to individual statistics subjects (natural or legal persons), data obtained directly from statistical research or indirectly through administrative sources or from other suppliers".
HICP inflation [1)]	
Compliance with legal minimum standards	Eurostat made a compliance monitoring visit in 2018 and published a report in February 2020 confirming that, in general, the methods used for producing the HICP are satisfactory. There were no apparent instances of non-compliance with the HICP methodology.
Other issues	Eurostat considered the representativeness of the HICP in terms of accuracy and reliability to be generally adequate.
Government finance statistics	
Data coverage	Revenue, expenditure, deficit and debt data are provided for the period 2012-21.
Outstanding statistical issues	No major outstanding statistical issues identified. Eurostat made an EDP visit in 2021 and published the final findings on its website.
Institution responsible for the compilation of statistics	The NSI compiles the non-financial accounts of government. The Ministry of Finance compiles government debt. The NCB compiles the financial accounts of government.

Sweden

Institutional features relating to the quality and integrity of the statistics used in assessing the convergence process	
Legal independence of the national statistical institute	Under Section 3 of the Official Statistics Act, statistics are objective and available to the public. The Head of the NSI is appointed by the Government. The term of office is fixed (six years; three-year reappointment possible, only once).
Administrative supervision and budget autonomy	The NSI is a central statistics agency, subordinated to, but not part of, the Ministry of Finance. Approximately half of its turnover is provided by the Ministry of Finance, the other half stems from charging government agencies and commercial customers for statistical production and advice.
Legal mandate for data collection	The Official Statistics Act determines the main principles of data collection.
Legal provisions regarding statistical confidentiality	Under Sections 5 and 6 of the Official Statistics Act, the confidentiality of the statistical data is assured.
HICP inflation [1)]	
Compliance with legal minimum standards	Eurostat made a compliance monitoring visit in 2011 and published a report in 2013 confirming that, in general, the methods used for producing the HICP are satisfactory. Some instances of non-compliance with the HICP methodology were identified, but those were considered by Eurostat to be limited and unlikely to have a major impact in practice on the annual average rates of change in the HICP.
Other issues	Eurostat considered the representativeness of the HICP in terms of accuracy and reliability to be generally adequate.
Government finance statistics	
Data coverage	Revenue, expenditure, deficit and debt data are provided for the period 2012-21.
Outstanding statistical issues	There is a public unit currently classified as an MFI, which may be subject to a reclassification into the general government sector. Eurostat made an EDP visit in 2019 and published the final findings on its website.
Institution responsible for the compilation of statistics	The NSI compiles the non-financial and financial accounts of government, as well as government debt.

1) See Eurostat's website for the full reports on the findings and recommendations of the HICP compliance monitoring visits for each country.

6.2 HICP inflation

This section considers the methodology and quality of the statistics underlying the measurement of price developments, specifically the HICP. The HICP was developed for the purpose of assessing convergence in terms of price stability on a comparable basis. It is published for all EU Member States by Eurostat.[207] The HICP covering the euro area as a whole has been the main measure of price developments for the monetary policy of the ECB since January 1999.

Article 1 of Protocol (No 13) on the convergence criteria (annexed to the Treaties) requires price convergence to be measured by means of the CPI on a comparable basis, taking into account differences in national definitions. The framework regulation introduced to establish HICPs, Council Regulation (EC) No 2494/95[208], was adopted in October 1995 and subsequently replaced by Regulation (EU) 2016/792[209], which entered into force in June 2016. The HICPs have also been harmonised on the basis of EU Council and European Commission regulations. They use common standards for the coverage of the items, the territory and the population included (all these elements are major reasons for differences between national CPIs). Common standards have also been established in several other areas, for example the treatment of new goods and services.

The HICPs use annually updated expenditure weights (or, until 2011, less frequent updates if this did not have a significant effect on the index) and cover all goods and services included in household final monetary consumption expenditure. The latter is derived from the national accounts domestic concept of household final consumption expenditure but excludes owner-occupied housing. The prices observed are the prices households actually pay for goods and services in monetary transactions and thus include all taxes (minus subsidies) on products, e.g. VAT and excise duties. Expenditure on health, education and social services is covered to the extent that it is financed (directly or through private insurance) by households and not reimbursed by the government. The "HICP – administered prices" includes only prices which are directly set or significantly influenced by the government, including national regulators. It is based on a common definition and compilation, and is published by Eurostat.

Eurostat must ensure that the statistical practices used to compile national HICPs comply with HICP methodological requirements and that good practices in the field of consumer price indices are being followed. Eurostat carries out compliance monitoring visits and publishes its findings in information notes made available on its website.

[207] See Eurostat's website for details on the HICP legislative framework. Eurostat has also published recommendations and a methodological manual.

[208] Council Regulation (EC) No 2494/95 of 23 October 1995 concerning harmonized indices of consumer prices (OJ L 257, 27.10.1995, p. 1).

[209] Regulation (EU) 2016/792 of the European Parliament and of the Council of 11 May 2016 on harmonised indices of consumer prices and the house price index, and repealing Council Regulation (EC) No 2494/95 (OJ L 135, 24.5.2016, p. 11).

6.3 Government finance statistics

This section describes the methodology and quality of the statistics used to measure fiscal developments. GFS are based mainly on national accounts concepts as defined in the ESA 2010[210] and Commission Regulation (EU) No 220/2014[211]. They refer to the institutional sector "general government" as defined in the ESA 2010. This comprises central government, state government (in Member States with a federal structure), local government and social security funds. It typically does not include public corporations.

The general government deficit (−)/surplus (+) is equal to the ESA 2010 item "net lending (+)/net borrowing (−)", which in turn is equal to "total revenue" minus "total expenditure". The primary government deficit/surplus is the government deficit/surplus excluding interest expenditure.

The general government debt is the sum of the outstanding gross liabilities at nominal value (face value) in currency and deposits, debt securities (e.g. government bills, notes and bonds) and loans. It excludes financial derivatives, such as swaps[212], as well as trade credits[213] and other liabilities not represented by a financial document, such as overpaid tax advances. It also excludes contingent liabilities, such as government guarantees and pension commitments. While government debt is a gross concept in the sense that neither financial nor non-financial assets are deducted from liabilities, it is consolidated within the general government sector and therefore does not include government debt held by other government units.

Government deficit and debt ratios are expressed as a percentage of GDP at current market prices.

6.3.1 Data source

The NCBs provide the ECB with detailed GFS data under the ECB's GFS Guideline[214]. Although the Guideline is only legally binding for the euro area NCBs, the non-euro area EU NCBs also transmit GFS data to the ECB by the same deadlines and using the same procedures. The Guideline lays down requirements for the transmission of annual data with detailed breakdowns of annual revenue and expenditure and the deficit-debt adjustment. In addition, it requests figures on general

[210] See Regulation (EU) No 549/2013 of the European Parliament and of the Council of 21 May 2013 on the European system of national and regional accounts in the European Union (OJ L 174, 26.6.2013, p. 1).

[211] Commission Regulation (EU) No 220/2014 of 7 March 2014 amending Council Regulation (EC) No 479/2009 as regards references to the European system of national and regional accounts in the European Union (OJ L 69, 8.3.2014, p. 101).

[212] However, on the basis of a Eurostat guidance note released in 2008, lump sums received by government under off-market interest rate swaps are treated as government loans.

[213] A 2012 Eurostat decision stipulates that trade credits that are refinanced without recourse to the original holder and trade credits that are renegotiated beyond the simple extension of the initial maturity need to be reclassified as loans and are thus included in the EDP general government debt.

[214] Guideline (EU) 2020/1552 of the European Central Bank of 14 October 2020 amending Guideline ECB/2013/23 on government finance statistics (ECB/2020/50) (OJ L 354, 26.10.2020, p. 22).

government debt with breakdowns by instrument, by initial and residual maturity and by holder.

6.3.2 Methodological issues

The GFS must comply with the ESA 2010 and reflect decisions and guidelines issued by Eurostat for specific cases involving the general government sector. The borderline classification cases between the financial, non-financial and general government sectors continue to be examined closely by Eurostat and national statistical compilers and may lead to further reclassifications and changes in the EDP and GFS data.

In the Czech Republic and Hungary, there are MFIs that are reclassified into the general government sector for EDP purposes. These units are classified as part of the financial sector in other statistical data compiled by the NCB (e.g. monetary and financial statistics, and balance of payments statistics). The resultant discrepancy in sector classification between those statistics and GFS is well documented and has been made known to users.

In the Czech Republic, a new unit (the National Development Fund) was established in 2021 and licenced by the NCB to act as a self-managed investment fund. The sector classification of this unit is still under discussion.

In Sweden, a public unit is currently classified as part of the financial sector and is on the ECB's list of MFIs but may be reclassified into the general government sector subject to the outcome of methodological discussions at the European level.

6.4 Exchange rates

Article 3 of Protocol (No 13) on the convergence criteria defines what is meant by the criterion on participation in the exchange rate mechanism of the European Monetary System. The bilateral exchange rates of the Member States' currencies vis-à-vis the euro are daily reference rates recorded by the ECB at 14:15 CET and published on the ECB's website.[215] Nominal and real effective exchange rates (EERs) are constructed by applying trade weights (based on a geometric weighting) to the bilateral nominal and real exchange rates of the Member States' currencies vis-à-vis the currencies of 42 trading partners. Both nominal and real EER statistics are published by the ECB.

[215] Since 1 July 2016 the reference rates have been published at around 16:00 CET (for details see "ECB introduces changes to euro foreign exchange reference rates", *press release*, ECB, 7 December 2015).

6.5 Long-term interest rates

Article 4 of Protocol (No 13) on the convergence criteria requires interest rates to be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions. While Article 5 assigns the responsibility for providing the statistical data for the application of the Protocol to the European Commission, the ECB, given its expertise in the area, assists in this process by defining representative long-term interest rates and collecting the data from the NCBs for transmission to the Commission. This is a continuation of the work carried out by the EMI as part of the preparations for Stage Three of EMU in close cooperation with the Commission. The conceptual work resulted in the definition of seven key features to be considered in the calculation of long-term interest rates, as presented in Table 6.2. Long-term interest rates refer to bonds denominated in national currency.

Table 6.2
Statistical framework for defining long-term interest rates for the purpose of assessing convergence

Concept	Recommendation
Bond issuer	The bond should be issued by the central government.
Maturity	As close as possible to ten years' residual maturity. Any replacement of bonds should minimise maturity drift; the structural liquidity of the market must be considered.
Coupon effects	No direct adjustment.
Taxation	Gross of tax.
Choice of bonds	The selected bonds should be sufficiently liquid. This requirement should determine the choice between benchmark or sample approaches, depending on national market conditions.
Yield formula	The "redemption yield" formula should be applied.
Aggregation	Where there is more than one bond in the sample, a simple average of the yields should be used to produce the representative rate.

6.6 Other factors

The last paragraph of Article 140(1) of the Treaty states that the reports of the European Commission and the ECB shall take account of, in addition to the four main criteria, the results of the integration of markets, the situation and development of the national balance of payments and an examination of the development of unit labour costs and other price indices. Whereas, for the four main criteria, Protocol (No 13) stipulates that the Commission will provide the data to be used for the assessment of compliance and describes those statistics in more detail, it makes no reference to the provision of statistics for these "other factors".

With regard to the results of the integration of markets, two sets of indicators are used. These are i) statistics on financial development and integration referring to the structure of the financial system,[216] and ii) statistics on financial and non-financial integration with the euro area.[217]

The data covering the structure of the financial system are provided by the NCBs. The data underlying the indicators concerning the debt securities issued by resident financial corporations (MFIs excluding the national central bank and non-monetary financial corporations) and non-financial corporations are reported by the respective NCBs in accordance with the methodology set out in Guideline ECB/2021/15[218]. The indicator relating to stock market capitalisation refers to listed shares issued by resident corporations following the methodology given in the same Guideline. The indicators concerning MFI credit to residents and claims of euro area MFIs on resident MFIs are based on available data collected by the ECB as part of the MFI balance sheet statistics collection framework. The data are obtained from the countries under review and, for the latter indicator, also from the euro area countries covered by Regulation (EU) No 2021/379[219]. Historical data are compiled by the relevant NCBs, where appropriate. For the indicators mentioned in this paragraph, the statistical data relating to the euro area cover the countries that had adopted the euro at the time to which the statistics relate.

Balance of payments and international investment position statistics are compiled in accordance with the concepts and definitions laid down in the sixth edition of the IMF's Balance of Payments and International Investment Position Manual (BPM6) and with compilation guidance provided by the ECB and Eurostat.[220] This Convergence Report examines developments in the current (goods, services, primary income and secondary income) and capital accounts; the sum of the balances of these two accounts corresponds to the net lending/net borrowing of the total economy. In addition, developments in the main components of the financial account are presented together with the net international investment position and gross external debt of each country. Exports and imports of goods and services are presented vis-à-vis both the rest of the world and the euro area countries. Direct and portfolio investment assets and liabilities with the euro area are also directly identified. Forecasted data are taken from the European Commission's Economic Forecast.[221]

The Convergence Report also looks at the development of unit labour costs and other price indices. With regard to producer price indices, these data refer to domestic sales of total industry excluding construction. The statistics are collected on a harmonised basis under the EU Regulation on European business statistics[222].

[216] Debt securities issued by resident corporations, stock market capitalisation, MFI credit to non-government residents and claims of euro area MFIs on resident MFIs.

[217] External trade and investment position with the euro area.

[218] Guideline (EU) 2021/834 of the European Central Bank of 26 March 2021 on statistical information to be reported on securities issues (ECB/2021/15) (OJ L 208, 11.6.2021, p. 311).

[219] Regulation (EU) 2021/379 of the European Central Bank of 22 January 2021 on the balance sheet items of credit institutions and of the monetary financial institutions sector (recast) (ECB/2021/2) (OJ L 73, 3.3.2021, p. 16).

[220] For further details, see "European Union Balance of Payments and International Investment Position statistical sources and methods ("B.o.p. and i.i.p. book")", ECB, Frankfurt am Main, 2016.

[221] The economic forecasts made by the Directorate-General for Economic and Financial Affairs (DG ECFIN) on behalf of the European Commission.

[222] Regulation (EU) No 2019/2152 of the European Parliament and of the Council of 27 November 2019 on European business statistics (OJ L 327, 17.12.2019, p. 1).

Statistics on unit labour costs (calculated as compensation per employee divided by GDP chain-linked volumes per person employed) are derived from data provided under the ESA 2010 transmission programme.

7 Examination of compatibility of national legislation with the Treaties

The following country assessments report only on those provisions of national legislation which the ECB considered to be problematic from the perspective of their compatibility with provisions on the independence of NCBs in the Treaty (Article 130) and the Statute (Articles 7 and 14.2), provisions on confidentiality (Article 37 of the Statute), prohibitions on monetary financing (Article 123 of the Treaty) and privileged access (Article 124 of the Treaty), and the single spelling of the euro as required by EU law. They also cover the perspective of legal integration of the NCBs into the Eurosystem (in particular as regards Articles 12.1 and 14.3 of the Statute).[223]

7.1 Bulgaria

7.1.1 Compatibility of national legislation

The following legislation forms the legal basis for Българска народна банка (Bulgarian National Bank) and its operations:

- the Bulgarian Constitution,[224]
- the Law on Българска народна банка (Bulgarian National Bank) (hereinafter the “Law on BNB”).[225]

The Law on counter-corruption and unlawfully acquired assets forfeiture (hereinafter the “Law on counter-corruption”)[226] applies to public office holders.

There have been several changes in relation to the points identified in the ECB’s Convergence Report of June 2020, also addressing some of the recommendations made in previous Convergence Reports.

7.1.2 Independence of the NCB

With regard to the independence of Българска народна банка (Bulgarian National Bank), the Law on BNB and the Law on counter-corruption need to be adapted as set out below.

[223] According to Section 2.2.2.1 of this Convergence Report.

[224] Constitution of the Republic of Bulgaria, Darjaven vestnik issue 56, 13.7.1991.

[225] Law on Българска народна банка (Bulgarian National Bank), Darjaven vestnik issue 46, 10.6.1997.

[226] Darjaven vestnik issue 7, 19.01.2018.

Institutional independence

Article 44 of the Law on BNB prohibits European Union institutions, bodies, offices or agencies, the Council of Ministers or the governments of other EU Member States, as well as any other bodies and institutions from giving instructions to Българска народна банка (Bulgarian National Bank), the Governor or the members of the Governing Council. This provision is in line with Article 130 of the Treaty and Article 7 of the Statute.[227]

Personal independence

Article 14(1) of the Law on BNB lists the grounds on which members of the Governing Council may be relieved from office; it provides that the National Assembly or Bulgaria's President may relieve a member of the Governing Council, including the Governor, from office if they no longer fulfil the conditions required for the performance of their duties or if they have been found guilty of serious misconduct. Article 14(3) of the Law on BNB provides that the decision to relieve the Governor of Българска народна банка (Bulgarian National Bank) from office may be referred to the Court of Justice of the European Union on the grounds of infringement of the Treaties or of a rule of law relating to their application. Article 14 of the Law on BNB therefore complies with Article 14.2 of the Statute.[228]

The Law on counter-corruption repealed the Law on the prevention of conflicts of interests in January 2018. Article 80(1) of the Law on counter-corruption initially replicated Article 33(1) of the Law on the prevention of conflicts of interests, providing that the ascertainment of a conflict of interests by an enforceable legal act is a ground for relieving the Governor, Deputy Governors and the other members of the Governing Council of Българска народна банка (Bulgarian National Bank) from office. Thus, the Law on counter-corruption specified a ground for relieving an individual from office that is in addition to the two grounds contained in Article 14.2 of the Statute. Therefore, the Law on counter-corruption was deemed incompatible with the Treaty and the Statute and needed to be brought into line with them.[229] Article 80(1) of the Law on counter-corruption was amended in 2021[230] to specify that the ascertainment of a conflict of interest by an enforceable instrument is a ground for relieving the Governor, Deputy Governors and the other members of the Governing Council of Българска народна банка (Bulgarian National Bank) from office, unless otherwise provided for in the Constitution or in the Statute. Even though this specification aligns with EU law, the ECB suggested to explicitly clarify that the provision of Article 80(1) of the Law on counter-corruption must not apply to the Governor, the Deputy Governors and the other members of the Governing Council of Българска народна банка (Bulgarian National Bank)[231] for the sake of legal certainty and transparency. Article 80(2) of the Law on counter-corruption provides that the relieve from office must follow the

[227] See paragraph 3.2 of Opinion CON/2018/53.

[228] See paragraph 3.1 of Opinion CON/2018/53.

[229] See paragraph 3.1 of Opinion CON/2021/2 as well as Opinion CON/2009/13.

[230] Darjaven vestnik issue 12, 12.02.2021.

[231] See paragraph 3.1 of Opinion CON/2021/2.

procedure established in the relevant laws. It is understood that in the case of the Governor, Deputy Governors and the other members of the Governing Council of Българска народна банка (Bulgarian National Bank) this refers to Article 14(1) of the Law on BNB.

The Law on BNB is silent on the right of national courts to review a decision to dismiss any member, other than the Governor, of the decision-making bodies of Българска народна банка (Bulgarian National Bank), who is involved in the performance of ESCB-related tasks. In accordance with general Bulgarian law, as indicated by the Supreme Court of Cassation,[232] national courts may not annul the decision to dismiss any member, other than the Governor, of the decision-making bodies of Българска народна банка (Bulgarian National Bank), but such national courts may only award compensation for the damages caused by the dismissal decision.

In this regard it must be taken into account that the rationale of personal independence is to shield the members of the decision-making bodies of ESCB central banks from political interference when exercising the powers conferred upon them by the Treaty and the Statute. Therefore, Article 130 of the Treaty, which guarantees the independence of members of the decision-making bodies of Българска народна банка (Bulgarian National Bank), requires that they have access to effective legal remedies for cases concerning their dismissal, including – but not limited to – compensation. Bulgarian law should thus provide for a remedy capable of annulling unlawful decisions to dismiss any member, other than the Governor, of the decision-making bodies of Българска народна банка (Bulgarian National Bank). Any relevant legislation needs to be amended to ensure consistency with Article 130 of the Treaty and the Statute.

Article 12(1) and (2) of the Law on BNB provide for the National Assembly's powers to elect the Governor and the Deputy Governors of Българска народна банка (Bulgarian National Bank). In 2009, the National Assembly claimed and acted upon the claim that it has the power to annul or amend its previous decisions, including decisions concerning the election of the Governor and Deputy Governors of Българска народна банка (Bulgarian National Bank) taken under Article 12(1) and (2) of the Law on BNB. In practice, any proper election or appointment of members of an NCB's decision-making body should enable them to assume office following their election. Once elected or appointed, the Governor and the other members of the Governing Council of Българска народна банка (Bulgarian National Bank) may not be relieved from office under conditions other than those mentioned in Article 14.2 of the Statute, even if they have not yet taken up their duties.

7.1.3 Confidentiality

Article 4(2) of the Law on BNB provides that Българска народна банка (Bulgarian National Bank) may not disclose or transmit to other persons any information it obtained that constitutes a banking, professional, commercial or other legally protected secret for the banks and the other participants in monetary and credit

[232] Order of the Supreme Court of Cassation No 541 of 17 December 2019 in civil case No 2980/2019.

transactions, except in two cases: (i) exchange of information within the framework of the close cooperation established with the ECB under Article 7 of Council Regulation (EU) No 1024/2013;[233] and (ii) exchange of information with the Single Resolution Board in accordance with Regulation (EU) No 806/2014.[234] Article 23(2) of the Law on BNB provides that the employees of Българска народна банка (Bulgarian National Bank) shall observe secrecy requirements concerning negotiations, deals contracted, the amount of assets on customers' deposits and their transactions, and information received by the Bank, as well as any circumstances concerning the activities of the Bank and its customers, which constitute business, banking, professional, commercial or other legally protected secrets, even after termination of their employment contract. Under Article 37 of the Statute, professional secrecy is an ESCB-wide matter. Therefore, the ECB assumes that Articles 4(2) and 23(2) of the Law on BNB are without prejudice to the confidentiality obligations towards the ECB and the ESCB.

7.1.4 Monetary financing and privileged access

Article 45(1) of the Law on BNB provides that Българска народна банка (Bulgarian National Bank) may not extend credit or guarantees in any form whatsoever to, or purchase debt instruments directly from, the Council of Ministers, municipalities, other government or municipal institutions, organisations or undertakings in the public sector, European Union institutions, bodies, offices or agencies, the central government, regional, local or other public authorities, other bodies governed by public law or public sector entities of EU Member States. Article 45(3) of the Law on BNB provides that Българска народна банка (Bulgarian National Bank) may not purchase in the primary and/or secondary markets debt instruments issued by the Bulgarian government or municipalities, or by Bulgarian government or municipal institutions, organisations or public sector entities.

The prohibition of monetary financing prohibits the direct purchase of public sector debt, but such purchases in the secondary market are allowed, in principle, as long as such secondary market purchases are not used to circumvent the objective of Article 123 of the Treaty. For this reason, Article 45(3) of the Law on BNB should be amended and references to “primary” and “secondary” markets should be deleted.[235]

Furthermore, while acknowledging the particularities arising out of the currency-board regime, i.e. the prohibition on Българска народна банка (Bulgarian National Bank) extending credit to credit institutions other than in the context of emergency liquidity operations, it is recommended that the scope of the exemption in Article 45(2) of the Law on BNB addressed to publicly owned and municipal credit institutions is brought into line with the scope of the exemption under Article 123(2) of the Treaty. That article

[233] Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (OJ L 287, 29.10.2013, p. 63).

[234] Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010 (OJ L 225, 30.7.2014, p. 1).

[235] See paragraph 3.3 of Opinion CON/2018/53.

of the Treaty provides that the prohibition of monetary financing under Article 123(1) of the Treaty does not apply to publicly owned credit institutions which, in the context of the supply of reserves by central banks, must be given the same treatment by national central banks as private credit institutions.[236]

Pursuant to the Law on credit institutions,[237] Българска народна банка (Bulgarian National Bank) operates a central credit register (Article 56) and a bank account register (Article 56a). The costs of obtaining information from these registers by government and judicial authorities are to be borne by the State budget. In past Convergence Reports the ECB considered that in order to further ensure compatibility with the prohibition of monetary financing, the Law on credit institutions would benefit from a limitation of the liability of Българска народна банка (Bulgarian National Bank) in relation to the operation of the two registers.[238] The provisions of both Articles 56 and 56a have been amended to waive the liability of Българска народна банка (Bulgarian National Bank) in relation to the operation of the two registers. Instead of Българска народна банка (Bulgarian National Bank), the State will be liable for damages resulting from the operation of the two registers in accordance with the general regime for State liability.[239] This makes the rules compliant with the prohibition of monetary financing.

7.1.5 Legal integration of the NCB into the Eurosystem

With regard to the legal integration of Българска народна банка (Bulgarian National Bank) into the Eurosystem, the Law on BNB needs to be adapted in the respects set out below.

Tasks

Monetary policy

Article 2(1) and Article 16, items 4 and 5 and Articles 28, 30, 31, 32, 35, 38, 41 and 61 of the Law on BNB, which provide for the powers of Българска народна банка (Bulgarian National Bank) in the field of monetary policy and instruments for the implementation thereof, do not recognise the ECB’s powers in this field.

Article 33 of the Law of BNB, which empowers Българска народна банка (Bulgarian National Bank) to enter into certain financial transactions, also fails to recognise the ECB’s powers in this field.

[236] See paragraph 3.3 of Opinion CON/2018/53.

[237] Darjaven vestnik issue 59, 21.07.2006.

[238] See paragraph 3.1.6 of Opinion CON/2015/46, paragraph 3.2.1 of Opinion CON/2016/19 and paragraph 2.2 of Opinion CON/2016/57.

[239] See paragraph 3.2 of Opinion CON/2021/2.

Collection of statistics

Article 4(1) and Article 42 of the Law on BNB, which provide for the powers of Българска народна банка (Bulgarian National Bank) relating to the collection of statistics, do not recognise the ECB’s powers in this field.

Official foreign reserve management

Article 20(1) and Articles 28, 31 and 32 of the Law on BNB, which provide for the powers of Българска народна банка (Bulgarian National Bank) with regard to the management of official foreign reserves, do not recognise the ECB’s powers in this field.

Payment systems

Articles 2(4) and 40(1) of the Law on BNB, which provide for the powers of Българска народна банка (Bulgarian National Bank) with regard to the promotion of the smooth operation of payment systems, do not recognise the ECB’s powers in this field.

Issue of banknotes

Article 2(5), Article 16, item 9, and Articles 24 to 27 of the Law on BNB, which provide for the powers of Българска народна банка (Bulgarian National Bank) with regard to the issue of banknotes and coins, do not recognise the Council’s and the ECB’s powers in this field.

Financial provisions

Appointment of independent auditors

Article 49(4) of the Law on BNB, which provides that the external auditor is appointed by the Governing Council for a term of three years on the basis of a procedure complying with the Law on public procurement, does not recognise the Council’s and the ECB’s powers under Article 27.1 of the Statute.

Financial reporting

Article 16, item 11 and Articles 46 and 49 of the Law on BNB do not reflect the obligation to comply with the Eurosystem’s regime for financial reporting of NCB operations, pursuant to Article 26 of the Statute.

Exchange rate policy

Articles 28, 31, 32 of the Law on BNB, which provide for the powers of Българска народна банка (Bulgarian National Bank) with regard to the exchange rate policy, do not recognise the Council's and the ECB's powers in this field.

International cooperation

Article 5, Article 16, item 12 and Article 37(4) of the Law on BNB, which provide for the powers of Българска народна банка (Bulgarian National Bank) with regard to international cooperation, do not recognise the ECB's powers in this field.

Miscellaneous

Articles 61 and 62 of the Law on BNB do not recognise the ECB's powers to impose sanctions.

7.1.6 Conclusions

The Law on BNB does not comply with all the requirements for central bank independence, the monetary financing prohibition, and legal integration into the Eurosystem. Bulgaria is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.

7.2 Czech Republic

7.2.1 Compatibility of national legislation

The following legislation forms the legal basis for Česká národní banka and its operations:

- the Czech Constitution,[240]
- the Law on Česká národní banka (hereinafter the "Law on CNB").[241]

The assessment takes into account amendments made to the Law on CNB by Law No 219/2021 and minor changes made by Laws No 192/2020, No 238/2020, No 353/2021 and No 417/2021 . It also takes into account the current Law No 166/1993 Coll. on the Supreme Audit Office (hereinafter the "Law on NKU").

[240] Constitutional Law No 1/1993 Coll.

[241] Law No 6/1993 Coll.

In relation to the points identified in the ECB's Convergence Report of June 2020, the comments made in that report are largely repeated, with the exception set out below.

7.2.2 Independence of the NCB

With regard to Česká národní banka's independence, the Law on CNB needs to be adapted as set out below.

Functional independence

Article 2(1) of the Law on CNB provides that in addition to the primary objective of price stability, Česká národní banka's objective is "to ensure financial stability and the safe and sound operation of the financial system in the Czech Republic". In line with Article 127(1) of the Treaty, the secondary objective of Česká národní banka should be stated to be without prejudice to Česká národní banka's primary objective of maintaining price stability.

Institutional independence

Article 3 of the Law on CNB obliges Česká národní banka to submit a report on monetary development to the Chamber of Deputies at least twice a year for review; the Law on CNB also provides for an optional extraordinary report to be prepared pursuant to a Chamber of Deputies resolution. The Chamber of Deputies has the power to acknowledge the report or ask for a revised report; such a revised report must comply with the Chamber of Deputies' requirements. These parliamentary powers could potentially breach the prohibition on giving instructions to NCBs pursuant to Article 130 of the Treaty and Article 7 of the Statute.

In addition, Article 47(5) of the Law on CNB requires Česká národní banka to submit a revised report if the Chamber of Deputies rejects its annual financial report. This revised report must comply with the Chamber of Deputies' requirements. Such parliamentary powers breach the prohibition on approving, annulling or deferring decisions. Article 3 and Article 47(5) of the Law on CNB are therefore incompatible with central bank independence and should be adapted accordingly.

Further, Article 130 of the Treaty and Article 7 of the Statute are partially mirrored in the Law on CNB. Article 9(1) of the Law on CNB expressly prohibits Česká národní banka and its Board from seeking or taking instructions from the President of the Republic, from Parliament, from the Government, from administrative authorities of the Czech Republic, from the bodies, institutions or other entities of the European Union, from governments of the Member States or from any other body, but it does not expressly prohibit the Government from seeking to influence the members of Česká národní banka's decision-making bodies in situations where this may have an impact on Česká národní banka's fulfilment of its ESCB-related tasks. In this respect the Law on CNB needs to be adapted to be fully consistent with Article 130 of the Treaty and Article 7 of the Statute.

Pursuant to the Law on NKU, the Supreme Audit Office (NKU) is empowered to audit Česká národní banka’s financial management as regards its operating expenditure and expenditure for the purchase of property. The ECB understands that: (i) the NKU’s auditing powers in relation to Česká národní banka are without prejudice to Article 9 of the Law on CNB, which concerns the general prohibition on Česká národní banka seeking or taking instructions from other entities; and (ii) the NKU has no power to interfere with either the external auditors’ opinion or with Česká národní banka’s ESCB-related tasks.

In so far as this understanding is correct, the NKU’s auditing powers vis-à-vis Česká národní banka are not incompatible with central bank independence.

Česká národní banka is assigned certain tasks relating to preparedness for crisis situations and to their resolution. Pursuant to Article 13 of Law No 240/2000 Coll. on the management of crisis situations, and to Article 23 of Law No 241/2000 Coll. on economic measures for crisis situations (hereinafter together referred to as the “Laws on management of crisis situations and on economic measures for crisis situations”), Česká národní banka is obliged, among other things, to discuss with the government proposals for crisis measures which affect Česká národní banka, to adopt a crisis plan and to establish and operate a crisis headquarters. To ensure compatibility with the principle of central bank independence, those provisions of Law No 240/2000 Coll. and Law No 241/2000 Coll. should be amended to make it clear that they are without prejudice to the independent exercise by Česká národní banka of its ESCB-related tasks.

Personal independence

The Law on CNB, in particular Article 6, does not explicitly refer to the Governor’s right in the case of dismissal to seek a remedy before the Court of Justice of the European Union in accordance with Article 14.2 of the Statute. The ECB understands that although the Law on CNB is silent on the jurisdiction of the Court of Justice of the European Union to hear cases with regard to decisions to dismiss the Governor, Article 14.2 of the Statute applies. It is noted in this regard that Article 14.2 of the Statute is cited in a footnote to Article 6(10) of the Law on CNB, which deals with relieving a Česká národní banka board member from office.

The Law on CNB is also silent on the right of national courts to review a decision to dismiss any member, other than the Governor, from Česká národní banka’s Board who is involved in the performance of ESCB-related tasks. Even though this right may be available under general law, providing specifically for such a right of review would increase legal certainty.

7.2.3 Monetary financing and privileged access

Under Article 33a of the Law on CNB, Česká národní banka, upon request, may exceptionally provide the Financial Market Guarantee System (FMGS) with short-term credit guaranteed by government bonds or other securities underwritten by the Government and owned by the FMGS, for a maximum of three months, in order to address an urgent situation, where the FMGS does not have sufficient funds to perform its tasks and this situation might jeopardise the stability of the financial market. Even if such funding is discretionary, temporary and in the interests of financial stability,[242] it remains the case that Article 123(1) of the Treaty prohibits any type of credit facility in favour of "bodies governed by public law". Given the features of the FMGS, the provisions laid down in the Law on CNB are not compatible with the monetary financing prohibition and should be amended accordingly.[243] The FMSG qualifies as a "body governed by public law" within the meaning of Article 123(1) of the Treaty, as has been recently clarified. In particular, the FMGS has all of the following characteristics: (a) it is established for the specific purpose of meeting needs in the general interest, not having an industrial or commercial character; (b) it has legal personality; and (c) it is closely dependent on the public sector entities referred to in Article 123(1) of the Treaty, given that, although only a minority of the members of FMGS's governing body are representatives of the Ministry of Finance, the Ministry of Finance has in fact the right to appoint and dismiss all the members of the FMGS's governing body.

As outlined in Section 7.2.2, Česká národní banka has been assigned certain tasks relating to national preparedness for crisis situations and to their resolution under the Laws on management of crisis situations and on economic measures for crisis situations. No provision is made for the costs incurred by Česká národní banka in carrying out such tasks to be met by the State. If they were to go beyond the internal contingency planning tasks of a central bank and to the extent that such tasks would be performed on behalf of, and in the exclusive interest of, the government, they would be government tasks, rather than central banking tasks. Therefore, in such a case, a mechanism for the reimbursement of Česká národní banka for any costs incurred in the performance of those tasks would need to be introduced in order to comply with the monetary financing prohibition.

7.2.4 Legal integration of the NCB into the Eurosystem

With regard to Česká národní banka's legal integration into the Eurosystem, the Law on CNB and Law No 2/1969 Coll., establishing ministries and other central administrative bodies of the Czech Republic (hereinafter the "Law on competences") need to be adapted as set out below.

[242] See paragraphs 3.1.2 and 3.1.3 of Opinion CON/2015/22, and paragraph 3.2. of Opinion CON/2016/60.

[243] See *supra,* page [XX] and Opinions CON/2020/24 and CON/2021/17.

Economic policy objectives

Article 2(1) of the Law on CNB, the last sentence of which provides that without prejudice to its primary objective, Česká národní banka shall support the general economic policies of the Government leading to sustainable economic growth and the general economic policies in the EU with a view to contributing to the achievement of the objectives of the EU, is not fully compatible with Article 127(1) of the Treaty and Article 2 of the Statute. The Law on CNB should make it clear that the objective of financial stability and the objective of supporting the general economic policies of the Government leading to sustainable growth are subordinate not only to the primary objective of price stability as specified in Section 6.2.2.1 but also to the secondary objective of the ESCB.

Tasks

Monetary policy

Article 2(2)(a), Article 5(1) and Part Five (namely Articles 23 to 26) of the Law on CNB, which provide for Česká národní banka's powers in the field of monetary policy and instruments for the implementation thereof, do not recognise the ECB's powers in this field.

Articles 28, 29, 32 and 33 of the Law on CNB, which empower Česká národní banka to enter into certain financial transactions, also fail to recognise the ECB's powers in this field.

Official foreign reserve management

Article 35(c) and Articles 36 and 47a of the Law on CNB, which provide for Česká národní banka's powers relating to foreign reserve management, do not recognise the ECB's powers in this field. Article 4(1) of the Law on competences, according to which the Ministry of Finance is the central administrative body for, inter alia, "foreign exchange affairs including the State's claims and obligations towards foreign entities" does not recognise the ECB's powers in this field.

Payment systems

Article 2(2)(c) and Articles 38 and 38a of the Law on CNB, which provide for Česká národní banka's powers relating to the smooth operation of payment systems, do not recognise the ECB's powers in this field. Article 4(1) of the Law on competences, according to which the Ministry of Finance is the central administrative body for, inter alia, "payments systems", does not recognise the ECB's powers in this field.

Issue of banknotes

Article 2(2)(b) of the Law on CNB, which empowers Česká národní banka to issue banknotes and coins, and Part Four of the Law on CNB, namely Articles 12 to 22, which specify Česká národní banka's powers in this field and the related implementing instruments, do not recognise the Council's and the ECB's powers in this field.

Financial provisions

Appointment of independent auditors

Article 48(2) of the Law on CNB, which provides that Česká národní banka's annual financial statements are audited by auditors selected on the basis of an agreement between Česká národní banka's Board and the Minister for Finance, does not recognise the Council's and the ECB's powers under Article 27.1 of the Statute.

Financial reporting

Article 48 of the Law on CNB does not reflect Česká národní banka's obligation to comply with the Eurosystem's regime for financial reporting of NCB operations, pursuant to Article 26 of the Statute.

Exchange rate policy

Article 35 of the Law on CNB, which authorises Česká národní banka to conduct exchange rate policy, does not recognise the Council's and the ECB's powers in this field. Article 4 of the Law on competences also fails to recognise the Council's and the ECB's powers in this field.

International cooperation

Article 2(3) of the Law on CNB, which empowers Česká národní banka to cooperate and negotiate agreements with the central banks of other countries, international financial institutions and other foreign and international organisations performing similar tasks to those performed by Česká národní banka, does not recognise the ECB's powers in this field.

Miscellaneous

Article 37 of the Law on CNB, which provides for the respective legislative powers of Česká národní banka and the Ministry of Finance in areas relating, inter alia, to currency, the circulation of money, the financial market, the adoption of the euro in the

Czech Republic, the payment system, foreign exchange management, and the status, competence, organisation and activities of Česká národní banka, does not recognise the Council’s and the ECB’s powers in this field.

Article 46a of the Law on CNB, which sets out the sanctions against third parties which fail to comply with their statistical obligations, does not recognise the Council’s and the ECB’s powers to impose sanctions.

7.2.5 Conclusions

The Law on CNB, the Law on competences and the Laws on management of crisis situations and on economic measures for crisis situations do not comply with all the requirements for central bank independence, the monetary financing prohibition and legal integration into the Eurosystem. The Czech Republic is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.

7.3 Croatia

7.3.1 Compatibility of national legislation

The following legislation forms the legal basis for Hrvatska narodna banka and its operations:

- the Croatian Constitution,[244]
- the Law on Hrvatska narodna banka (hereinafter the “Law on HNB”).[245]

There have been several changes in relation to the points identified in the ECB’s Convergence Report of June 2020, also addressing the recommendations made in previous Convergence Reports.

7.3.2 Independence of the NCB

With regard to Hrvatska narodna banka’s institutional independence, the Law on HNB has been adapted to implement the recommendations made in previous Convergence Reports, as set out below.

[244] Constitution of the Republic of Croatia, OG 5/2014. - Decision of the Constitutional Court No SuP-O-2014 of 14 January 2014.

[245] Law on Hrvatska narodna banka OG 75/2008 of 01 July 2008. Amendments to the Law on Hrvatska narodna banka OG 54/2013 of 7 May 2013. Amendments to the Law on Hrvatska narodna banka OG 47/2020 of 17 April 2020.

Institutional and personal independence

Article 71 of the Law on HNB mirrors Article 130 of the Treaty and Article 7 of the Statute. In particular Article 71(2) of the Law on HNB expressly prohibits the Croatian Government from seeking to influence the members of Hrvatska narodna banka's decision-making bodies in the performance of their tasks.

7.3.3 Legal integration of the NCB into the Eurosystem

With regard to the legal integration of Hrvatska narodna banka into the Eurosystem, the Law on HNB has been adapted to implement the recommendations made in previous Convergence Reports, as set out below.

International cooperation

Pursuant to Article 104(9) of the Law on HNB, Hrvatska narodna banka's Council decides on Hrvatska narodna banka's membership of international institutions and organisations. The Law on HNB explicitly prescribes that this power of Hrvatska narodna banka's Council is without prejudice to the ECB's powers under Article 6(1) of the Statute.

7.3.4 Conclusions

The Law on HNB has been amended to reflect and implement the recommendations made in the ECB's Convergence Report of June 2020. As a result, the national legislation is consistent with the Treaty and the Statute.

7.4 Hungary

7.4.1 Compatibility of national legislation

The following legislation forms the legal basis for the Magyar Nemzeti Bank and its operations:

- The consolidated version of the Fundamental Law of Hungary,[246]
- Law CXXXIX of 2013 on the Magyar Nemzeti Bank (hereinafter the "Law on the MNB").[247]

[246] Magyarország Alaptörvénye, Magyar Közlöny 2013/163. (X.3.).

[247] 2013. évi CXXXIX. törvény a Magyar Nemzeti Bankról, Magyar Közlöny 2013/158. (IX.26.). Law CXXXIX of 2013 on the Magyar Nemzeti Bank repealed Law CCVIII of 2011 on the Magyar Nemzeti Bank with effect from 1 October 2013. See Opinions CON/2013/56 and CON/2013/71.

There have been no major changes in relation to the points identified in the ECB's Convergence Report of June 2020, and those comments are therefore repeated in this year's assessment. Although the Law on the MNB has been amended several times since that Convergence Report, no additional points are necessary in this year's assessment.

7.4.2 Independence of the NCB

With regard to the Magyar Nemzeti Bank’s independence, the Law on the MNB and Law XXVII of 2008[248] need to be adapted as set out below.

Institutional independence

After introducing significant changes in 2013-2015,[249] minor amendments were made to the Law on the MNB. In the past two years, the Magyar Nemzeti Bank has been entrusted with supervisory tasks in relation to financial service providers and their identification and reporting obligations,[250] and with tasks arising from the implementation of EU legislation.[251] The mandate of the Magyar Nemzeti Bank has been extended in order to support, as a secondary objective, the government’s policy

[248] Law XXVII of 2008 on the oath of certain public officials (2008. évi XXVII. törvény egyes közjogi tisztségviselők esküjéről és fogadalmáról).

[249] The most notable amendment was the integration of the Hungarian Financial Supervisory Authority (HFSA) into the Magyar Nemzeti Bank as a general legal successor to the HFSA’s scope of competence, rights and obligations (see Articles 176 to 183 of the Law on the MNB as well as Opinions CON/2013/56 and CON/2013/71). Further amendments concerned the allocation of new tasks to the Magyar Nemzeti Bank, such as: resolution tasks (Law XXXVII of 2014); supervisory tasks involving the verification of compliance with the new legal measures applicable to consumer loan contracts (Law XL of 2014); mediation of complaints and the initiation of legal proceedings in the public interest (Law XL of 2014 and Law LXXXV of 2015). The combination of the changes to the institutional framework of the Magyar Nemzeti Bank and the frequency of changes to the Law on the MNB, not always backed by robust justification of the need to amend the Magyar Nemzeti Bank’s institutional framework, were mentioned in previous Convergence Reports as adversely affecting the organisational and governance stability of the Magyar Nemzeti Bank and having an impact on its institutional independence. The principle of central bank independence requires that a central bank has a stable legal framework to enable it to function.

[250] Law XLIII of 2021 on the establishment and operation of the reporting framework of financial and other service providers relating to their identification tasks.

[251] Article 40(32)-(37) of the Law on the MNB covers the following EU secondary legislation: Regulation (EU) 2019/2033 of the European Parliament and of the Council of 27 November 2019 on the prudential requirements of investment firms and amending Regulations (EU) No 1093/2010, (EU) No 575/2013, (EU) No 600/2014 and (EU) No 806/2014 (OJ L 314, 5.12.2019, p. 1); Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (OJ L 317, 9.12.2019, p. 1); Regulation (EU) 2019/2089 of the European Parliament and of the Council of 27 November 2019 amending Regulation (EU) 2016/1011 as regards EU Climate Transition Benchmarks, EU Paris-aligned Benchmarks and sustainability-related disclosures for benchmarks (OJ L 317, 9.12.2019, p. 17); Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088 (OJ L 198, 22.6.2020, p. 13); Regulation (EU) 2020/1503 of the European Parliament and of the Council of 7 October 2020 on European crowdfunding service providers for business, and amending Regulation (EU) 2017/1129 and Directive (EU) 2019/1937 (OJ L 347, 20.10.2020, p. 1); Regulation (EU) 2021/168 of the European Parliament and of the Council of 10 February 2021 amending Regulation (EU) 2016/1011 as regards the exemption of certain third-country spot foreign exchange benchmarks and the designation of replacements for certain benchmarks in cessation, and amending Regulation (EU) No 648/2012 (OJ L 49, 12.2.2021, p. 6).

related to environmental sustainability.[252] Given the nature of these changes, – including the supervisory tasks in relation to the identification and reporting obligations of financial service providers, it is unlikely that these changes will have a material impact on the institutional framework and organisational and governance stability of the Magyar Nemzeti Bank.

Personal independence

The ECB’s Convergence Reports of 2010, 2012, 2014, 2016, 2018 and 2020 noted that Law XXVII of 2008 specifies the wording of the oath that the members of the Monetary Council – including the Governor – are required to take. Pursuant to Article 9(7), in conjunction with Articles 10(3) and 11(2) of the Law on the MNB which entered into force on 1 October 2013, the Governor and the Deputy Governors of the Magyar Nemzeti Bank must take an oath before Hungary’s President, while other members of the Monetary Council take an oath before the Parliament. Law XXVII of 2008 specifies the wording of the oath to be taken by public officials appointed by the Parliament.[253] Therefore, it is not clear whether the Governor and Deputy Governors take the same oath as the other members of the Monetary Council.

The Magyar Nemzeti Bank’s Governor acts in a dual capacity as a member of both the Magyar Nemzeti Bank’s Monetary Council and the ECB decision-making bodies. The wording of the oath should take into account and reflect the status, obligations and duties of the Governor as a member of the ECB’s decision-making bodies. Furthermore, the other members of the Monetary Council are also involved in the performance of ESCB-related tasks. The oath taken should not hinder the Governor, Deputy Governors and other members of the Monetary Council from performing ESCB-related tasks. Law XXVII of 2008 and Articles 9(7), 10(3) and 11(2) of the Law on the MNB need to be adapted in this regard.[254]

In addition, in accordance with Article 152(2) of the Law on the MNB, by way of exception from the general rule laid down in Article 152(1), all employees of the Magyar Nemzeti Bank, including the members of the Monetary Council, may: (1) hold membership of any kind in some but not all of the entities[255] subject to the Magyar Nemzeti Bank’s supervisory powers, which fall under the scope of the laws

[252] Article 3(2) of the Law on the MNB stipulates that without prejudice to its primary objective of achieving and maintaining price stability, the Magyar Nemzeti Bank shall support, as a secondary objective, the government’s policy related to environmental sustainability using instruments at its disposal. See Opinion CON/2021/12.

[253] Law XXVII of 2008 on the oath of certain public officials. The wording of the oath is: “I, … [name of the person taking the oath], hereby undertake to be faithful to Hungary and to its Fundamental Law, I will comply and ensure compliance with its laws, I will fulfil my office as a … [name of the position] for the benefit of the Hungarian people. [Depending on the belief of the person taking the oath] So help me God!”

[254] Law XXVII of 2008 was amended by Law XIV of 2014, but these changes did not affect the assessment of the Hungarian law laid down in this section.

[255] These entities are voluntary mutual insurance funds, private pension funds, cooperative credit institutions and insurance associations.

enumerated in Article 39 of the Law on the MNB; [256] (2) have an employment relationship or any other work-related relationship, including by being executive officer or a supervisory board member, in a financial institution in which the Magyar Nemzeti Bank holds shares; and (3) be a supervisory board member of a non-profit business association the purpose of which is the resolution of entities subject to Article 39. In addition, pursuant to Article 153(1) of the Law on the MNB, employees of the Magyar Nemzeti Bank, including the members of the Monetary Council, performing the Magyar Nemzeti Bank's basic tasks can maintain an employment relationship, including by being an executive officer or a supervisory board member, with financial institutions owned by the Magyar Nemzeti Bank. Furthermore, pursuant to Article 153(6) of the Law on the MNB,[257] by way of exception from Article 152, Article 153(1) to (5) and Articles 154 to 156 of the Law on the MNB, the members of the Monetary Council may, without being subject to a formal disclosure requirement (unless it amounts to an employment relationship), be an executive officer or a member of a supervisory board of a business association under the majority ownership of the Magyar Nemzeti Bank, as well as a member of the management, board of trustees or supervisory board of a foundation established by the Magyar Nemzeti Bank. On the basis that it gives rise to potential conflicts of interest, the exception provided for in Article 152(2) - in conjunction with Article 153(1) - and Article 153(6) of the Law on the MNB should be removed in relation to the entities subject to the Magyar Nemzeti Bank's supervisory powers that fall under the scope of the laws enumerated in Article 39 of the Law on the MNB, in order to safeguard the personal independence of the members of the Monetary Council. Furthermore, in relation to entities that are not subject to the Magyar Nemzeti Bank's supervisory powers and do not fall under the scope of the laws enumerated in Article 39 of the Law on the MNB, it should be clarified that the memberships or relationships specified in the abovementioned provisions of the Law on the MNB are not permitted if they give rise to a conflict of interest.

In addition, Article 153(4) of the Law on the MNB stipulates that all employees of the Magyar Nemzeti Bank, including the members of the Monetary Council, must notify the Magyar Nemzeti Bank when acquiring financial instruments subject to the Law CXXXVIII of 2007 on Investment Service Providers and Commodity Traders and the Rules of their Services except for state bonds and securities issued by open-ended public investment funds. The notification must be made within three working days of acquiring the instruments. In order to avoid any potential conflict of interest, however,

[256] These acts are as follows: (a) the Law on voluntary mutual insurance funds; (b) the Law on the Hungarian Export-Import Bank Corporation and the Hungarian Export Credit Insurance Corporation; (c) the Law on credit institutions and financial enterprises; (d) the Law on home savings and loan associations; (e) the Law on mortgage loan companies and mortgage bonds; (f) the Law on private pensions and Private Pension Funds; (g) the Law on the Hungarian Development Bank Limited Company; (h) the Law on credit institutions and financial enterprises; (i) the Law on the capital markets; (j) the Law on insurance institutions and the insurance business;(k) the Law on the distance marketing of consumer financial services; (l) the Law on occupational retirement pensions and institutions for occupational retirement provision; (m) the Law on investment firms and commodity dealers, and on the regulations governing their activities; (n) the Law on collective investment trusts and their managers, and on the amendment of financial regulations; (o) the Law on reinsurance; (p) the Law on the pursuit of the business of payment services; (q) the Law on insurance against civil liability in respect of the use of motor vehicles; (r) the Law on the central credit information system; (s) the Law on settlement finality in payment and securities settlement systems; (t) the Law on payment service providers.

[257] As introduced by Law LXXXV of 2015 on amendments to specific acts in order to enhance the development of the system of financial intermediation, 2015. évi LXXXV.

this notification obligation should cover all instruments including state bonds and securities issued by open-ended public investment funds.

In addition, Article 156(7) of the Law on the MNB in conjunction with Article 152(1), sets out post-employment conflict of interest rules for the members of the Monetary Council. It provides the members of the Monetary Council with an exemption from the cooling-off period of six months with regard to any membership or shareholder relationship, employment relationship or work-related contractual relationship, executive officer relationship or supervisory board membership with any of the entities subject to the Magyar Nemzeti Bank's supervisory powers, which fall under the scope of the laws enumerated in Article 39 of the Law on the MNB and in which the Hungarian State or the Magyar Nemzeti Bank has a majority stake.[258] Providing for such an exemption may give rise to potential conflicts of interest for the members of the Monetary Council. In order to safeguard those members' personal independence, the exemption from the post-employment restrictions provided for in Article 156(7) of the Law on the MNB should be removed as regards the entities subject to the Magyar Nemzeti Bank's supervisory powers and should be amended to clarify that such membership is not permitted if it gives rise to a conflict of interest as regards the other entities covered by Article 156(7) of the Law on the MNB.

Article 157 of the Law on the MNB defines the rules that members of the Monetary Council must abide by when submitting their declarations of wealth. The Governor and the Deputy Governors must also follow these rules, by reference to the application of the provisions laid down in Law XXXVI of 2012 on the Parliament governing the declaration of wealth of members of the Parliament and related proceedings. Pursuant to Article 90(3) of Law XXXVI of 2012, which applies to the members of the Monetary Council by virtue of Article 157(2) of the Law on the MNB, in the case of non-compliance with the obligation to submit a declaration of wealth, the members of the Monetary Council will be prohibited from carrying out their duties and, as a consequence, they will not be entitled to receive their remuneration for the period of non-compliance. The sanction provided for in Article 90(3) of Law XXXVI of 2012 in effect allows the members of the Monetary Council to be temporarily removed from office for grounds other than those pursuant to Article 14.2 of the Statute. The provisions of Article 157(2) of the Law on the MNB should be adapted so that the members of the Monetary Council may not be dismissed for reasons other than those laid down in Article 14.2 of the Statute.[259]

Financial independence

Article 183 of the Law on the MNB, read in conjunction with Article 176, provided that on 1 October 2013 all employees of the HFSA would be employees of the Magyar Nemzeti Bank and that the Magyar Nemzeti Bank was to bear the financial obligations arising from any employment relations which HSFA staff transferred to the Magyar Nemzeti Bank may have had with the HFSA in the past. This provision alone, taken

[258] Introduced to Article 156(7) of the Law on the MNB by Article 174 of Law LXXXV of 2015.

[259] See paragraphs 2.3 to 2.5 of Opinion CON/2014/8.

together with the mass redundancy scheme provided for under Article 183(10) of the Law on the MNB and the aim of eliminating positions not essential for the discharge of duties in order to optimise staff management, is incompatible with the Magyar Nemzeti Bank's financial independence and more specifically its autonomy in staff matters. It impeded the Magyar Nemzeti Bank's ability to decide on employing and retaining necessary and qualified staff for the Magyar Nemzeti Bank. See, also, the following Section regarding compatibility with the prohibition on monetary financing.[260]

7.4.3 Monetary financing and privileged access

Article 36 of the Law on the MNB provides that if circumstances arise which jeopardise the financial system's stability due to a credit institution's operations, the Magyar Nemzeti Bank may extend an emergency loan to such credit institution subject to observing the prohibition on monetary financing in Article 146 of the Law on the MNB. However, it would be useful to specify that such loans are granted independently and at the Magyar Nemzeti Bank's full discretion, which may make such extensions conditional if necessary and against adequate collateral, thus introducing an additional safeguard which should minimise the possibility of the Magyar Nemzeti Bank suffering any loss.

Article 37 of the Law on the MNB provides that on request, the Magyar Nemzeti Bank at its full discretion may provide a loan to the National Deposit Insurance Fund, subject to the prohibition on monetary financing in Article 146 of the Law on the MNB, in urgent

[260] As noted in the section on institutional independence, over the past years the Magyar Nemzeti Bank has been entrusted with several new tasks. The legal provisions entrusting the Magyar Nemzeti Bank with these new tasks that required additional human and financial resources within a relatively short period of time were seen, in previous Convergence Reports, as an instrument to influence the Magyar Nemzeti Bank's ability to fulfil its mandate, both operationally and financially. Therefore, this raised concerns as regards the provisions' compliance with the principle of financial independence. Any allocation of new tasks should be supplemented by the necessary resources to carry them out. See paragraph 2.2 of Opinion CON/2014/62 and paragraph 3.4 of Opinion CON/2014/72. It is also important to note that, as introduced by Law LXIX of 2017, the Magyar Nemzeti Bank also acts, within its existing tasks, as a competent authority to implement several delegated acts related to Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (OJ L 173, 12.6.2014, p. 349) and Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012 (OJ L 173, 12.6.2014, p. 84). The Magyar Nemzeti Bank also implements Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds and amending Directives 2008/48/EC and 2014/17/EU and Regulation (EU) No 596/2014 (OJ L 171, 29.6.2016, p. 1), and shall function as a competent authority as referred to in Article 16 of Regulation (EU) 2015/2365 of the European Parliament and of the Council of 25 November 2015 on transparency of securities financing transactions and of reuse and amending Regulation (EU) No 648/2012 (OJ L 337, 23.12.2015, p. 1). In addition, the Magyar Nemzeti Bank implements the following Regulations: Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation, and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012 (OJ L 347, 28.12.2017, p. 35); Regulation (EU) 2017/1129 of the European Parliament and the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC (OJ L 168, 30.6.2017, p. 12); and Regulation (EU) 2019/1156 of the European Parliament and of the Council of 20 June 2019 on facilitating cross-border distribution of collective investment undertakings and amending Regulations (EU) No 345/2013, (EU) No 346/2013 and (EU) No 1286/2014 (OJ L 188, 12.7.2019, p. 55). The Magyar Nemzeti Bank also acts in compliance with Regulation (EU) 2017/1131 of the European Parliament and of the Council of 14 June 2017 on money market funds (OJ L 169, 30.6.2017, p. 8) and with Regulation (EU) 2017/1991 of the European Parliament and of the Council of 25 October 2017 amending Regulation (EU) No. 345/2013 on European venture capital funds and Regulation (EU) No. 346/2013 on European social entrepreneurship funds (OJ L 293, 10.11.2017, p. 1).

and exceptional cases threatening the stability of the financial system as a whole and the smooth completion of cash transactions, the term of which loan may not be longer than three months. Law LXXXV of 2015 extended the scope of Article 37 in order to enable such emergency short-term loan facilities to be provided to the Hungarian Investor Protection Fund, under the same conditions as to the National Deposit Insurance Fund. This provision is compatible with the monetary financing prohibition. As also already clarified in ECB opinions,[261] it may be useful to specify that such loans are extended against adequate collateral, thus introducing an additional safeguard which should minimise the possibility of the Magyar Nemzeti Bank suffering any loss.

The integration of the HFSA into the Magyar Nemzeti Bank took place on 1 October 2013. Based on Articles 176 to 181 of the Law on the MNB, all of the HFSA's assets were transferred to the Magyar Nemzeti Bank. The Magyar Nemzeti Bank also became a general legal successor to all obligations of the HFSA including, inter alia, its contractual relationships, pending procurement procedures, out-of-court redress procedures, tax-related administrative procedures as well as any other type of legal procedure (including pending administrative legal procedures)[262]. As a consequence, any payment obligation from a legal relationship or a requirement to pay compensation following any judgment handed down by a Hungarian court granting compensation to an individual or entity challenging a prior decision of the HFSA is to be borne by the Magyar Nemzeti Bank.

Although Article 177(6) of the Law on the MNB provides for compensation by the State to the Magyar Nemzeti Bank for all expenses resulting from the above-mentioned obligations that would exceed the assets taken over from the HFSA, the Law on the MNB does not specifically lay down the procedure and deadlines applicable to financing by the State and reimbursement of the Magyar Nemzeti Bank. This can only be considered to be an ex-post financing scheme. The provisions applying to the assignment of the obligations of the HFSA to the Magyar Nemzeti Bank were not accompanied by measures that would fully insulate the Magyar Nemzeti Bank from all financial obligations resulting from any activities and contractual relationships of the HFSA originating prior to the transfer of tasks, and the provisions of the Law on the MNB introduced a time gap between the costs arising and the Hungarian State reimbursing the Magyar Nemzeti Bank, should the expenses incurred at the Magyar Nemzeti Bank exceed the value of assets taken over from the HFSA. As mentioned in previous Convergence Reports, such a scenario would constitute a breach of the prohibition on monetary financing laid down in Article 123 of the Treaty as well as of the principle of financial independence under Article 130. Hence the Magyar Nemzeti Bank must be insulated from all financial obligations resulting from the prior activities or legal relationships of the HFSA.

Article 183 of the Law on the MNB read in conjunction with Article 176 of the Law on the MNB provides that the Magyar Nemzeti Bank bears the financial obligations arising from the employment relationships which HFSA staff transferred to the Magyar Nemzeti Bank may have had with the HFSA in the past. In order to comply with Article 123 of the Treaty, the Magyar Nemzeti Bank should be insulated from all obligations

[261] See, for example, paragraph 9.3 of Opinion CON/2011/104.

[262] See paragraph 3.7 of Opinion CON/2008/83.

arising out of employment relationships between any new Magyar Nemzeti Bank staff member and the HFSA, in the light of the mass redundancy scheme provided for under Article 183(10) of the Law on the MNB[263].

7.4.4 Single spelling of the euro

In several Hungarian legal acts[264] the name of the single currency is spelled in a way ("euró"), which is inconsistent with EU law. Under the Treaties a single spelling of the word “euro” in the nominative singular case is required in all EU and national legislative provisions, taking into account the existence of different alphabets. The Hungarian legal acts in question should therefore be amended accordingly.[265]

The ECB expects that the correct spelling of the word “euro” will be applied in Hungarian legal acts and the euro changeover law. Only when all national legal acts use the correct spelling of the word “euro” will Hungary comply with the Treaties.

7.4.5 Legal integration of the NCB into the Eurosystem

With regard to the Magyar Nemzeti Bank’s legal integration into the Eurosystem, the Law on the MNB needs to be adapted as set out below.

Economic policy objectives

Article 3(2) of the Law on the MNB provides that the Magyar Nemzeti Bank supports, without prejudice to the primary objective of price stability, the maintenance of the stability of the financial intermediary system, the enhancement of its resilience, its sustainable contribution to economic growth and the Government’s general economic policies and environmental sustainability policy. This provision is incompatible with Article 127(1) of the Treaty and Article 2 of the Statute as it does not reflect the secondary objective of supporting the general economic policies in the EU.

Tasks

Monetary policy

Article 41 of the Fundamental Law of Hungary and Article 1(2) and Articles 4, 9, 16 to 22, 159 and 171 of the Law on the MNB establishing the Magyar Nemzeti Bank’s

[263] Although this concern and the one explained in the previous paragraph remain, they are obviously less strong than they were in the immediate years that followed the integration of the HFSA into the Magyar Nemzeti Bank as, due to the passage of time, it is less likely that Magyar Nemzeti Bank has to assume new financial obligations resulting from the legal succession of HFSA.

[264] For example, the Laws on the 2022 general budget in Hungary.

[265] Opinion CON/2006/55.

powers in the field of monetary policy and instruments for the implementation thereof do not recognise the ECB's powers in this field.

Collection of statistics

Although Article 4(7) of the Law on the MNB refers to the Magyar Nemzeti Bank's obligation to transfer specific statistical data to the ECB in accordance with Article 5 of the Statute, Article 1(2), as well as Articles 30 and 171(1) of the Law on the MNB establishing the Magyar Nemzeti Bank's powers relating to the collection of statistics do not recognise the ECB's powers in this field.

Official foreign reserve management

Article 1(2), Article 4(3), (4) and (12), Article 9 and Article 159(2) of the Law on the MNB, which provide for the Magyar Nemzeti Bank's powers in the field of foreign reserve management, do not recognise the ECB's powers in this field.

Payment systems

Article 1(2), Article 4(5) and (12), Articles 27 and 28, and Article 171(2) and (3) of the Law on the MNB establishing the Magyar Nemzeti Bank's powers with regard to the promotion of the smooth operation of payment systems do not recognise the ECB's powers in this field.

Issue of banknotes

Article K of the Fundamental Law and Article 1(2), Article 4(2) and (12), Articles 9, 23 to 26 and Article 171(1) of the Law on the MNB establishing the Magyar Nemzeti Bank's exclusive right to issue banknotes and coins do not recognise the Council's and the ECB's powers in this field.

Financial provisions

Appointment of independent auditors

Article 144 of the Law on the MNB providing that the President of the State Audit Office must be consulted before the Magyar Nemzeti Bank's auditor is elected or his or her dismissal is proposed, Article 6(1) of the Law on the MNB, which provides for the shareholder's power to appoint and dismiss the auditor, and Article 15 of the Law on the MNB do not recognise the Council's and the ECB's powers under Article 27.1 of the Statute.

Financial reporting

Article 12(4)(b) of the Law on the MNB and Law C of 2000,[266] in conjunction with Government Decree 221/2000 (XII.19),[267] do not reflect the Magyar Nemzeti Bank's obligation to comply with the Eurosystem's regime for financial reporting of NCB operations, pursuant to Article 26 of the Statute.

Exchange rate policy

Article 1(2), 4(4) and (12), Articles 9, 22 and 147 of the Law on the MNB lay down the Government's and the Magyar Nemzeti Bank's respective powers in the area of exchange rate policy. These provisions do not recognise the Council's and the ECB's powers in this field.

International cooperation

Article 1(2), 135(5) of the Law on the MNB providing that, upon authorisation by the Government, the Magyar Nemzeti Bank may undertake tasks arising at international financial organisations, unless otherwise provided for by a legislative act, fails to recognise the ECB's powers as far as issues under Article 6 of the Statute are concerned.

Miscellaneous

Articles 75 and 76 of the Law on the MNB do not recognise the ECB's powers to impose sanctions.

With regard to Article 132 of the Law on the MNB, which entitles the Magyar Nemzeti Bank to be consulted on draft national legislation related to its tasks, it is noted that consulting the Magyar Nemzeti Bank does not obviate the need to consult the ECB under Articles 127(4) and 282(5) of the Treaty.

As set out in Section 7.4.2, Article 9(7) of the Law on the MNB requires the members of the Monetary Council to make an oath in accordance with the wording specified in Article 1 of Law XXVII of 2008. Article 9(7) of the Law on the MNB needs to be adapted to comply with Article 14.3 of the Statute.[268]

[266] A számvitelről szóló törvény, Magyar Közlöny 2000/95. (IX. 21.).

[267] A Magyar Nemzeti Bank éves beszámoló készítési és könyvvezetési kötelezettségének sajátosságairól szóló kormányrendelet, Magyar Közlöny 2000/125. (XII.19.).

[268] See paragraph 3.7 of Opinion CON/2008/83.

7.4.6 Conclusions

The Fundamental Law of Hungary, the Law on the MNB and Law XXVII of 2008 do not comply with all the requirements for central bank independence, the prohibition on monetary financing, and legal integration into the Eurosystem. Other Hungarian legal acts do not comply with the requirements for the single spelling of the euro. Hungary is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.

7.5 Poland

7.5.1 Compatibility of national legislation

The following legislation forms the legal basis for Narodowy Bank Polski and its operations:

- the Polish Constitution,[269]
- the Law on Narodowy Bank Polski (hereinafter the “Law on NBP”),[270]
- the Law on the Bank Guarantee Fund, deposit guarantee system and compulsory restructuring (hereinafter the “Law on the Fund”),[271]
- the Law on banking (hereinafter the “Law on banking”),[272]
- the Law on settlement finality in the payment and settlement systems and on the supervision of such systems.[273]

No major new legislation has been enacted in relation to the points identified in the ECB’s Convergence Report of June 2020, and those comments are therefore largely repeated in this year’s assessment. The Law on NBP has been amended several times since the last Convergence Report. These changes did not result in the need to add additional points in the current assessment, as they do not affect the issues covered in it. However, an additional incompatibility of the existing legislation was discovered and is addressed in Section 7.5.4.

[269] Konstytucja Rzeczypospolitej Polskiej of 2 April 1997, Dziennik Ustaw of 1997, No 78, item 483, with further amendments.

[270] Ustawa o Narodowym Banku Polskim of 29 August 1997. Consolidated version published in Dziennik Ustaw of 2022, item 492.

[271] Ustawa o Bankowym Funduszu Gwarancyjnym, systemie gwarantowania depozytów oraz przymusowej restrukturyzacji of 10 June 2016. Consolidated version published in Dziennik Ustaw of 2022, item 793.

[272] Ustawa Prawo bankowe of 29 August 1997. Consolidated version published in Dziennik Ustaw of 2021, item 2439.

[273] Ustawa o ostateczności rozrachunku w systemach płatności i systemach rozrachunku papierów wartościowych oraz zasadach nadzoru nad tymi systemami of 24 August 2001. Consolidated version published in Dziennik Ustaw of 2019, item 212, with further amendments.

7.5.2 Independence of the NCB

With regard to Narodowy Bank Polski’s independence, the Polish Constitution, the Law on NBP and the Law on the State Tribunal[274] need to be adapted in the respects set out below.

Institutional independence

The Law on NBP does not prohibit Narodowy Bank Polski and members of its decision-making bodies from seeking or taking outside instructions; it also does not expressly prohibit the Government from seeking to influence members of Narodowy Bank Polski’s decision-making bodies in situations where this may have an impact on Narodowy Bank Polski’s fulfilment of its ESCB-related tasks. In this respect, the Law on NBP needs to be adapted to comply with Article 130 of the Treaty and Article 7 of the Statute. Even though the Polish Constitutional Court has confirmed[275] that while the Polish Constitution does not expressly lay down the principle of Narodowy Bank Polski's independence, such principle can be implicitly derived from the Constitution's provisions relating to Narodowy Bank Polski. Legal certainty would nevertheless be increased by making explicit provision for this principle in the Polish Constitution on the occasion of a future amendment.

Article 11(3) of the Law on NBP, which provides that Narodowy Bank Polski’s President represents Poland’s interests within international banking institutions and, unless the Council of Ministers decides otherwise, within international financial institutions, needs to be adapted to comply with Article 130 of the Treaty and Article 7 of the Statute.

Article 23(1)(2) of the Law on NBP, which obliges Narodowy Bank Polski’s President to forward draft monetary policy guidelines to the Council of Ministers and the Minister for Finance, needs to be adapted to comply with Article 130 of the Treaty and Article 7 of the Statute.

The Supreme Audit Office (NIK), a constitutional body, has wide powers under Article 203(1) of the Polish Constitution to control the activities of, among others, all public administrative authorities and Narodowy Bank Polski as regards their legality, economic prudence, efficiency and diligence. The scope of the NIK’s control should be clearly defined, should be without prejudice to the activities of Narodowy Bank Polski’s independent external auditors,[276] should comply with the prohibition on giving instructions to an NCB and its decision-making bodies and should not interfere with the NCB’s ESCB-related tasks. In particular, it should be ensured that when auditing Narodowy Bank Polski, the application by the NIK of the “efficiency criterion” does not extend to an evaluation of Narodowy Bank Polski’s activities related to its primary

[274] Ustawa o Trybunale Stanu of 26 March 1982. Consolidated version published in Dziennik Ustaw of 2022, item 762.

[275] Judgment of 16 July 2009 of the Polish Constitutional Court. Kp 4/08.

[276] For the activities of the NCB’s independent external auditors see, as an example, Article 27.1 of the Statute.

objective of price stability.[277] Article 203(1) of the Constitution needs to be adapted to comply with Article 130 of the Treaty and Article 7 of the Statute.

Personal independence

Article 9(5) of the Law on NBP regulates the dismissal of Narodowy Bank Polski's President by the Sejm (lower house of Parliament), if he or she has:

- been unable to fulfil his or her duties due to prolonged illness,
- been convicted of a criminal offence under a final court sentence,
- submitted an untruthful disclosure declaration, confirmed by a final court judgment,[278]
- been prohibited by the State Tribunal from occupying executive positions or holding posts of particular responsibility in state bodies.[279]

Moreover, under Article 25(3) in conjunction with Article 3 and Article 1(1)(3) of the Law on the State Tribunal, Narodowy Bank Polski's President may also be removed from office if he or she violates the Constitution or a law.[280]

The grounds listed above are in addition to the two grounds for dismissal provided for in Article 14.2 of the Statute. Therefore, Article 9(5) of the Law on NBP and the relevant provisions of the Law on the State Tribunal need to be adapted to comply with Article 14.2 of the Statute.

With regard to security of tenure and grounds for dismissal of other members of Narodowy Bank Polski's decision-making bodies involved in the performance of ESCB-related tasks (i.e. the members of the Management Board, and in particular the First Deputy President, and the members of the Monetary Policy Council), Article 13(5) and Article 17(2b), second sentence, of the Law on NBP provide the following grounds for dismissal:

- an illness which permanently prevents them from performing their responsibilities,
- a conviction for a criminal offence under a final court sentence,
- submission of an untruthful lustration declaration, and this has been confirmed by a final court judgment,[281]

[277] See paragraph 3.6 of Opinion CON/2011/9.

[278] The provision was added with effect from 15 March 2007 by Article 37a of the Law on disclosure of information relating to documents of state security services from the period 1944-1990 (Ustawa o ujawnianiu informacji o dokumentach organów bezpieczeństwa państwa z lat 1944-1990 oraz treści tych dokumentów of 18 October 2006. Consolidated version published in Dziennik Ustaw of 2007, No 63, item 425).

[279] The resolution of the Sejm producing an indictment of the President of Narodowy Bank Polski before the State Tribunal results, by operation of law, in suspension of the President from office (Article 11(1), second sentence in connection with Article 1(1)(3) of the Law on the State Tribunal).

[280] The indictment by the Sejm of the President of Narodowy Bank Polski before the State Tribunal results, by operation of law, in suspension of the President from office, see previous footnote.

- non-suspension of membership of a political party or trade union.

The grounds listed above are in addition to the two grounds for dismissal provided for in Article 14.2 of the Statute. Article 13(5) of the Law on NBP therefore needs to be adapted to comply with Article 14.2 of the Statute. Article 14(3) of the Law on NBP, which reaffirms the possibility of dismissal of a member of the Monetary Policy Council of Narodowy Bank Polski for a conviction for a criminal offence, also needs to be adapted to comply with Article 14.2 of the Statute.

The President of Narodowy Bank Polski acts in dual capacity as a member of Narodowy Bank Polski's decision-making bodies and of the relevant decision-making bodies of the ECB. Article 9(3) of the Law on NBP, which specifies the wording of the oath sworn by Narodowy Bank Polski's President, needs to be adapted to reflect the status and the obligations and duties of the President of Narodowy Bank Polski as member of the relevant decision-making bodies of the ECB.

The Law on NBP is silent on the right of national courts to review a decision to dismiss any member of the NCB's decision-making bodies who is involved in the performance of ESCB-related tasks. Even though this right may be available under general Polish law, providing specifically for such a right of review would increase legal certainty.

Financial independence

In March 2019 the Law amending the Law on prohibitions regarding conducting of business activities by public officials and the Law on NBP[282] entered into force. According to Article 66(3) of the amended Law on NBP, the upper salary limit (salary cap) for all employees (excluding members of the Management Board of Narodowy Bank Polski) is set at 60% of the salary of the President of Narodowy Bank Polski (the salary of the President is determined on the basis of other provisions which have not been amended). However, amendments included in any legislative proposal that lead to reductions in remuneration are not compatible with the principle of financial independence if the ability of the relevant national central bank to employ and retain staff to perform independently the tasks conferred on it by the Treaty and the Statute is affected. Any adopted legislative solution should provide for a cooperation mechanism with Narodowy Bank Polski, to ascertain if it considers that an exception to a cap on remuneration is required. Such an exception should be decided upon in close and effective cooperation with Narodowy Bank Polski, taking due account of its views, to ensure its ongoing ability to independently carry out its tasks.[283] As such close and effective cooperation with Narodowy Bank Polski is not provided for in the present

[281] This provision was added with effect from 15 March 2007 by Article 37a of the Law on disclosure of information relating to documents of state security services from the period 1944-1990 (Ustawa o ujawnianiu informacji o dokumentach organów bezpieczeństwa państwa z lat 1944-1990 oraz treści tych dokumentów of 18 October 2006.Consolidated version published in Dziennik Ustaw of 2007, No 63, item 425).

[282] Ustawa z dnia 22 lutego 2019 r. o zmianie ustawy o ograniczeniu prowadzenia działalności gospodarczej przez osoby pełniące funkcje publiczne oraz ustawy o Narodowym Banku Polskim, Dz. U. 2019 item 371.

[283] See paragraph 2.2.3 of Opinion CON/2019/3.

legal framework regarding the salary cap, the legislation does not satisfy the requirements of Article 130 of the Treaty and Article 7 of the Statute.

7.5.3 Confidentiality

Article 23(7) of the Law on NBP specifies instances in which data collected from individual financial institutions, as well as statistical surveys, studies and assessments enabling identification of individual entities, are subject to disclosure by Narodowy Bank Polski to external parties. One such instance covers disclosure to "unspecified recipients", under "separate applicable provisions".[284] Such disclosure may potentially affect data protected under the ESCB's confidentiality regime and therefore the Law on NBP should be adapted to fully comply with Article 37 of the Statute.[285]

In addition, since NIK has wide powers under Article 203(1) of the Polish Constitution to control the activities of Narodowy Bank Polski, as mentioned in Chapter 7.5.2.1, NIK also has wide access to Narodowy Bank Polski's confidential information and documents. However, pursuant to Article 37 of the Statute in conjunction with Article 130 of the Treaty, NIK's access to Narodowy Bank Polski's confidential information and documents must be limited to that necessary for the performance of NIK's statutory tasks. Such access must also be without prejudice both to the ESCB's independence and to its confidentiality regime, to which the members of the NCBs' decision-making bodies and staff are subject. In addition, the relevant Polish legislation should be amended to stipulate that NIK shall safeguard the confidentiality of information and documents disclosed by Narodowy Bank Polski to an extent corresponding to that applied by Narodowy Bank Polski.

7.5.4 Monetary financing and privileged access

Article 42(1) in conjunction with Article 3(2)(5) of the Law on NBP provides for Narodowy Bank Polski's powers to grant refinancing credit to banks satisfying specified conditions.[286] In addition, Article 42(3) of the Law on NBP allows Narodowy Bank Polski to grant refinancing credit for the purpose of implementing a bank recovery plan, which is initiated in the event of a bank infringing, or being likely to infringe, certain requirements relating to, among other things, own funds and liquidity ratio.[287] Granting of refinancing credit is in all cases subject to the general rules of the Law on banking, with the modifications resulting from the Law on NBP.[288] Safeguards currently contained in such rules aiming at ensuring timely repayment of the credit do not fully exclude an interpretation that would allow an extension of refinancing credit to

[284] Article 23(7)(3) of the Law on NBP.

[285] See Opinion CON/2008/53.

[286] Narodowy Bank Polski's decision whether to grant refinancing credit is based on its assessment of the bank's ability to repay the principal amount and the interest on time (Article 42(2) of the Law on NBP).

[287] Article 142(1) and (2) of the Law on banking.

[288] Article 42(7) of the Law on NBP.

a bank undergoing recovery proceedings which then becomes insolvent.[289] More explicit safeguards in relation to all financial institutions receiving liquidity support from Narodowy Bank Polski are needed to avoid incompatibility with the monetary financing prohibition under Article 123 of the Treaty.[290] The Law on NBP should be adapted to make clear that such liquidity support is only temporary and it may not be extended to insolvent financial institutions.

Article 42 of the Law on NBP in conjunction with Articles 270 and 306 of the Law on the Fund provides for Narodowy Bank Polski's powers to grant, at its discretion, short-term credit to the Bank Guarantee Fund (hereinafter the "Fund") related to the financing of its deposit guarantee function, if a threat to financial stability arises and in view of its urgent needs. Given the current features of the Fund, the provisions laid down in the Law on NBP and the Law on the Fund regarding the possibility of NBP granting loans to the Fund are not compatible with the monetary financing prohibition and should be amended accordingly. The Fund qualifies as a "body governed by public law" within the meaning of Article 123(1) of the Treaty. In particular, the Fund has all of the following characteristics: (a) it has been established for the purpose of meeting needs in the general interest – especially tasks related to financial stability, administering the deposit guarantee scheme and resolution; (b) it has legal personality; and (c) it is closely dependent on public sector entities referred to in Article 123(1) of the Treaty, as the majority of the members of the Fund's Council, which acts as the Fund's administrative board, are appointed by the Minister competent for financial institutions and the Chairman of the Financial Supervisory Authority.[291] Additionally, the Fund is included in the catalogue of entities that are part of the public sector for the purposes of the Law of 27 August 2009 on public finance.[292]

Article 220(2) of the Polish Constitution provides that "the budget shall not provide for covering a budget deficit by way of contracting credit obligations to the State's central bank". While this provision prohibits the State from financing its budgetary deficit via Narodowy Bank Polski, the ECB understands that it does not constitute an implementation of Article 123 of the Treaty prohibiting monetary financing, and its aim and function are therefore not identical to those of the said Treaty prohibition. Article 123 of the Treaty, supplemented by Council Regulation (EC) No 3603/93, is directly applicable, so in general, it is unnecessary to transpose it into national legislation.

[289] Under the Law on banking which applies to the provision of refinancing credit by Narodowy Bank Polski, a commercial bank may extend credit to an uncreditworthy borrower, provided that: (i) qualified security is established; and (ii) a recovery programme is instituted, which the crediting bank considers will ensure the borrower's creditworthiness during a specified period (Article 70(2) of the Law on banking). Furthermore, Narodowy Bank Polski may demand early repayment of any refinancing credit if the financial situation of the credited bank has worsened to the extent of putting the timely repayment at risk (Article 42(6) of the Law on NBP).

[290] See Opinion CON/2013/5.

[291] See Opinion CON/2021/17.

[292] Ustawa o finansach publicznych. Consolidated version published in Dziennik Ustaw of 2021, item 305.

7.5.5 Legal integration of the NCB into the Eurosystem

With regard to Narodowy Bank Polski’s legal integration into the Eurosystem, the Polish Constitution and the Law on NBP need to be adapted in the respects set out below.

Economic policy objectives

Article 3(1) of the Law on NBP provides that Narodowy Bank Polski’s primary objective is to maintain price stability, while supporting the economic policies of the Government, insofar as this does not constrain the pursuit of its primary objective. This provision is incompatible with Article 127(1) of the Treaty and Article 2 of the Statute, as it does not reflect the ESCB’s secondary objective of supporting the general economic policies in the Union.

Tasks

Monetary policy

Article 227(1) and (6) of the Constitution and Article 3(2)(5), Articles 12, 23 and 38 to 50a and 53 of the Law on NBP, which provide for Narodowy Bank Polski’s powers with regard to monetary policy, do not recognise the ECB’s powers in this field.

Collection of statistics

Article 3(2)(7) and Article 23 of the Law on NBP, which provides for Narodowy Bank Polski’s powers relating to the collection of statistics, do not recognise the ECB’s powers in this field.

Official foreign reserve management

Article 3(2)(2) and Article 52 of the Law on NBP, which provide for Narodowy Bank Polski’s powers in the field of foreign exchange management, do not recognise the ECB’s powers in this field.

Payment systems

Article 3(2)(1) of the Law on NBP, which provides for Narodowy Bank Polski’s powers in organising monetary settlements, does not recognise the ECB’s powers in this field.

Issue of banknotes

Article 227(1) of the Constitution and Article 4 and Articles 31 to 37 of the Law on NBP, which provide for Narodowy Bank Polski's exclusive powers to issue and withdraw banknotes and coins having the status of legal tender, do not recognise the Council's and the ECB's powers in this field.

Financial provisions

Appointment of independent auditors

Article 69(1) of the Law on NBP, which provides for the auditing of Narodowy Bank Polski, does not recognise the Council's and the ECB's powers under Article 27.1 of the Statute. The powers of the NIK to control the activities of Narodowy Bank Polski should be clearly defined by legislation and should be without prejudice to the activities of Narodowy Bank Polski's independent external auditors, as laid down in Article 27.1 of the Statute.

Exchange rate policy

Articles 3(2)(3) and 17(4)(2) and Article 24 of the Law on NBP, which provide for Narodowy Bank Polski's power to implement the exchange rate policy set in agreement with the Council of Ministers, do not recognise the Council's and the ECB's powers in this field.

International cooperation

Articles 5(1) and 11(3) of the Law on NBP, which provide for Narodowy Bank Polski's right to participate in international financial and banking institutions, do not recognise the ECB's powers in this field.

Miscellaneous

Article 9(3) of the Law on NBP, which specifies the wording of the oath sworn by Narodowy Bank Polski's President, needs to be adapted to comply with Article 14.3 of the Statute.

With regard to Article 21(4) of the Law on NBP, which provides for Narodowy Bank Polski's rights to present its opinion on draft legislation concerning the activity of banks and having significance to the banking system, it is noted that consulting Narodowy Bank Polski does not obviate the need to consult the ECB under Articles 127(4) and 282(5) of the Treaty.

7.5.6 Conclusions

The Polish Constitution, the Law on NBP and the Law on the State Tribunal do not comply with all the requirements of central bank independence, confidentiality, the monetary financing prohibition and legal integration into the Eurosystem. Poland is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.[293]

7.6 Romania

7.6.1 Compatibility of national legislation

The following legislation forms the legal basis for Banca Naţională a României and its operations:

- Law No 312/2004 on the Statute of Banca Naţională a României (hereinafter the "Law on BNR").[294]

There have been no changes in relation to the points identified in the ECB's Convergence Report of June 2020 concerning the Law on BNR, and therefore those comments are repeated in this year's assessment.

7.6.2 Independence of the NCB

With regard to Banca Naţională a României's independence, the Law on BNR and other legislation needs to be adapted in the respects set out below.

Institutional independence

Article 3(1) of the Law on BNR provides that, when carrying out their tasks, Banca Naţională a României and the members of its decision-making bodies may not seek or take instructions from public authorities or from any other institution or authority. The ECB understands that the provision encompasses both national and foreign institutions in line with Article 130 of the Treaty and Article 7 of the Statute. For legal certainty reasons, the next amendment to the Law on BNR should bring this provision fully in line with Article 130 of the Treaty and Article 7 of the Statute.

Further, Article 3 of the Law on BNR does not expressly prohibit the Government from seeking to influence the members of Banca Naţională a României's decision-making bodies in situations where this may have an impact on Banca Naţională a României's

[293] For a detailed review of necessary adaptations of the Constitution, the Law on NBP and other laws, see Opinion CON/2011/9.

[294] Published in Monitorul Oficial al României, Part One, No 582, 30.6.2004.

fulfilment of its ESCB-related tasks. In this respect the Law on BNR needs to be adapted to be fully consistent with Article 130 of the Treaty and Article 7 of the Statute.

Personal independence

Article 33(9) of the Law on BNR provides that an appeal may be brought to the High Court of Cassation and Justice against a decision to recall from office a member of the Board of Banca Naţională a României within 15 days of its publication in Monitorul Oficial al României. The Law on BNR is silent on the jurisdiction of the Court of Justice of the European Union to hear cases with regard to the dismissal of the Governor. The ECB understands that in spite of this silence, Article 14.2 of the Statute applies.

Article 33(7) of the Law on BNR provides that no member of the Board of Banca Naţională a României may be recalled from office for reasons other than or following a procedure other than those provided for in Article 33(6) of the Law on BNR. Article 33(6) of the Law on BNR contains grounds for dismissal which are compatible with those laid down in Article 14.2 of the Statute. Law 161/2003 on certain measures for transparency in the exercise of public dignities, public functions and business relationships and for the prevention and sanctioning of corruption,[295] and Law 176/2010 on the integrity in the exercise of public functions and dignities,[296] define the conflicts of interest and incompatibilities applicable to the Governor and the other members of the Board of Banca Naţională a României and require them to report on their interests and wealth. The ECB understands that the sanctions provided for in these Laws for the breach of such obligations as well as the automatic resignation mechanism in cases of incompatibility[297] do not constitute new grounds for dismissal of the Governor or other members of the Board of Banca Naţională a României in addition to those contained in Article 33 of the Law on BNR. For legal certainty reasons and in line with Article 33 of the Law on BNR, a clarification to this end in the above-mentioned Laws would be welcome.

Financial independence

Article 43 of the Law on BNR provides that each month, Banca Naţională a României must transfer to the State budget an 80% share of the net revenues left after deducting expenses relating to the financial year, including provisions for credit risk, and any losses relating to previous financial years that remain uncovered. As noted in Chapter 7.6.4, this arrangement may in certain circumstances amount to an intra-year credit, which in turn may undermine the financial independence of Banca Naţională a României.

[295] Published in Monitorul Oficial al României, Part One, No 279, 21.4.2003.

[296] Published in Monitorul Oficial al României, Part One, No 621, 2.9.2010.

[297] According to the relevant provisions of Article 99 of Law 161/2003, if a member of the Board of Banca Naţională a României or an employee occupying a leading position with Banca Naţională a României does not choose within a given period of time between their function and the one which they have declared to be incompatible with their function, they are considered to have resigned from their function and the Parliament takes note of the resignation.

A Member State may not put its NCB in a position where it has insufficient financial resources to carry out its ESCB or Eurosystem-related tasks, and also its own national tasks, such as financing its administration and own operations.

Article 43(3) of the Law on BNR also provides that Banca Naţională a României sets up provisions for credit risk in accordance with its rules, after having consulted the Ministry of Public Finance. The ECB notes that NCBs must be free to independently create financial provisions to safeguard the real value of their capital and assets.

Article 43 of the Law on BNR should therefore be adapted, in addition to taking into account the issues highlighted in Chapter 7.6.4, to ensure that such arrangement does not undermine the ability of Banca Naţională a României to carry out its tasks in an independent manner.

Pursuant to Articles 21 and 23 of Law 94/1992 on the organisation and functioning of the Court of Auditors,[298] the Court of Auditors is empowered to control the establishment, management and use of the public sector's financial resources, including Banca Naţională a României's financial resources, and to audit the management of the funds of Banca Naţională a României. The scope of audit by the Court of Auditors is further defined in Article 47(2) of the Law on BNR, which provides that commercial operations performed by Banca Naţională a României, as shown in the revenue and expenditure budget and in the annual financial statements, shall be subject to auditing by the Court of Auditors. As the provisions of Law 94/1992 on the organisation and functioning of the Court of Auditors expressly apply to Banca Naţională a României, in the interests of legal certainty it should be clarified in Romanian legislation that the scope of audit by the Court of Auditors is provided by Article 47(2) of the Law on BNR and is therefore limited to commercial operations performed by Banca Naţională a României.[299]

7.6.3 Confidentiality

Pursuant to Article 52(2) of the Law on BNR, the Governor may release confidential information on the four grounds listed. Under Article 37 of the Statute, professional secrecy is an ESCB-wide matter. Therefore, the ECB assumes that such release is without prejudice to the confidentiality obligations towards the ECB and the ESCB.

7.6.4 Monetary financing and privileged access

Articles 6(1) and 29(1) of the Law on BNR expressly prohibit direct purchase on the primary market by Banca Naţională a României of debt instruments issued by the State, central and local public authorities, autonomous public service undertakings, national societies, national companies and other majority State-owned companies. Such prohibition has been extended by Article 6(2) to other bodies governed by public law and public undertakings in Member States. Furthermore, under Article 7(2) of the

[298] Published in Monitorul Oficial al României, Part One, No 238, 3.4.2014.

[299] For the activities of the NCB's independent external auditors see, for example, Article 27.1 of the Statute.

Law on BNR, Banca Naţională a României is prohibited from granting overdraft facilities or any other type of credit facility to the State, central and local public authorities, autonomous public service undertakings, national societies, national companies and other majority State-owned companies. Article 7(4) extends this prohibition to other bodies governed by public law and public undertakings in Member States. The range of public sector entities referred to in these provisions needs to be extended to be consistent with and fully mirror Article 123 of the Treaty and aligned with the definitions contained in Regulation (EC) No 3603/93.

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

Article 26 of the Law on BNR provides that, to carry out its task of ensuring financial stability, in exceptional cases and only on a case-by-case basis, Banca Naţională a României may grant to credit institutions loans which are unsecured or secured by assets other than assets eligible to collateralise the monetary or foreign exchange policy operations of Banca Naţională a României. Article 26 does not contain sufficient safeguards to prevent such lending from potentially breaching the monetary financing prohibition contained in Article 123 of the Treaty, especially given the risk that such lending could result in the provision of solvency support to a credit institution experiencing financial difficulties, and should be adapted accordingly.

Article 43 of the Law on BNR provides that Banca Naţională a României must transfer to the State budget an 80% share of the net revenues left after deducting expenses relating to the financial year, including provisions for credit risk, and losses related to the previous financial years that remained uncovered. The 80% of the net revenues is transferred monthly before the 25th day of the following month, based on a special statement. The adjustments relating to the financial year are performed by the deadline for submission of the annual balance sheet, based on a rectifying special statement. This provision is constructed in a way which does not rule out the possibility of an intra-year anticipated profit distribution in circumstances where Banca Naţională a României accumulates profits during the first half of the year but suffers consecutive losses during the second half of the year. Although the State is under an obligation to make adjustments after the closure of the financial year and would therefore have to return any excessive distributions to Banca Naţională a României, this would only happen after the deadline for submission of the annual balance sheet and may therefore be viewed as amounting to an intra-year credit to the State. Article 43 should be adapted to ensure that such an intra-year credit is not possible to rule out the possibility of breaching the monetary financing prohibition in Article 123 of the Treaty.

7.6.5 Legal integration of the NCB into the Eurosystem

With regard to Banca Naţională a României's legal integration into the Eurosystem, the Law on BNR needs to be adapted in the respects set out below.

Economic policy objectives

Article 2(3) of the Law on BNR provides that, without prejudice to the primary objective of price stability, Banca Naţională a României must support the State's general economic policy. This provision is incompatible with Article 127(1) of the Treaty, as it does not reflect the ESCB's secondary objective of supporting the general economic policies in the Union.

Tasks

Monetary policy

Article 2(2)(a), Article 5, Articles 6(3) and 7(1), Articles 8, 19 and 20 and Article 33(1)(a) of the Law on BNR, which provide for the powers of Banca Naţională a României in the field of monetary policy and instruments for the implementation thereof, do not recognise the ECB's powers in this field.

Collection of statistics

Article 49 of the Law on BNR, which provides for the powers of Banca Naţională a României relating to the collection of statistics, does not recognise the ECB's powers in this field.

Official foreign reserve management

Articles 2(2)(e) and 9(2)(c) and Articles 30 and 31 of the Law on BNR, which provide for the powers of Banca Naţională a României relating to foreign reserve management, do not recognise the ECB's powers in this field.

Payment systems

Article 2(2)(b), Article 22 and Article 33(1)(b) of the Law on BNR, which provide for the role of Banca Naţională a României in relation to the smooth operation of payment systems, do not recognise the ECB's powers in this field.

Issue of banknotes

Article 2(2)(c) and Articles 12 to 18 of the Law on BNR, which provide for Banca Naţională a României's role in issuing banknotes and coins, do not recognise the Council's and the ECB's powers in this field.

Financial provisions

Appointment of independent auditors

Article 36(1) of the Law on BNR, which provides that the annual financial statements of Banca Naţională a României are audited by financial auditors that are legal entities authorised by the Financial Auditors Chamber in Romania and selected by the Board of Banca Naţională a României through a tender procedure, does not recognise the ECB's and the Council's powers under Article 27.1 of the Statute.

Financial reporting

Article 37(3) of the Law on BNR, which provides that Banca Naţională a României establishes the templates for the annual financial statements after having consulted the Ministry of Public Finance, and Article 40 of the Law on BNR, which provides that Banca Naţională a României adopts its own regulations on organising and conducting its accounting, in compliance with the legislation in force and having regard to the advisory opinion of the Ministry of Public Finance, and that Banca Naţională a României registers its economic and financial operations in compliance with its own chart of accounts, also having regard to the advisory opinion of the Ministry of Public Finance, do not reflect Banca Naţională a României's obligation to comply with the Eurosystem's regime for financial reporting of NCB operations, pursuant to Article 26 of the Statute.

Exchange rate policy

Article 2(2)(a) and (d), Article 9 and Article 33(1)(a) of the Law on BNR, which empower Banca Naţională a României to conduct exchange rate policy, do not recognise the Council's and the ECB's powers in this field.

Articles 10 and 11 of the Law on BNR, which allow Banca Naţională a României to draw up regulations on monitoring and controlling foreign currency transactions in Romania and to authorise foreign currency capital operations, transactions on foreign currency markets and other specific operations, do not recognise the Council's and the ECB's powers in this field.

7.6.6 Miscellaneous

With regard to Article 3(2) of the Law on BNR, which entitles Banca Naţională a României to be consulted on draft national legislation, consulting Banca Naţională a României does not obviate the need to consult the ECB under Articles 127(4) and 282(5) of the Treaty.

Article 57 of the Law on BNR does not recognise the ECB's powers to impose sanctions.

Article 4(5) of the Law on BNR entitles Banca Naţională a României to conclude short-term credit arrangements and to perform other financial and banking operations with other entities, including central banks, and provides that such arrangements are possible only if the credit is repaid within one year. The ECB notes that such a limitation is not foreseen in Article 23 of the Statute.

7.6.7 Conclusions

The Law on BNR does not comply with all the requirements for central bank independence, the monetary financing prohibition and legal integration into the Eurosystem. Romania is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty.

7.7 Sweden

7.7.1 Compatibility of national legislation

The following legislation forms the legal basis for Sveriges Riksbank and its operations:

- the Instrument of Government,[300] which forms part of the Swedish Constitution,
- the Law on Sveriges Riksbank,[301]
- the Law on exchange rate policy.[302]

The ECB notes that a proposal for a new Law on Sveriges Riksbank, together with proposed amendments to the Instrument of Government, the Law on exchange rate policy and other legislation have been included in the Swedish Government's Official Report published on 29 November 2019.[303]

[300] SFS 1974:152.

[301] SFS 1988:1385.

[302] SFS 1998:1404.

[303] SOU 2019:46 – En ny riksbankslag (A new Law on Sveriges Riksbank).

On 20 April 2020, the ECB delivered an opinion on the proposed reform of Sveriges Riksbank.[304] It states that any legislative reform in Sweden should aim to gradually achieve legal convergence with, rather than divergence from, ESCB standards, in accordance with the convergence process obligations enshrined in the Treaty.

In particular, the Parliament's (Sveriges Riksdag) right to approve or reject Sveriges Riksbank's decisions on the design of the price stability objective would be inconsistent with Article 130 of the Treaty. Furthermore, a narrow conceptualisation of monetary policy and broad conceptualisation of financial stability under the draft law, combined with the prohibition on Sveriges Riksbank seeking and taking instructions applying only within the narrowly defined area of monetary policy, does not provide the legally required compatibility with the Treaties and the Statute. The ECB has expressed particular concern that, under the draft law, Sveriges Riksbank may only build up its foreign reserves for financial stability purposes. The constraints on Sveriges Riksbank's ability to increase its foreign reserves whenever necessary, through appropriate means, in pursuance of its independently formulated monetary, foreign exchange and liquidity policies encroach on Sveriges Riksbank's independence under the Treaty and Statute in the performance of its basic monetary, foreign exchange and liquidity policies.

The Swedish Government submitted a revised legislative proposal to Sveriges Riksdag on 28 October 2021,[305] where it is now being processed. However, no changes have yet been made to Swedish legislation in relation to the points identified in the ECB's Convergence Report of June 2020, and the proposed new Law on Sveriges Riksbank and the proposed amendments to the Instrument of Government and the Law on exchange rate policy are only intended to enter into force in 2023, according to the current legislative proposal. Therefore, the comments made in the ECB's Convergence Report of June 2020 are largely repeated in this year's assessment.

7.7.2 Independence of the NCB

With regard to Sveriges Riksbank's independence, the Law on Sveriges Riksbank needs to be adapted in the respects set out below.

Institutional independence

Article 13 of Chapter 9 of the Instrument of Government states that Sveriges Riksbank is an authority under the Riksdag. Article 2 of Chapter 3 of the Law on Sveriges Riksbank, which prohibits the members of the Executive Board from seeking or taking of instructions, and Article 13 of Chapter 9 of the Instrument of Government, which prohibits any authority from giving instructions to Sveriges Riksbank, do not cover all

[304] Opinion CON/2020/13.

[305] Regeringens proposition 2021/22:41 – En ny riksbankslag (A new Law on Sveriges Riksbank).

ESCB-related tasks, as required by Article 130 of the Treaty and Article 7 of the Statute.

Although the explanatory memorandum to the Law on Sveriges Riksbank extends the coverage to all ESCB-related tasks, it would be beneficial if this issue and the relation with Article 13 of Chapter 9 of the Instrument of Government were addressed in the next amendments to the relevant provisions of Swedish legislation.

In addition, pursuant to Article 13(1) of Chapter 8 of the Instrument of Government, the Parliament may direct Sveriges Riksbank in an act of law within its sphere of responsibility under Chapter 9 (Financial power) to adopt provisions concerning its duty to promote a secure and efficient payments system. The ECB understands that this provision only enables the Parliament to assign the adoption of regulations to Sveriges Riksbank within the Sveriges Riksbank’s areas of responsibility for promoting secure and efficient payment systems.

Article 3 of Chapter 6 of the Law on Sveriges Riksbank, which establishes the right of the minister appointed by the Swedish Government to be informed prior to Sveriges Riksbank making a monetary policy decision of major importance, could potentially breach the prohibition on giving instructions to the NCBs pursuant to Article 130 of the Treaty and Article 7 of the Statute. Article 3 of Chapter 6 of the Law on Sveriges Riksbank should therefore be adapted accordingly. The Swedish Government has referred the issue to the Parliamentary Committee on Sveriges Riksbank, which has investigated how the Swedish Government may continue to be kept informed of monetary policy decisions of major importance without restricting the independence of Sveriges Riksbank. The conclusions of that investigation, including the relevant proposals, were presented in the Swedish Government’s Official Report referred to in Section 7.7.1.

Financial independence

In accordance with Article 3 of Chapter 10 of the Law on Sveriges Riksbank, the General Council of Sveriges Riksbank submits proposals to the Swedish Parliament and the Swedish National Audit Office on the allocation of Sveriges Riksbank’s profit. Pursuant to Article 4 of Chapter 10 of the Law on Sveriges Riksbank, the Swedish Parliament then determines the allocation of Sveriges Riksbank’s profit. These provisions are supplemented by non-statutory guidelines on profit distribution, which state that Sveriges Riksbank should pay 80% of its profit to the Swedish State, after adjustment for exchange rate and gold valuation effects and based on a five-year average, with the remaining 20% used to increase its own capital. However, these guidelines are not legally binding and there is no statutory provision limiting the amount of profit that may be paid out.

The present arrangements on profit distribution have been reviewed. The Swedish Government submitted a draft legislative proposal to strengthen the Sveriges Riksbank’s financial independence and balance sheet, which the ECB has reviewed and commented on.[306] After receiving extensive comments on the proposal from a number of consultation bodies, the Swedish Government appointed the Parliamentary Committee on Sveriges Riksbank to further investigate the matters addressed in the draft legislative proposal as well as to propose appropriate amendments to the Law on Sveriges Riksbank in order to enhance the financial independence and balance sheet of Sveriges Riksbank. The conclusions of that investigation, including the relevant proposals, were presented in the Swedish Government's Official Report referred to in Section 7.7.1. However, as the legislation currently stands, it is incompatible with the requirement of central bank independence in Article 130 of the Treaty and Article 7 of the Statute. To safeguard Sveriges Riksbank's financial independence, statutory provisions should be adopted containing clear provisions concerning the limitations applicable to the Swedish Parliament's decisions on Sveriges Riksbank's profit allocation.

7.7.3 Monetary financing prohibition

Article 1(3) of Chapter 8 of the Law on Sveriges Riksbank provides that Sveriges Riksbank may not extend credit or purchase debt instruments directly from the State, another public body or a Union institution. Although the explanatory memorandum to the Law on Sveriges Riksbank, which according to Swedish legal tradition will be closely followed by Swedish courts when interpreting national legislation, states that the coverage is extended to Union bodies and the public sector including public undertakings of other Member States, it would be beneficial if this issue could be addressed when the Law on Sveriges Riksbank is next amended, to bring it fully in line with Article 123 of the Treaty.

In addition, Article 1(4) of Chapter 8 of the Law on Sveriges Riksbank provides that "subject to other provisions in this Law, the Riksbank may also grant credit to and purchase debt instruments from financial institutions owned by the State or another public body". The wording of Article 1(4) of Chapter 8 of the Law on Sveriges Riksbank should be aligned with the wording of Article 123(2) of the Treaty, which only exempts publicly owned credit institutions from the prohibition on monetary financing in respect of the supply of reserves by central banks; the central bank may not supply reserves to other public financial institutions. In the same vein, the range of public sector entities would need to be made consistent with Article 123(2) of the Treaty, and the ECB suggests, for reasons of legal certainty, inserting a reference to Article 123 of the Treaty in Article 1 of Chapter 8 of the Law on Sveriges Riksbank.

As noted above, the provisions of the Law on the allocation of Sveriges Riksbank's profit are supplemented by non-statutory guidelines on profit distribution, that are not legally binding, and state that Sveriges Riksbank should pay 80% of its profit to the Swedish State, after adjustment for exchange rate and gold valuation effects and based on a five-year average, with the remaining 20% used to increase its own capital. It is essential for the five-year average rule to be applied in a way which remains consistent with the prohibition on monetary financing under Article 123 of the Treaty,

[306] See Opinion CON/2017/17.

i.e. only as a calculation method and a cap for the NCB’s profit distribution to the State budget. Statutory provisions providing for necessary limitations and ensuring that a breach of the monetary financing prohibition may not occur in this respect should also be adopted. To comply with the monetary financing prohibition, the amount distributed to the State budget pursuant to the applicable profit distribution rules cannot be paid, even partially, from the NCB’s reserve capital. Therefore, profit distribution rules should leave unaffected the NCB’s reserve capital.

7.7.4 Legal integration of the NCB into the Eurosystem

With regard to Sveriges Riksbank’s legal integration into the Eurosystem, the Law on Sveriges Riksbank, the Constitution and the Law on exchange rate policy need to be adapted in the respects set out below.

Economic policy objectives

Article 2 of Chapter 1 of the Law on Sveriges Riksbank provides that Sveriges Riksbank’s objective is to maintain price stability. The ECB notes that Article 2 should reflect the ESCB’s secondary objective of supporting the general economic policies of the Union in line with Article 127(1) of the Treaty and Article 2 of the Statute.

Article 2 of Chapter 1 of the Law on Sveriges Riksbank provides that Sveriges Riksbank shall promote a safe and efficient payments system. The ECB notes that insofar as this is a task and not an objective of the Sveriges Riksbank, there is no need to subordinate it to the ESCB’s primary and secondary objectives.

Tasks

Article 1 of Chapter 1 of the Law on Sveriges Riksbank, which provides that Sveriges Riksbank may only conduct, or participate in, such activities for which it has been authorised by Swedish law, is incompatible with the provisions of the Treaty and the Statute as it does not provide for Sveriges Riksbank’s legal integration into the Eurosystem.

Monetary policy

Article 13 of Chapter 9 of the Instrument of Government and Article 2 of Chapter 1 of the Law on Sveriges Riksbank, which establish Sveriges Riksbank’s powers in the field of monetary policy, do not recognise the ECB’s powers in this field.

Articles 2, 5 and 6 of Chapter 6 of the Law on Sveriges Riksbank, which provide for Sveriges Riksbank’s powers in the field of monetary policy, do not recognise the ECB’s powers in this field.

Article 6 of Chapter 6 and Articles 1 and 2a of Chapter 11 of the Law on Sveriges Riksbank, concerning the imposition of minimum reserves on financial institutions and the payment of a special fee to the Swedish State in the event of a breach of this requirement, do not recognise the ECB's powers in this field.

Collection of statistics

Article 4(2) and Articles 9, 10 and 11[307] of Chapter 6 of the Law on Sveriges Riksbank, which establish Sveriges Riksbank's powers relating to the collection of statistics, do not recognise the ECB's powers in this field.

Official foreign reserve management

Chapter 7 of the Law on Sveriges Riksbank, and Article 12 of Chapter 9 of the Instrument of Government, which provide for Sveriges Riksbank's powers in the field of foreign reserve management, do not recognise the ECB's powers in this field.

Payment systems

The second sentence of Article 14 of Chapter 9 of the Instrument of Government and Article 2 of Chapter 1 and Article 7 of Chapter 6 of the Law on Sveriges Riksbank, which establish Sveriges Riksbank's powers with regard to the smooth operation of payment systems, do not recognise the ECB's powers in this field.

Issue of banknotes

Article 14 of Chapter 9 of the Instrument of Government and Chapter 5 of the Law on Sveriges Riksbank, which lay down Sveriges Riksbank's exclusive right to issue banknotes and coins, do not recognise the Council's and the ECB's powers in this field.

Financial provisions

Appointment of independent auditors

The Law on Sveriges Riksbank does not recognise the Council's and the ECB's powers under Article 27.1 of the Statute.

[307] These articles have been introduced in Chapter 6 of the Law on Sveriges Riksbank by amendments which entered into force in June 2014 (SFS 2014:485).

Exchange rate policy

Article 12 of Chapter 9 of the Instrument of Government and Chapter 7 of the Law on Sveriges Riksbank, together with the Law on exchange rate policy, lay down the powers of the Swedish Government and Sveriges Riksbank in the area of exchange rate policy. These provisions do not recognise the Council's and the ECB's powers in this field.

International cooperation

Pursuant to Article 6 of Chapter 7 in the Law on Sveriges Riksbank, Sveriges Riksbank may serve as a liaison body in relation to international financial institutions of which Sweden is a member. This provision does not recognise the ECB's powers in this field.

Miscellaneous

With regard to Article 4 of Chapter 2 of the Law on Sveriges Riksbank, which provides for the General Council's right to submit consultation opinions on behalf of Sveriges Riksbank within its area of competence, it is noted that consulting Sveriges Riksbank does not obviate the need to consult the ECB under Articles 127(4) and 282(5) of the Treaty.

As specified in Chapter 2.2.4, the primacy of Union law and rules adopted thereunder also means that national laws on access by third parties to documents may not lead to infringements of the ESCB's confidentiality regime. The ECB understands that the Public Access to Information and Secrecy Act[308] and any other relevant Swedish legislation will permit Sveriges Riksbank to apply it in a manner that ensures compliance with the ESCB's confidentiality regime.

7.7.5 Conclusions

The Law on Sveriges Riksbank, the Swedish Instrument of Government and the Law on exchange rate policy do not comply with all the requirements for central bank independence, the monetary financing prohibition and legal integration into the Eurosystem. Sweden is a Member State with a derogation and must therefore comply with all adaptation requirements under Article 131 of the Treaty. The ECB notes that the Treaty has obliged Sweden to adopt national legislation for integration into the Eurosystem since 1 June 1998. Over the years no legislative action has been taken by the Swedish authorities to remedy the incompatibilities described in this and previous reports. At present it is not clear to what extent the legislative proposal referred to in Section 7.7.1 may result in such legislative action. Although the proposals contained in

[308] SFS 2009:400.

that legislative proposal should aim to achieve the required legal convergence, they would not do so as they stand.[309]

[309] Opinion CON/2020/13.

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Postal address 60640 Frankfurt am Main, Germany
Telephone +49 69 1344 0
Website www.ecb.europa.eu

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For terminology and abbreviations, please refer to the ECB glossary.

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Conventions used in the tables

“-” data do not exist/data are not applicable
“.” data are not yet available

Anlage 4

EUROPEAN
COMMISSION

Brussels, 1.6.2022
COM(2022) 282 final

2022/0179 (NLE)

Proposal for a

COUNCIL DECISION

on the adoption by Croatia of the euro on 1 January 2023

EXPLANATORY MEMORANDUM

1. CONTEXT OF THE PROPOSAL

On 3 May 1998, the Council decided that Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Austria and Finland fulfilled the necessary conditions for the adoption of the euro on 1 January 1999. Denmark and the United Kingdom made use of their opt-out clauses and were therefore not assessed by the Council. Greece and Sweden were considered by the Council as Member States with a derogation.

On 19 June 2000, the Council decided that Greece fulfilled the necessary conditions to adopt the euro on 1 January 2001. The countries that joined the European Union on 1 May 2004 (the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia) became Member States with a derogation in accordance with Article 4 of the respective Act of Accession.

On 11 July 2006, the Council decided that Slovenia fulfilled the necessary conditions to adopt the euro on 1 January 2007.

Bulgaria and Romania, who joined the European Union on 1 January 2007, became Member States with a derogation in accordance with Article 5 of the respective Act of Accession.

On 10 July 2007, the Council decided that Cyprus and Malta fulfilled the necessary conditions to adopt the euro on 1 January 2008.

On 8 July 2008, the Council decided that Slovakia fulfilled the necessary conditions for adopting the euro as of 1 January 2009.

On 13 July 2010, the Council decided that Estonia fulfilled the necessary conditions for adopting the euro as of 1 January 2011.

Croatia joined the European Union on 1 July 2013 and became a Member State with a derogation in accordance with Article 5 of the Act of Accession.

On 9 July 2013, the Council decided that Latvia fulfilled the necessary conditions for adopting the euro as of 1 January 2014.

On 23 July 2014, the Council decided that Lithuania fulfilled the necessary conditions for adopting the euro as of 1 January 2015.

Article 140(1) of the Treaty on the Functioning of the European Union ('the Treaty') states that at least once every two years or at the request of a Member State with a derogation, the Commission and the European Central Bank have to report to the Council on the progress made by Member States with a derogation in fulfilling their obligations regarding the achievement of economic and monetary union.

Based on its own report and that of the ECB, the Commission should submit to the Council a proposal for a Council decision, in accordance to the procedure laid down in Article 140(2) of the Treaty, to abrogate the derogation of the Member States fulfilling the necessary conditions.

Both the Commission and the ECB convergence reports were released on 1 June 2022. The reports include an examination of the compatibility between Croatia's national legislation, including the statutes of its national central bank, with Articles 130 and 131 of the Treaty and the Statute of the ESCB and of the ECB.

The reports also examine whether a high degree of sustainable convergence has been achieved, by reference to the fulfilment of the convergence criteria, and take account of several other factors required under the final sub-paragraph of Article 140(1) of the Treaty.

In its convergence report, the Commission concludes that Croatia fulfils the conditions for the adoption of the euro.

On the basis of its report and that of the ECB, the Commission has adopted the attached proposal for a Council decision to abrogate the derogation of Croatia, with effect from1 January 2023.

2. RESULTS OF CONSULTATIONS WITH THE INTERESTED PARTIES AND IMPACT ASSESSMENT

Discussions with Member States on economic policy challenges in Member States are held under various headings on a regular basis in the Economic and Financial Committee (EFC) and the ECOFIN/Eurogroup. These include informal discussions on issues specifically relevant to the preparation of eventual euro-area entry (including exchange rate policies). Dialogue with academics and other interested groups takes place in conferences/seminars and on an ad-hoc basis.

Economic developments in the euro area and the Member States are assessed through the various procedures of economic policy coordination and surveillance (notably under Art. 121 of the Treaty), as well as in the context of the Commission's regular monitoring and analysis of country-specific and area-wide developments (including forecasts, regular publication series, and input to the EFC and ECOFIN/Eurogroup). In accordance with the proportionality principle and in line with past practice, no formal impact assessment has been carried out.

3. LEGAL ELEMENTS OF THE PROPOSAL

3.1. Legal basis

The legal basis for this proposal is Article 140(2) of the Treaty, which lays down the procedure for a Council decision on euro adoption and for abrogating the derogation in the concerned Member States.

The Council shall act on a proposal from the Commission, after consulting the European Parliament, after discussion in the European Council and after having received a recommendation of a qualified majority of those among its members representing Member States whose currency is the euro.

3.2. Subsidiarity and proportionality

The proposal falls under the exclusive competence of the Union. The subsidiarity principle therefore does not apply.

This initiative does not go beyond what is necessary to achieve its objective and, therefore, complies with the proportionality principle.

3.3. Choice of legal instrument

A Decision is the only appropriate legal instrument according to Article 140(2) of the Treaty.

4. BUDGETARY IMPLICATION

The proposal has no implications for the budget of the Union.

2022/0179 (NLE)

Proposal for a

COUNCIL DECISION

on the adoption by Croatia of the euro on 1 January 2023

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 140(2) thereof,

Having regard to the proposal from the European Commission,

Having regard to the report from the European Commission ([1])

Having regard to the report from the European Central Bank ([2])

Having regard to the opinion of the European Parliament,

Having regard to the discussion in the European Council,

Having regard to the recommendation of the members of the Council representing Member States whose currency is the euro,

Whereas:

(1) The third stage of economic and monetary union ('EMU') started on 1 January 1999. The Council, meeting in Brussels on 3 May 1998 in the composition of Heads of State or Government, decided that Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland fulfilled the necessary conditions for adopting the euro on 1 January 1999 ([3]).

(2) By Decision 2000/427/EC ([4]) the Council decided that Greece fulfilled the necessary conditions for adopting the euro on 1 January 2001. By Decision 2006/495/EC ([5]) the Council decided that Slovenia fulfilled the necessary conditions for adopting the euro on 1 January 2007. By Decisions 2007/503/EC ([6]) and 2007/504/EC ([7]) the Council decided that Cyprus and Malta fulfilled the necessary conditions for adopting the euro on 1 January 2008. By decision 2008/608/EC ([8]) the Council decided that Slovakia

[1] Report of 1 June 2022 (not yet published in the Official Journal).

[2] Report of 1 June 2022 (not yet published in the Official Journal).

[3] Council Decision 98/317/EC of 3 May 1998 in accordance with Article 109j(4) of the Treaty (OJ L 139, 11.5.1998, p. 30).

[4] Council Decision 2000/427/EC of 19 June 2000 in accordance with Article 122(2) of the Treaty on the adoption by Greece of the single currency on 1 January 2001 (OJ L 167, 7.7.2000, p. 19).

[5] Council Decision 2006/495/EC of 11 July 2006 in accordance with Article 122(2) of the Treaty on the adoption by Slovenia of the single currency on 1 January 2007 (OJ L 195, 15.7.2006, p. 25).

[6] Council Decision 2007/503/EC of 10 July 2007 in accordance with Article 122(2) of the Treaty on the adoption by Cyprus of the single currency on 1 January 2008 (OJ L 186, 18.7.2007, p. 29).

[7] Council Decision 2007/504/EC of 10 July 2007 in accordance with Article 122(2) of the Treaty on the adoption by Malta of the single currency on 1 January 2008 (OJ L 186, 18.7.2007, p. 32).

[8] Council Decision 2008/608/EC of 8 July 2008 in accordance with Article 122(2) of the Treaty on the adoption by Slovakia of the single currency on 1 January 2009 (OJ L 195, 24.7.2008, p. 24).

fulfilled the necessary conditions for adopting the euro. By decision 2010/416/EU [9] the Council decided that Estonia fulfilled the necessary conditions for adopting the euro. By decision 2013/387/EU [10] the Council decided that Latvia fulfilled thenecessary conditions for adopting the euro. By decision 2014/509/EU [11] the Council decided that Lithuania fulfilled the necessary conditions for adopting the euro.

(3) In accordance with paragraph 1 of the Protocol on certain provisions relating toDenmark annexed to the Treaty establishing the European Community and the Decision taken by the Heads of State or Government in Edinburgh in December 1992, Denmark has notified the Council that it will not participate in the third stage of EMU.Denmark has not requested that the procedure referred to in Article 140(2) of the Treaty on the Functioning of the European Union (TFEU) be initiated.

(4) By virtue of Decision 98/317/EC Sweden has a derogation as defined in Article 139(1) TFEU. In accordance with Article 4 of the 2003 Act of Accession [12], the Czech Republic, Hungary and Poland have derogations as defined in Article 139(1) TFEU. In accordance with Article 5 of the 2005 Act of Accession [13], Bulgaria and Romania have derogations as defined in Article 139(1) TFEU. In accordance with Article 5 of the 2012 Act of Accession [14], Croatia has a derogation as defined in Article 139(1) TFEU.

(5) The European Central Bank ('ECB') was established on 1 July 1998. The European Monetary System has been replaced by an exchange rate mechanism, the setting-up of which was agreed by a resolution of the European Council on the establishment of an exchange-rate mechanism in the third stage of economic and monetary union of 16 June 1997 [15]. The procedures for an exchange-rate mechanism in stage three of economic and monetary union (ERM II) were laid down in the Agreement of 16 March 2006 between the European Central Bank and the national central banks of the Member States outside the euro area laying down the operating procedures for an exchange rate mechanism in stage three of economic and monetary union.[16]

(6) Article 140(2) TFEU lays down the procedures for abrogation of the derogation of the Member States concerned. At least once every two years, or at the request of a Member State with a derogation, the Commission and the ECB shall report to the Council in accordance with the procedure laid down in Article 140(1) TFEU.

(7) National legislation in the Member States, including the statutes of national central banks, is to be adapted as necessary with a view to ensuring compatibility with Articles 130 and 131 TFEU and with the Statute of the European System of Central Banks and of the European Central Bank ('Statute of the ESCB and of the ECB'). The reports of the Commission and the ECB provide a detailed assessment of the compatibility of the legislation of Croatia with Articles 130 and 131 of the Treaty and with the Statute of the ESCB and of the ECB.

[9] Council Decision 2010/416/EU of 13 July 2010 in accordance with Article 140(2) of the Treaty on the adoption by Estonia of the euro on 1 January 2011 (OJ L 196, 28.7.2010, p. 24).

[10] Council Decision 2013/387/EU of 9 July 2013 on the adoption by Latvia of the euro on 1 January 2014 (OJ L 195, 18.7.2013, p. 24).

[11] Council Decision 2014/509/EU of 23 July 2014 on the adoption by Lithuania of the euro on 1 January 2014 (OJ L 228, 31.7.2014, p. 29).

[12] OJ L 236, 23.9.2003, p. 33.

[13] OJ L 157, 21.6.2005, p. 203.

[14] OJ L 112, 24.4.2012, p. 21.

[15] OJ C 236, 2.8.1997, p. 5.

[16] OJ C 73, 25.3.2006, p. 21.

(8) In accordance with Article 1 of Protocol No 13 on the convergence criteria referred to in Article 140 TFEU, the criterion on price stability referred to in the first indent of Article 140(1) TFEU means 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 one and a half percentage points that of, at most, the three best performing Member States in terms of price stability. For the purpose of the criterion on price stability, inflation is measured by the harmonised indices of consumer prices (HICPs) defined in Regulation (EU) 2016/792 of the European Parliament and of the Council ([17]). To assess the price stabilitycriterion, a Member State's inflation is measured by the percentage change in the arithmetic average of 12 monthly indices, relative to the arithmetic average of 12 monthly indices from the previous period. A reference value calculated as the simple arithmetic average of the inflation rates of the three best-performing Member States in terms of price stability, plus 1,5 percentage points, was used in the reports of the Commission and the ECB. In the one-year period ending in April 2022, the inflation reference value was calculated to be 4,9 per cent, with France, Finland and Greece as the three best-performing Member States in terms of price stability, with inflation ratesof 3,2 per cent, 3,3 per cent and 3,6 per cent, respectively. It is warranted to exclude from the best performers countries whose inflation rates cannot be seen as a meaningful benchmark for other Member States. Such outliers were in the past identified in 2004, 2010, 2013, 2014 and 2016. Currently, it is warranted to exclude Malta and Portugal from the best performers ([18]). For the calculation of the reference value, they are replaced by Finland and Greece, the Member States with the next- lowest average inflation rates.

(9) In accordance with Article 2 of Protocol No 13, the criterion on the government budgetary position referred to in the second indent of Article 140(1) TFEU requires that, at the time of the examination, the Member State not be the subject of a Council decision under Article 126(6) TFEU that an excessive deficit exists.

(10) In accordance with Article 3 of Protocol No 13, the criterion on participation in the exchange-rate mechanism of the European Monetary System referred to in the third indent of Article 140(1) TFEU requires a Member State to have complied with the normal fluctuation margins provided for by the exchange-rate mechanism (ERM) of the European Monetary System, without severe tensions, for at least the last two years before the examination. In particular, the Member State must not have devalued its currency's bilateral central rate against the euro on its own initiative for the same period. Since 1 January 1999, the ERM II provides the framework for assessing the fulfilment of the exchange rate criterion. In assessing the fulfilment of this criterion in their reports, the Commission and the ECB have examined the two-year period ending on 18 May 2022.

(11) In accordance with Article 4 of Protocol No 13, the criterion on the convergence of interest rates referred to in the fourth indent of Article 140(1) TFEU requires that, observed over a period of one year before the examination, a Member State have had an average nominal long-term interest rate that does not exceed by more than two percentage points that of, at most, the three best performing Member States in terms of

[17] Regulation (EU) 2016/792 of the European Parliament and of the Council of 11 May 2016 on harmonised indices of consumer prices and the house price index, and repealing Council Regulation (EC) No 2494/95 (OJ L 135, 24.05.2016, p.11).

[18] In April 2022, the 12-month average inflation rates of Malta and Portugal were respectively 2,1% and 2,6% and that of the euro area 4,4%.

price stability. The criterion used to assess the convergence of interest rates was comparable interest rates on ten-year benchmark government bonds. To assess the fulfilment of the interest-rate criterion, a reference value calculated as the simple arithmetic average of the nominal long-term interest rates of the three best performing Member States in terms of price stability, plus two percentage points, was considered in the reports of the Commission and the ECB. The reference value is based on the long-term interest rates in France (0,3 per cent), Finland (0,2 per cent) and Greece (1,4per cent) and in the one-year period ending in April 2022 it was 2,6 per cent.

(12) In accordance with Article 5 of Protocol No 13, the data used in assessing the fulfilment of the convergence criteria is to be provided by the Commission. The Commission provided that data. Budgetary data were provided by the Commission after reporting by the Member States before 1 April 2022, in accordance with Council Regulation (EC) No 479/2009. ([19])

(13) On the basis of reports presented by the Commission and the ECB on the progress made by Croatia in fulfiling its obligations regarding the achievement of economic and monetary union, it is concluded that:

(a) in Croatia, national legislation, including the Statute of the national central bank, is compatible with Articles 130 and 131 of the Treaty and with the Statute of the ESCB and of the ECB;

(b) regarding the fulfilment by Croatia of the convergence criteria mentioned in the four indents of Article 140(1) TFEU:

– the average inflation rate in Croatia in the year ending in April 2022 stood at4,7 per cent, which is below the reference value, and it is likely to remain below the reference value in the months ahead,

– Croatia is not the subject of a Council decision on the existence of an excessive deficit,

– Croatia has been a member of ERM II since 10 July 2020. During the two years preceding the assessment, the kuna exchange rate (HRK) has not been subject to severe tensions and Croatia has not devalued the HRK bilateral central rate against the euro on its own initiative,

– in the year ending April 2022, the long-term interest rate in Croatia was, on average, 0,8 per cent, which is well below the reference value.

(c) in the light of the assessment on legal compatibility and on the fulfilment of the convergence criteria as well as the additional factors, Croatia fulfils the necessary conditions for the adoption of the euro,

HAS ADOPTED THIS DECISION:

Article 1

Croatia fulfils the necessary conditions for the adoption of the euro. The derogation in favour of Croatia referred to in Article 5 of the 2012 Act of Accession is abrogated with effect from 1 January 2023.

([19]) Council Regulation (EC) No 479/2009 of 25 May 2009 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community (OJ L 145, 10.6.2009, p. 1).

Article 2

This Decision is addressed to the Member States.

Done at Brussels,

For the Council
The President

Anlage 5

EUROPEAN
COMMISSION

Brussels, 1.6.2022
COM(2022) 281 final

2022/0178 (NLE)

Proposal for a

COUNCIL REGULATION

amending Regulation (EC) No 974/98 as regards the introduction of the euro in Croatia

EXPLANATORY MEMORANDUM

1. CONTEXT OF THE PROPOSAL

On 1 June 2022, the Commission released a proposal for a Council Decision in accordance with Article 140(2) of the Treaty on the Functioning of the European Union (‘the Treaty’), indicating that Croatia fulfils the necessary conditions for the adoption of the euro and that the derogation of Croatia is abrogated with effect from 1 January 2023.

In the event of a positive decision, the Council will subsequently have to take the other measures necessary for the introduction of the euro in Croatia.

Council Regulation (EC) No 974/98 on the introduction of the euro[1] governs the initial introduction of the euro in the first-wave euro-area Member States and Greece[2]. That Regulation was amended by:

- Regulation (EC) No 2169/2005, in order to prepare for future enlargements of the euro area
- Regulation (EC) No 1647/2006, to cover Slovenia (which adopted the euro on 1 January 2007)
- Regulation (EC) No 835/2007, to cover Cyprus (which adopted the euro on 1 January 2008)
- Regulation (EC) No 836/2007, to cover Malta (which adopted the euro on 1 January 2008)
- Regulation (EC) No 693/2008, to cover Slovakia (which adopted the euro in January 2009)
- Regulation (EU) No 670/2010, to cover Estonia (which adopted the euro in January 2011)
- Regulation (EU) No 678/2013, to cover Latvia (which adopted the euro in January 2014)
- Regulation (EU) No 827/2014, to cover Lithuania (which adopted the euro in January 2015).

For Croatia to also be covered by Regulation (EC) No 974/98, a reference to this Member State needs to be added to that Regulation. This proposal contains the necessary amendments to that Regulation.

Croatia's National Euro Changeover Plan specifies that the ‘big bang’ scenario should be applicable, i.e. that the adoption of the euro as the currency of Croatia and the introduction of euro banknotes and coins in Croatia should coincide.

2. RESULTS OF CONSULTATIONS WITH THE INTERESTED PARTIES AND IMPACT ASSESSMENT

Discussions with Member States on economic policy challenges in Member States are held under various headings on a regular basis in the Economic and Financial

[1] OJ L 139, 11.5.1998, p. 1.

[2] Cf. Council Regulation (EC) No 2596/2000 of 27 November 2000 amending Council Regulation (EC) No 974/98 on the introduction of the euro (OJ L 300, 29.11.2000, p, 2).

Committee (EFC) and the ECOFIN/Eurogroup. These include informal discussions on issues specifically relevant to the preparation of eventual euro area entry (including exchange rate policies). Dialogue with academics and other interested groups takes place conferences/seminars and on an ad-hoc basis.

Economic developments in the euro area and the Member States are assessed through the various procedures of economic policy coordination and surveillance (notably under Art. 121 of the Treaty), as well as in the context of the Commission's regular monitoring and analysis of country-specific and area-wide developments (including forecasts, regular publication series, and input to the EFC and ECOFIN/Eurogroup). In accordance with the proportionality principle and in line with past practice, no formal impact assessment is necessary.

3. LEGAL ELEMENTS OF THE PROPOSAL

3.1. Legal basis

The legal basis for this proposal is Article 140(3) of the Treaty, which allows for the adoption of the other measures necessary for the introduction of the euro in the Member State the derogation of which has been abrogated under Article 140(2) of the Treaty.

The Council shall act with the unanimity of the Member States whose currency is the euro and the Member State concerned, on a proposal from the Commission and after consulting the ECB.

3.2. Subsidiarity and proportionality

The proposal falls under the exclusive competence of the Union. The subsidiarity principle therefore does not apply.

This initiative does not go beyond what is necessary to achieve its objective and, therefore, complies with the proportionality principle.

3.3. Choice of legal instrument

A Regulation is the only appropriate legal instrument for amending Council Regulation (EC) No 974/98 on the introduction of the euro.

4. BUDGETARY IMPLICATION

The proposal has no implications for the budget of the Union.

5. COMMENTARY ON INDIVIDUAL ARTICLES

5.1. Article 1

In accordance with Article 1 lit. (a) and with Article 1a of Regulation (EC) No 974/98, the table in the Annex to that Regulation lists the participating Member States and defines the euro adoption date, the cash changeover date, and the 'phasing-out' period, if applicable, for all these Member States.

According to Article 1 lit. (i) of Regulation (EC) No 974/98, a 'phasing-out' period can only apply to Member States where the euro adoption date and the cash changeover date fall on the same day. This was not the case for the eleven Member States that adopted the euro on 1 January 1999, nor for Greece, which adopted the euro on 1 January 2001.

Slovenia, Cyprus, Malta, Slovakia, Estonia, Latvia and Lithuania's euro adoption date and cash changeover date coincided (1 January 2007 for Slovenia, 1 January 2008 for Cyprus and Malta, 1 January 2009 for Slovakia, 1 January 2011 for Estonia,1 January 2014 for Latvia, 1 January 2015 for Lithuania), but the countries chose not to have a 'phasing-out' period.

Also Croatia's National Euro Changeover Plan sets the same date for the euro adoption date and for the cash changeover date (1 January 2023), and Croatia has chosen not to have a 'phasing-out' period.

This Article adds Croatia and the following relevant data for this Member State to the table in the Annex to Regulation (EC) No 974/98 in protocol order.

Member State	Euro adoption date	Cash changeover date	Member State with a 'phasing-out' period
'Croatia	1 January 2023	1 January 2023	No'

5.2. Article 2

This Article sets the date of entry into force of the Regulation as 1 January 2023, ensuring that it will be applicable in conformity with the timing of the other Council acts relating to the adoption of the euro by Croatia, i.e. the date of on which the derogation is abrogated and the date on which the conversion rate for the Croatian kuna enters into force.

2022/0178 (NLE)

Proposal for a

COUNCIL REGULATION

amending Regulation (EC) No 974/98 as regards the introduction of the euro in Croatia

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 140(3) thereof,

Having regard to the proposal from the European

Commission, Having regard to the opinion of the European

Central Bank, Whereas:

(1) Council Regulation (EC) No 974/98 ([3]) provides for the substitution of the euro for the currencies of the Member States which fulfiled the necessary conditions for the adoption of the euro at the time when the Community entered the third stage of economic and monetary union.

(2) According to Article 5 of the 2012 Act of Accession, Croatia is a Member State with a derogation, as defined in Article 139(1) of the Treaty on the Functioning of the European Union (the 'Treaty').

(3) Pursuant to Council Decision 2022/…/EU of … … 2022 on the adoption by Croatia of the euro on 1 January 2023 ([4]), Croatia fulfils the necessary conditions for the adoption of the euro and the derogation in favour of Croatia is to be abrogated with effect from 1 January 2023.

(4) The introduction of the euro in Croatia requires the extension to Croatia of the existing provisions on the introduction of the euro that are set out in Regulation (EC) No 974/98.

(5) Croatia's National Euro Changeover Plan specifies that euro banknotes and coins should become legal tender in that Member State on the day of the introduction of the euro as its currency. Consequently, the euro adoption date and the cash changeover date shall be 1 January 2023. No 'phasing-out' period should apply.

(6) Regulation (EC) No 974/98 should therefore be amended accordingly,

HAS ADOPTED THIS REGULATION:

Article 1

The Annex to Regulation (EC) No 974/98 is amended by inserting the following row in the table between the entries for France and Ireland:

[3] Council Regulation (EC) No 974/98 of 3 May 1998 on the introduction of the euro (OJ L 139, 11.5.1998, p. 1).

[4] OJ L […], […], p. […].

‘Croatia	1 January 2023	1 January 2023	No’

Article 2

This Regulation shall enter into force on 1 January 2023.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels,

For the Council
The President

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