



Council of the
European Union

Brussels, 13 June 2022
(OR. en)

10055/22

LIMITE

ECOFIN 605
UEM 177

Interinstitutional Files:
2022/0178 (NLE)
2022/0179 (NLE)

NOTE

From: General Secretariat of the Council
To: Permanent Representatives Committee (part 2)/Council
Subject: DRAFT Letter from the ECOFIN President to the European Council
Euro area enlargement – Croatia

Delegations will find attached a draft letter from the Council (Ecofin) President to the European Council regarding the euro area enlargement (Croatia).



ECONOMIC AND FINANCIAL COMMITTEE

THE SECRETARIAT

Brussels, 17 June 2022

DRAFT

***Letter from the ECOFIN President
to the European Council***

Euro area enlargement – Croatia

In accordance with the procedures laid down in Article 140 of the Treaty on the Functioning of the European Union (TFEU or the Treaty), the Council (ECOFIN) discussed the Convergence Reports prepared by the Commission and the European Central Bank (ECB), in particular assessing the state of convergence achieved by the Croatian economy as well as the Commission proposals for abrogating the derogation of Croatia with effect from 1 January 2023.

I would like to inform you under my own responsibility about the main elements of the Ministers' discussion at the Ecofin Council held on 17 June. This summary does not represent a formal position of the Council (ECOFIN), but is intended to inform the European Council about our deliberations. The Council will take the formal decisions on this matter in the course of July, taking into account the opinions of the European Parliament and the ECB as well as the discussion by the European Council and the recommendation of euro area Member States under Article 140(2) TFEU. Ministers have discussed economic developments in Croatia and assessed the level of the country's convergence. The discussion underlined the following elements:

- **Public finances:** Due to the COVID-19 crisis, the general government deficit swung sharply in a deficit in 2020 (7.3%). 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 temporary emergency measures. Croatia's 2022 Convergence 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. The Commission's Spring 2022 Economic Forecast expects the general government deficit to narrow further to 2.3% of GDP in 2022 and to 1.8% in 2023. This is expected to bring general government public debt down to 73.1% of GDP in 2023 according to the Commission's forecast, very close to the pre-COVID level recorded in 2019, and to decline until the mid 2020s, assuming a favourable interest-growth rate differential. 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.
- **Price stability:** In April 2022, the 12-month average inflation rate was 4.7%, below the reference value of 4.9%. In general, inflation developments in Croatia have been closely aligned with those of the euro area over the decade preceding the COVID-19 crisis. Croatian inflation has diverged from that of the euro area in recent months, partially as a consequence of higher food prices, but also reflecting a stronger economic recovery than in the euro area. However, the inflation rate is projected to remain below the reference value in the months ahead and close to the euro area average in both 2022 and 2023. Croatia's successful integration in the euro area will require the continued monitoring of a number of upside risks in terms of inflation and appropriate policies to accompany the catching-up process. There is scope to better align wage-setting with productivity developments, taking into account the role of the public sector as the wage leader. The implementation of the Recovery and Resilience Plan (RRP) is expected to mitigate inflationary risks, as many reforms included in the RRP have scope to enhance competition on the market and reduce costs for companies, thus putting some downward pressures on prices of final products in the long run.

- **Exchange rate stability:** 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 $\pm 15\%$. Over the last two years, the kuna has remained broadly stable and fluctuated in a narrow band of less than $\pm 1\%$ around its central rate against the euro. Upon ERM II entry, the authorities committed to post-entry commitments, with the aim of achieving a high degree of sustainable economic convergence ahead of the euro adoption. The Commission presented its assessment according to which the commitments had been fully implemented.
- **Long-term interest rates:** The average long-term interest rate in Croatia in the year to April 2022 stood at 0.8%, 1.8 percentage points below the reference value of 2.6%.
- **National legislation**, including the statute of Croatia's national central bank, is fully compatible with Articles 130 and 131 TFEU and with the Statute of the European System of Central Banks and of the European Central Bank.

Additional factors, to which the Treaty refers, including balance of payments developments and product and financial market integration, have also been examined. Croatia's economy is well integrated within the EU economy, however in 2021 Croatia was proposed for an in-depth review under the Macroeconomic Imbalance Procedure due to the fact that 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. Croatia's RRP should facilitate reforms in different areas and thus support the further unwinding of macroeconomic imbalances in the medium term. 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 and the net international investment position (NIIP) returned to an upward trajectory. A range of RRP reforms should help improve the fiscal framework, the cost effectiveness in the public sector, access to financing, strengthen its AML framework 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. The authorities should ensure timely and full implementation of the reforms envisaged in the RRP.

In the light of this analysis, ECOFIN Ministers share the Commission and ECB assessment that Croatia has achieved legal compatibility and respects the convergence criteria and, also taking into account the additional factors, consider that Croatia fulfils the necessary conditions for the adoption of the euro.

Ministers also stressed the importance of the post-entry commitments, made by Croatia in July 2020 upon entry into ERM-II, which were deemed of high relevance for achieving a high degree of sustainable economic convergence and for a successful participation in the third stage of the Economic and Monetary Union. In particular this includes measures to strengthen the anti-money laundering framework following the transposition of the 5th Anti-Money Laundering Directive, reduction of the administrative and financial burden for the economy through further simplification of administrative procedures and reduction of parafiscal and non-tax charges, improvement of corporate governance of state-owned enterprises; and strengthening the national insolvency framework in line with Directive (EU) 2019/1023.

Ministers support the Commission proposals to abrogate the derogation of Croatia with effect from 1 January 2023 and welcome the enlargement of the euro area to Croatia.

Ministers welcome the recommendation adopted by Members of the Council representing Member States whose currency is the euro. They strongly encourage the Croatian authorities to pursue, for the period beyond 2023, a fiscal policy aimed at achieving prudent medium-term fiscal positions and to implement further structural reforms and investments included in Croatia's RRP and sound micro- and macro-prudential policies to maintain sustainable convergence, in particular inflation convergence, and to ensure a successful participation in the monetary union. Ministers welcome the firm commitment of the Croatian authorities to this effect.