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COVER NOTE

From:	Ms Christine LAGARDE, President of the European Central Bank
date of receipt:	1 June 2022
To:	Mr Charles MICHEL, President of the European Council
Subject:	ECB Convergence Report 2022

Delegations will find attached the 2022 Convergence Report by the European Central Bank and the accompanying cover letter by ECB President Christine Lagarde.

Encl.:

Cover letter
ECB Convergence Report June 2022

E-MAIL



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Christine Lagarde
President

Mr Charles Michel
President of the European Council
Rue de la Loi 175
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Frankfurt am Main, 31 May 2022

Dear Mr. Michel,

In accordance with Article 140 of the Treaty on the Functioning of the European Union, the European Central Bank (ECB) shall report to the Council of the European Union at least once every two years "on the progress made by the Member States with a derogation in fulfilling their obligations regarding the achievement of economic and monetary union".

Against this background, you will receive the English version of the ECB's Convergence Report 2022, as adopted by the ECB General Council, in advance of its publication through a secure platform in view of its discussion – along with the European Commission's Convergence Report – at the meeting of the ECOFIN Council on 17 June and the European Council on 23-24 June. Please note that the report is under embargo until its release via the websites of the ECB and the National Central Banks on 1 June at 17:00. We will inform you in case the embargo is lifted earlier.

I am also transmitting an advance copy of the ECB's Convergence Report to the Presidents of the ECOFIN Council, the European Parliament, and the European Commission.

Yours sincerely,

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Convergence Report

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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 2014³ 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 2241, 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 2241, 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 2022⁷, 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 1467/97⁹ as amended by Regulation (EU) No 1177/2011¹⁰, 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 1466/97¹² 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/EU¹³. 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 4¹⁹ and 5²⁰ 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 provisions²⁴ 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 Latvija*, C-202/18, EU:C:2019:139, paragraph 76.

³⁹ See *Rimšēvičs v Latvija*, 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 equity⁵¹ 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 provides⁵³ 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 Assistance⁵⁴).

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 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 auditors⁶² 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 covered⁶⁶ 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 tasks⁹⁷ or tasks relating to those supervisory tasks, such as those relating to consumer protection in the area of financial services⁹⁸ or compliance of credit institutions with loan restructuring requirements,⁹⁹ supervision over credit-acquiring companies¹⁰⁰ 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 schemes¹¹¹, 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 Directive¹²⁶ and the Investor Compensation Schemes Directive¹²⁷ 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 Națională 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/2014/60¹⁴⁶ 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 euro¹⁵⁰ 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 reserves¹⁶² 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 requirements¹⁶³ 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 assets¹⁶⁹ 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.

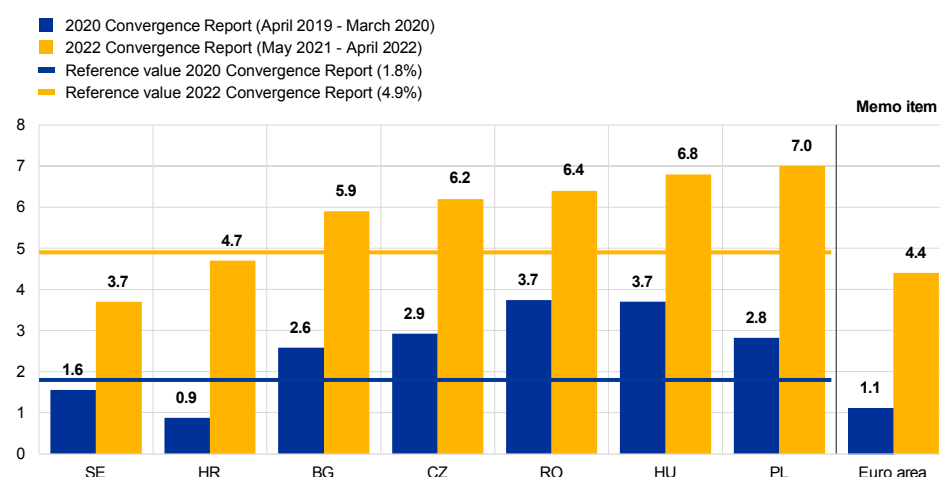
After the publication of the previous Convergence Report in 2020, the EU experienced a longer than initially expected COVID-19 shock, which led to a significant drop-in economic activity in 2020, from which all the countries under review rebounded strongly. More recently, however, the outbreak of the 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.

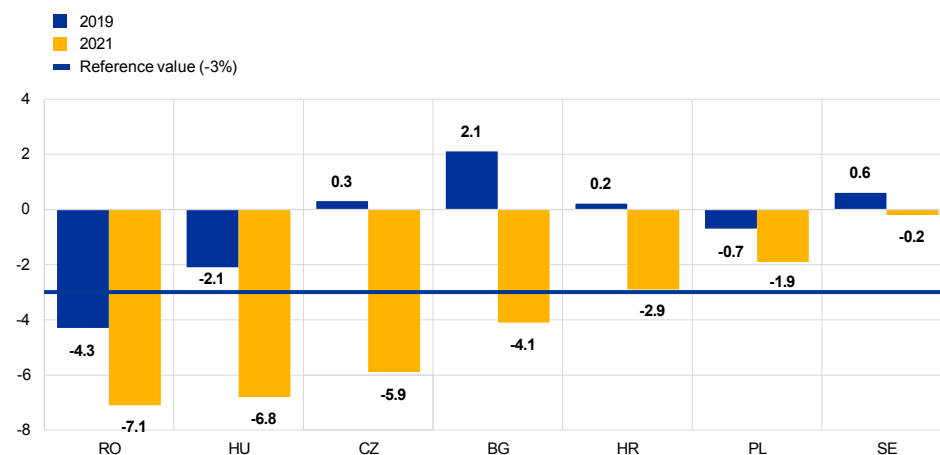
At the time of publication of this report, only Romania is subject to an excessive deficit procedure. Although four of the countries under review exceeded the

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 budget 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 (-)**

(percentages of GDP)

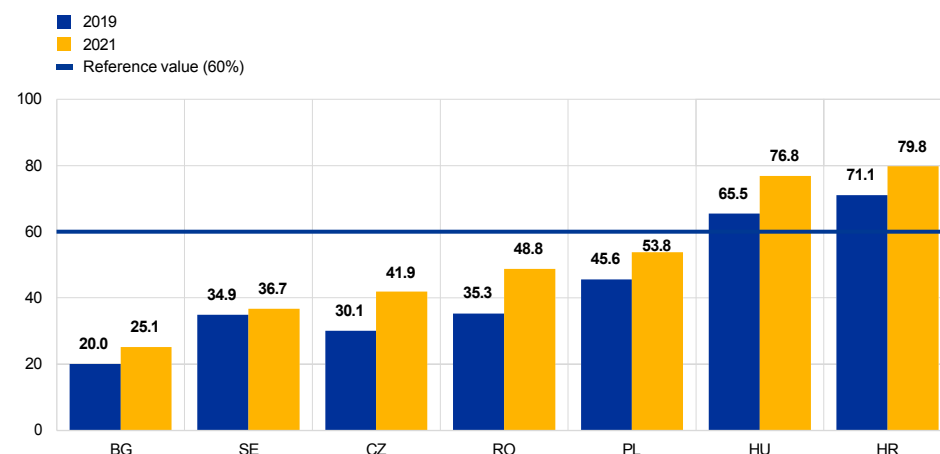


Source: Eurostat.

Note: Data for 2019 have been revised slightly since the 2020 Convergence Report.

Chart 3.3**General government gross debt**

(percentages of GDP)



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 $\pm 15\%$. Bulgaria joined the

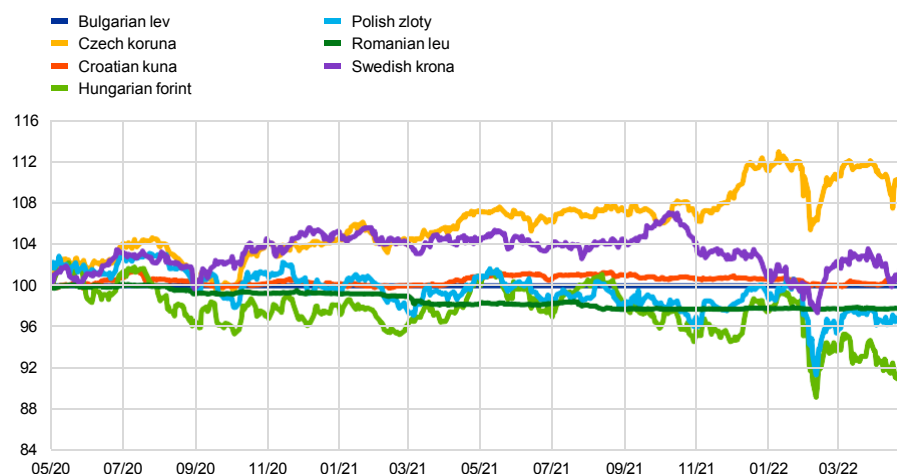
¹⁷¹ For the purpose of this report exchange rates are quoted in units of national currency per euro. Thus a decrease in the exchange rate corresponds to an appreciation of the currency against the euro, whereas an increase in the exchange rate corresponds to a depreciation of the currency against the 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.

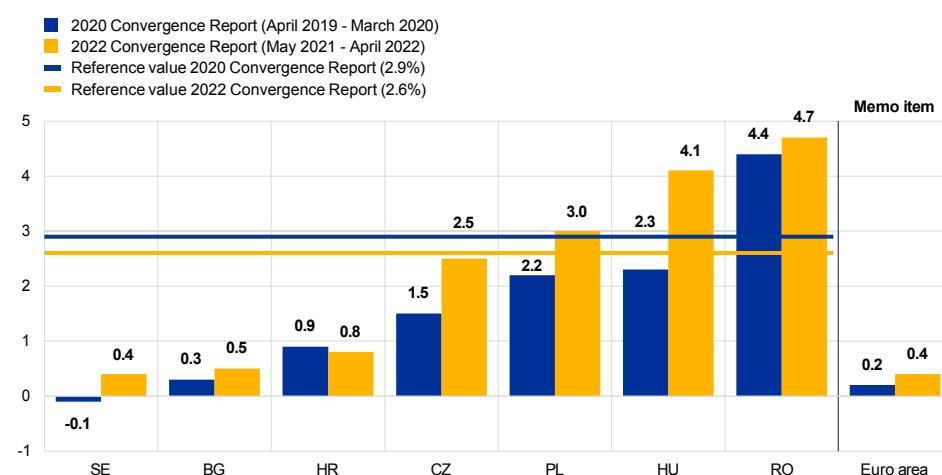
Note: An upward (downward) movement indicates appreciation (depreciation) of the currency.

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.

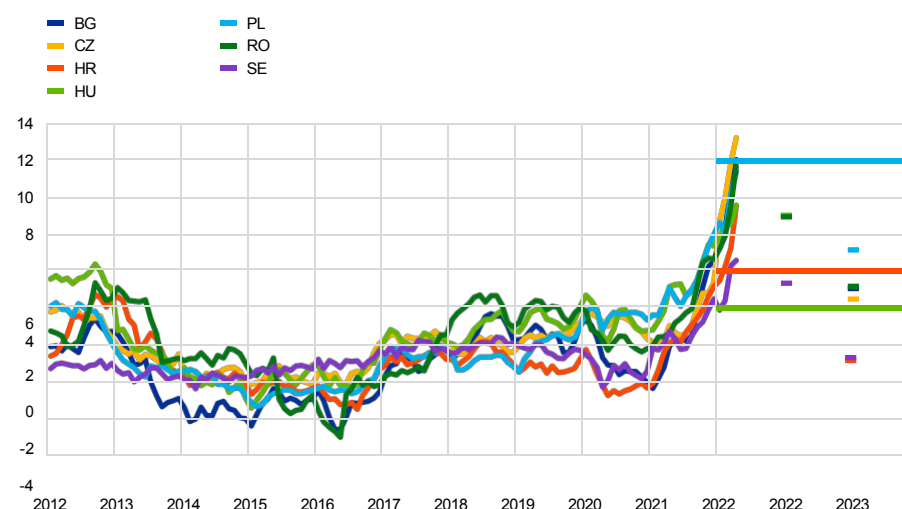
Over the past ten years, both the average rate and the volatility of inflation have varied significantly across the countries examined (Chart 3.6). Over this period, Hungary and Romania recorded average HICP inflation rates above 2.0%. In the Czech Republic the average inflation rate was 2.0%, and in 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.

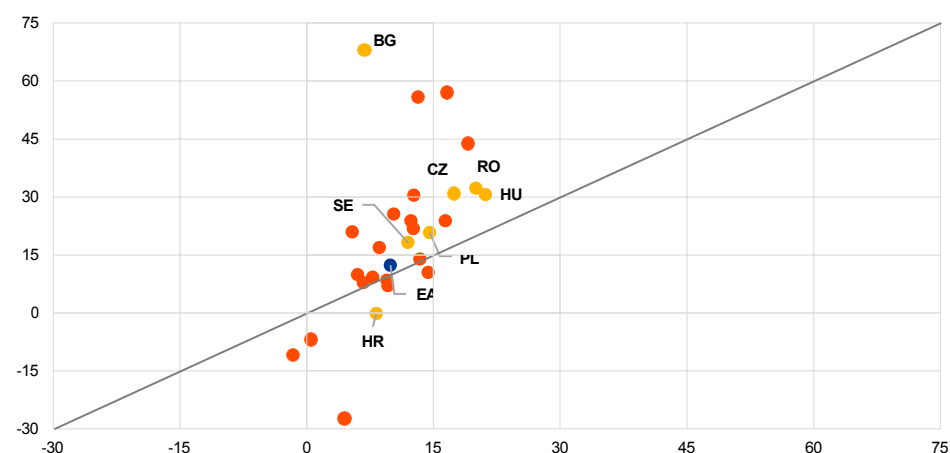
An environment that is conducive to sustainable price stability in the countries covered in this report requires stability-oriented economic policies, structural reforms and measures to safeguard financial stability. Achieving or maintaining an environment supportive of price stability will crucially 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 2022¹⁷³ 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 leva per euro with a standard fluctuation band of $\pm 15\%$. 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 $\pm 15\%$. 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.

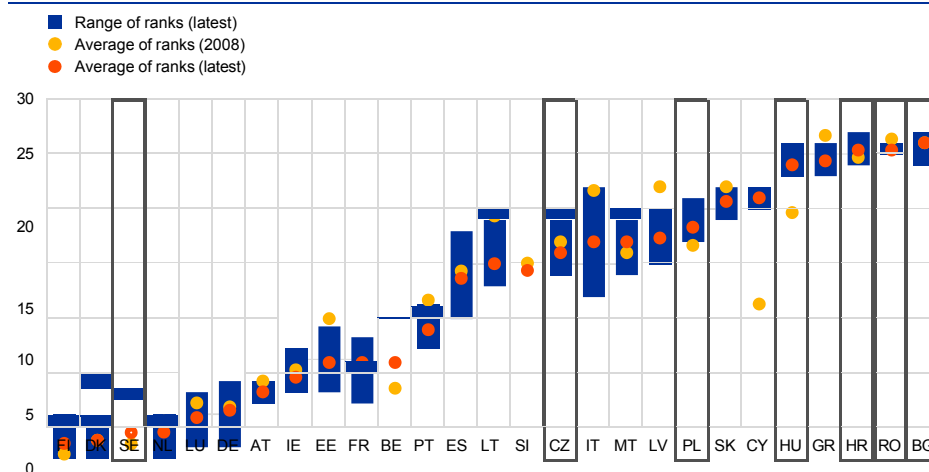
The strength of the institutional environment is another important factor in the analysis of the sustainability of economic integration and convergence. Low quality of institutions and weak governance may reflect, for example, weaknesses in the business environment, an inefficient public administration, 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.

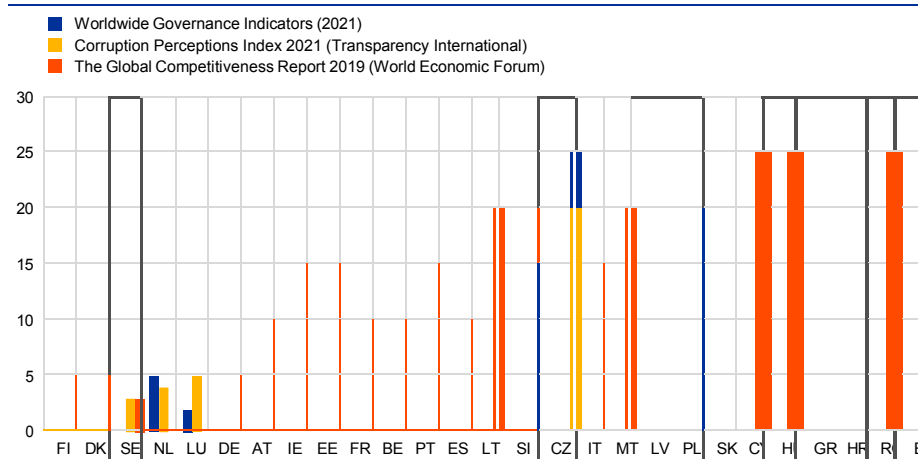
On the other hand, perception-based surveys also produce distortions. For instance, they may be heavily influenced by a recent episode or poorly designed questions.

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 $\pm 15\%$. 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 $\pm 15\%$. 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 at 3.0% 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 Națională 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 leva per euro with a standard fluctuation band of $\pm 15\%$. 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

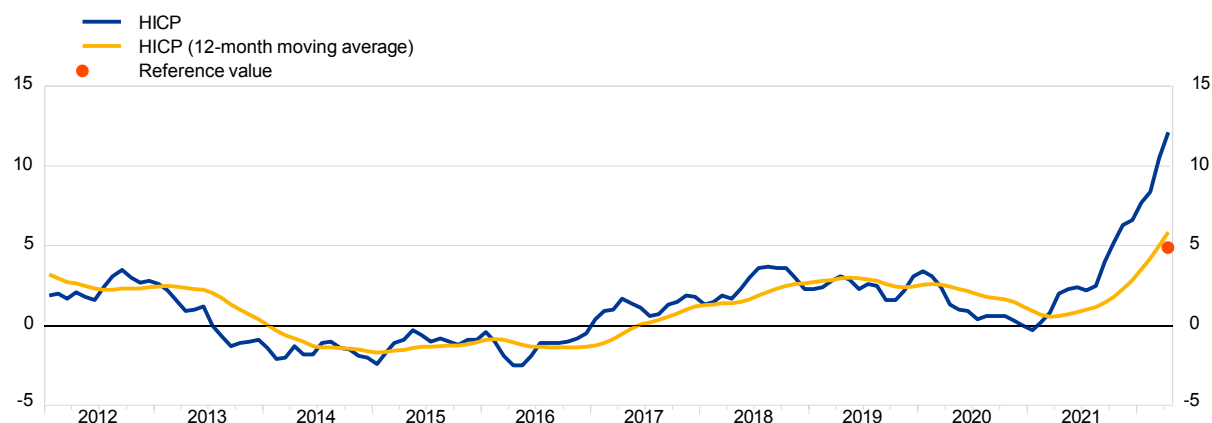
improvement in Bulgaria's macroeconomic performance and the stability of its fiscal outlook have also contributed to the decline in the default risk on long-term Bulgarian debt – as measured by ten-year credit default swap spreads – which fell from over 400 basis points in early 2012 to around 115 basis 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).

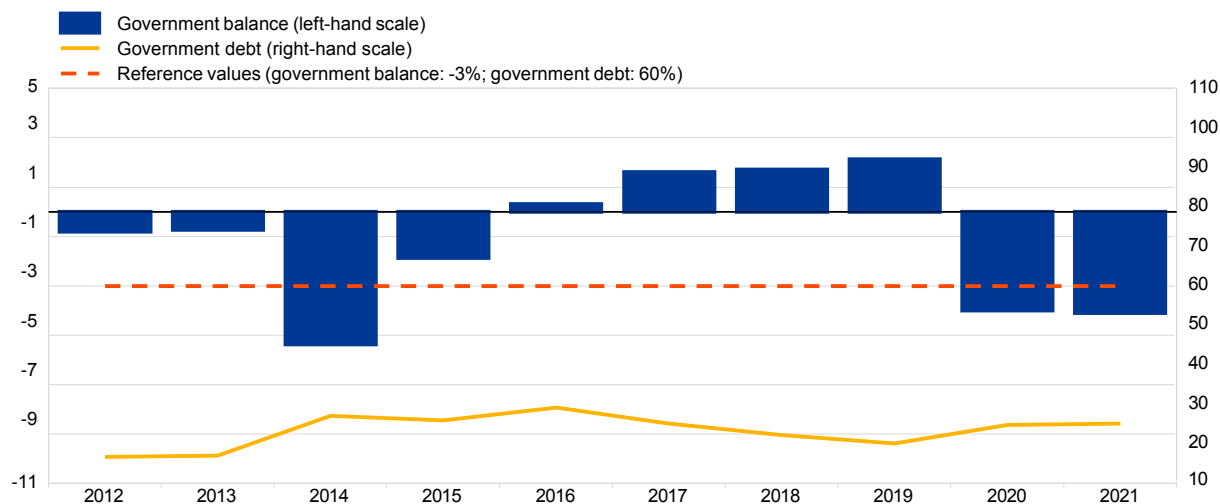
9) The series includes repurchase agreements with central counterparties.

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	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	.	.
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.

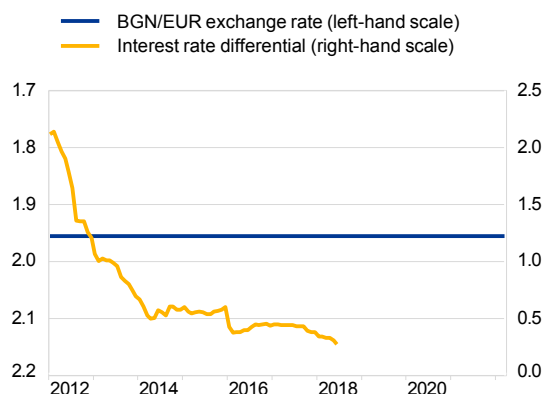
6) Original maturity of more than one year.

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)

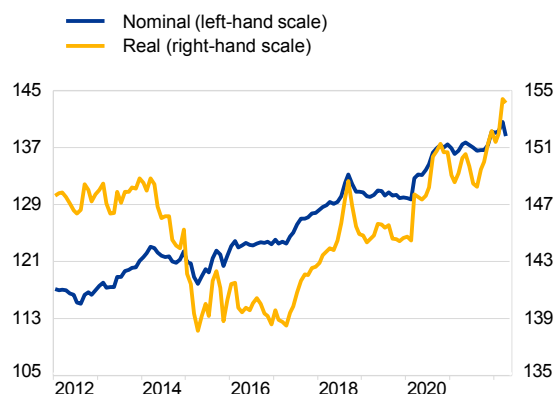


Sources: National data and ECB calculations.

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.

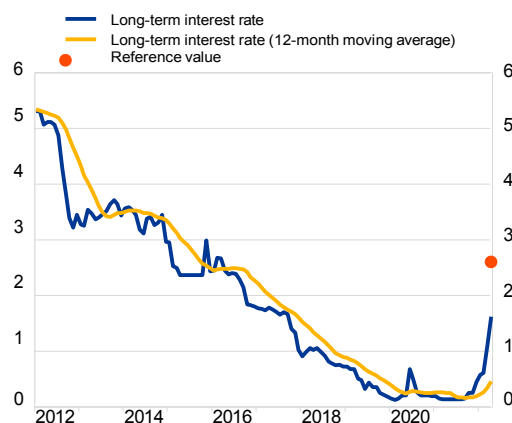
3) Differences between totals and the sum of their components are due to rounding.

4) End-of-period outstanding amounts.

5) As a percentage of the total.

Bulgaria - Long-term interest rate developments

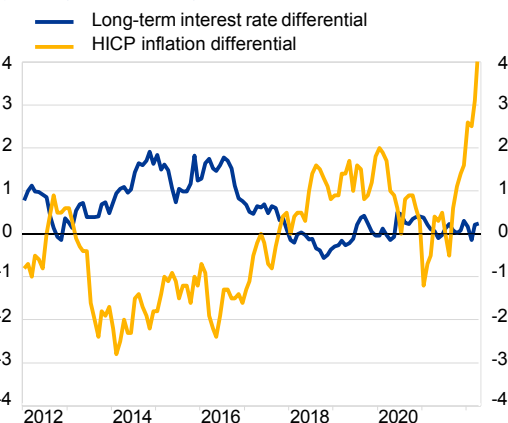
Chart 5.1.5 Long-term interest rate ¹⁾
(monthly averages in percentages)



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

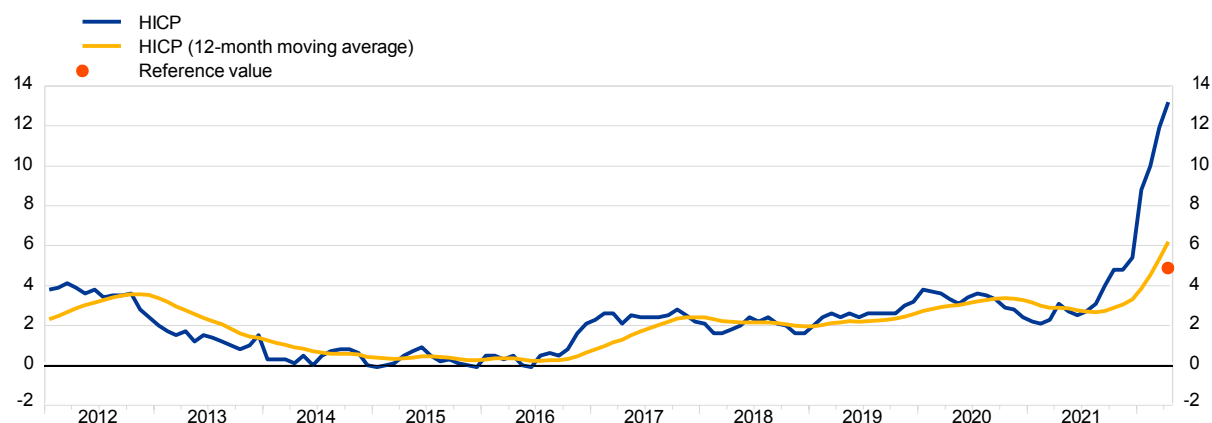
countries in recent months, stabilising at slightly below 50 basis points. The Czech Republic's government debt is rated high investment grade by all three main rating agencies (Moody's: Aa3; S&P: AA-; Fitch: AA-).

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).

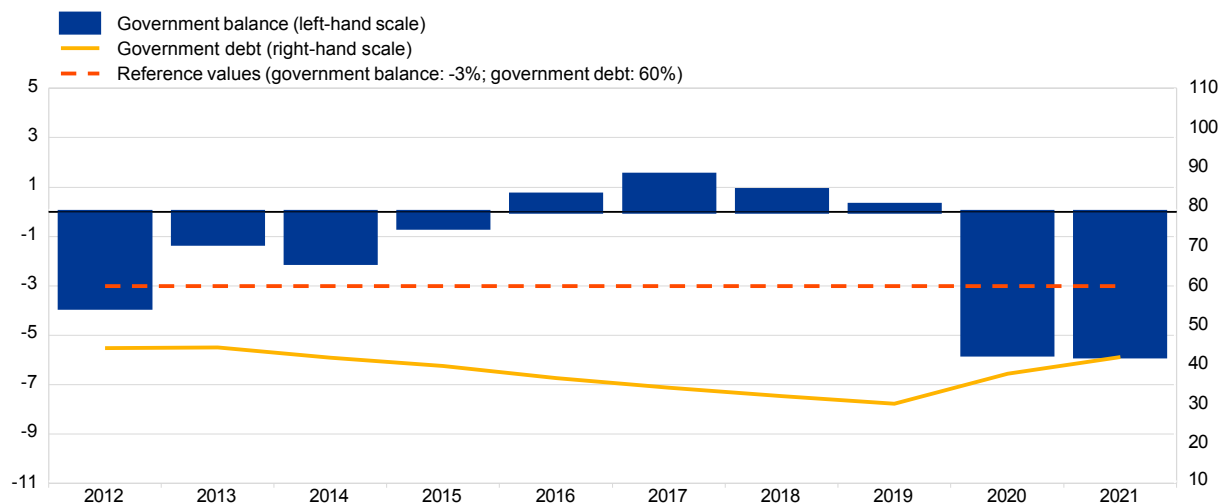
9) The series includes repurchase agreements with central counterparties.

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.

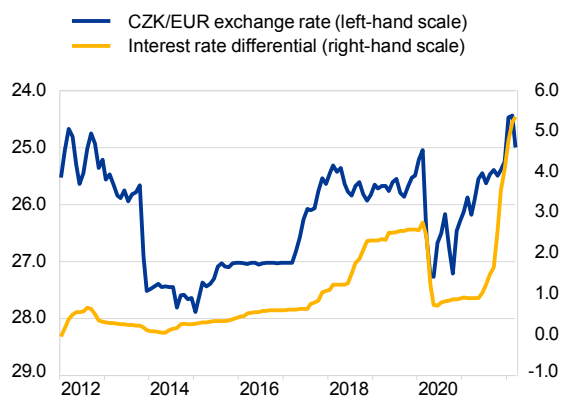
6) Original maturity of more than one year.

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

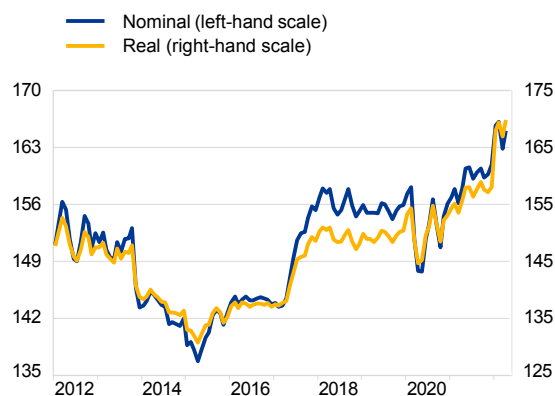
(CZK/EUR exchange rate: monthly averages;
difference between three-month interbank interest rates
and three-month EURIBOR: basis points, monthly values)



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.

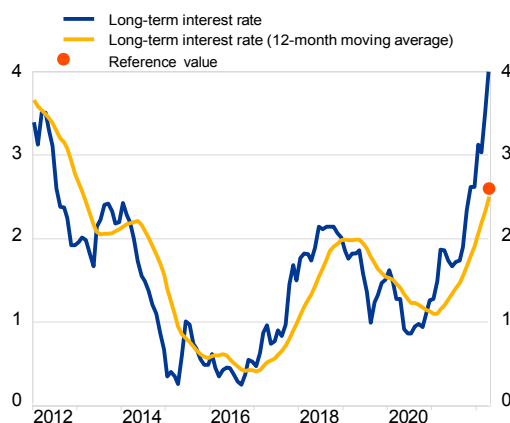
³⁾ Differences between totals and the sum of their components are due to rounding.

⁴⁾ End-of-period outstanding amounts.

⁵⁾ As a percentage of the total.

Czech Republic - Long-term interest rate developments

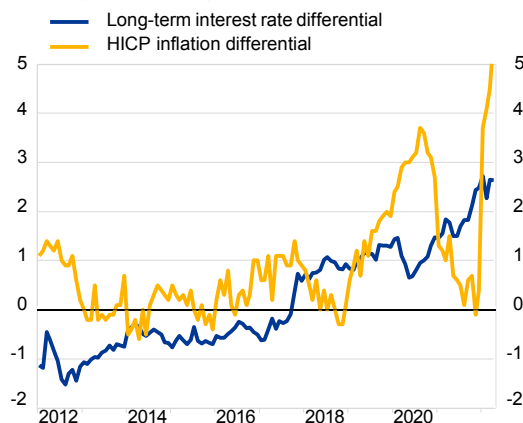
Chart 5.2.5 Long-term interest rate ¹⁾
(monthly averages in percentages)



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 $\pm 15\%$. 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

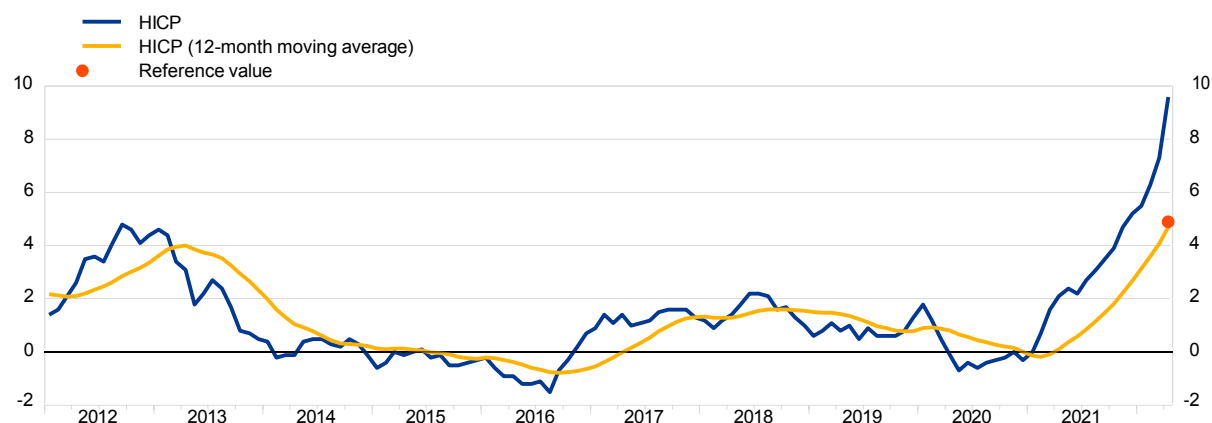
more persistent than previously expected. In April 2022 the long-term interest rate stood at 2.4%. Over the review period, credit default swap spreads have widened slightly by around 10 basis points. In the past two years two of the three main international rating agencies have upgraded the country's 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).

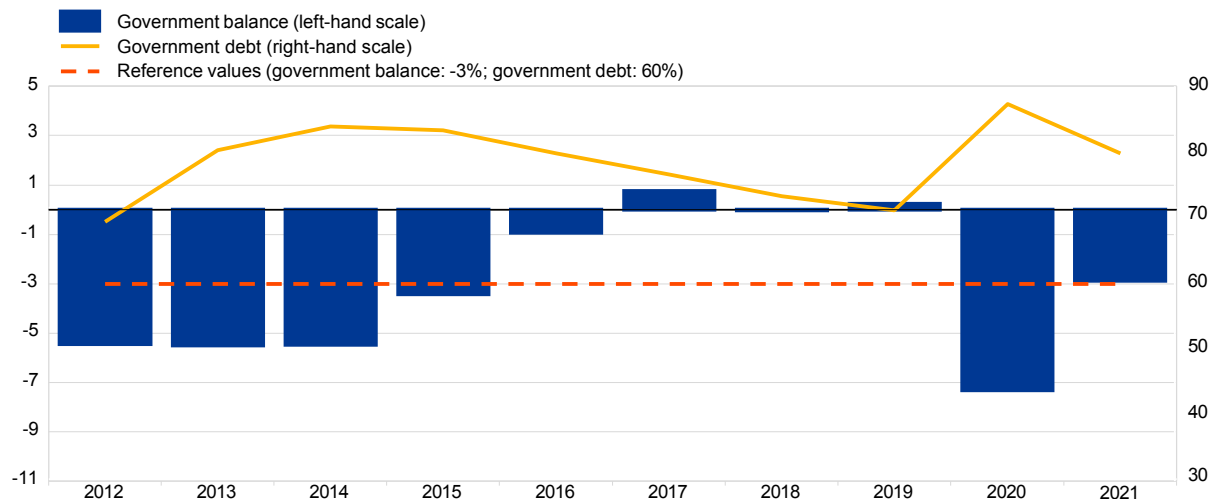
⁹⁾ The series includes repurchase agreements with central counterparties.

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.

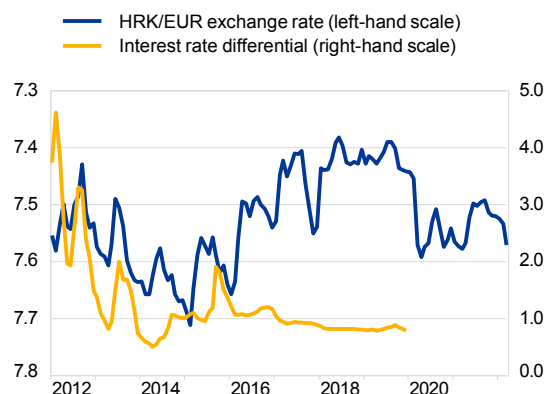
6) Original maturity of more than one year.

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)

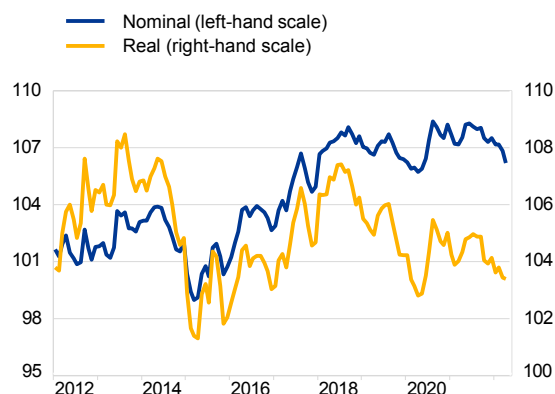


Sources: National data and ECB calculations.

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.

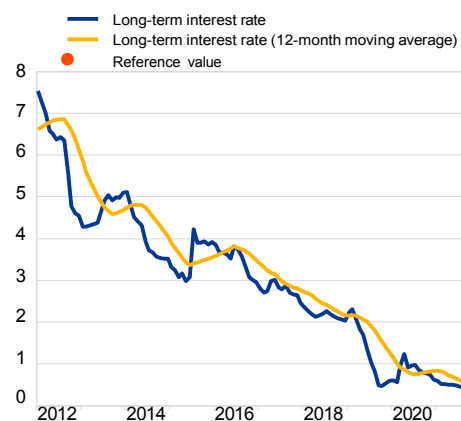
3) Differences between totals and the sum of their components are due to rounding.

4) End-of-period outstanding amounts.

5) As a percentage of the total.

Croatia - Long-term interest rate developments

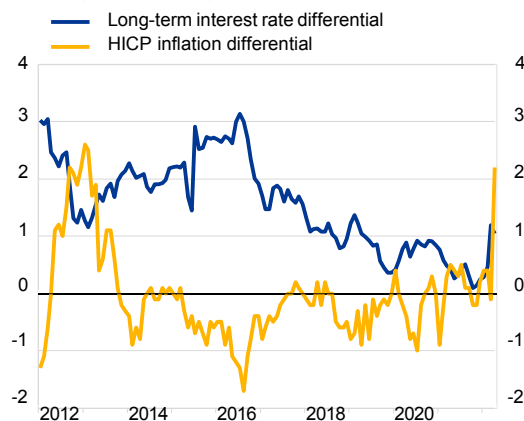
Chart 5.3.5 Long-term interest rate ¹⁾
(monthly averages in percentages)



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 term¹⁹⁰ 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.

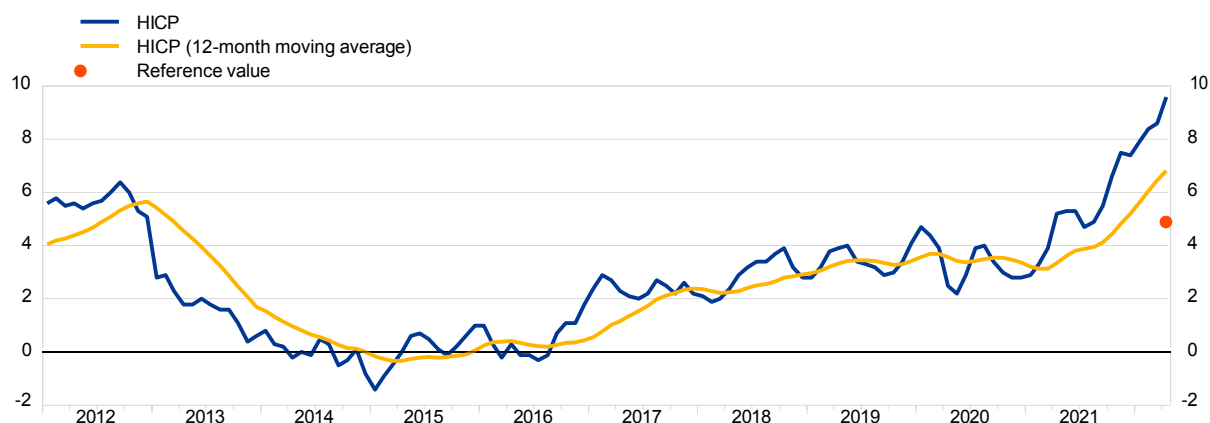
Hungary's long-term interest rate differential vis-à-vis the euro area increased recently after a long period of stabilisation (Chart 5.4.6). Hungary's long-term interest rate differential declined from around 5% in 2012 to around 2% in 2015, where it stayed for a long period. The decline in the interest 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).

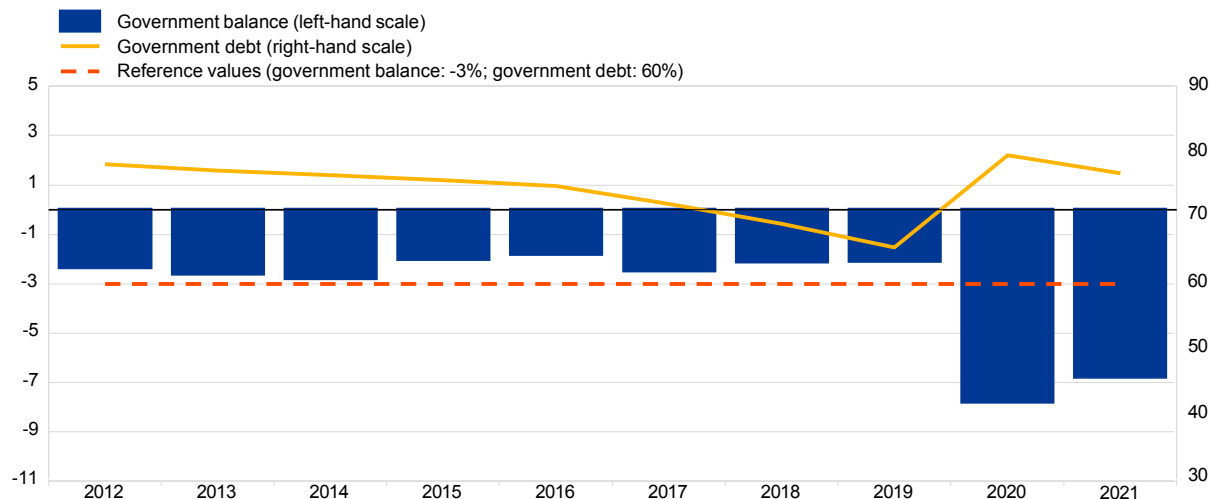
⁹⁾ The series includes repurchase agreements with central counterparties.

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.

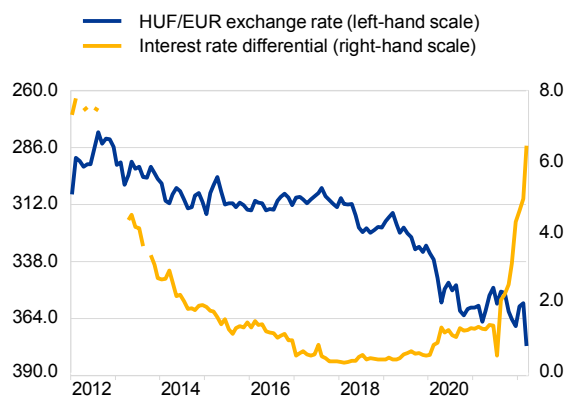
6) Original maturity of more than one year.

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

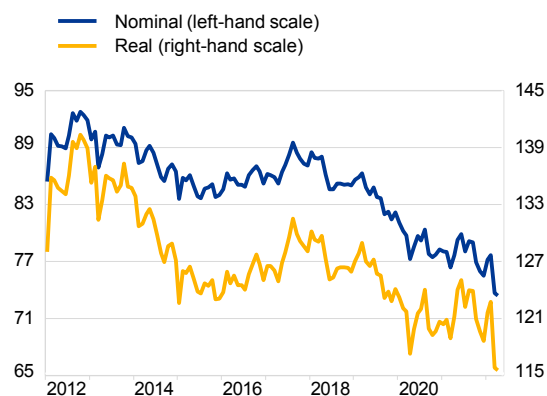
(HUF/EUR exchange rate: monthly averages;
difference between three-month interbank interest rates
and three-month EURIBOR: basis points, monthly values)



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.

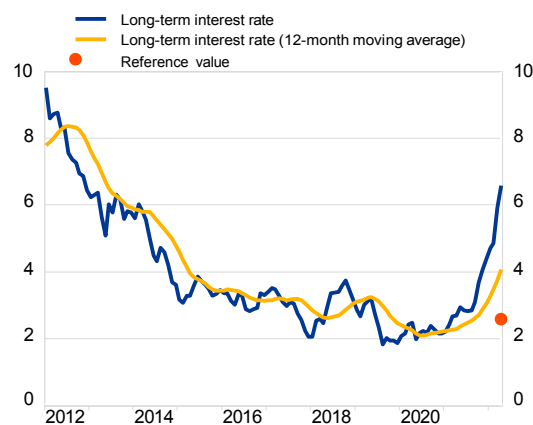
³⁾ Differences between totals and the sum of their components are due to rounding.

⁴⁾ End-of-period outstanding amounts.

⁵⁾ As a percentage of the total.

Hungary - Long-term interest rate developments

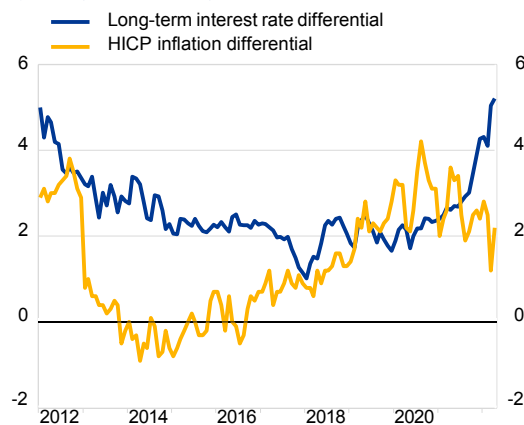
Chart 5.4.5 Long-term interest rate ¹⁾
(monthly averages in percentages)



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 Committee¹⁹³ 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.

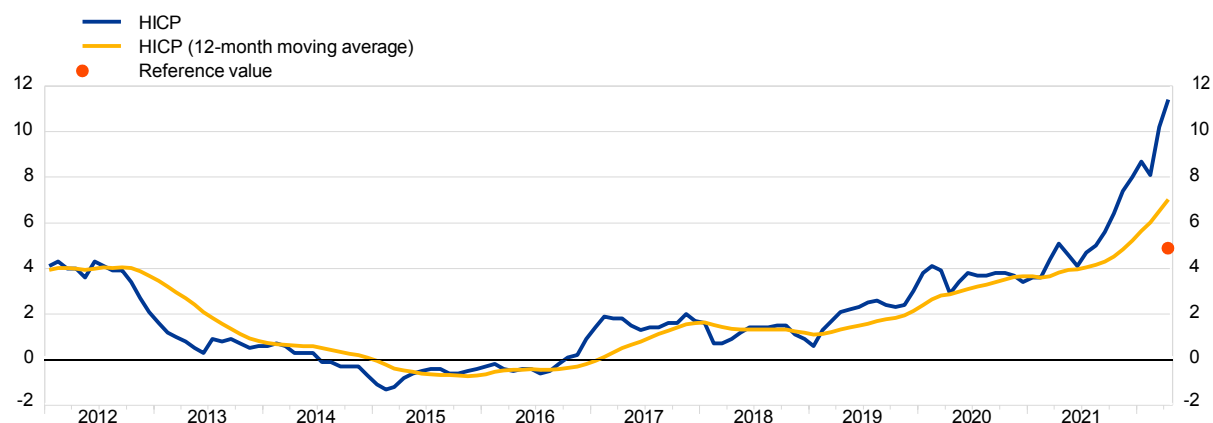
Poland's long-term interest rate differential vis-à-vis the euro area has increased recently, reaching 4.6% (Chart 5.5.6). Over the period 2012-13 the faster decline in Poland's long-term interest rates compared with the euro area took the differential vis-à-vis the euro area to its lowest level of around 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).

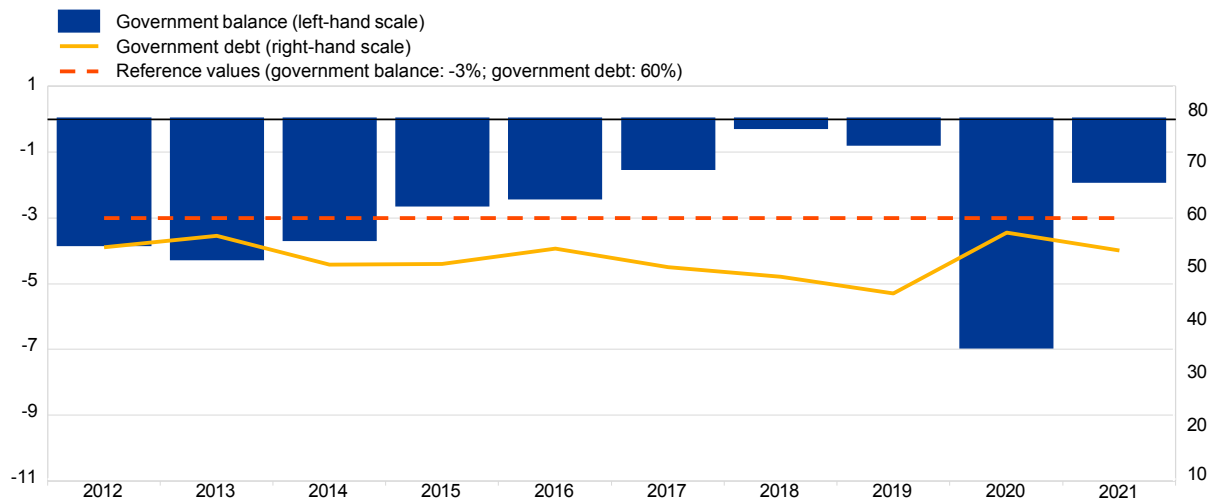
⁹⁾ The series includes repurchase agreements with central counterparties.

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.

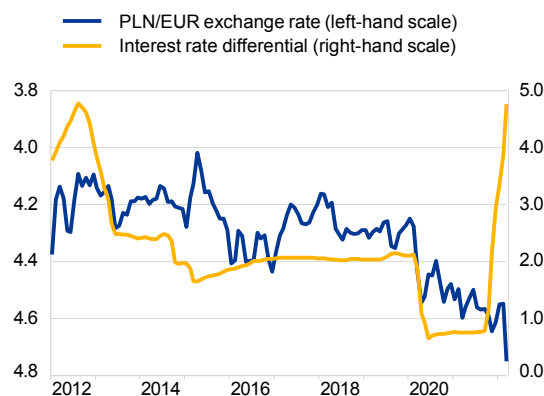
6) Original maturity of more than one year.

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

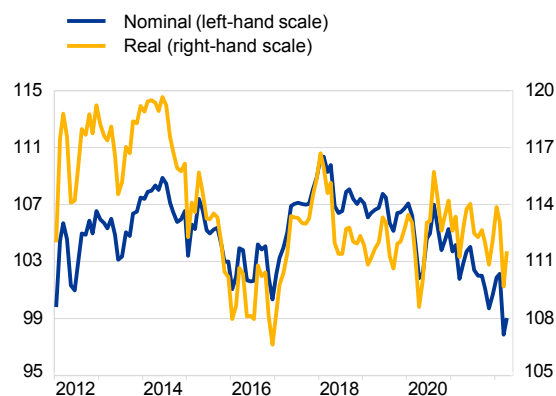
(PLN/EUR exchange rate: monthly averages;
difference between three-month interbank interest rates
and three-month EURIBOR: basis points, monthly values)



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.

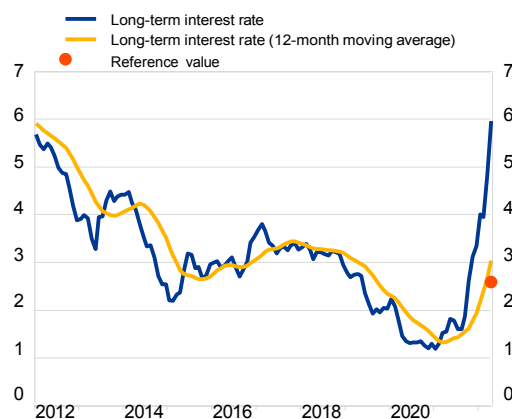
³⁾ Differences between totals and the sum of their components are due to rounding.

⁴⁾ End-of-period outstanding amounts.

⁵⁾ As a percentage of the total.

Poland - Long-term interest rate developments

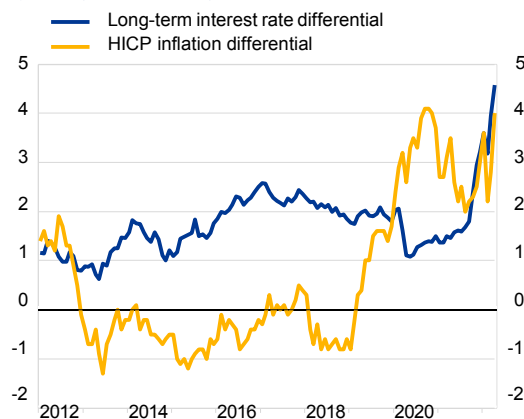
Chart 5.5.5 Long-term interest rate ¹⁾
(monthly averages in percentages)



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 Națională 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 Națională 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 Națională 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 Națională 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 Națională 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 Report¹⁹⁶ 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 Națională 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 Națională 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 Națională 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 Națională 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 Națională 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.

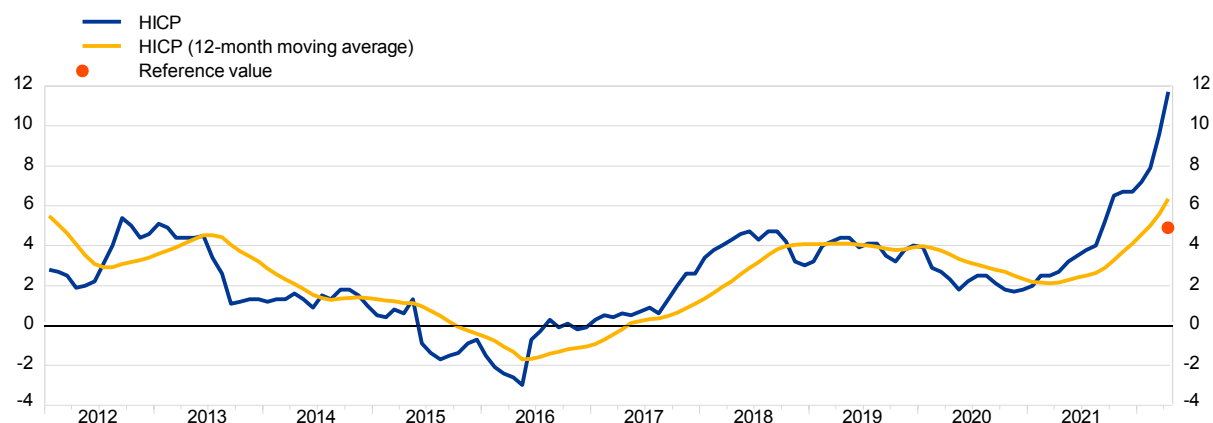
The long-term interest rate differential of Romanian bonds vis-à-vis the euro area has steadily increased since the end of 2016. After a period of relatively high volatility, the long-term interest rate differential of Romanian sovereign bonds vis-à-vis the euro area average stabilised between the end 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).

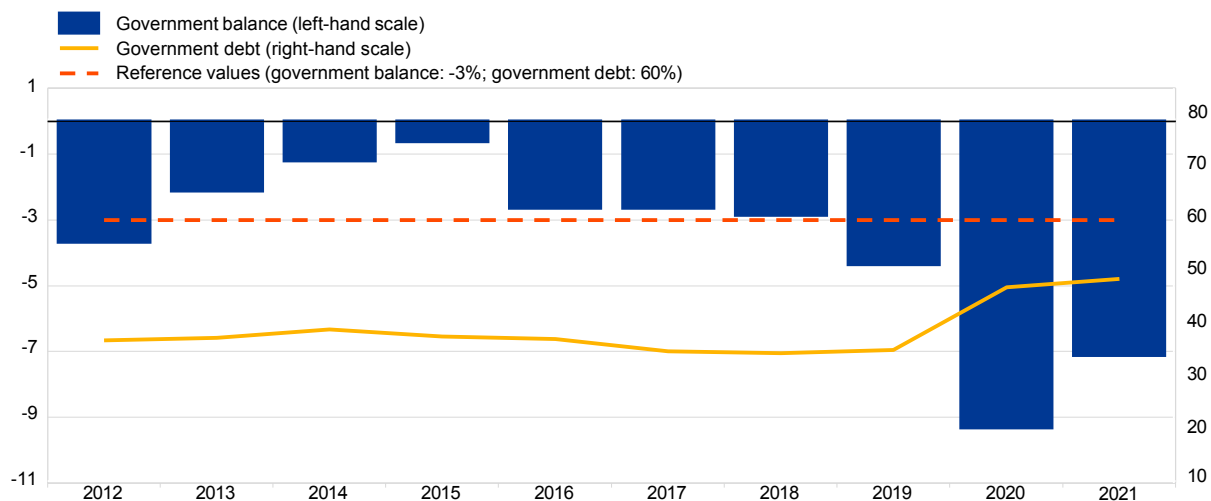
⁹⁾ The series includes repurchase agreements with central counterparties.

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.

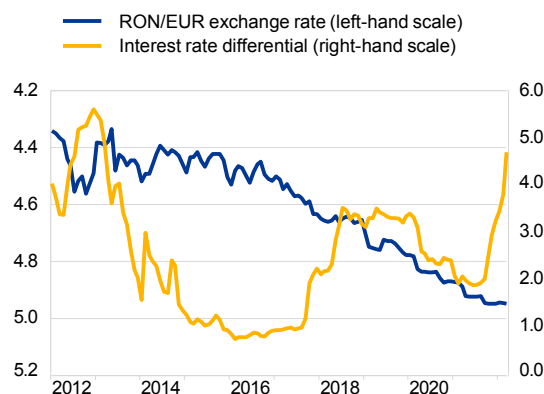
6) Original maturity of more than one year.

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

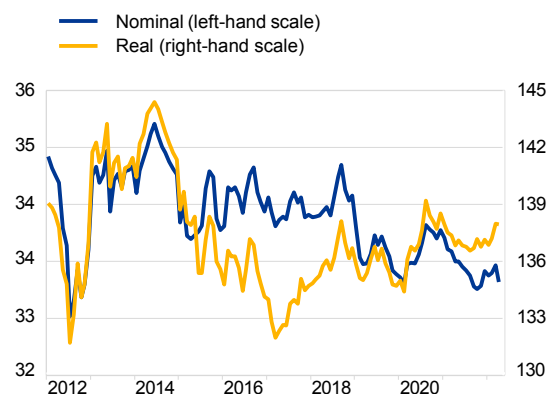
(RON/EUR exchange rate: monthly averages;
difference between three-month interbank interest rates
and three-month EURIBOR: basis points, monthly values)



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.

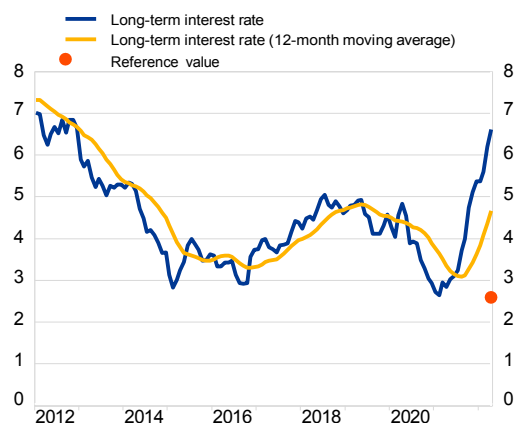
³⁾ Differences between totals and the sum of their components are due to rounding.

⁴⁾ End-of-period outstanding amounts.

⁵⁾ As a percentage of the total.

Romania - Long-term interest rate developments

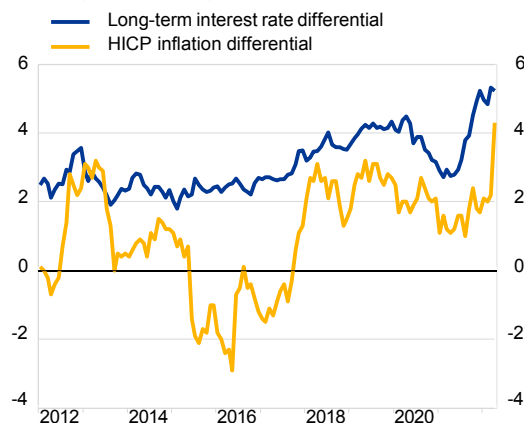
Chart 5.6.5 Long-term interest rate ¹⁾
(monthly averages in percentages)



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 1/3% 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 medium¹⁹⁷ 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

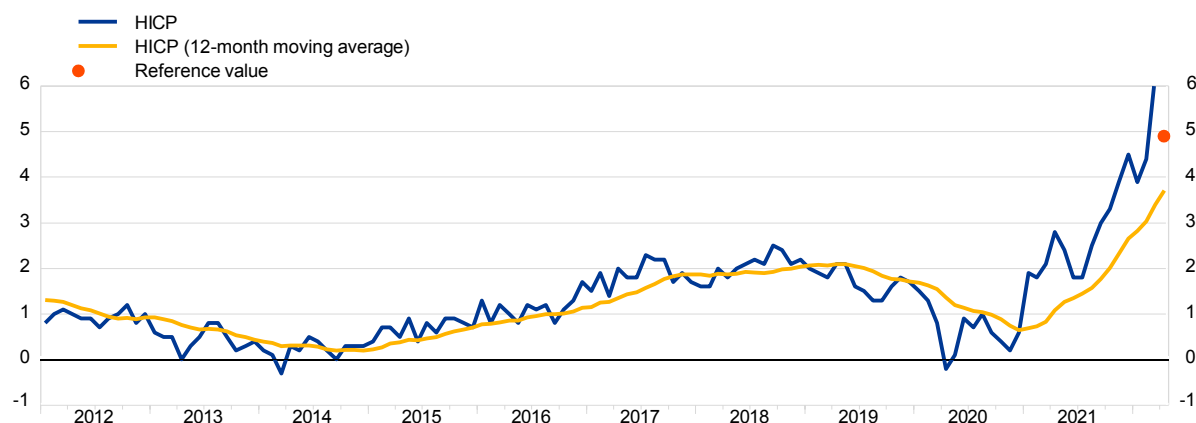
increase in the envelope of its quantitative easing programme until the end of 2021. The programme includes government and corporate bonds as well as commercial paper purchases and aims to counteract the negative economic effects of the pandemic, ensure loose financing conditions and foster market functionality. 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).

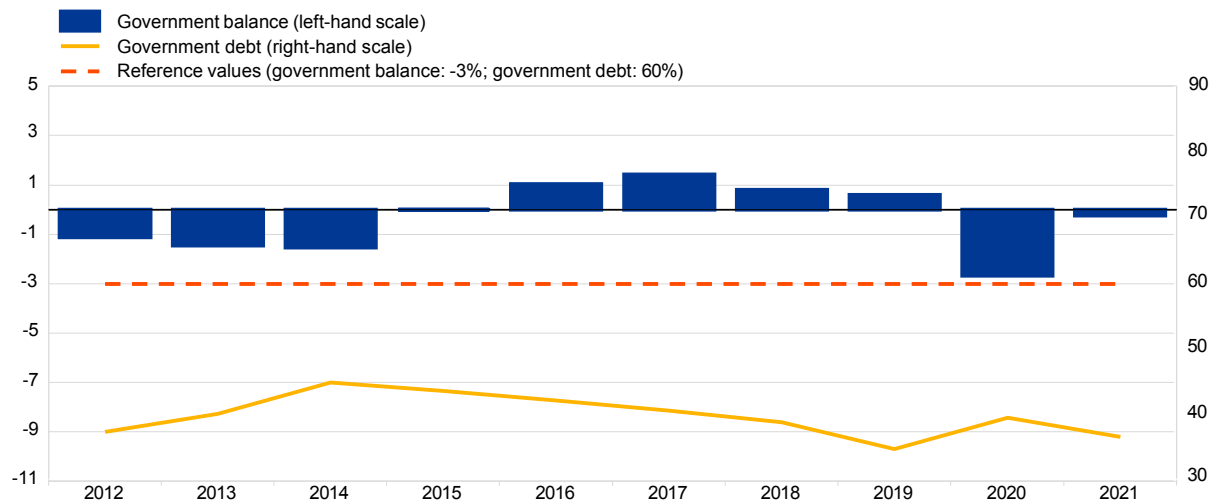
⁹⁾ The series includes repurchase agreements with central counterparties.

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.

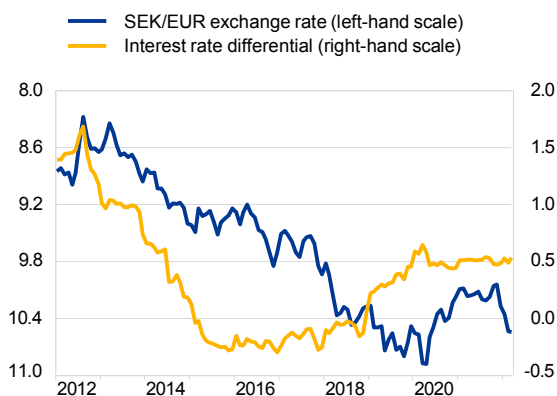
6) Original maturity of more than one year.

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

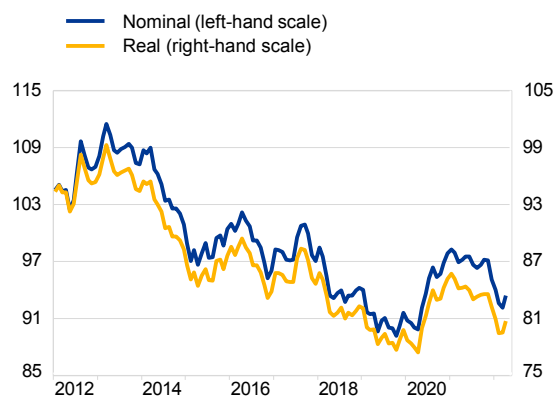
(SEK/EUR exchange rate: monthly averages; difference between three-month interbank interest rates and three-month EURIBOR: basis points, monthly values)



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.

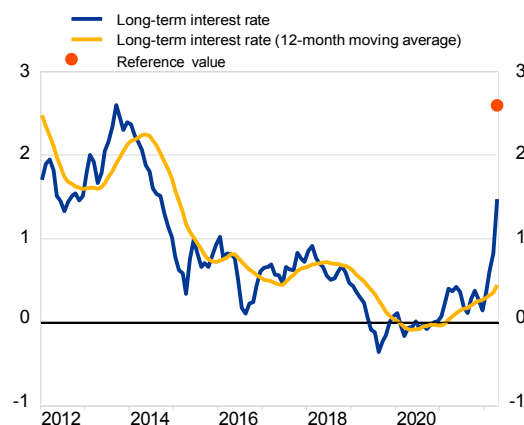
³⁾ Differences between totals and the sum of their components are due to rounding.

⁴⁾ End-of-period outstanding amounts.

⁵⁾ As a percentage of the total.

Sweden - Long-term interest rate developments

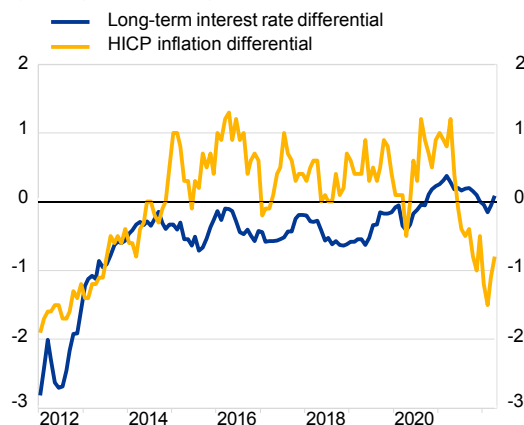
Chart 5.7.5 Long-term interest rate ¹⁾
(monthly averages in percentages)



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 statistics²⁰⁰ and the European Statistics Code of Practice²⁰¹. 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 679/2010²⁰² 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 statistics²⁰⁴) at the level of their national statistical systems and the ESS respectively.

In 2015 the Regulation on European statistics was amended²⁰⁵ 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 2494/95²⁰⁸, was adopted in October 1995 and subsequently replaced by Regulation (EU) 2016/792²⁰⁹, 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 2010²¹⁰ and Commission Regulation (EU) No 220/2014²¹¹. 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 swaps²¹², as well as trade credits²¹³ 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 Guideline²¹⁴. 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/2021/15²¹⁸. 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 2021/379²¹⁹. 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 statistics²²².

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 2021²³⁰ 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 FMGS 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 2008²⁴⁸ 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 entities²⁵⁵ 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 HFSA 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 MNB²⁶³.

7.4.4 Single spelling of the euro

In several Hungarian legal acts²⁶⁴ 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 könyvvizelési 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 Tribunal²⁷⁴ 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 confirmed²⁷⁵ 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 NBP²⁸² 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 Națională a României and its operations:

- Law No 312/2004 on the Statute of Banca Națională 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 Națională 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 Națională 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 Națională a României’s decision-making bodies in situations where this may have an impact on Banca Națională 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 Națională 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 Națională 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 Națională 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 incompatibility²⁹⁷ do not constitute new grounds for dismissal of the Governor or other members of the Board of Banca Națională 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 Națională 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 Națională 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 Națională a României or an employee occupying a leading position with Banca Națională 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 Națională 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 Națională 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 Națională a României's financial resources, and to audit the management of the funds of Banca Națională 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 Națională 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 Națională 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 Națională 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 Națională 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 Națională 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 Națională a României in the same way as any other credit institution eligible under Banca Națională 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 Națională 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 Națională 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 Națională 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 Națională 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 Națională 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 Națională 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 Națională 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 Națională 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 Națională 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 Națională 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 Națională 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 Națională 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 Națională 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 Națională 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 Națională 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 Națională 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 Națională 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 Națională 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 Națională 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 Națională 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 Națională a României to be consulted on draft national legislation, consulting Banca Națională 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 Națională 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 11³⁰⁷ 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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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